FOR AGENDA

SM/98/8

January 9, 1998

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Fund Policy on Sovereign Arrears to Private Creditors**

Attached for consideration by the Executive Directors is a paper on Fund policy on sovereign arrears to private creditors, which will be brought to the agenda for discussion on a date to be announced. Issues for discussion appear on pages 45 and 46.

Mr. Fisher (ext. 38755), Mr. Hagan (ext. 37715), or Mr. R. Gordon (ext. 34103) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Fund Policy on Sovereign Arrears to Private Creditors

Prepared by the Policy Development and Review and Legal Departments

(In consultation with other departments)

Approved by Jack Boorman and François Gianviti

January 9, 1998

Contents Page

EXECUTIVE SUMMARY

In response to requests by the Executive Board and the G–10 Deputies, this paper considers a number of issues relating to the Fund's approach to liquidity crises that pose the risk of default on international bonds issued or guaranteed by the sovereign.[1]

The Fund's primary role regarding sovereign liquidity crises focuses on prevention. Specifically, one of the Fund's key objectives is to encourage members, through the surveillance process, to adopt sound macroeconomic, structural, debt management, and other policies which serve to minimize the risks of crises. Notwithstanding these efforts, it is possible that some members, including those with significant external debt in the form of sovereign bonds will, on occasion, face the threat of balance of payments crises. With forceful and prompt adjustment to emerging pressures, markets may be willing to support a country's adjustment efforts with new money, albeit with higher interest rates, and thereby help countries to weather the storm. However, there may be cases wherein, if the impact of adverse developments on the external accounts is too large, and adjustment efforts are delayed, members may not be able to avoid a default on sovereign bonds, even as appropriate adjustment efforts are introduced.

There is relatively little modern experience with defaults on international sovereign bonds, and it is therefore difficult to predict with any certainty how a default situation would unfold. Nevertheless, in the absence of the legal and institutional arrangements that have in the past served to ensure that, as a general matter, relations with commercial banks remained relatively orderly in the face of arrears on syndicated debt, there would appear to be a significant risk that a sovereign bond default could become disorderly; i.e., result in aggressive litigation. Creditors could trigger an acceleration of principal and a chase for assets. This could seriously complicate the task of economic management and could result in a protracted stalemate in relations between a member and its bondholders.

Against this background, there is a question of how the Fund should respond to a liquidity crisis that poses the risk of a members's default on international bonds issued or guaranteed by the sovereign. Within the existing legal and institutional framework, there would appear to be three options.

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[1]It does not directly address the question of default on nonsovereign obligations, which involves issues relating, inter alia, to bankruptcy laws and procedures that are not applicable to sovereign debt. Many of the issues and considerations discussed in the paper are nevertheless relevant to the unfolding crisis in Southeast Asia which, while involving predominantly nonsovereign obligations in the first instance, also gives rise to a sovereign liquidity crisis. A subsequent paper will deal with issues relating specifically to nonsovereign obligations.

- Under the first, the Fund would provide support for a member's adjustment program and seek to mobilize financing from other sources so as to forestall the emergence of arrears. Circumstances may arise, however, where a member may face the prospect of a large, and possibly sustained, outflow of private capital notwithstanding the implementation of forceful corrective policies. The provision of official financing in such circumstances would allow a member to avoid a default, but it may be at a scale

officials are unwilling to provide or may give rise to concerns that it permits private creditors to withdraw with claims satisfied in full in a way that could give rise to moral hazard.

- Under the second option, the Fund would not provide financing to forestall the emergence of arrears and would delay approval of an arrangement until agreement in principle has been reached on the restructuring of the sovereign bonds in question.

- Under the third approach, the Fund would approve an arrangement prior to agreement in principle with bondholders on a restructuring. The G–10 Deputies asked the Fund to consider this approach under which, in exceptional circumstances, the Fund would extend the policy of "lending into arrears" currently applied only to commercial banks to other groups of private creditors.

As will be discussed, all of these approaches have shortcomings in terms of meeting the Fund's objectives of promoting effective balance of payments adjustment while safeguarding its resources.

In an earlier discussion, Directors considered that, in some circumstances, countries might be obliged to impose a moratorium on certain debt–service payments while seeking to reschedule their obligations, and that consideration should be given to improving existing mechanisms for the orderly renegotiation of sovereign bonds. In that context, the paper gives preliminary consideration to possible options that might facilitate a resolution of a crisis in a manner that would allow the Fund to support effective and orderly balance of payments adjustment.

- The first is a recommendation from the G–10 working party report that legal provisions of new bond contracts should be modified so as to facilitate orderly renegotiations. While such modifications to *new* bonds would not address issues raised by the *outstanding* stock of bonds, this could, over time, make an important contribution to helping countries facing sovereign liquidity crises.

- The second relates to proposals for a sovereign bankruptcy mechanism. This has been discussed by the Executive Board in the past, and the discussion is summarized briefly here. Directors were cautious—and most were negative—about proposals for establishing a formal international debt adjustment mechanism.

- The third is whether the Fund has, or could have, authority to establish a mechanism that would require bondholders to exercise the same degree of forbearance that official creditors and commercial banks generally exercised throughout the 1980s debt crisis, through the imposition of a temporary stay on the ability of creditors to bring legal action in the event of a default. An amendment of the Articles of Agreement would be needed to give the Fund such authority, and the paper notes some of the issues that would arise in considering such an approach. Activation of such a mechanism could require a qualified majority of the Fund's total voting power, which would help to ensure that it would be activated only with broad support among the membership. A temporary stay could help to ensure that the process of renegotiation remains orderly and give countries breathing space to elaborate and implement corrective policies which could be supported by the Fund. Nevertheless, such a mechanism could raise concerns regarding moral hazard, in that it would reduce the potential cost of default to the debtor. Moreover, there is a question whether a mechanism could be designed to strike an appropriate balance between resolving the immediate liquidity problems of a particular country and ensuring that international capital markets operate efficiently.

I. INTRODUCTION

1. This paper reviews the evolution of, and experience with, the Fund's treatment of external payments arrears to private creditors by sovereign borrowers under its policies on the use of its resources. In that context, it also provides a preliminary analysis of the feasibility of Fund support following a default on sovereign bonds. The analysis has been guided by an earlier informal discussion[2] of a previous paper, Recent Proposals in International Debt Adjustment (SM/96/25, 2/2/96). In that discussion, most Directors believed that in some circumstances countries might be obliged to impose a moratorium on certain debt–service payments while seeking to reschedule their obligations, and that consideration should be given to improving existing mechanisms for the orderly renegotiation of sovereign bonds. This paper discusses possible options for improving existing mechanisms, and responds to a request from the G–10 Deputies[3] for the Fund to reexamine its policy of lending to members with unresolved arrears to commercial banks, and to consider whether the scope of the policy should be extended in exceptional circumstances to members that accumulate arrears to other groups of private creditors.[4] The paper also provides preliminary discussion of some issues related to the treatment of Article VIII, Section 2(b) under an amendment of the Articles.

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[2]Concluding Remarks, Executive Board Seminar 96/2 (2/16/96), circulated as BUFF/96/17.

[3]"The Resolution of Sovereign Liquidity Crises," A report to Ministers and Governors prepared under the auspices of the Deputies, (Group of Ten), May 1996.

[4]The paper does not review the Fund's treatment of external payments arrears in the exercise of its jurisdiction over the making of current international payments and transfers under Article VIII, Section 2(a). The Fund's policies regarding members' overdue obligations to the Fund is also outside the scope of this paper. The scope of the arrears policy adopted by the Fund for purposes of implementing Article VIII, Section 2(a) is narrower than the scope of the policy reviewed in this paper in at least two respects. First, because a member's obligation under Article VIII, Section 2(a) only applies to "current" payments and transfers, the relevant policy does not apply to arrears arising from those capital–related payments (including bullet redemption payments) falling outside the Articles' broad definition of "current payments." In contrast, the Fund's policy on arrears in the context of the use of its resources encompasses arrears on both current and capital transactions. Second, a default by a government on one of its own external obligations does not fall within the Fund's jurisdiction, because the Fund has determined that such proprietary acts of a government cannot be characterized as a "restriction" within the meaning of Article VIII, Section 2(a). These defaults are, however, the subject of the policy reviewed in this paper. As will be discussed in Chapter V, these differences have implications for the Fund's ability to take measures under its existing Articles that could contribute to an orderly rescheduling following a sovereign bond default.

2. Responding to the earlier requests from the Executive Board and the G–10 Deputies for consideration of issues relating to sovereign debt, the paper does not directly address the question of defaults on nonsovereign obligations, which involves issues relating, inter alia, to bankruptcy laws and procedures that are not applicable to sovereign debt. Many of the issues and considerations discussed in the paper are nevertheless relevant to the unfolding crisis in Southeast Asia which, while involving predominantly nonsovereign obligations in the first instance, also gives rise to a sovereign liquidity crisis. A subsequent paper will provide a preliminary discussion of the arrears and financing assurances policies relating to external arrears on nonsovereign obligations and will consider, inter alia, the extent to which the protection provided to nonsovereign borrowers by bankruptcy and bank insolvency laws would be applicable to a default on such obligations arising from the imposition of exchange controls. That paper will also provide a preliminary consideration of issues concerning a possible amendment of Article VIII, Section 2(b), relating to restrictions on nonsovereign obligations.

3. The rest of this paper is organized as follows. Chapter II provides a brief summary of the Fund's arrears policy, including the 1989 modification concerning commercial banks, and experience under the modified policy; Chapter III provides an overview of issues associated with the renegotiation of sovereign bonds following a possible default; Chapter IV examines existing options for Fund involvement in a sovereign liquidity crisis; and Chapter V presents a preliminary discussion of possible options for strengthening existing mechanisms for resolving sovereign liquidity crises. Finally, Chapter VI suggests issues for discussion.

4. Appendix I reproduces the Executive Summary of the G–10 report; Appendix II provides a discussion of the evolution of the Fund's arrears policy and experience under the 1989 modification; Appendix III provides a brief discussion of the prisoners' dilemma paradigm; Appendix IV provides a summary of the legal issues associated with litigation against sovereign debtors; and Appendix V provides an analysis of the legal issues raised by the application of Article VIII, Section 2(b).

II. SUMMARY OF THE FUND'S POLICIES ON EXTERNAL PAYMENTS ARREARS AND FINANCING ASSURANCES

5. This chapter summarizes the evolution of the Fund's policies on external payments arrears and financing assurances and the Fund's experience with these policies since their modification in 1989. A more in–depth discussion of these policies is provided in Appendix II.

6. The scope and objectives of the Fund's policies on external payments arrears and financing assurances have always been guided by two principles. Specifically, the policies were conceived as a means of helping the Fund, in accordance with Article V, Section 2(b) of its Articles, to promote *effective balance of payments adjustment*, while *safeguarding the Fund's resources*. Until 1989, these objectives were achieved by the adoption of a financing assurances policy that required, as a prior condition for the use of the Fund's resources,

other creditors (both official and private) to furnish specific assurances that they would provide the necessary support (through new loans and/or refinancing) to meet the program financing requirements on terms consistent with the member's return to external viability.[5] It was recognized that creditors would be willing to provide the necessary assurances only if any arrears to them were eliminated. Accordingly, the Fund's adoption of a policy that called for the elimination and nonaccumulation of arrears during the period of the program was seen as complementary to the above–described financing assurances policy. Moreover, it was recognized that, beyond the period of the program, concern over the members' medium–term balance of payments viability (and capacity to repay the Fund) would be alleviated only if the member were making progress in re–establishing relations with its creditors.

7. The success of these policies in the early 1980s was attributable, in part, to commercial banks' recognition that cooperation in the financing of Fund supported programs was in their own–self interest. By the late 1980s, however, commercial banks had become increasingly reluctant to provide the financing assurances that the Fund required, resulting in growing delays in Fund support for members' adjustment efforts.

8. In these circumstances, the Fund recognized that the policies on financing assurances and external payments arrears described above gave the banks an effective veto over Fund arrangements and that, given the extensive delays being experienced in supporting members' programs, these policies were no longer consistent with the principles and objectives that underlay them. Against this background, in 1989, the Fund decided to modify the financing assurances policy so as to permit the approval of a Fund arrangement ahead of agreement in principle with commercial banks.[6] As a consequence, the Fund also modified its arrears policy, in that it also agreed to support programs that tolerated the accumulation of arrears to commercial banks pending the negotiation of a voluntary market restructuring agreement; to that extent, the Fund has been willing to "lend into arrears." In effect, pending such agreement, the accumulation of arrears to commercial creditors provided the financing that would have previously been provided voluntarily through a combination of rescheduling principal and new money to pay interest.

9. As noted above, these modifications were designed to enable the Fund to provide timely support to members' adjustment efforts during a process of negotiations with commercial banks that had become increasingly complex and protracted. Under the terms of the 1989 decision, such support can be granted only in cases where: (i) prompt Fund support is judged to be essential for the successful implementation of the member's adjustment program; (ii) negotiations between the member and its commercial bank creditors have begun;

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[5]In the case of commercial banks, the Fund required the agreement of a "critical mass" of banks holding around 90 percent of total bank exposure in principle to a restructuring package.

[6]EBM/89/61, May 24, 1989.

and (iii) it can be expected that a financing package consistent with external viability can be negotiated within a reasonable period. As a further means of facilitating agreement, the Fund also established a policy of making its resources available to members to help finance the up–front cost of Brady–style debt and debt–service reduction (DDSR) operations.

10. To date, the Fund has supported adjustment programs with a total of 38 members with unresolved arrears to commercial banks. This has allowed the Fund to provide early support for programs designed to allow members to regain, or make adequate progress toward, viability. Members that have received such support, normalized relations with creditors, and have established strong track records of stabilization in recent years have been able to regain access to international capital markets. While the decision to approve Fund arrangements in advance of receipt of financing assurances from banks entailed some risks for the Fund's resources, it should be noted that, to date, repayments to the Fund by members to which the 1989 modification has been applied have in all cases been timely. Similarly, all new instruments issued in the context of Brady restructurings have continued to be serviced on schedule. In sum, the 1989 modification to the financing assurances and arrears policies has allowed the Fund to provide early support for members' adjustment efforts during the negotiations with commercial banks without undermining the safeguards for the use of Fund resources.

III. Issues Relating to Sovereign Bond Defaults and Renegotiations

A. Development of the Sovereign Bond Markets

11. One reason for developing the financing assurances policy was to ensure that the principal creditor groups that could expect to benefit from the concerted effort to provide financing for a country's adjustment program would participate fairly in the provision of that support. Private creditors that were not members of bank syndicates and that had relatively small exposure were generally exempted, as were bondholders, who collectively also had relatively small exposure. Others, however, were expected to participate in concerted financing broadly in line with their existing exposure. In interrupting debt service, debtor countries have taken care to ensure that they did not lose access to the external resources needed to continue normal economic operations. Thus, debt–service moratoria have normally been limited to payments on those claims where restructuring could be expected (often in the light of practice in other cases).

12. In the 1990s, with the globalization of international financial markets and improved access of emerging market countries to international capital markets, the acquisition by nonresidents of domestically issued government debt [7] instruments and international sovereign

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[7]Data on nonresident holdings of domestic debt instruments are not available as such

(continued...)

bond issues has become an increasingly important source of external financing. International sovereign bond issues by developing and transition countries grew from an average of $2.5 billion per year in 1985–90 to $38.1 billion in 1996. At the same time, commitments of medium– and long–term bank loans to these sovereigns remained small at around $3 billion in 1996 (Figure 1 and Table 1). The outstanding stock of sovereign bonds issued by developing and transition countries is estimated at $233 billion at end–1996, of which $137 billion were Brady bonds issued in the context of DDSR operations, and $96 billion were other sovereign bonds placed on international capital markets.[8] Scheduled repayments at maturity on sovereign bonds issued by developing and transition countries (excluding prepayments on Brady bonds) increased from an average of less than $0.2 billion per year in 1985–90, to an estimated $7 billion in 1996. These payments will increase dramatically in the next several years. For example, redemptions on bonds issued through end–September 1997 are projected to reach about $19 billion in 2001.

13. The development of the bond market and shift away from syndicated bank lending in recent years reflects, in large part, the response of international capital markets to the debt crisis, as well as developments in the regulatory frameworks and interest rates in industrial countries. The practice of generally exempting bondholders from any requirement to participate in burden sharing during the 1980s had the effect of giving bonds *de facto* seniority over commercial bank syndicated loans. This was reinforced by the 1989 modification of the arrears and financing assurances policies under which the Fund was willing to tolerate unresolved arrears to commercial banks. Moreover, as discussed below, creditors may have considered that the legal remedies available to bondholders are likely to be more effective than those associated with syndicated loans, thereby strengthening their ability to enforce contractual obligations.

14. The emergence of a large and liquid secondary market in Brady bonds provided an important impetus to the development of the bond market. These bonds are held by a wide range of investors, and provide a benchmark for the more creditworthy emerging market economies to issue conventional (i.e., uncollateralized) bonds, thereby facilitating the integration of these countries into international financial markets. The demand for bonds issued by emerging markets was underpinned by a combination of the track record of payments to private creditors following the conclusion of Brady operations, and the low interest rates in a number of industrial countries which encouraged investors to search for higher yields in emerging markets. In addition, changes in the regulatory framework in the

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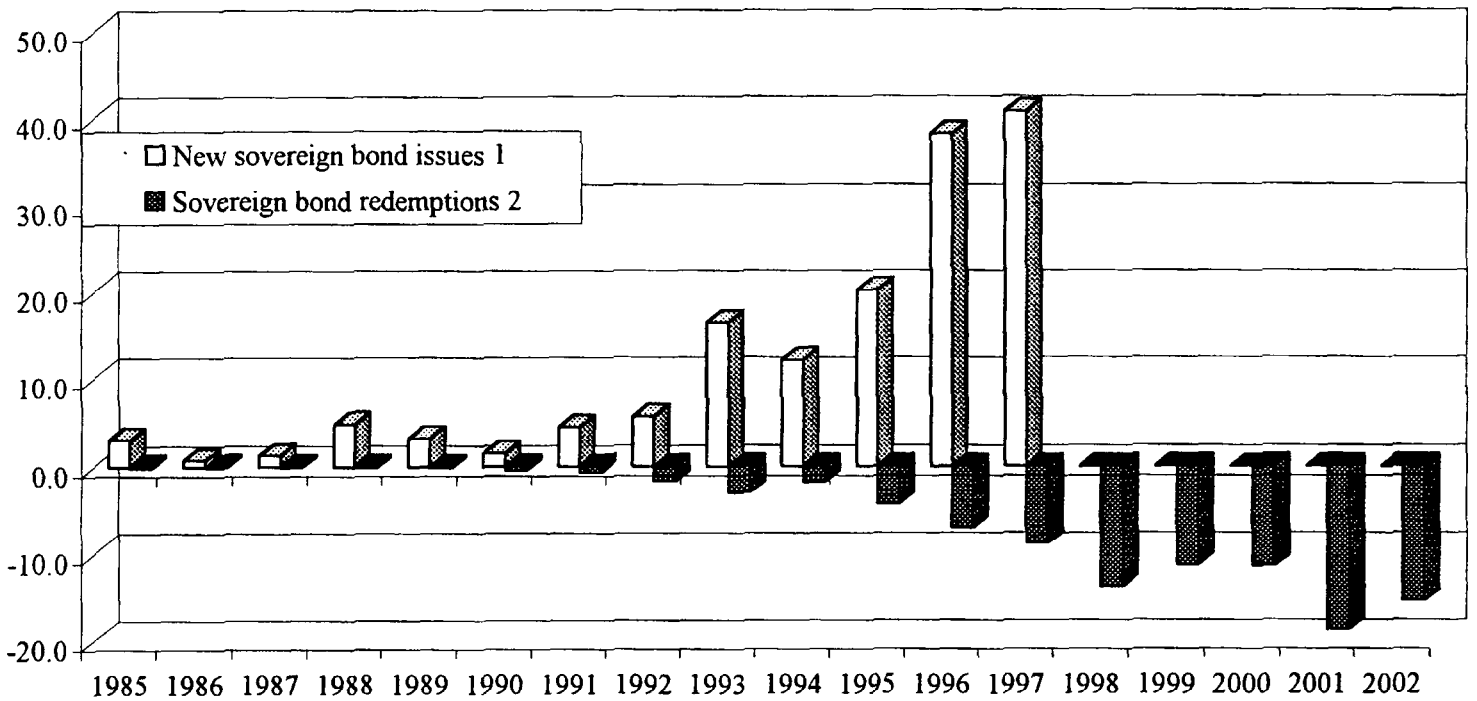
[7](...continued)
instruments are, in many cases, structured as bearer instruments.

[8]Bond placements by nonsovereign borrowers from transition and developing countries have also increased substantially in recent years, and amounted to some $63 billion in 1996, while redemptions amounted to an estimated $19 billion. The outstanding stock at end–1996 amounted to an estimated $204 billion.

Figure 1. International New Bond Issues and Bond Redemptions by Developing Country Sovereign Borrowers

(In billions of U.S. dollars)



Source: DCBEL database.

1 Excludes Brady bonds but includes bonds issued to retire Brady bonds. Data for bonds issued in 1997 refer to bonds issued in the period of January to September.

2 Based on bonds outstanding as of end-September 1997 and valued at the exchange rates prevailing as of end-September 1997. Excludes prepayments of bonds.

Table 1. Private Capital Flows to Developing Countries and Countries in Transition
(In billions of U.S. dollars)

	1989	1990	1991	1992	1993	1994	1995	1996
Balance on current account	-43.5	-41.7	-94.6	-81.7	-125.0	-80.9	-97.8	-99.1
Net private capital inflows	58.0	71.5	85.6	125.0	149.5	143.0	170.4	252.8
Direct and portfolio investment flows (net)	18.5	19.5	34.8	44.1	83.0	100.0	100.0	129.3
Loans and other flows (net)	39.5	52.0	50.8	80.9	66.5	43.0	70.4	123.5
Memorandum items:								
Loan commitments 1/	26.9	32.8	55.9	50.7	54.9	69.5	96.5	110.1
Medium- and long-term	19.4	28.4	50.7	42.5	43.0	55.2	74.9	79.7
Public sector	16.5	21.5	41.7	31.4	22.3	31.9	39.4	28.6
Of which: Sovereign	2.4	1.0	12.0	4.3	2.4	4.4	5.0	3.1
Private sector	2.9	6.9	9.0	11.1	20.7	23.3	35.5	51.1
Short-term	7.5	4.4	5.2	8.2	11.9	14.3	21.6	30.4
Public sector	6.2	2.0	2.5	3.9	5.4	5.4	6.6	8.5
Private sector	1.3	2.4	2.7	4.3	6.5	8.9	15.0	21.9
International bonds								
New issues	7.4	7.8	13.9	24.4	62.7	56.5	57.6	101.9
Public sector	6.6	6.2	8.9	12.9	33.3	25.2	32.8	59.4
Sovereign	3.2	1.5	4.5	5.7	16.4	12.1	20.1	38.1
Other public sector	3.3	4.7	4.4	7.3	16.9	13.1	12.7	21.2
Private sector	0.9	1.6	5.0	11.5	29.3	31.4	24.8	42.5
Net placements	5.5	3.9	9.2	17.0	54.7	46.8	39.0	75.7
Public sector	5.8	4.2	6.7	9.0	27.2	19.4	20.3	42.8
Sovereign	3.1	1.1	3.8	3.9	13.5	10.3	15.8	31.1
Other public sector	2.7	3.2	2.9	5.1	13.8	9.1	4.5	11.8
Private sector	-0.4	-0.3	2.6	8.0	27.5	27.4	18.7	32.9
International equity issues (gross)	0.7	1.2	5.6	7.3	11.9	18.1	11.2	16.4

Sources: IMF, World Economic Outlook (October 1997), pp. 195-96; and DCBEL database.

1/ Loan commitments provide an indication of banks' willingness to lend, but do not indicate the magnitude of gross or net disbursements in particular years.

United States, which eliminated the minimum holding period on privately–placed securities for large institutional investors, increased the liquidity, and thus the attractiveness, of these instruments.[9] More recently, developments in information technology have facilitated ready access by all investors to information on economic developments and asset prices, thereby broadening the potential investor base for bonds issued by developing and transition economies.

15. Against the background of the generally good payments record in recent years, it is difficult to assess how capital markets would respond to an isolated default by a major issuer of sovereign bonds. On the one hand, such a default would demonstrate the limits to the seniority of debts structured in the form of bonds, which could lead creditors to reassess the riskiness of this form of lending to emerging markets. On the other hand, the difficulties and costs likely to be faced by a borrower following a default could strengthen the incentives for other borrowers to avoid imprudent policies, and to adopt early corrective measures in the face of emerging difficulties. It seems likely that there could be some short–term correction in the volume of sovereign bond issues, and there may also be a longer–term impact to the extent that some creditors may reassess the possibility that defaults could occur.

B. General Considerations Regarding Bond Defaults

16. After an overview of the growing shift in the structure of sovereign debt from syndicated bank loans to bonds, the remainder of this chapter provides a comparison between the legal and institutional framework relating to these types of debt, and the ways that these may affect the restructuring process. It suggests that such differences would mean that, unlike the general experience with bank debt, bondholders may eschew collective negotiations and seek redress by suing a defaulting member in national courts. The section also outlines legal remedies that could be sought by creditors, and provides a preliminary discussion of how these remedies could undermine the ability of the authorities to conduct economic policy.

17. This paper addresses issues relating to *international sovereign* bonds. For purposes of this paper, "international" bonds are bonds which require (or give the lender the option to require) payments of interest and principal to be made in a foreign jurisdiction. As is described in greater detail in Appendix IV to this paper, bonds payable in foreign jurisdictions are almost always subject to foreign laws; indeed, international bonds typically provide that they are governed by the laws of a particular foreign jurisdiction and that jurisdiction is also a forum for dispute settlement. In the context of a sovereign liquidity crisis, this feature has two important consequences. First, in the event of a default, the government cannot, through its own laws, protect itself from being sued in a foreign court. Second, while the government might, through its own laws, be able to protect its domestic assets from being attached in execution of judgment, it cannot similarly protect its foreign assets from being attached. Accordingly, in these circumstances, there is the potential for creditors to use legal process

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[9] SEC Rule 144A, which became effective in April 1990.

either to collect from defaulting debtors or as a means to apply pressure so as to improve the terms of any negotiated refinancing.[10]

18. With respect to the meaning of "sovereign" bonds, it is understood to include, for purposes of this paper, bonds that are issued or guaranteed either by the state (the government) or by the central bank. Although a state or central bank guarantee is often provided at the time the underlying debt is contracted, it may also be given at a later stage e.g., in the face of emerging financial difficulties. Guarantees could be provided in respect of nonsovereign bonds, or other debts, such as the liabilities of financial institutions. The scope for creditor litigation against a sovereign following a default on a guarantee would depend on the terms of the original loan agreement and the guarantee contract.[11] The above definition of "sovereign" is important for a number of reasons. First, as defined above, sovereign borrowers are those who benefit from the protections against the execution of judgment on domestic and foreign assets afforded by the debtor's domestic laws and the sovereign immunity laws of foreign countries. Sovereigns may often use these laws to ensure that their assets cannot be attached through legal process. By and large, private borrowers may not. Second, sovereign borrowers and their creditors cannot take advantage of foreign or domestic bankruptcy laws. This means that, in the event of a default, the sovereign cannot turn to a bankruptcy court for a temporary stay of suits by creditors. It also means that a bankruptcy proceeding cannot be used by creditors to enforce an equitable distribution of a sovereign's attachable assets among them. The unavailability of bankruptcy laws has an important effect on a sovereign issuer's ability to negotiate refinancing agreements with its bondholders. Finally, as will be discussed in Chapter V, sovereign defaults, being proprietary acts, are not covered under Article VIII, Section 2(b) of the Fund's Articles.

19. Almost all recent experiences with defaults on sovereign debt to private creditors have involved credit extended by commercial banks and, to a lesser extent, other financial institutions such as insurance companies and pension funds.[12] By and large, the rescheduling

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[10]Domestic debt, on the other hand, is governed by domestic law, which the government can use to protect itself from both suit and from attachment. Moreover, the laws of sovereign immunity in other jurisdictions would protect assets located abroad (except perhaps from the actual proceeds of the initial borrowing) from attachment. Therefore, creditors would generally not be able use litigation to collect from defaulting debtors, or to improve the terms of any refinancing. Also of great importance, while domestic debt is typically payable in local currency, international debt is typically payable (either directly or at the option of the holder) in a foreign currency.

[11]It is typical for guarantees to provide that the guarantor will, on default, assume the liability on the same terms and conditions, although it is possible for guarantees to be more limited.

[12]There have been two recent examples of sovereign bond defaults to private creditors. The

(continued...)

of such debt has generally been orderly. Almost all such credit was extended by large banking syndicates. London Club procedures developed over time, whereby members of bank syndicates negotiate a restructuring of their claims with debtor governments. Creditor steering committees, consisting of the most heavily–exposed banks along with representatives of those with lesser exposure, have taken the lead in negotiations with the member. By and large, other members of the syndicate have cooperated with this procedure, and have not derailed the process by seeking settlement independent of the London Club process. While London Club negotiations were in many cases difficult and protracted, individual syndicate members have generally not exercised their right to sue the defaulting member and to seize available assets. There are a number of reasons for such forbearance, the most important of which involve both the nature of the creditors and the legal structure of the typical syndicate agreement, and which are discussed at greater length below.

20. The extent of cooperation among creditors has an important role in determining whether a negotiation will result in a "good" or "bad" outcome, from the perspective of the debtor and creditors as a group. Viewed through the prism of the prisoners' dilemma paradigm, it can be argued that the renegotiations with commercial banks generally resulted in a good (i.e., cooperative) outcome, in the sense that creditors as a group ended up better off

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[12](...continued)
first is Argentina, which defaulted on its bonds in 1986. Argentina unilaterally extended the time for repayment, which was accepted by most bondholders. However, three bondholders refused to accept the rescheduling and sued successfully in the United States. This case is discussed in Appendix IV. The second is Panama, which defaulted on its bonds in 1987. Panama reached an agreement on the restructuring of its bonds. This agreement provided for restructuring, including the partial capitalization of interest arrears in 1994. It appears that only one creditor initiated litigation; the case was settled out of court. The lack of widespread litigation in this case presumably reflected creditors' assessment that, in the particular circumstances of Panama under the Noriega regime, litigation may not have facilitated the settlement of arrears. One notable feature is that, although Panama was negotiating a DDSR deal with commercial bank creditors simultaneously with a bond restructuring, the agreement with bondholders contained no element of debt and debt–service reduction (see WP/95/27 and WP/96/11). While sovereign defaults occurred more commonly in the first half of the 20th century, negotiations to resolve the defaults were conducted under a different legal regime. The most important aspect was the sovereign's protection against seizure of its assets to satisfy a judgement. See William H. Wynn, I *State Insolvency and Foreign Bondholders*, pp. 162–171 (1951). However, developments in the law of sovereign immunity since the Second World War have restricted this immunity, and recognize the right of the sovereign to waive its immunity against seizure of certain classes of assets. For this reason, creditors now generally insist that bond contracts include such waivers.

than they would have had they decided to "race for the exit."[13] As discussed in paragraphs 24–36 below, the incentives for banks to cooperate diminish the likelihood of disruptive behavior, thereby reducing the likelihood of a "bad" (i.e., uncooperative) result.

21. The absence of those incentives in bond contracts means that litigation is more likely to shape the renegotiation process than in the case of syndicated bank debt. This increases the likelihood of a noncooperative outcome in the prisoners' dilemma paradigm. It would be in the interests of *bondholders as a group* to avoid a race to court and rely, instead, on orderly renegotiations. However, the absence of mechanisms to enforce collective action and curtail the activities of free riders could make it optimal for *bondholders acting individually* to start a chase for assets through litigation.[14] This behavior would be mutually reinforcing. Indeed, the limited availability of attachable assets invites bondholders to rush to sue before there are no assets left to attach. These problems of collective action could be an important source of market failure. Accordingly, as discussed below, absent the existing *private contractual* incentives for cooperation found in syndicated bank debt, creating incentives for a cooperative result for a bond renegotiation could require a modification to the terms of all bond contracts or some form of *public* intervention.

22. Although there are no established institutional mechanisms for bond renegotiations, it is possible that informal committees of bondholders with substantial exposure would form for the purpose of negotiating with the defaulting borrower, possibly organized by the banks which arranged for the bond issues. This reflects the congruent interests of borrower, bondholders as a group, and banks in orderly renegotiations. Bondholders will be interested in preserving the value of their existing claims, and some may wish to re–establish an economic

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[13]The prisoners' dilemma is described in Appendix III.

[14]It may be noted that, if the number of creditors is small and their identities are known, creditors and the debtor may be able to negotiate a mutually advantageous agreement at the time of a default, and thereby avoid a creditor race. But in cases in which there are a larger number of creditors, or their identities are not known (bonds are generally widely held bearer instruments), the ability of creditors to reach a mutually advantageous agreement and avoid a creditor race may be lost. See "Experimental Tests of the Coase Theorem With Large Bargaining Groups" by E. Hoffman and M.L. Spitzer, *Journal of Legal Studies*, 1986. It may also be noted that, if creditors expect to face defaults by a large number of debtors, they may conclude that cooperation will be the best strategy. Although an individual default may signal the end of a creditor's relationship with a particular defaulting debtor (and therefore with the other creditors of that debtor), the prospect of future dealings with other defaulting debtors (and therefore with creditors of those debtors) may lead a creditor to favor a general policy of cooperation. But not all creditors will expect repeated defaults, and therefore would not be expected to cooperate. Thus, creditor races can be caused by these few "bad apples." See "Bankruptcy, Non–Bankruptcy Entitlement, and Creditors' Bargain" by T.H. Jackson, *Yale Law Journal*, 1982.

environment conducive to new investment, while the banks would wish to limit the potential damage to the market for new bond issues. However, due to the relatively large number and the lack of uniformity of type and therefore interest of bondholders, it may be difficult to develop a common negotiating position. Uncertainty about the borrower's capacity and willingness to service the bonds, coupled with divergent interest among creditors, could create a tendency toward protracted negotiations. Moreover, it is the lack of incentives to reach a cooperative decision discussed below that ultimately may make it difficult for bondholder committees to reach the unanimous agreement on rescheduling required.[15] Indeed, there is a danger that even in the absence of litigation negotiations could reach a stalemate.

23. Four key inter–related legal and institutional factors discussed below have helped to ensure that the process of negotiations with commercial banks generally remained orderly. None exist with bonds.

Regulatory supervision

24. *While bank supervisory bodies influenced bank syndicate members to reach a settlement through negotiation, not all of the numerous nonbank institutions and individuals that may hold bonds are covered by supervisory bodies.*

25. Syndicated bank loans involve primarily commercial banks and occasionally other financial institutions, which are typically under the supervision of central banks and other regulatory authorities. Those authorities sought to persuade syndicate members through a combination of moral suasion, the application of provisioning regulations, and other regulatory benefits, to enter into voluntary agreements with sovereign debtors, particularly in the early stage of the debt crisis when arrears posed a systemic risk to the financial systems of creditor countries. By the same token, the prospect of having to renegotiate the debt of several countries during the debt crisis would have reinforced incentives for cooperation among banks in any one case, as they would have faced the prospect of repeated dealings on other cases.[16] A related point, discussed below, is that the ownership of bank loans has largely been retained within the banking community, thereby preserving the homogeneity of creditors and the influence of regulators.

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[15]Individual bondholders generally cannot be forced to accept a renegotiation without their consent. Some bonds, however, do have less than unanimity provisions, which entail declining majorities required for modifying the terms of a bond following consecutive bondholder meetings. Nevertheless, the uncertainty inherent as to whether a sufficient majority will be reached still suggests that, during the process of holding consecutive bondholder meetings, there will be an incentive to rush to court.

[16]See Jackson, *op cit.*

26. Bondholders, on the other hand, may include not only banks and other financial institutions, but also pension and mutual funds, other investment companies, and individuals. Therefore, because many bondholders are unlikely to be subject to regulatory oversight, there is no central mechanism for applying pressure to bondholders as a group to enter into orderly negotiations. Moreover, to the extent that bondholdings are widely dispersed, and a default would not pose systemic risks to financial systems, regulators may be reluctant to exercise influence on bondholders to keep the process of negotiation orderly. Further, information on actual bondholders is not available prior to a default, as publicly–placed bonds are generally bearer instruments traded on the secondary markets. Recent years, however, have witnessed substantial sales of subinvestment grade sovereign bonds to the household sector, particularly in Germany and Japan.

Sharing clauses

27. *The terms of syndicated loans require that any single member of the syndicate must share payments or other amounts it has received with other syndicate members which have not received similar amounts due to them. The terms of bonds do not include sharing clauses.*

28. Syndicated loan agreements require syndicate members to share any money recovered from the debtor with other members of the syndicate, in proportion to holdings of principal. Therefore, in the event of a default, if a bank recovers any money from the borrower, including the proceeds of any litigation, that bank can keep only a fraction of the proceeds. The inability to keep all or even a substantial part of any recovery substantially curtails the potential gains of individual creditors from legal action and provides a strong incentive for negotiated solutions to debt–servicing difficulties.

29. Because bond terms do not include sharing clauses,[17] individual bondholders would be able to retain any money recovered through litigation. This greatly increases the incentive of a single creditor to sue. As is discussed below, this increases the likelihood that bonds will be purchased in the secondary market by companies that are interested in short–term financial gain through litigation.

Acceleration: right to payment of both interest and principal

30. *While it is difficult to "accelerate" syndicated loans in the event of default, it is relatively easy to accelerate bonds.*

31. Virtually all international credit extended to sovereign borrowers includes a provision allowing for acceleration of unpaid principal (which would make all unpaid principal

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[17]The differences in the terms and conditions of syndicated bank loans and debt structured in the form of bonds are discussed in Legal Aspects of Standstills and Moratoria on Sovereign Debt Payments and their Effects on Actions by Creditors (EBS/96/26, 2/24/96).

immediately payable) following an event of default.[18] Such acceleration can only be effected, however, if sufficient support among creditors is secured. Syndicated loans typically require the support of banks holding more than 50 percent of unpaid principal to force an acceleration. This relatively high threshold serves to ensure that creditors with a relatively small exposure cannot force an acceleration. In contrast, bond terms require only modest support to force an acceleration of principal which, after a default, is likely to be easily obtainable.

32. An acceleration would complicate debt renegotiation because it would give rise to the immediate obligation to repay all unpaid principal in addition to overdue interest payments. The terms of an eventual settlement covering the stock of bonds following an acceleration would be subject to negotiation. Clearly, this opens the possibility that a default would enable bondholders to improve the terms of the whole of their claim.[19] When bond holdings are widely dispersed, the concern that dissident creditors may be able to obtain full payment provides incentives for other holders to accelerate their claims. In contrast, when the holdings are concentrated in a few large financial institutions, it would seem less likely that the bonds would be accelerated, as bondholders with large exposure would recognize that their claims could not be satisfied through litigation by the limited assets available.

Secondary market trading

33. *Syndicated loans are typically traded primarily within the banking community, but bonds are traded in secondary markets open to both banks and nonbanks. While it is difficult to predict who would buy distressed bonds, the possibility that some would be acquired by "vulture companies," i.e., companies that specialize in extracting "salvage value" through litigation, cannot be precluded.*

34. Although it is possible for individual banks in a syndicated loan to sell their share of a syndicated loan, such secondary market trading has generally been primarily among other banks and financial institutions.[20] Financial institutions which have acquired claims in the secondary market have in most cases been willing to participate in orderly negotiations.

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[18]"Events of default" are defined circumstances and typically include not only failure to make a timely payment of interest or principal, but other events as well, including a declaration of a debt moratorium. A default on other international debt is usually an event of default.

[19]For example, by an increased spread. Creditors may hold out for such improvements in negotiations with countries that enjoy strong medium–term prospects.

[20]Syndicated loan terms typically require that all participants be financial institutions. However, courts have interpreted the term "financial institution" very broadly.

35. While aggressive litigation by financial institutions has been rare, there are a number of reasons why bondholders are more likely to pursue this course of action. Markets for sovereign bonds (other than Brady bonds) issued by emerging market countries are generally illiquid, as investors typically hold such bonds until maturity. However, it is probable that secondary market trading would become more active in the face of a developing crisis, with a number of players willing to provide liquidity to holders of distressed debt. Bonds considered to be particularly at risk, as well as those on which a default has occurred, may be sold by banks, institutional investors, and individual creditors who do not have an interest in the process of restructuring.[21] It is possible that "vulture companies" with an appetite for risk may enter the secondary market with the express purpose of extracting salvage value through the quick realization of capital gains, rather than through the more protracted, if orderly, process of negotiation.[22] Such purchasers are not likely to be subject to regulatory oversight and would tend to favor recourse to legal remedies over cooperative solutions, especially given the absence of sharing clauses. Indeed, in the Argentine case, one of the few instances of a sovereign bond default, litigation was initiated shortly after a default by an offshore company (though the size of the claim was small in relation to the balance payments of the member concerned) (Box 1). Another example is the Congo case, where a Federal District Judge, in agreeing to execute judgment in New York, commented that the strategy of seeking to attach assets "will certainly serve to disrupt attempts to complete [Congo's] rescheduling effort and will definitely have an adverse effect on Congo's international trade and banking business. Although we would prefer to avoid this situation, it is clearly a viable, and rational strategy."[23]

C. Implications of Bondholder Litigation

36. To date there has been relatively little litigation against sovereign and nonsovereign debtors. Accordingly, the following analysis of the means by which creditors could enforce their claims against debtors is necessarily tentative. However, recent litigation illustrates a number of the issues relevant to litigation against sovereigns (Boxes 1 and 2).

37. Enforcing creditors' legal rights entails a two-step procedure. A creditor would first obtain a court judgment of default. This would then be followed by actions to recover the missed payment(s) (and, in the event of acceleration, the principal amount of the bonds)

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[21]For example, it is understood that Bulgarian Brady bonds, which have traded at steep discounts, were held largely outside banks and major pension and mutual funds.

[22]While there was a limited tendency in the 1980s for distressed commercial bank debt to be acquired by "vulture" creditors, the potential benefits of litigation were generally limited by a combination of sharing clauses of syndicated loans and the difficulty in garnering the support required for an acceleration.

[23]*National Union Fire Insurance Company of Pittsburgh, PA, v. People's Republic of the Congo*, 729 F. Supp. 936, 944 (1989).

Box 1. Litigation Against Sovereigns—Recent Cases

There have been a number of recent cases where creditors have refused to accede to renegotiations of the terms of sovereign debt, and have instead pursued aggressive legal strategies to recover the full amount owed. In each of these cases, other creditors have accepted the rescheduling; and, the creditors undertaking litigation had purchased their claims on secondary markets.

In the case of **Argentina**, the state unilaterally extended the time for payment on certain dollar bonds maturing in 1986. While most bondholders agreed to the extension and voluntarily exchanged their bonds for new instruments, three bondholders, including two offshore companies and a Swiss bank, sued in the Southern District of New York to enforce in full the terms of the bonds. The total amount of bonds held by the three plaintiffs, however, was relatively small ($1.3 million in face value). Following a decision by the U.S. Supreme Court affirming the judgement of default by the District Court, an out of court settlement was reached.

Brazil also reached agreement with a large majority of its commercial bank creditors on a Brady deal. However, as was the case with Peru, an offshore company that had purchased some long-term claims on the secondary market eschewed the agreement and sued in the Southern District of New York. The rights of other creditors to share in the proceeds of litigation were extinguished by their acceptance of bonds in exchange for their claims. Although the plaintiff received a judgment of default, it did not have a sufficient amount of the remaining syndicated debt to force an acceleration. The creditor has subsequently agreed to exchange its claims for new instruments.

In the case of the **Republic of Congo**, a private bank with a claim against the Congo for $22.5 million pursuant to default on a credit facility refused to accept London Club terms, and instead sold its claim to the plaintiff, a casualty insurance company. The plaintiff received a judgment against the debtor in the London High Court, and then proceeded to move to recognize that judgment in the Southern District of New York. The plaintiff was then able to execute judgment against the Congo's financial assets in New York.

In 1983, **Peru** announced that it could no longer service its foreign debt in full, and began negotiations with its creditors. During this period, a number of claims representing short term debt were sold on the secondary market. While a large majority of Peru's private creditors eventually agreed to a Brady rescheduling, at least three market purchasers, all offshore companies, rejected the agreement and began litigation in the Southern District of New York. As the debt was not syndicated, there are no sharing clauses limiting the financial benefits of recovery through litigation. The full amount of the loan is in arrears. Two creditors holding claims with a combined face value of only $7 million filed first. The third creditor, holding claims with a face value of over $20 million, did not file until after the first two creditors received a judgement of default. In the first and second cases, the plaintiffs are now attempting to execute judgment against Peru's foreign assets, thereby complicating the task of managing these assets. In the third case, the plaintiff has initiated litigation, but has yet to obtain a default judgment.

There have also been cases of recent litigation against **Paraguay**, **Ecuador**, and **Panama** by plaintiffs who have dissented from London Club agreements, for amounts ranging up to $20 million. There have been informal reports of additional suits either filed or contemplated in a number of other cases stemming from the London Club process.

The case of **Zambia** is discussed in Box 2.

Box 2: Litigation Against Sovereigns—The Case of Zambia

One of the most important examples of litigation against a sovereign involves both the Bank of Zambia and the Republic of Zambia.

The Bank of Zambia was in default on a medium-term deposit loan extended to it by the central bank of a country that is not a regular participant in the Paris Club. Subsequently, with the agreement of the Zambian authorities, the claim was purchased by an offshore company which, as with the cases discussed in Box 2, was not subject to the moral suasion of bank regulators. As the debt was not syndicated there were no sharing clauses limiting the financial benefits of recovery through litigation. The full amount of the loan was in arrears. The loan agreement includes a comprehensive waiver of the Bank of Zambia's immunities.

The creditor entered into negotiations with the Bank of Zambia for payment of the arrears, while simultaneously filing suit against Zambia in London. After securing a judgment of default, the creditor made several attempts to attach foreign exchange assets of the Bank of Zambia. The creditor is understood to have mounted at least 15 separate legal actions in 5 jurisdictions to secure repayment of the claim, which amounts to approximately $120 million. Unlike the cases discussed in Box 2, the absolute size of this claim was large in relation to the member's balance of payments.

This litigation made it very difficult for the Bank of Zambia to manage the country's official reserves. A settlement offer was recently accepted that is more generous to the creditor than either Naples terms or the IDA financial buyback accepted by other creditors.

In a second case, litigation is currently being brought against the Republic of Zambia. A creditor, who declined to participate in the IDA debt reduction operation, sold its claim of about $20 million to another offshore company.

In a third case, yet another offshore company, a bank, held a deposit of the Bank of Zambia with an agreement that the deposit could be used by the bank to offset liabilities of the Republic of Zambia or parastatal companies. When the plaintiff in the litigation against the Bank of Zambia moved the court to attach the Bank of Zambia's deposit, the bank used the deposit to offset the balance of its outstanding loan to the Bank of Zambia, as well as claims against the Republic of Zambia, which it had acquired in the secondary market. The authorities have protested but to date have not been able to recover the money.

In two further cases, uninsured suppliers with relatively small claims on the Bank of Zambia (which had also declined to participate in the IDA debt reduction operation) brought suits. In one case, the claim was settled through the seizure of assets and, in the other, through a negotiated settlement on terms more favorable to the creditor than would otherwise have been the case.

through the "attachment" of assets of the borrower,[24] i.e., the seizure of assets by a court for the purpose of paying off the amount of a judgment against the debtor. Litigation could serve the twin objectives of obtaining a direct settlement of the arrears, and applying pressure on the sovereign debtor for a favorable settlement. While the resources available for attachment are likely to be very limited, and therefore full settlement for all bondholders is likely to be precluded, the possibility of bondholders with relatively small exposure using an aggressive legal strategy to obtain substantial settlement may provide strong incentives for seeking remedies through the courts.

38. Several problems confront bondholders contemplating litigation. Litigation is expensive, and creditors would need to weigh the chances of success against its costs.[25] The ability of creditors to obtain settlement through attachment will depend upon the availability of assets amenable to legal process. Assets must be: (i) owned by the borrower or guarantor; (ii) of value to either the creditor or borrower;[26] and (iii) subject to the jurisdiction of a court that will order attachment of the assets.

39. The rest of this chapter provides a preliminary discussion of the scope for litigation against sovereign borrowers, including with respect to bonds issued by the state (i.e., the government) and bonds issued by central banks, as well as bonds issued by nonsovereign borrowers.

40. The legal remedies available to holders of internationally placed sovereign bonds will depend upon the foreign sovereign immunity laws and the terms of the bond.[27] The application of the principles of sovereign immunity varies, depending on whether bonds are issued by the state or the central bank. As noted earlier, while domestic sovereign immunity laws would likely preclude the seizure of assets located within the territory of the sovereign debtor, it

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[24]If attachment is to take place in a country other than that where the judgment was rendered, attachment would require recognition of the foreign judgment by the other country.

[25] In New York (which along with London is the most important jurisdiction for obtaining judgments of defaults), law firms may be willing to finance the costs of litigation on a contingency basis, thereby minimizing the up–front costs for the suing creditor.

[26]Some assets may only be of substantial value to the borrower. However, attachment of these assets could be attempted solely to put pressure on the borrower into settling.

[27]Internationally–placed bonds establish the choice of legal framework for resolving disputes. Brady bonds are generally subject to New York law; Euro and Global bonds are generally governed by English, New York, German, or more rarely, French law, while Samurai bonds are governed by Japanese law. As noted above, domestically placed bonds (including Tesobonos), in contrast, are governed by domestic laws and generally do not permit attachment of sovereign assets in satisfaction of judgment.

provides no protection for assets located abroad. Moreover, the protection offered by foreign sovereign immunity laws is limited by waivers of sovereign immunity, which are common features of international bond contracts.

International bonds issued by states

41. The majority of sovereign bond debt is issued by the state (i.e., by the government). (Bonds issued by central banks are discussed separately, below.) While international bonds typically contain comprehensive waivers of sovereign immunity against attachment, a wide range of government assets would continue to be protected from attachment. Nevertheless, the rules in this area are not uniform across jurisdictions, and in some cases have not been fully elaborated, thus providing scope for aggressive litigation. In any event, proceeds of loan disbursements held in foreign bank accounts owned by the government would be vulnerable to attachment. It should be noted that, with respect to bonds issued by the government, the central bank's assets would not be subject to attachment because the central bank would not be the borrower. Accordingly, to the extent that the country's reserves are the property of the central bank and not the government, they will be protected.

42. Even if a borrower has few attachable assets immediately following a default, creditors may be able to attach assets in settlement of a judgment after the initial liquidity crisis has passed. In this context, it may be noted that the protection provided to debtors by statutes of limitation is unlikely to be of practical help to the debtor.[28]

43. It is also possible that a judgment creditor (i.e., a creditor that has obtained a default judgment) may attempt to attach a loan disbursement to be made by another creditor to the debtor government. Once all the requirements of the loan agreement are fulfilled such that the debtor government has the right to receive the loan disbursement, the government is said to have a "claim" against the lender for the amount of the disbursement. Such claims could be subject to judicial attachment. The result of such an attachment would be that the court would transfer the right to receive the loan disbursement from the debtor government to the bondholder. The lender would continue to have a contractual claim against the country to repay the loan, notwithstanding the fact that the proceeds of the disbursement were never received by the debtor government. However, because the debtor government would presumably be less willing to repay an amount that it never actually received, a commercial lender could be expected, as a matter of practice, to exercise its right to cancel the loan agreement and make no further disbursements.[29] Thus, while such an attachment order would

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[28]Under New York law, for example, which is the applicable law for Brady and many global bonds, the statute of limitations would curtail litigation six years after the default.

[29] Most commercial loan agreements contain provisions that give a lender the right to cancel the loan or suspend disbursements in the event of significantly changed circumstances, which

(continued...)

be unlikely to enable the bondholder actually to seize a government's assets, it could be an effective means of cutting off any resumption of access to private financing, thereby exerting pressure on the government to negotiate a settlement. Such a strategy could be pursued even if the size of a creditor's claim is small in relation to disbursement.

International bonds issued by central banks

44. Bonds issued by a number of central banks also contain comprehensive waivers of immunities which would expose the official reserves to attachment after a judgment of default had been obtained. The loss of foreign exchange assets would be of great consequence for a member's balance of payments and for the successful implementation of a Fund–supported program. Indeed, a principal objective of a Fund arrangement with a member experiencing a sovereign liquidity crisis would typically be to rebuild the official reserves. Although reserves may be minimal immediately following a default, as noted above, patient creditors may be willing to wait for the initial liquidity crisis to pass before trying to attach assets.

45. In order to prevent an attachment of assets by a creditor, it may be possible to transfer the ownership of the reserves from the debtor to another legal person who is not a party to the suit. For example, if the borrower is a central bank, it might be possible to transfer title to the assets to the government, or vice versa.[30] However, the transfer may be deemed by a court to be fraudulent and invalid, especially if the asset transfer occurs too close in time to a default. In any event, title to any reserves accumulated *after* a default could be held by the government, and thus be sheltered from suits against the central bank.

46. It should be underscored, however, that, if both the government and the central bank were in default, the possibility of finding a safe haven to hold title to foreign exchange assets would become considerably more difficult. This would greatly complicate the task of national policy makers in managing a sovereign liquidity crisis. One implication is that so long as central banks have outstanding liabilities in the form of bonds that include waivers of immunities, considerable caution should be exercised with regard to any possible bond issues by the state, and vice versa.

D. Conclusion

47. Due to the institutional and legal differences discussed above, there is a significant risk that the experience of relatively orderly resolution of members' defaults on syndicated commercial loans would not be repeated in the event of a default on international sovereign

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[29](...continued)
would include such an attachment.

[30]It is assumed, in this case, that the government is not the guarantor of the central bank's indebtedness, or vice versa.

bonds. It is possible that some bondholders would choose not to participate in a cooperative strategy of refinancing, but would instead adopt an aggressive legal strategy of accelerating principal, instituting litigation, and chasing assets. This could severely complicate members' efforts to resolve their balance of payments difficulties. Moreover, until the member had reached voluntary agreement with all bondholders, it would remain vulnerable to the threat of litigation for an extended period. At the same time, this would reduce the collective value of bondholders' claims.

48. The potential difficulties that would be faced by a member in default on its sovereign bonds would be an incentive to avoid such defaults. By encouraging members facing emerging balance of payments difficulties to pursue rigorous adjustment programs, possibly in cooperation with the Fund, these incentives may enhance the efficient operation of the international monetary system. However, if a default were nevertheless to become unavoidable, it could be highly problematic for a sovereign debtor successfully to negotiate a refinancing with its bondholders.

IV. Options for Fund Involvement in a Sovereign Liquidity Crisis Within the Current Legal and Institutional Framework

49. The Fund's primary role regarding liquidity crises focuses on prevention. One of the key objectives of surveillance is to encourage members to adopt sound macroeconomic, structural, and debt management policies which should help to minimize the risks of liquidity crises. The globalization of international capital markets and the improvements in market access have increased the importance of private capital as a source of external financing for many developing countries, but at the same time have increased these countries' vulnerability to shifts in market sentiment. This has underscored the importance of taking early, forceful corrective measures in the face of emerging difficulties. Some relatively recent experience (for example, Argentina (1995) and Hungary (1988)) suggests that markets would be willing to support such policies with new financing, albeit with higher interest rates, and thereby help countries to weather the storm.[31] By the same token, the increased range of opportunities for sovereign borrowing has underscored the importance of debt management policies designed to avoid excessive government borrowing (particularly foreign currency borrowing subject to the

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[31]Market financing in the face of emerging liquidity difficulties may take the form of new loans, or a voluntary exchange of instruments which would have the effect of extending the maturities on sovereign bonds. Such exchanges were successfully arranged by Costa Rica and Guatemala in 1985 and 1989, respectively. In both cases, the new bonds, and the old bonds that had not been exchanged for new instruments, continued to be serviced in full and a sovereign default was avoided. See Historical Experience with Bond Financing to Developing Countries, by J. J. Fernández–Ansola and T. Laursen (WP/95/27, March 1995); and Private Bond Restructurings: Lessons for the Case of Sovereign Debtors, by M. Piñón–Farah (WP/96/11, February 1996).

jurisdiction of other countries' legal systems), substantial short–term borrowing, and a bunching of debt service obligations.

50. In the aftermath of the 1994–95 Mexican crisis, the Fund has paid increasing attention to factors that could potentially lead to liquidity crises. The Fund has intensified its surveillance over international capital markets with the aim of improving its ability to identify emerging financial tensions at an early stage. At the same time, the Fund is strengthening its surveillance over the financial and banking sectors, focusing on countries facing financial sector problems that could have macroeconomic significance. In addition, the Fund has developed the Special Data Dissemination Standard, which is intended to help ensure regular reporting of comprehensive economic data to the public by countries having or seeking market access, has now been subscribed to by over 40 countries.

51. Balance of payments crises will nevertheless occur, and given the developments noted above, it is increasingly likely that members experiencing such crises will have significant external debt in the form of sovereign bonds. With forceful and prompt adjustment to emerging pressures, members that still have market access may be able to address such problems effectively and avoid default on sovereign obligations. But if the impact on the external accounts of adverse developments is too large and/or the policy response is delayed, members may face an intensification of balance of payments difficulties. Unless official creditors are prepared to provide substantial financing when appropriate adjustment measures are finally put in place, it may not be possible to avoid a default on sovereign obligations.[32]

52. This chapter provides a preliminary discussion of the ways in which the Fund could respond to such an emerging crisis—within the existing legal and institutional frameworks—and whether they would support or undermine the principles and objectives, noted in Chapter II, regarding promotion of effective balance of payments adjustment in a manner consistent with the Fund's purposes and safeguarding the Fund's resources. Three approaches are examined: The first, discussed in Section A, would be for the Fund to provide early support for a member's adjustment program and, through its catalytic role, to mobilize sufficient financing from official creditors to prevent the emergence of arrears. If official creditors were unwilling to provide financing on a scale necessary to avoid the need for a restructuring of sovereign bonds, there would be two further approaches the Fund could take to support a member's adjustment efforts. Under the first of these, discussed in Section B, the Fund would apply to bondholders the arrears and financing assurances policies applied to

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[32]Moreover, in the face of a sovereign liquidity crisis, payments difficulties may not be confined to sovereign obligations. The authorities may be forced to impose controls on private resident and nonresident outflows, which may lead to an interruption to private sector debt–service payments. As noted above, issues associated with arrears on nonsovereign debt resulting from the imposition of exchange controls will be discussed in a forthcoming paper. It may be noted that to the extent that members assume the obligations on nonsovereign bonds, they would face similar issues to those discussed below.

commercial banks prior to the 1989 modification. This would delay the provision of Fund financial support for a possibly protracted period until agreement in principle had been reached on a bond restructuring, even if understandings had been reached on appropriate stabilization and structural reform policies. An alternative approach, discussed in Section C, would be for the Fund to apply the 1989 modification of the arrears and financing assurances policies to bondholders. Under this approach, the Fund could "lend into arrears," i.e., it could approve an arrangement after emergence of arrears to bondholders, but before agreement in principle on a restructuring had been reached.

A. Provision of Official Financing

53. One approach to addressing a sovereign liquidity crisis would be for the Fund to provide support for a member's adjustment program and, through its catalytic role, seek to mobilize financing from other official sources. Such financing would help cover temporary imbalances until corrective policies have taken hold, and help members either maintain or regain access to international capital markets. It is recognized that during a Fund supported program there may be a temporary reduction in the exposure of private creditors, associated with a partial or full interruption in the member's access to capital markets. There would always be uncertainty at the start of an arrangement regarding the timing and pace at which the member would be able to regain or deepen access to capital markets. Nevertheless, in circumstances that could be characterized as those normally faced by the Fund, the strength of the member's program would need to be such as to provide satisfactory assurances that the problem would be corrected within a reasonable period.

54. In contrast, circumstances may arise in which, as a result of the combination of the maturity structure of a member's external obligations and the likely protracted timeframe for regaining access to international capital markets, a member may face the prospect of a large and possibly sustained outflow of private capital, notwithstanding the implementation of forceful corrective policies. The provision of official financing in such circumstances, enabling the member to avoid a default, could be expected to strengthen the prospects for restoration of the debtor's access to capital markets. Moreover, a default by a major sovereign borrower could have adverse systemic effects on international capital markets, which could jeopardize the continued access of a wide range of other countries to these markets. In such circumstances, the Fund and bilateral and other official sources might consider that the provision of large amounts of financing in support of strong adjustment efforts would be appropriate, notwithstanding a large, and possibly sustained, withdrawal of private capital. It should be noted that the support of bilateral and other official creditors would be critical in such cases, as the limitations on the Fund's authority to finance large or sustained capital outflows (Article VI, Section 1), and concerns about the adequacy of the safeguards for the Fund's resources would, as a general matter, imply that the Fund would not be in a position to meet the whole of the member's financing needs. In such circumstances, the Fund's involvement would require a particularly forceful adjustment effort by the debtor and the

prospect of substantial support from other official sources.[33] Broad support would serve both to reduce the scope of the Fund's potential involvement and risk, and, by engendering greater confidence in the member's position, help to facilitate a restoration of market access.

55. Notwithstanding the possibility of systemic implications of an interruption to debt service, there may be concerns that the provision of official financing in such circumstances would create an expectation on the part of other members and capital markets that official financing packages would be available to meet debt–service obligations to private creditors in other cases. Such an expectation may be perceived as engendering moral hazard vis–à–vis both debtors and creditors and as having adverse consequences for the international monetary system. Regarding borrowers, there may be concerns that the prospect of substantial official financial support could weaken incentives for members to take early corrective measures in the face of emerging pressures. It should be noted, however, that the conditionality associated with such financing would tend to limit the weakening of incentives for members to take early corrective measure. Regarding creditors, there may be concerns that such an approach would enable private creditors to repatriate capital and interest without the losses they would otherwise have incurred, and would thereby undermine market discipline by shielding private lenders from the normal risks of lending. This could lead to an unduly favorable market assessment of the risk of lending to a member and, therefore, to a mispricing of credit and unstainable levels of external financing. Official creditors may be concerned that through the erosion of the incentives for prudent behavior on the part of creditors, an official "bail out" of private creditors could increase the likelihood and potential magnitude of future crises.[34]

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[33]In circumstances where official bilateral creditors would be willing to provide new money to finance outflows to private creditors because of the systemic implications of default, the question would arise as to whether the systemic nature of the crisis would provide a basis for the Fund to provide the debtor member with an exceptional level of access to the Fund's resources to finance the servicing of its debt (including amortization) or to reconstitute its reserves. (The limitation of Article VI, Section I would continue to apply.) When the policy regarding the "exceptional circumstances" exception to access limits was discussed by the Executive Board in 1983, the Board preferred not to codify the circumstances that might entail exceptional access and specifically expressed its opposition to "singling out the impairment of the international monetary system as a criterion, because it might imply special treatment for larger members."

[34]There is a tension between the view that moral hazard exists and that spreads are therefore often too low and concerns that introduction of new mechanisms that could reduce moral hazard (or at least alter its impact), noted at several points below, will raise borrowing costs. If it is correct that spreads are often too low because of moral hazard, then increases in borrowing costs, particularly to marginally creditworthy borrowers, would be a desirable outcome. Market reactions to events probably result in spreads that are sometimes too low, sometimes too high.

B. Application of the General Arrears Policy to Arrears on Sovereign Bonds

56. If the official community is not willing to provide sufficient support to prevent the emergence of arrears on sovereign bonds, the debtor would have to seek a restructuring of those obligations. In such circumstances, one approach to assisting a member would be to apply the Fund's general policies on arrears and financing assurances, i.e., to delay the approval of a Fund arrangement until *after* agreement in principle had been reached with bondholders to restructure the arrears. This would apply to holders of sovereign bonds the arrears and financing assurances policies that applied to commercial banks prior to the 1989 modification.

57. From the perspective of the official community, such an approach would ensure that bondholders would share in financing following a liquidity crisis and, thereby, would avoid the associated moral hazard discussed in the previous section. The terms of the restructured instruments would be determined through negotiation. In some cases, this might include an improvement in the terms from the perspective of bondholders (for example, through an increased spread), while in other cases, some element of debt and debt–service reduction might be included.

58. Although such a policy would help satisfy the requirement of *safeguarding the Fund's resources*, the extent to which it would weaken Fund's ability to *promote effective balance of payments adjustment* would depend in part upon the type of bond in default. As discussed above, in the case of a default on *domestic sovereign bonds* (for example, through a compulsory exchange of instruments), there would be limited scope for creditor litigation.[35] In the absence of legal remedies, creditors might be willing to accept, within a reasonable period, restructuring provided that the terms were considered appropriate. The application of the general arrears policy in such circumstances could allow the Fund to promote effective balance of payments adjustment without introducing an undue delay in provision of Fund support for a member's adjustment efforts.

59. In the case of a default on *international sovereign bonds*, however, while many creditors would presumably have a strong interest in reaching agreement on an orderly restructuring, as discussed above, the legal and institutional arrangements relevant to the restructuring of such bonds suggest that disruptive behavior of dissident creditors could make the process of reaching agreement among bondholders substantially more protracted than was the case with commercial banks in the 1980s. In the absence of mechanisms to limit the power of individual bondholders to engage in disruptive behavior, negotiations could reach a

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[35]A default on domestic bonds could be avoided through payment in local currency combined with the imposition of exchange controls. To the extent that the authorities would be willing and able to honor their obligation to make payment in local currency, they could suspend convertibility and transfer as a means of addressing a balance of payments crisis.

stalemate. As noted in Chapter II, it was the increasing delays in reaching agreement with commercial banks that led to the modification of the arrears policy vis–à–vis bank creditors in 1989. Delaying financial support from the Fund until agreement had been reached with bondholders could jeopardize the successful implementation of adjustment programs and hamper efforts to mobilize concerted financing from other sources. Such delays would, as a result, jeopardize the member's prospects for regaining external viability and undermine its capacity to service its debts. This would, in turn, have an adverse impact on the value of creditors' claims on the member concerned.

C. Application of the 1989 Modification to Sovereign Bonds

60. As noted above, the G–10 Deputies have asked the Fund to consider extending, in exceptional circumstances, the scope of the 1989 modification to the arrears and financing assurances policies to members that face the prospect of continued accumulation of arrears to private creditors other than commercial banks. Under such an approach, the Fund could consider providing support for a member's adjustment efforts, on a case–by–case basis, after the emergence of arrears but before an agreement in principle had been reached with bondholders; the Fund–supported program would be financed, in part, through the toleration of arrears pending a restructuring.

61. There is a question whether such an extension could have an adverse effect on the efficient operation of international market for sovereign credit. Creditors may be concerned that the toleration of arrears to bondholders in the context of a Fund supported program may reduce the costs of a default to borrowers and, thereby, create moral hazard. To the extent this is the case, it could be argued that such an approach could increase the cost of capital to a large class of debtors, and make creditors less willing to lend to marginally creditworthy members. On the other hand, there are reasons why the cost of a default to debtors would still remain high if the "lending into arrears" policy were extended to sovereign bonds. First, markets presumably would be reluctant to reestablish access quickly for countries that had defaulted, especially if they were not seen as having made best efforts to avoid/resolve their balance of payments difficulties. The reduced ability of such countries to attract foreign savings would diminish the prospects for economic growth, possibly over a protracted period, and could serve to limit moral hazard. Second, the existence of such a policy would not provide members with a firm assurance that the Fund or other official support would be forthcoming in the event of a crisis. Third, Fund support would be conditional upon the implementation of a strong adjustment program. Fourth, the approval of a Fund arrangement does not affect creditors' contractual rights, including the ability to use litigation to secure a favorable settlement.

62. The formulation of a policy of "lending into arrears" raises two further sets of issues. The first concerns the timing of Fund involvement. While the Fund has been willing to play a constructive role in helping countries normalize relations with creditors, it has not recommended that a country default on its external obligations. Such an approach would be inconsistent with the Fund's support of the international payments system and could have an

adverse effect on international bond markets. Moreover, it could also risk pulling the Fund into bondholder litigation. These considerations notwithstanding, if the Fund were perceived as advising a member to default, there is a risk that, in the litigation that may follow such a default, the Fund could be named as a defendant in an action by bondholders for any damages resulting from the default. The basis of such a legal action against the Fund would be that, by (allegedly) advising the member to default, the Fund had tortiously interfered with bondholders' contractual rights. While the Fund's immunity from the jurisdiction of the courts would most likely be upheld, such immunities would not shield it from any public relations fallout, that might result from such an action. Moreover, the Fund could find itself in the uncomfortable position of being asked to waive its immunities. Finally, reliance on immunities in these circumstances might have an adverse effect on the Fund's efforts to mobilize support for other initiatives.

63. The above suggests that there could be adverse implications of the Fund approving a new arrangement immediately after a default. However, the alternative of allowing for an extended "cooling off" period following a default before providing support could lead to delays in the elaboration and implementation of adjustment policies and could thereby have an adverse effect on the value of creditors' claims.

64. The second set of issues raised by the possible extension of the 1989 modification to encompass sovereign bonds concerns whether it would be consistent with the objectives and principles regarding promotion of effective balance of payments adjustment and safeguarding the Fund's resources that underlie the existing arrears policy.

65. With respect to balance of payments adjustment, early Fund support for the implementation of adjustment programs would be intended to overcome the market failure associated with a failure of collective action by bondholders, and to promote balance of payments adjustment during possibly protracted negotiations with creditors. Moreover, through its catalytic role, early Fund support would be intended to help mobilize support from other sources.

66. There is, however, a risk that the accumulation of arrears to holders of *international sovereign bonds* would result in a swirl of litigation by individual creditors, which would likely have an adverse impact on the member's adjustment program. Holders of distressed debt could try to attach those government assets that are not protected by sovereign immunity or, in the case of bonds issued by central banks that contain explicit waivers of immunities, official reserves. While such reserves would presumably be minimal immediately following a default, rebuilding reserves would be an important objective of an adjustment program. Patient creditors may be willing to wait for the initial liquidity crisis to pass before trying to attach assets.

67. As discussed above, creditors could also try to attach the proceeds of official borrowing from international capital markets as a means of applying pressure for a favorable settlement. Such litigation would likely preclude a resumption of market access, and would

place the burden of providing new money (as distinct from financing in the form of arrears) on official creditors until a negotiated agreement had been reached with all bondholders.[36] While countries' ability to raise new money from capital markets would presumably be limited immediately following a default, litigation could delay a resumption of market access. This would erode the catalytic effect of Fund involvement (particularly under successor arrangements) and could undermine the authorities' continued ability to implement adjustment programs. There is thus some doubt whether early Fund involvement following a default on international bonds could serve to promote balance of payments adjustment as effectively as it has in the case of arrears to commercial banks.

68. With respect to safeguards, against the background of legal remedies available to holders of international sovereign bonds, there are also doubts regarding whether it would be possible to obtain adequate financing assurances in the event of a country defaulting on bond liabilities. The ability of creditors to accelerate principal and seize assets, including the proceeds of loan disbursements, suggests that there would be considerable uncertainties regarding both the magnitude of financing requirements and the availability of external financing. Accordingly, unlike the fairly orderly and relatively predictable environment that existed when the Fund tolerated arrears to commercial banks, in the case of arrears to bondholders the strong potential for litigation would make it very difficult to obtain adequate assurances that the financing requirement during the period of the arrangement would be met. Moreover, as discussed in the previous chapter, given the differences between bondholders and commercial banks, there is a risk that, even in the absence of litigation, negotiations could reach a stalemate, which would raise doubts concerning the member's ability to regain external viability and its capacity to repay the Fund. There is a question, therefore, whether the requirement of adequate safeguards for the use of Fund resources (Article V, Section 3) would preclude the Fund from making its resources available in such circumstances.

69. In sum, in the absence of features which served to ensure that the process of renegotiation with commercial banks remained reasonably orderly and allowed agreements to be reached within reasonable periods, there are doubts whether the objectives and principles of the Fund's arrears and financing assurances policies, including the 1989 modification, would be met if those policies were extended to holders of international sovereign bonds (or to other external obligations that do not have the characteristics of syndicated bank loans discussed in Section III above).[37] As modern experience with sovereign bond defaults is

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[36]In contrast, a number of countries with unresolved arrears to commercial banks were able to mobilize resources from private capital markets ahead of agreements in principle on restructurings.

[37]In contrast, with respect to *domestic sovereign bonds*, there would appear to be no danger that litigation by such creditors could derail a program. Accordingly, an extension of the scope of the 1989 modification to cases in which a member has unresolved arrears on domestic

(continued...)

extremely limited, it is impossible to predict with certainty whether a default on sovereign bonds would lead to an unacceptably disorderly situation. Nevertheless, the analysis presented in this paper strongly suggests that there is a significant danger that disruptive and litigious behavior by dissident creditors could lead to a protracted stalemate.

70. Against this background, a possibility would be for the Fund to extend the modified financing assurances and arrears policies in a manner that attempts to take particular account of these risks. The Fund could consider, on a case–by–case basis, approving arrangements before agreement in principle had been reached on a bond restructuring. To help ensure that such a policy is not viewed by financial markets as weakening members' obligations to their creditors, it would seem desirable for the Fund to approve arrangements only when the sovereign was judged to be making a good faith effort to regularize creditor relations. As with arrangements for members negotiating with commercial banks, purchases under such an arrangement could be conditioned on financing reviews. The reviews could, inter alia, provide an opportunity for the Executive Board to form an assessment of the threat to the adjustment efforts posed by ongoing litigation and allow the Fund to suspend purchases if it was judged that creditor relations had become too disorderly. This could be seen as a flexible and pragmatic response, which attempted to strike a balance between the provision of effective balance of payments adjustment on the one hand, and safeguarding the Fund's resources on the other. A serious shortcoming, however, would be that the Fund could not be confident that litigation would not derail the program, even if the implementation of economic policies was fully satisfactory. Moreover, even in the absence of extensive litigation, there would be considerable uncertainty regarding whether an agreement could be reached in a reasonable period.

V. Improving Existing Mechanisms for Resolving Sovereign Liquidity Crises

71. The analysis in earlier chapters suggests that the possible approaches for the Fund to support a member facing a sovereign liquidity crisis which could potentially result in a default on international sovereign bonds or certain other debt instruments would have important shortcomings in some circumstances. In many respects, this assessment was anticipated by Directors in an earlier discussion. While Directors considered that existing mechanisms for handling official bilateral debt—the Paris Club—and medium– and long–term commercial bank claims—the London Club—had worked well, many of them were less confident that

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[37](...continued)
bonds, but ***not*** international bonds, could allow the Fund to *promote effective balance of payments adjustment* while providing adequate *safeguards for the Fund's resources.*

forbearance on the part of holders of bonds could be achieved.[38] As noted above, most Directors believed that in some circumstances countries might be obliged to impose a moratorium on certain debt–service payments while seeking to reschedule their obligations, and that consideration should be given to improving existing mechanisms for rescheduling bonds. Most Directors also considered that, if a suspension of payments on certain debt–service obligations was an essential element of resolving a crisis, it should be supported by the international community. While many Directors considered that the possible rush for the exits and the problems of market failure could justify official intervention in this area, others considered that these phenomena were an essential element of the market process and should be allowed to take their course.

72. The legal remedies available to bondholders should provide powerful incentives for countries to implement adjustment policies to avoid the possibility of a default, thereby helping to ensure the efficient operation of the international monetary system. An effective means for penalizing defaults is in the joint interests of both borrowers and lenders; without such penalties, creditors would not have reasonable assurances that debts would be repaid and the market for sovereign debt would be unlikely to function efficiently. Accordingly, it is critically important to ensure that any mechanisms designed to help individual members do not undermine the efficient operation of international capital markets, which would be to the detriment of borrowers and lenders alike.

73. Consideration could be given to improving existing mechanisms with a view to achieving a more orderly resolution of sovereign liquidity crises, while paying particular attention to the danger that, by reducing the disincentives for default, such mechanisms may be perceived as giving rise to moral hazard and thereby adversely affecting the efficient operation of the international monetary system. Such an approach could be justified if it were considered that the failure of collective action represented a market failure, and that the benefits of the Fund having effective instruments to fulfill its mandate for promoting effective balance of payments adjustment, including for members which had defaulted on sovereign bonds, outweighed the costs associated with a possible weakening of incentives for members to avoid default.

74. Against this background, this chapter examines three options that might facilitate a speedy resolution of crises in a manner that would allow the Fund to support effective balance of payments adjustment with adequate safeguards for its resources. Section A considers a recommendation from the G–10 working party report that legal provisions of new bond contracts should be modified so as to facilitate orderly renegotiations. Section B provides a brief summary of the views expressed in the G–10 working party report regarding a sovereign bankruptcy mechanism and in the earlier Board discussion of this issue. Finally, Section C provides a preliminary discussion of a mechanism that would impose a temporary stay on creditors' ability to seek redress through litigation.

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[38]BUFF/96/17.

A. Modification of the Legal Provisions of Sovereign Bond Contracts

75. The G–10 Deputies' report recommended that new provisions should be introduced voluntarily in sovereign bond contracts. Specifically, contracts should include provisions for: (i) the collective representation of debt holders; (ii) qualified majority voting to alter the terms and conditions of the debt contract; and (iii) the sharing of proceeds among creditors. The introduction of such terms would address a number of the issues discussed in Section III, and would tend to facilitate the process of renegotiation. In effect, it would make renegotiation of sovereign bonds similar to the renegotiation of sovereign commercial bank debt, in terms of the risks of litigation and a stalemate in negotiations. In particular, the introduction of sharing clauses, and the ability legally to require individual bondholders to accept a modification to the terms of bond contracts agreed by a qualified majority, would severely limit the ability of free riders to derail the process of negotiation through aggressive litigation. The introduction of such provisions could serve to strengthen the prospect for a cooperative outcome to renegotiation, and to alter the pattern of secondary market trading in distressed debt as such bonds would presumably be less attractive to "vulture" creditors.

76. It should be noted that the introduction of such terms in *new* contracts would not address issues raised by *outstanding* bonds, which in the case of Brady bonds have residual maturities of up to 30 years. Moreover, the introduction of such terms into new bond contracts would in effect create what would possibly be interpreted a class of subordinated debt. In the event of a default, the remedies available to holders of these "new" bonds would be weaker than those available to holders of "old" bonds. While it is necessarily difficult to quantify the impact, it seems possible that markets would require an increased spread on such bonds, thereby raising the cost of borrowing, particularly for marginally creditworthy borrowers. (As noted above, if there is a bias in the system that makes spreads too low, this could be in part a desirable outcome.)

77. Despite the recommendation, a number of recent bond issues by both developed and developing countries do not contain such provisions. Indeed, there are indications that the members of the International Primary Market Association, an organization representing banks that arrange and underwrite new issues, opposes any change in the terms of bond contracts that may be seem as enhancing the possibility of a borrower defaulting. Also, it may be noted that industrial countries have not modified the terms of their own debt instruments. Nevertheless, the introduction of such terms in new contracts could, over time, make an important contribution to the orderly resolution of sovereign liquidity crises. For this reason, the incorporation of such terms into new bond issues warrants careful consideration by developing and transition country borrowers, notwithstanding the possibility that it could result in a somewhat higher cost of borrowing, particularly for marginally creditworthy sovereigns. If such an approach were favored by the international community, a place to begin the introduction of such terms might be with bond issuance by major industrial countries, together with signals from the international community that this would be useful elsewhere.

B. Sovereign Bankruptcy Mechanism

78. The G–10 Deputies' report examined the feasibility of a sovereign bankruptcy mechanism. The report concluded that the establishment of a formal international bankruptcy procedure would not be feasible or appropriate under present circumstances or in the foreseeable future (Box 3).

79. Previous Board papers have also examined both the policy and legal aspects of an international debt adjustment mechanism.[39] Under a mandatory approach, it has been suggested that such a mechanism could apply legally binding procedures resembling the bankruptcy provisions of national laws to all international and domestic sovereign debts. The mechanism could be established either through an amendment of the Fund's Articles, or through the establishment of a separate international organization. It could involve a number of powers. First, once the debt adjustment process has been initiated, an automatic stay would come into effect which would restrain creditors from litigating against the borrower. Second, the mechanism would oversee the preparation of a debt adjustment plan. Following approaches taken by various national laws, responsibility for the preparation of such a plan could be given to the mechanism or to the debtor. Third, after the debt adjustment plan had been accepted by qualified majorities of classes of creditors, the mechanism could make the plan.legally binding on the debtor and all creditors.

80. During their informal discussion,[40] Directors were cautious—and most were negative—about proposals for establishing a formal international debt adjustment mechanism. Directors were concerned that, if such a mechanism were seen as making it easier for troubled debtors to restructure their debts without significant costs, international capital markets might raise the cost of capital to a broad range of members. Moreover, proposals in this area would have to balance the need for speedy resolution of individual crises with that of protecting the contractual rights of creditors. Directors also recognized that large–scale financial assistance to troubled debtors, or mechanisms to give relief on debt obligations at little cost to the debtor, had the potential to create moral hazard for debtors. They considered that strict conditionality in the provision of assistance was the best safeguard against such moral hazards. However, they were also concerned about the moral hazard that applies to creditors, and generally wanted to maintain constructive ambiguity as to the amounts and speed with which assistance would be available to minimize this particular hazard.

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[39]See Note on an International Debt Adjustment Facility for Sovereign Debtors (EBS/95/90, 5/26/95) and Recent Proposals on International Debt Adjustment (SM/96/25, 2/2/96).

[40]BUFF/96/17.

Box 3. The G-10 View on a Formal International Bankruptcy Procedure

In May 1996, the Working Party of the G-10 concluded that the establishment of a formal international bankruptcy procedure would not be feasible or appropriate under present circumstances or in the foreseeable future. At the same time, the Working Party concluded that it is not possible or desirable to preclude official involvement altogether in the event of a serious crisis as the official community's interest in containing systemic risk, and its role as a lender to sovereign borrowers means that it has a role to play in fostering cooperative efforts by debtors and creditors to contend with unexpected payments problems.

In order to consider whether an international bankruptcy code would help resolve sovereign debt crises, the economic aims and operation of existing corporate insolvency procedures were examined. It was noted that these arrangements provide court assistance for the orderly treatment of the debts of insolvent private or, in some cases, local government entities. Although existing bankruptcy procedures differ across jurisdictions they have two basic economic purposes. First, by specifying ex ante the rules for distributing any partial or delayed payments, they reduce uncertainty and make it easier for markets to assess and price risk. Second, by providing the debtor with temporary protection from its creditors and access to interim finance, bankruptcy procedures enable an enterprise whose value as a going concern exceeds its salvage value to continue to operate. To this end, it may be necessary to provide the debtor enterprise with protection from creditors who wish to invoke remedies available to them individually and, at the same time, enable creditors to influence the management of the company, including the possible replacement of management.

Despite their advantages in a national context and some theoretical appeal by analogy in an international context, the Working Party noted the following difficulties in translating private bankruptcy procedures to cover sovereign debt: (i) it would be neither appropriate nor possible to replace the authorities of a sovereign state with "new management" or to take possession of a state's noncommercial property; (ii) the need for additional protection from creditors has not been a serious problem as the seizure of assets has not been a serious problem in the past; (iii) any international solvency convention would involve a long and cumbersome negotiating process; and (iv) many of the desirable results could be achieved in more informal ways. Approaches based on arbitration and mediation were also found to be infeasible due to concerns relating to consensus and enforceability, respectively.

C. A Temporary Stay on Creditor Litigation

81. During the discussions of the G–10 Deputies on the resolution of sovereign liquidity crises, the question was raised as to whether the Fund already has the legal authority to impose a mandatory temporary stay on litigation against sovereigns through the operation of Article VIII, Section 2(b) of the Fund's existing Articles. This section first addresses the limitations on the feasibility of using Article VIII, Section 2(b) to fulfill this purpose and concludes that an amendment of the Articles would be needed to give the Fund such authority. It then provides a preliminary consideration of such an approach.

Feasibility of using Article VIII, Section 2(b)

82. The relevant text of Article VIII, Section 2(b) is as follows:

> "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

83. The use of this provision as a means of imposing a mandatory stay of enforcement actions in the context of sovereign defaults was discussed in a report prepared by the staff for the G–10 on November 28, 1995, and circulated to the Board (as EBS/96/26) with minor changes on February 22, 1996, the relevant section of which is reproduced in Appendix V. On the basis of the analysis provided there, the following observations may be made regarding Article VIII, Section 2(b) in the context of temporary stays on sovereign debt.

84. The meaning of Article VIII, Section 2(b) has not been interpreted uniformly by the courts of the Fund's various members. Under the narrow interpretation, which prevails in the United States and the United Kingdom, the term "exchange contracts" has been interpreted in such a way that Article VIII, Section 2(b) is not applicable to credit agreements. Under the broad interpretation that prevails in a number of other jurisdictions, the Fund's temporary approval of restrictions imposed on loan repayments that fall within its jurisdiction (interest payments and moderate amortization of principal) will result in an automatic stay on creditor actions relating to the arrears arising from such restrictions. Such a stay would lapse upon the expiration of Fund approval.

85. As has been discussed on previous occasions, uniformity of interpretation under the existing Articles could be achieved through the an authoritative interpretation adopted by the Fund. However, even if the Fund were to adopt the broad interpretation described above, there are several reasons why the existing provision would not be a an effective means of implementing a temporary stay on litigation against sovereigns.

86. First, an objective interpretation of Article VIII, Section 2(b) based on the Fund's understanding of what constitutes exchange controls would not support the conclusion that a

sovereign debtor's default on its external debt is an "exchange control regulation" that would be protected by this provision. This is because sovereign defaults have been treated by the Fund as proprietary acts rather than regulatory measures of general applicability. For this reason, governmental defaults are not treated as exchange "restrictions" under Article VIII, Section 2(a) and, therefore, do not give rise to a breach of a member's obligations under the Articles.

87. Second, even if the expression "exchange control regulation" could be interpreted as including a sovereign default, under the existing Articles, Fund approval could not be used as a means of imposing a temporary stay on the capital portion of the arrears (e.g., the bullet repayment of principal). There are only two ways in which this capital portion could be treated under an authoritative interpretation. Controls on capital repayments could be considered as ***always*** being "consistent" with the Articles—regardless of the Fund's views on the appropriateness of the control—by virtue of the fact that the Articles specifically give members the right to maintain such controls under Article VI, Section 3.[41] Alternatively, the term "consistent" with the Articles could be interpreted more narrowly as only including restrictions that have been approved by the Fund under Article VIII, Section 2(a), i.e., restrictions on current payments and transfers.[42] Under this interpretation, therefore, controls on capital repayments would ***never*** be "consistent" with the Fund's Articles. Neither of these interpretations would enable the Fund to apply Article VIII, Section 2(b) in such a way that would enable capital arrears to be temporarily protected on a selective basis, i.e., only in situations where the Fund judged that arrears in question were justified while other corrective actions were being implemented.

88. Third, although an authoritative interpretation of the Fund is binding on all members, one could not be entirely certain that the courts of members would be prepared to give it effect. There would be particular uncertainty in jurisdictions where courts have given a narrow and, therefore, very different interpretation of this provision.

89. If the Articles are amended to give the Fund jurisdiction over capital movements, the second of the three problems identified above would be resolved by virtue of the fact that restrictions on capital movements would be consistent with the Articles only if they had been approved by the Fund. However, the first problem discussed above would continue to exist since Article VIII, Section 2(b) would still not apply to proprietary acts. The third problem would also not be resolved because of the continued possibility that courts would not apply the authoritative interpretation.

90. Accordingly, if it were considered desirable to establish a mechanism which would allow the Fund to impose a temporary stay on litigation against a sovereign, one approach

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[41]This is the approach followed by the French courts.

[42]This is the interpretation that has been recently adopted by the German courts.

would be to amend Article VIII, Section 2(b) to provide that, following a decision by the Fund, claims arising from sovereign defaults would be unenforceable during the period specified in that decision. If such an amendment were considered desirable, it would be for consideration as to whether the Fund, through a similar procedure, should also have the authority to impose a temporary stay on actions against nonsovereign debtors when their default is caused by the imposition of exchange controls that are consistent with the Fund's Articles.[43]

91. If sovereign defaults are to be covered by a modified Article VIII, Section 2(b), a determination will need to be made as to whether such defaults will encompass defaults of subnational entities. Moreover, inclusion of sovereign defaults under Article VIII, Section 2(b) would raise the question of whether such defaults should, absent approval, also constitute a breach of a member's obligations under the Fund's expanded jurisdiction.

92. To ensure that the mechanism could be activated only with broad support among the membership, the amendment could specify that a qualified majority would be needed to take the decision (e.g., 70 percent or 85 percent of the total voting power). To limit the impact of moral hazard, consideration could be given to limiting the activation of the mechanism to circumstances in which the member was: (i) negotiating in good faith or implementing an adjustment program supported or endorsed by the Fund; and (ii) actively engaged in good faith negotiations with its creditors on the rescheduling of its claims. Consideration could also be given to requiring debtors to continue to make at least partial interest payments during the stay.

93. If it is decided that Article VIII, Section 2(b) should *not* provide the Fund with the authority to impose temporary stays on creditor litigation (whether sovereign or otherwise), it may be preferable to take advantage of the proposed amendment regarding capital movements by amending the text of Article VIII, Section 2(b) so as to reflect this intent clearly. As has been noted in a previous paper,[44] in the absence of any revision of the text, the existing ambiguity and confusion within the Fund's membership regarding the applicability of this provision to loan repayments will only be exacerbated following an extension of the Fund's

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[43] To the extent that the control is subject to approval under the Fund's jurisdiction, this could involve a two–step procedure. First, the Fund would decide whether to approve the exchange restriction in question; such approval (which would be taken by majority of votes cast) would render the control consistent with the member's obligations under the Articles. Second, if such approval is granted, a subsequent decision could be taken (perhaps by a qualified majority) to grant a temporary stay on creditor actions.

[44] SM/97/173 (7/1/97), pp. 7–8.

jurisdiction over capital movements.[45] Whether such a limiting revision to the text of Article VIII, Section 2(b) should actually take the form of a complete deletion of the provision would depend on whether the membership believes that the retention of Article VIII, Section 2(b) may be beneficial in contexts other than that of a temporary stay. This issue will be addressed at a later stage of the discussions on the proposed amendment.

94. The intent of a mandatory stay would be to require creditors to exercise the same degree of forbearance that official creditors and commercial banks exercised on a voluntary basis throughout the debt crisis. This could pave the way for the Fund to approve an arrangement with a member with unresolved arrears on sovereign bonds, when prompt support is judged to be essential for the successful implementation of the member's adjustment program, without the risk that the program would be derailed through bondholder litigation.

Preliminary consideration of such a mechanism

95. A temporary stay, though more modest than the establishment of a full bankruptcy mechanism (discussed above), would be a major step. Consideration of such a mechanism would give rise to a number of questions and difficulties, some of which are discussed briefly below.

96. *Would a temporary stay help to encourage an orderly renegotiation process?* It may be noted that legal mechanisms which give temporary stays on litigation against private sector entities have facilitated the restructuring of private debt. In some cases, creditors have recognized that litigation would not be cost effective as it would result in a borrower seeking the protection of a bankruptcy court, and debts (including junk bonds) have been restructured without the activation of bankruptcy procedures. By the same token, the availability of a mechanism to enforce a temporary stay on litigation with respect to sovereign bonds could discourage disorderly behavior, possibly without the need to activate the mechanism, and

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[45]With respect to those members that adopted a broad interpretation of this provision, the extension of Fund jurisdiction to cover capital movements would mean that restrictions imposed on the capital portion of loan repayments (i.e., bullet repayments of bonds or loans) would result in a temporary stay if they have received Fund approval. However, for these members, an extension of Fund jurisdiction would give rise to new problems regarding the meaning of Article VIII, Section 2(b). Since an unrevised Article VIII, Section 2(b) would only be applicable to restrictions on capital movements that are "exchange controls," the question would arise as to whether "exchange controls" would be limited to capital payments and transfers or would also embrace underlying capital transactions and, if so, which transactions.

could thereby facilitate the orderly restructuring of such bonds.[46] A temporary stay would presumably diminish the attractiveness of distressed debt to secondary market "vulture" companies and therefore increase the likelihood that the claims would be held by creditors interested in orderly workouts.

97. A temporary stay on legal action by creditors would not permanently preclude dissident bondholders from enforcing their contractual rights and suing; creditors would be able to seek legal redress after the temporary stay expired. In this sense, it would represent a "shield but not a sword." However, this does not mean that negotiations would necessarily become disorderly, as debt instruments subject to temporary stays would presumably not be held by investors interested in obtaining quick capital gains through litigation.

98. *What impact would the activation of the mechanism have on the members' access to new financing?* In order to facilitate access to new spontaneous and concerted financing in support of a member's adjustment efforts, consideration could be given to limiting the scope of a temporary stay to debt contracts entered into before a specified date which could be determined by the Executive Board on a case–by–case basis. Suits on loan contracts entered into after the "cut–off" date would not be stayed, which would help to provide creditors with an assurance that they would be serviced promptly, notwithstanding the ongoing negotiations with respect to pre–cutoff date debt. The adoption of a cut–off date in respect of a temporary stay would be comparable to the Paris Club policy of limiting the scope of potential reschedulings to pre–cutoff date debt. It would also be comparable to the practice in corporate financing, under which new loans committed after a company has filed for the protection of a bankruptcy court are given seniority over other unsecured liabilities. Similarly, the interests of existing creditors would be protected to the extent that adherence to a Fund supported program were made a condition for the continuation of the temporary stay.

99. *Could a temporary stay help the Fund obtain adequate financing assurances?* By ensuring that the process of debt renegotiation remained orderly, a temporary stay could help to provide the necessary financing assurances to enable the Fund to play an effective role in promoting balance of payments adjustment and catalyzing support from other creditors,

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[46]It should be noted that the imposition of a temporary stay should have no operational impact on the renegotiation of the claims of official bilateral creditors. Such negotiations are held under the auspices of the Paris Club or are conducted bilaterally. This is generally an orderly process which has stayed out of the courts. Suspending official creditors' ability to seek legal remedies is therefore unlikely to have any practical effect. By the same token, the effect on commercial bank renegotiations would be limited to preventing the few instances of small rogue creditors seeking redress through litigation. As such litigation is rare, a suspension of creditors' ability to seek legal remedies would likely have little effect on the conduct of negotiations. It should also be noted that a stay would have no effect on creditors' positions regarding domestic sovereign bonds which, as noted above, typically do not provide legal remedies in the event of a default.

thereby helping the member regain external viability and achieve sustainable growth. The duration of the temporary stay would presumably depend upon both the period required to reach agreement on a restructuring,[47] and continued implementation of appropriate policies. This raises questions regarding the circumstances in which the Fund would lift the temorary stay before agreement had been reached on a debt restructuring, as a result of policy slippages and the impact such a lifting of the safeguards for the Fund's resources.

100. *Could such a mechanism be designed to strike an appropriate balance between solving the immediate liquidity problems of a particular country and ensuring that international capital markets operate efficiently?*

101. The activation of a temporary stay mechanism in the context of a sovereign default would be intended to help ensure that the process of renegotiating sovereign bonds remains orderly. It would be designed only to give the member breathing space to elaborate and implement corrective policies and to negotiate a restructuring with creditors. On the one hand, it would protect the member from litigation by creditors that are interested in a short–term capital gain, rather than an orderly workout. On the other hand, it would serve to preserve the interests of bondholders as a group, in that it would: (i) prevent aggressive creditors from capitalizing on the forbearance of other creditors; and (ii) reduce the risks of a stalemate in negotiations, which would reduce the value of all creditors' claims; and (iii) strengthen the Fund's ability to provide early support for the implementation of macroeconomic stabilization policies. Indeed, the mechanism could be particularly helpful in protecting the claims of large institutional investors from the effects of litigation by rogue creditors.[48]

102. Nevertheless, creditors could be concerned that the use of such a mechanism would diminish the cost of a default to the member, thereby introducing moral hazard and increasing likelihood of default. Without an effective mechanism for enforcing penalties on sovereign debtors who default, creditors cannot have reasonable assurance that debts will be repaid, and the market for sovereign credit cannot function efficiently. This leads again to the point that the cost of borrowing could be increased.

103. While it is inevitably difficult to form a firm assessment of the likely extent of moral hazard, it may be noted that legal remedies available to creditors are not the only deterrent to a sovereign default. Members continue to meet their obligations to official bilateral and commercial bank creditors despite the absence of any threat of litigation, *inter alia*, to preserve access to new financing from these sources. There is a question whether the

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[47]It may be noted that negotiations with bondholders may be more protracted than with commercial banks—particularly for the initial cases.

[48]See M. Miller and L. Zhang, "A Bankruptcy Procedure for Sovereign States," Global Economic Institutions Working Paper, No. 34, University of Warwick, London, United Kingdom.

likelihood that international capital markets will be reluctant to reestablish access for sovereign borrowers which were not seen as having made major efforts to address emerging balance of payments pressures and to avoid a default, coupled with the likely adverse impact on the private sectors' access to foreign capital as well, could provide adequate incentives for members to avoid a default. It may also be noted that bankruptcy laws set a socially–determined limit on the destitution that can result from the enforcement of claims. There is a question of whether it would be desirable to limit the extent to which creditors are able to take actions destructive to the prosperity of debtor countries, notwithstanding the possible impact on the efficient operation of capital markets. Finally, it may be noted that the existence of such a mechanism would not provide members with a firm assurance that it would be activated in the event of a crisis; the absence of such an assurance would be underscored to the extent that activation required a qualified majority well in excess of 50 percent of the total voting power.

104. *Allowing the Fund to impose temporary stays on litigation could raise concerns regarding a conflict of interest between the Fund's role as a regulator and its position as a creditor.* The Fund already faces similar issues by virtue of its ability to approve a restriction on the making of current international payments and transfers.[49] Moreover, it is likely that a stay would be activated only in circumstances in which a member had lost spontaneous access to capital markets. By helping to provide adequate financing assurances, a temporary stay could pave the way for the Fund to provide possibly substantial resources in support of strong adjustment programs, thereby facilitating a normalization of creditor relations. Finally, requiring the support of a qualified majority in excess of 50 percent of the voting power for the imposition of a temporary stay would ensure that such stays could be imposed only with the broad support of the membership.

VI. Issues for Discussion

105. The paper has underscored that the Fund's primary role regarding sovereign liquidity crises focuses on prevention. Nevertheless, recognizing that such crises may occur on occasion, the paper has provided a preliminary consideration of a number of options for Fund involvement in a sovereign liquidity crisis.

- This paper has argued that in the absence of the legal and institutional factors which helped to keep negotiations of debtor governments with commercial banks orderly, there is a significant risk that a renegotiation with holders of international sovereign bonds could become disórderly, leading to a protracted stalemate. Do Directors agree? Directors may wish to comment on the application of the Fund's general financing assurances policy to arrears on sovereign bonds—which would delay the provision of

[49]It may be noted that similar issues could be raised by a possible extension of the Fund's jurisdiction to capital movements.

Fund resources until after agreement in principle had been reached on a bond restructuring.

- This paper has also argued that there is an important risk that an extension of the 1989 modification to the financing assurances and arrears policies to encompass international sovereign bonds could suffer from the serious shortcoming that the Fund could not be confident that litigation would not derail the program even if the implementation of adjustment policies was fully satisfactory. Directors may wish to comment.

- The legal remedies available to bondholders provide powerful incentives for debtors to adopt adjustment policies which will allow them to avoid a default, thereby enhancing the efficiency of the international monetary system. There is a risk, however, that these same remedies could limit the Fund's ability to support member's adjustment efforts following a sovereign liquidity crisis. In light of these competing considerations, the paper has discussed three possible ways of improving existing mechanisms for resolving sovereign liquidity crises. Directors may wish to comment on these possibilities:

  -- Modifying the terms of new bond contracts so as to facilitate a renegotiation.

  -- The establishment of a formal international bankruptcy procedure.

  -- Provision of the Fund with authority to impose a temporary stay on creditor litigation through an amendment to the Fund's Articles.

THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES

A Report to the Ministers and Governors
Prepared Under the Auspices of the Deputies

Executive Summary

1. Following an invitation to the Ministers and Governors of the Group of Ten by the Heads of State and Government of the Group of Seven in Halifax in June 1995, the Deputies of the Group of Ten established a working party to consider the complex set of issues arising with respect to the orderly resolution of sovereign liquidity crises. While taking a comprehensive view of the problem, the Working Party focused its attention on those forms of debt to private creditors, such as internationally traded securities, that have increased in importance in the new financial environment but that in the past have usually been shielded from payments suspensions or restructurings. In carrying out its work, the Working Party recognized that the highest priority needs to be given to measures that will help prevent crises from occurring and endorsed efforts underway in other forums to improve market discipline and strengthen the surveillance of sovereign borrowers' economic performance. It attached particular importance to the need for sovereign borrowers to make timely changes in their economic policies if conditions change in ways that may lead to reductions in capital inflows.

2. After careful review of analyses of the full range of questions involved, and taking into consideration surveys of the views of market participants and of legal practices relating to collective representation of debt holders that were conducted by its members for this purpose, the Working Party reached the following broad conclusions.

- First, it is essential to maintain the basic principles that the terms and conditions of all debt contracts are to be met in full and that market discipline must be preserved. However, in exceptional cases, a temporary suspension of debt payments by the debtor may be unavoidable as part of the process of crisis resolution and as a way of gaining time to put in place a credible adjustment programme.

- Second, neither debtor countries nor their creditors should expect to be insulated from adverse financial consequences by the provision of large-scale official financing in the event of a crisis. Markets are equipped, or should be equipped, to assess the risks involved in lending to sovereign borrowers and to set the prices and other terms of the instruments accordingly. There should be no presumption that any type of debt will be exempt from payments suspensions or restructurings in the event of a future sovereign liquidity crisis.

- Third, current flexible case-by-case practices and procedures, as they have evolved over the years, are an appropriate starting point for approaches to sovereign liquidity

crises. They emphasize the importance of adjustment efforts of the debtor country and place principal responsibility for workouts on the debtors and creditors, with the debtor country having primary responsibility for setting the process on a co–operative footing. Improvements in practices and procedures should continue to be evolutionary.

- Fourth, international bankruptcy procedures and other formal arrangements do not appear to provide, in current circumstances or in the foreseeable future, a feasible or appropriate way of dealing with sovereign liquidity crises. However, further study by private sector entities may be warranted.

- Fifth, further consideration should be given in appropriate forums to ways in which financial systems in emerging market economies could be strengthened in order to reduce the risks they might pose in the event of a sovereign liquidity crisis.

- Sixth, a market-led process to develop for inclusion in sovereign debt instruments contractual provisions that facilitate consultation and cooperation between debtors and their private creditors, as well as within the creditor community, in the event of crisis would be desirable. Market initiatives would deserve official support as appropriate.

- And seventh, note was taken of current policies of the IMF that provide, under exceptional circumstances, for lending in support of effective adjustment programmes prior to full and final resolution of a sovereign borrower's arrears to private creditors. It would be advisable for the IMF Executive Board to review existing policy in this area and to consider whether the scope of its application should be extended to other forms of debt not now covered, while remaining mindful of the need for prudence and the maintenance of strict conditionality.

3. The thinking of the Working Party was influenced by three basic changes in the financial environment bearing on the character of potential future sovereign liquidity crises. First, the broader and stronger linkages among domestic and international financial markets mean that crises can erupt much more quickly in today's markets and can be far larger in scope than in the past. Second, flows of capital to emerging market economies in the form of purchases of securities have increased greatly in size over the years and have substituted for other types of private capital. Third, when a crisis occurs new finance is unlikely to be forthcoming from those who undertook the original lending. These changes mean that financing available from official sources is less likely to be sufficient to enable a sovereign debtor experiencing a crisis to meet fully its external financing obligations. In any event, the Working Party stressed that provision of official funds to limit private losses raises serious moral hazard risks and could interfere with market discipline.

4. In considering means to deal with future sovereign liquidity crises, the Working Party was of the view that no single pre-set procedure can be suitable in all cases. However, it identified a broad set of desirable principles and features that provide a framework for the development of procedures for handling sovereign liquidity crises in a flexible, case-by-case

approach in light of the conditions prevailing at the time, the nature and the intensity of the crises, and the circumstances of the debtor. Any such procedure should have the following features.

- It should foster sound economic policies by all debtors.
- It should minimize moral hazard for both creditors and debtors.
- It should rely on market forces and not interfere with the efficient operation of secondary markets in relevant debt instruments.
- It should limit contagion from one debtor's problems to other countries.
- It should support credible and sustainable actions and, to this end, not impose excessive social, political, or economic costs on the debtor.
- It should seek to ensure that burdens associated with the provision of exceptional financing are allocated fairly within and across different classes of creditors.
- It should strengthen the ability of governments to resist pressures to assume responsibility for the external liabilities of their private sectors.
- It should be suitable for quick and flexible use in a variety of different cases.
- It should be cooperative and non-confrontational, and promote the adoption by debtors and creditors of arrangements to facilitate resolution of liquidity crises should they occur.
- It should build on existing contractual or other arrangements that facilitate the resolution of crises.
- It should make use of existing practices and institutions.

5. The Working Party concluded that the establishment of a formal international bankruptcy procedure would not be feasible or appropriate under present circumstances or in the foreseeable future. Sovereign debtors have not in the past had a strong need for legal protection against their creditors, nor could they be obligated to submit to the jurisdiction of a bankruptcy forum. However, the Working Party noted that interested private parties might wish to continue to study the merits of bankruptcy or other formal procedures. At the same time, the Working Party concluded that it is not possible or desirable to preclude official involvement altogether in the event of a serious crisis. The official community's interest in containing systemic risk and its role as a lender to sovereign borrowers mean that it has a stake, and therefore a role to play, in fostering cooperative efforts by debtors and creditors to contend with unexpected payments problems.

6. In considering specific ways to facilitate resolution of sovereign liquidity crises, the Working Party took the view that current practices are an appropriate starting point. Current practices were developed over the course of the past few decades to contend with real world problems in a pragmatic and flexible manner. They are voluntary and make use of market information and market forces. The practices recognize the distinct perspectives of the three main actors involved in a crisis - the official community, private creditors, and the sovereign debtor - as well as their common interest in the orderly resolution of the crisis. They involve national authorities and multilateral institutions but place principal responsibility on the individual debtor and its creditors. The practices are based on the implementation of an IMF-supported sustainable adjustment programme as a major precondition for the cooperative resolution of a crisis.

7. The Working Party recognized that structural weaknesses in the banking systems of debtor countries could seriously aggravate liquidity crises and might pose difficulties for financial systems in lender countries. The Working Party concluded that further work should be undertaken in appropriate international forums to promote the strengthening of financial system in emerging market economies and thus help to reduce such risks.

8. The Working Party took the view that certain contractual or statutory provisions governing debt contracts can facilitate the resolution of a crisis by fostering dialogue and consultation between the sovereign debtor and its creditors and among creditors, and by reducing the incentive for, or ability of, a small number of dissident creditors to disrupt, delay or prevent arrangements to support a credible adjustment programme that is acceptable to the vast majority of concerned parties. Among such provisions are those that (a) provide for the collective representation of debt holders in the event of crisis, (b) allow for qualified majority voting to alter the terms and conditions of debt contracts, and (c) require the sharing among creditors of assets received from the debtor. Such clauses have been employed in a limited set of debt contracts. The Working Party emphasized that evolution of contractual arrangements between sovereign borrowers and their creditors needs to be a market-led process if it is to be successful. Such efforts should receive official support as appropriate.

9. The Working Party strongly endorsed the fundamental principle that the terms and conditions of all debt contracts are to be met in full and on time. At the same time, it recognized that in certain exceptional cases the suspension of debt payments may be a necessary part of the crisis resolution process. Such payment suspensions should be non-confrontational and implemented in a way that does not hamper the operation of secondary markets. The Working Party did not consider that it would be feasible to operate any formal mechanism for signaling the official community's approval of a suspension of payments by the debtor. Although the Working Party rejected any formal international approval of a suspension of debt payments, it concluded that it would be advisable for the IMF Executive Board to consider extending the scope of its current policy of lending, in exceptional circumstances, to a country that faces the prospect of continuing to accumulate arrears on some of its contractual debt-service obligations to private sector creditors, in cases where the country is undertaking a strong adjustment programme and making reasonable efforts to

negotiate with its creditors. Such lending can both signal confidence in the debtor country's policies and longer-term prospects and indicate to unpaid creditors that their interests would best be served by quickly reaching an agreement with the debtor.

10. The Working Party reached the overall conclusion that there is no need to change current procedures for official bilateral credits and long-term bank claims. However, there is a need for the principles and procedures for handling sovereign liquidity crises to take into account the new importance of debt in the form of securities and the growing likelihood that some such debt may have to be subject to renegotiation in the future. While the official community may be able to facilitate dialogue and assist in data collection, market participants should make the decisions regarding any innovations in contractual provisions. The official community's primary role in the resolution of sovereign liquidity crises should remain centred on the promotion of strong and effective adjustment by debtor countries in the context of IMF-supported programmes, which would need to take into account any recourse to temporary suspensions of payments.

THE EVOLUTION OF THE EXISTING POLICY ON EXTERNAL PAYMENTS ARREARS AND EXPERIENCE UNDER THE MODIFIED ARREARS AND FINANCING ASSURANCES POLICIES

1. This Appendix provides an overview of the evolution of the arrears policy, including an analysis of the underlying basis of both the original policy and the 1989 modification, and a summary of experience under the modified arrears and financing assurances policies. Until 1989, the Fund implemented a policy of making the elimination of existing arrears and the nonaccumulation of new arrears general conditions for the availability of its resources. Following the 1989 modification, the Fund has supported programs that tolerate the accumulation of arrears to commercial banks pending the negotiation of a voluntary market restructuring agreement; to that extent, the Fund has been willing to "lend into arrears." The Fund's arrears policy is closely related to its policy on financing assurances. During the 1980s, the nontoleration of arrears became an important means of ensuring that creditors provided the necessary financing in the form of new money for Fund-supported programs. Indeed, the requirement that programs had to be fully financed (including the clearance of arrears) meant that creditors would have to wait for their money, unless they agreed to help the member clear its arrears. The 1989 modification of the arrears policy was, in large part, a necessary consequence of the Fund's revision of its policy on financing assurances, under which approval of an arrangement can be granted before the banks have provided assurances as to their willingness to support a financing package that is consistent with the assumptions of the program.

A. The Basis of the External Payments Arrears Policy

2. The legal basis of the external payments arrears policy is found in Article V, Section 3, which directs the Fund to "adopt policies on the use of its general resources. . .that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund." Because this language incorporates by reference all of the relevant provisions of the Fund's Articles, including the Fund's purposes, the basis for this policy is relatively broad. Over the years, two principles have had an important effect on the scope and objectives of this policy. [1]

3. *Effective balance of payments adjustment*—The arrears policy was conceived as a means of helping to ensure that members resolve their balance of payments problems "without resorting to measures destructive to national and international prosperity" (Article I(v)).

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[1]These principles have also been applied with respect to ESAF arrangements.

When the arrears policy was initially defined in 1970,[2] the Fund recognized that the incurrence of arrears by a member was perhaps the most disorderly and, therefore, the most destructive way in which a member could respond to balance of payments pressures. With respect to its own *national* prosperity, a member incurring arrears makes access to spontaneous financing all the more difficult, thereby exacerbating its balance of payments problems in the long term. As regards *international* prosperity, arrears can have an adverse impact on the international trade, payments, and monetary systems. Indeed, the systemic implications of arrears became a central consideration with the emergence of the debt crisis in the early 1980s. Accordingly, by providing support for programs that call for the nonaccumulation and elimination of arrears, the Fund not only assists the member in question to return to external viability, it also contributes to the orderly functioning of international capital markets, thereby deepening the access of members following sound policies.

4. ***Safeguarding the Fund's resources***—The debt crisis also highlighted the importance of a second principle: the requirement set forth in Article V, Section 3 that the Fund "establish adequate safeguards for the temporary use" of its resources. In an environment where commercial banks were trying to limit their exposure to heavily-indebted countries, the Fund could no longer assume that these banks would be willing to assist spontaneously in the financing of Fund-supported programs for these countries. Additional financial support from creditors was viewed as an essential complement to Fund support.

5. Against this background, the Fund developed a policy on financing assurances, which became closely related to—and had an important influence on—the Fund's policy on external payments arrears. Under the policy on financing assurances, the Fund required that, as a prior condition to the availability of its own assistance, other creditors (official and private) furnish specific assurances that they would provide the necessary support (either through new loans or refinancing) to fill the estimated gaps in the financing of the program on terms consistent with the member's return to external viability. Given the fact that there were limits both to the degree of adjustment that could be undertaken by a member, and the amount of financing that could be provided by the Fund, the absence of such financing assurances would undermine both the viability of the program and the member's capacity to repay the Fund.

6. The Fund's arrears policy is complementary to the financing assurances policy. Because of the limitations to financing and adjustment described above, an important element of the financing assurances policy has been burden sharing among official and private creditors. It was recognized, however, that creditors would be willing to provide the necessary support to fill any financing gaps only if the program provided for the elimination of arrears. Moreover, beyond the period of the program, concern over the member's ability to repay the Fund would be alleviated only if the member were making progress in re-

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[2]Decision No. 3153-(70/95), adopted October 26, 1970, *Selected Decisions, Twenty-First Issue*, pp. 67-68.

establishing relations with its creditors, and if the terms of new financing and refinancing were consistent with a return to external viability.

7. While in principle the application of the Fund's policies on arrears and financing assurances has required that all private creditors participate in burden sharing, small private creditors with relatively small exposure (for example, bondholders and uninsured suppliers) have generally been excluded from this requirement for practical reasons. Until now, the key private creditors that have been expected to provide the necessary financing have been commercial banks. As is discussed in the next section, the modification of the policy that took place in 1989 was necessitated by problems that arose in applying this policy to commercial banks.

B. The 1989 Modification of the Arrears Policy With Respect to Commercial Banks

8. During the early stages of the debt crisis, the application of a policy that made the nonaccumulation and elimination of arrears a general condition for the availability of the Fund's resources served to support all of the principles and objectives discussed above. With respect to arrears to commercial banks, the manner in which this policy was implemented was guided by the Fund's policy on financing assurances.[3] Specifically, under the Fund's financing assurances policy, approval of a Fund arrangement became conditioned on the Fund receiving assurances from commercial banks that the necessary external financing would be provided in the form of new loans or reschedulings (or both) to fill any financing gap in the program. These assurances often took the form of a notification from the banks' advisory committee to the Fund that the terms of the proposed financing package would be acceptable to the banks.[4]

9. Regarding the stock of arrears to banks existing at the time of the approval of the arrangement, the Fund adopted the convention that, upon the receipt of assurances from banks that sufficient financing would be available to eliminate arrears during the period of the arrangement in a manner that was in accordance with program assumptions (through some combination of new loans used to pay interest, and rescheduling of principal), the amounts to

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[3] With respect to official creditors, this policy was implemented primarily in the context of the Paris Club negotiations. As noted in paragraph 2 of the introduction, aspects of the Fund's arrears policy as applied to official creditors will be discussed in a forthcoming paper.

[4] In cases where the program required new lending, the Fund agreed to proceed with an arrangement after notification by the advisory committee that the proposed agreement had the support of a "critical mass" of banks. This was generally taken to mean the agreement of banks holding 90 percent of banks' total exposure. In some cases where delays were encountered, especially where new loans were involved, a Fund arrangement would be approved "in principle", only to become effective upon the receipt of the necessary notifications from the banks. This was an attempt to provide an early endorsement for a member's adjustment efforts, while encouraging banks to finalize the financing package.

be rescheduled or refinanced would not be classified as arrears for purposes of the program or the performance criteria in the arrangement, notwithstanding the fact that they technically would continue to constitute arrears until the necessary legal documents were finally agreed upon.[5] Regarding interest falling due pending rescheduling or refinancing, the banks generally required that such amounts be paid on a timely basis. The program would provide for such payments, and the failure of the debtor member to comply would constitute a nonobservance of the performance criterion regarding the nonaccumulation of new arrears.[6]

10. The success of the Fund's policies on arrears and financing assurances in the early 1980s was attributable, in part, to commercial banks' recognition that cooperation in the financing of Fund-supported programs was in their self interest. In view of the magnitude of their exposure (and the exposure of other banks with whom they had market links), banks were aware that they had to assume part of the burden of dealing with this crisis in order to maintain or enhance the value of their claims. Moreover, many (though not all) banks were interested in a long-term involvement in growing economies and in maintaining their involvement in the development of businesses in these countries.

11. By the late 1980s, however, commercial banks had become increasingly reluctant to provide the financing assurances that the Fund required. This unwillingness—which resulted in growing delays in Fund support for adjustment programs—was attributable to a variety of reasons, not least of which was the strengthening of banks' balance sheets. Having weathered the period of acute crisis in the early 1980s, commercial banks accumulated substantial loan-loss provisions against claims on countries with debt-servicing problems.[7] With the threat of insolvency greatly reduced, banks were less willing to provide new money. At the same time, a growing recognition that the difficulties faced by borrowers went beyond a severe liquidity constraint, and that some reduction in their debt burden might be required, reinforced banks' reluctance to provide new money and contributed to making the process of negotiation more protracted. In at least one case, banks delayed an agreement with a relatively small member

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[5]Accordingly, in such cases there was no performance criterion with respect to the elimination or reduction of arrears to banks. To the extent that the arrears in question evidence an exchange restriction, the exchange restriction is not eliminated until the rescheduling actually takes place.

[6] However, since commercial banks were generally willing to allow the accumulation of arrears on principal pending a final rescheduling, the program normally did not provide for the making of such payments prior to rescheduling and, accordingly, the performance criterion on nonaccumulation would generally exclude the accumulation of such arrears from its coverage.

[7] Moreover, the reaching of agreements had become more difficult as a result of the growing divergence of interests among banks and a more complex menu of options in debt packages. Some banks had sold their claims in the secondary market at a discount and were not willing to provide new money.

because of concerns that such an agreement would establish a precedent which could influence the outcome of ongoing negotiations with another relatively large member. Moreover, as was noted by the staff in a 1989 Board paper, commercial banks were aware that the Fund's policies on arrears and financing assurances gave them an effective veto over Fund support.

> "The Fund's policy on financing assurances, combined with its policies on payments arrears, has been designed to promote orderly relations by encouraging where necessary the restructuring of creditors' claims on the country on terms compatible with balance of payments viability. The policy on financing assurances meant, in effect, that the Fund would only provide financial support once the member and its creditors had agreed on terms that were consistent with the program's balance of payments objectives. Meanwhile, the policies on payments arrears meant that creditors had strong assurances that the member would ultimately meet its obligations, although these might need to be renegotiated. *However, the combination of the two policies now runs the risk of contributing to deadlock. On the one hand, certain creditors, having strengthened their balance sheets, have an interest in maintaining or increasing their claims on the debtor and are protected by the policies on payments arrears from the need to renegotiate and reduce those claims. On the other hand, the policy on financing assurances has begun to have the effect that, in the event of any delay in renegotiating claims on appropriate terms, support of the economic program had to be withheld"* (emphasis added).[8]

12. In these circumstances, the Fund concluded that the policies on arrears and financing assurances as applied to commercial banks were no longer consistent with the principles and objectives that underlay these policies. Specifically, while the receipt of explicit financing assurances and the nontoleration of arrears would continue to ensure that there were adequate safeguards for the Fund's resources, the strict adherence to such conditions undermined the Fund's ability to provide timely assistance to members that were making serious efforts to resolve their balance of payments difficulties. The Fund recognized that, if the implementation of programs continued to be delayed by the unwillingness of commercial banks to provide the necessary financing, members would no longer have the ability to carry out the necessary adjustment in an orderly way.

13. In view of the above, the Fund decided to modify its financing assurances and arrears policies to allow the approval of an arrangement before banks had provided assurances as to their willingness to support a financing package consistent with the assumptions of the program. Because this would mean that approval of an arrangement would occur before an agreement in principle had been reached with commercial banks regarding the restructuring of existing debt, this modification also necessitated a revision of the arrears policy to allow for the accumulation of arrears to commercial banks. It was recognized that this would entail certain risks regarding the safeguard of Fund resources. The 1989 modification was intended

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[8] "The Fund's Policy on Financing Assurances" (EBS/ 89/79, 4/20/89), pp. 8-9.

to facilitate the process of reaching agreement between creditors and debtors by removing commercial banks' *de facto* veto over Fund arrangements. As a further means of facilitating agreement, the Fund established a policy on making its resources available to members to help finance the up-front cost of Brady-style debt and debt-service reduction operations (DDSR).

14. Under the terms of the 1989 decision, such approval can be granted only in cases where: (i) prompt Fund support is judged to be essential for the successful implementation of the member's adjustment program; (ii) negotiations between the member and its creditors have begun; and (iii) it can be expected that a financing package consistent with external viability will be agreed upon within a reasonable amount of time. The arrangement would be structured so that progress in the negotiations could be closely monitored. In cases where the Fund approved an arrangement prior to an understanding with the banks regarding a new financing package, it was accepted that "an accumulation of arrears to banks may have to be tolerated where negotiations continue and the country's financing situation does not allow them to be eliminated."[9] In effect, the accumulation of arrears provided the financing that would have previously been provided voluntarily by commercial banks through a combination of rescheduling of principal and new money used to pay interest.[10] The 1989 decision was not intended to modify the arrears and financing assurance policy vis-à-vis official creditors, as the Fund had not experienced delays in obtaining the necessary financing assurances from Paris Club creditors.

C. Review of the Experience

15. Since the 1989 modification, the Fund has supported adjustment programs with a total of 38 members with unresolved arrears to commercial banks. It has approved arrangements for 15 members that tolerated the accumulation of arrears pending the conclusion of DDSR operations. [11] In addition, arrangements were approved for 18 members that had not yet

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[9] The Chairman's Summing Up on Fund Involvement in the Debt Strategy, Executive Board Meeting 89/61, May 23, 1989, *Selected Decisions, Twenty-First Issue*, June 30, 1996, p. 152. Although it was not made explicit in the relevant summing up, the general rule regarding the elimination of the existing stock of arrears was also modified by this change. As noted by the staff, it could not be assumed that agreement with the banks would have been reached by the end of the program period. While it was acknowledged that such a failure might undermine the normalization of relations between the member and the banks, it was considered preferable to the deadlock that existed (see EBS/89/60, 3/31/89, p. 10).

[10] In most cases care was taken to avoid an interruption in the servicing of short-term trade credit, which helped to facilitate normal economic operations, notwithstanding the ongoing negotiations of the claims of commercial banks.

[11] In addition, the Fund approved arrangements with Mexico and Uruguay which continued to

(continued...)

reached agreement on deep discount buybacks financed by the IDA debt reduction facility [12] [13] (Appendix Tables 1 and 2), and 5 members that eventually negotiated the rescheduling of the stock of debt to commercial banks (including arrears) without debt and debt-service reduction.

16. In the case of members that reached agreement on DDSR operations, negotiations between the member and its commercial bank creditors were under way at the time of approval of the arrangement. The record on this point is, however, mixed in the case of members seeking deep discount buybacks financed by the IDA debt reduction facility. In at least one case, an arrangement was approved before the initiation of negotiations. In the period before agreements were reached with the banks, financial programs (and performance criteria) were designed on the assumption that members (with the exception of Mexico and Uruguay) would continue to accumulate arrears of interest and principal to commercial banks. Nevertheless, programs with members negotiating DDSR operations typically assumed partial "goodwill" payments of interest which, inter alia, served to reestablish a track record of regular payments to banks. In contrast, in the case of IDA debt-reduction operations programs generally assumed no payments of interest. As the claims were expected to be extinguished through a buyback, the need to re-establish a payments track record on "old" debt was less clear cut.

17. *In the above cases, how successful were members in regularizing their relations with creditors?* To date, DDSR agreements have been concluded for 15 members, of which 13 had unresolved arrears at the time of the approval of the arrangement; and agreements in principle with their banks were reached by Côte d'Ivoire and Vietnam in November and May 1996, respectively. In addition to the general balance of payments support provided under the arrangements in question, the Fund has also provided support in the form of either set asides or augmentation to cover a portion of the up-front cost of eight DDSR operations. IDA debt-reduction operations have been completed with 12 members for which Fund arrangements were approved ahead of agreement on deep discount buybacks, as well as for Zambia for which the IDA debt reduction operation was completed ahead of the completion of the RAP and the approval of an ESAF arrangement; negotiations are under way in all of the remaining cases. Fund resources have not been used directly to contribute to the cost of buybacks supported by the IDA debt-reduction facility.

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[11](...continued)
service their obligations to commercial banks in full during the DDSR negotiations.

[12]Excludes Zambia, which completed an IDA debt reduction operation during the rights accumulation program (RAP).

[13]Debt bought back under the IDA debt reduction operations encompassed uninsured suppliers credits as well as the claims of commercial banks.

18. *How long did it take for the member to reach agreement with its creditors?* For the cases in which the accumulation of arrears was tolerated during the negotiation of DDSR operations,[14] the period required to reach agreement in principle after the approval of an arrangement averaged 25 months for DDSR operations. The period required to reach agreement in individual cases ranged from 5 months (Costa Rica) to 62 months (Côte d'Ivoire). With the exception of Côte d'Ivoire and Panama, agreements in principle were reached within 3 years, i.e., the period before the repurchase and repayment obligations to the Fund fall due. On average, it took a total of 33 months between the approval of a Fund arrangement, and the implementation of deals through a combination of cash buybacks and issuance of Brady bonds. For IDA debt reduction operations, it has taken an average of 43 months between the approval of an arrangement and conclusion of the operation (ranging from 15 months in the case of Sierra Leone to 87 months for Mauritania).[15] In the more protracted cases, agreement was not reached within the period of the first arrangement. In these cases, the Fund responded flexibly and approved successor arrangements, providing continued support for members' adjustment efforts pending the conclusion of the negotiations.

D. Assessing the 1989 Modification

19. Chapter II of this paper outlined the main principles that served as the basis for the Fund's policies on arrears and financing assurances. Judged against these principles, it would appear that the modified policies have worked relatively well.

20. ***Effective balance of payments adjustment***—Early Fund support enabled members to implement adjustment programs designed to allow members to regain, or make adequate progress toward, external viability. While a full discussion of performance under these adjustment programs and subsequent economic developments is beyond the scope of this paper, the following points may be noted. Performance under arrangements with members negotiating DDSR or IDA debt reduction operations was uneven. Over half of the arrangements remained broadly on track, though in some cases there were significant delays in the completion of reviews and the member requested waivers and/or modification of program targets, as a result of some combination of adverse external developments and slippages in

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[14]In other words, for all members which negotiated DDSR operations, except Mexico and Uruguay.

[15] For IDA debt reduction operations there is no well defined counterpart to the agreement in principle with commercial banks.

policy implementation.[16] The remaining programs went off-track and were allowed to lapse, but in most cases were replaced by successor arrangements.

21. Members that have normalized relations with creditors and established strong track records of stabilization in recent years have been able to regain access to international capital markets. Indeed, for several middle income countries (Argentina, Brazil, Panama, Phillippines, and Poland), the resumption of syndicated loan commitments and the initiation of international bond placements reflected markets' reactions to the members' commitments regarding economic policies, and coincided broadly with agreements in principle with commercial banks on DDSR operations. Agreement in principle with Vietnam came two years after the country regained access to capital markets (Appendix Table 3). Mexico and Uruguay, which did not have unresolved arrears to banks, also regained access to international capital markets around the time of their agreements with commercial banks. At the same time, the access to international capital markets of other members that have completed DDSR operations, but have had uneven records of policy implementation (Bulgaria, Costa Rica, Dominican Republic, and Nigeria) has generally been limited to normal trade finance. In addition, Ecuador, which has substantial arrears to Paris Club creditors, has recently issued a Euro bond. Members that have completed IDA debt reduction operations have generally not been able to gain access to the syndicated loan and bond markets, reflecting their limited creditworthiness, though some have been successful in attracting other forms of private capital.

22. While the 1989 modification contributed was of benefit to members in question, what impact did it have on international capital markets? As noted earlier, the original arrears policy was based, in part, on a recognition that the timely discharge of financial obligations was an important ingredient for the smooth functioning of the international trade, payments, and monetary systems. In that regard, the 1989 modification was generally seen by banks as "tilting the playing field" in favor of debtors and led to agreements which were seen by some banks as not being mutually beneficial to all concerned. The willingness of the Fund to tolerate arrears to commercial banks contributed to the subsequent shift in the composition of new sovereign borrowing toward bonds and away from syndicated loans.[17] It can be argued, however, that the efficient operation of the international monetary system would have been impaired if the Fund had let the deadlock which had developed by the late 1980s continue.

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[16] Between the 1989 modification of the financing assurances policy and agreement in principle on the restructuring of arrears under DDSR operations, the Fund approved 27 arrangements of which 12 went off track. Between the modification of the policy and the conclusion of the IDA debt reduction operations, the Fund approved 32 arrangements, of which 14 went off-track.

[17] It should be noted that while the 1989 modifications limited banks' *de facto* veto over Fund arrangements, the Fund continued to avoid becoming directly involved in negotiations; the staff's involvement in discussions between banks and members remained technical.

The early availability of Fund support facilitated the implementation of adjustment policies while helping to minimize the social cost of adjustment. This not only strengthened members' prospects for sustainable growth and external viability, but also enhanced the value of creditors' claims. The policy facilitated agreement on orderly, market-based resolutions to debt difficulties that in several cases, provided the foundation for members to regain access to international capital markets. This was ultimately in the interest of debtors, creditors, and more generally the orderly operation of the system.

23. ***Safeguarding the Fund's resources***—The decision by the Fund to approve arrangements in advance of the receipt of financing assurances from banks entailed some risk for the Fund's resources. In practice, however, these risks have not materialized.

- Despite the sustained accumulation of arrears, banks showed considerable forbearance. The process of renegotiation has largely remained orderly: creditors generally did not resort to legal remedies against debtors to settle their financial claims, and instead participated in frequently difficult and protracted negotiations. Aggressive litigation by banks could have led to the seizure of assets and, consequently, the derailing of Fund-supported programs. As is discussed in the next chapter, the relative absence of litigation reflected, in large part, certain standard provisions of syndicated loan agreements and the role of central banks of creditor countries in encouraging their commercial banks to seek cooperative solutions to payments difficulties. It should be noted that the 1989 modification to the policy of financing assurances was made against a background of experience since the early 1980s in which commercial banks, when confronted with arrears, generally had not resorted to litigation.

- In accordance with the 1989 decision, purchases under Fund arrangements with members negotiating with their commercial bank creditors have generally been conditioned on financing reviews which focussed on progress in the negotiations and provided an opportunity to bring any unforeseen developments to the Board's attention. In the early years these reviews were discussed by the Executive Board. More recently, however, with the experience of generally orderly— if protracted— negotiations, financing reviews have been approved on a lapse–of–time basis, or as part of a review of the arrangement.

- At the time of the 1989 modification, there was uncertainty regarding whether it would be possible to reach agreements on voluntary market-based DDSR operations, and if so, on the time frame for such agreements. A prolonged accumulation of arrears could have delayed normalization of relations with creditors to such an extent that, following the expiration of the Fund arrangement, members might not have been in a position to meet their obligations to the Fund as they fell due. As noted above, however, in most cases the normalization of relations with creditors occurred within three years of the approval of the arrangement; i.e., before repurchase and repayment obligations to the Fund fell due. To date, repayments to the Fund by members for which the 1989 modification has been applied have in all cases been timely. Similarly, all new instruments issued in the context of Brady restructurings have continued to be serviced promptly.

THE PRISONERS' DILEMMA

1. The Prisoners' Dilemma is a simple game that illustrates how inferior outcomes can emerge from strategic interaction between agents even though agents themselves are individually acting in their best interests. The game is relevant because a superior outcome exists, but cannot be attained in the absence of some form of cooperation.

2. Imagine that two suspects are arrested and charged with a crime, say robbery, which they actually committed. The police, however, lack sufficient evidence to convict the suspects in the absence of at least one confession. The suspects are held in separate cells (from an informational point of view, the suspects respond simultaneously), and the police explain to each of them the consequences of the actions they could take. If they both remain silent (cooperate with the other), then both will be convicted of a minor offense, say trespassing, and be sentenced to one month in jail. If they both implicate the other (not cooperate), they will each get six months in jail for robbery. If one talks and the other remains silent, then the one who implicates the other goes free, while the one implicated receives nine months in jail, six for robbery and three for obstructing justice.

3. This game is typically analyzed using a *payoff matrix*, shown below. Each player has two available strategies, cooperate or not cooperate, which are shown as rows for Player A and columns for Player B. The game has four possible outcomes, each represented as a cell in the matrix. The numbers in each cell correspond to the payoff to each player as explained above, with Player A's payoff shown first. Months in jail are shown as negative payoffs, with immediate release shown as zero. The objective of each player is to choose a strategy, cooperate or not cooperate, that maximizes his expected payoff.

	PLAYER B		
PLAYER A	(Cooperate)	Remain silent	Implicate Other (Not Cooperate)
	Remain silent (Cooperate)	-1,-1	-9,0
	Implicate Other (Not Cooperate)	0,-9	-6,-6

4. As mentioned, this game is interesting because each player has an incentive to implicate the other, even though this leads to an inferior outcome for both. To see how this outcome prevails, note from the matrix that if Player A chooses to implicate Player B, then he comes out ahead regardless of what Player B does (0 vs. -1 if Player B cooperates, -6 vs. -9 if Player B talks). Thus, implicating Player B is Player A's *dominant strategy*. Using the exact same reasoning, Player B's dominant strategy is to implicate Player A. The outcome of the game is therefore the southeast cell, where both players talk and receive six month sentences. Both players do better by remaining silent, but have no incentive to do so since cooperating is a *dominated strategy*. Thus, the Prisoners' Dilemma can only be resolved by some form of cooperation.

LEGAL ASPECTS OF INTERNATIONAL SOVEREIGN BOND DEFAULTS

A. General Features

1. *Definition*— For purposes of this paper international sovereign bonds have been defined as bonds which: (i) are issued or guaranteed by the state (the government) or the central bank and (ii) require (or permit the lender to require) payments of interest and principal to be made in a foreign country. Examples of international bonds are Brady, Euro, Global, and Samurai bonds. These bonds also typically include a number of special protections for bondholders that are not found in domestic sovereign bonds. Among these are clauses for cross default, and in the event of a default or debt moratorium, for acceleration of principal, and in the event of litigation, for waiver of sovereign immunity and for choice of law and forum.[1] These various features are described below.

2. In contrast, domestic sovereign bonds are bonds where payments are made only within the country of the issuer. As noted above, such bonds generally do not contain any cross default, acceleration of principal, waiver of sovereign immunity, or choice of law and forum clauses. One example of such bonds are the Mexican Tesobonos. Absent a choice of foreign law or forum clause, and with payments of interest and principal made domestically, it is unlikely that a foreign court would exercise jurisdiction. More importantly, because domestic bonds include no waivers of sovereign immunity, even if jurisdiction to hear the case were initially granted by a foreign court, it would be difficult to attach any assets in execution of a judgement.

3. *Cross default*—It is common for international sovereign bonds to include cross default clauses that treat defaults on certain types of other international debt[2] as being equivalent to a default on the bonds themselves. In the case of Eurobonds, for the cross default clause to apply the other international debt often must exceed a specified amount, and the default has to be such that it may result in an acceleration of principal. In the case of some Brady bonds the cross default clauses are more limited, applying only to other types of Brady bonds, and only when there has actually been an acceleration of principal on those bonds.

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[1]Courts will both serve as a forum for litigation and apply local law even without a choice of law or forum clause providing that payments of interest and principal are made within their jurisdiction.

[2]The definition of international debt for the purpose of cross-default clauses varies somewhat among different bond terms and conditions. One common definition is "indebtedness payable in a currency other than [the domestic currency]."

4. *Acceleration of principal*—It is common that, following an actual default, a declaration of a debt moratorium, or a cross default, full and immediate repayment of principal can be demanded after a minimum percentage of bond holdings have agreed. In the case of Euro and Global bonds, the amount is typically between 10 and 25 percent (although some bonds specify no lower limit), for Samurai bonds 50 percent, and for Brady bonds 25 percent (rising to 50 percent if it is a cross default rather than an actual default or debt moratorium).

5. *Waiver of sovereign immunity*—It is common for international sovereign bonds to include clauses that irrevocably waive any claims to sovereign immunity of the issuer, both as to judgment and as to execution of judgment through attachment of assets. As a practical matter, such waivers apply only to *foreign* sovereign immunities, and with regard to execution by attachment of assets, are limited by the unwaivable immunities provided in many sovereign immunity laws. See the discussion below.

6. *Choice of law and forum* —It is common for international sovereign bonds to include clauses that specify both the jurisdiction in which bondholders may bring suit against the sovereign, and the law that is to apply in adjudicating the suit. These clauses specify places and laws outside of the issuers jurisdiction so as to ensure that the issuer's domestic courts cannot protect the issuer from suit. The most common are New York, London, Frankfurt, and Tokyo. Once a judgment has been secured in the chosen forum, it can typically be recognized in virtually any other jurisdiction in the world. Once the judgment is recognized in these other jurisdictions, actions to attach assets held in those jurisdictions can be initiated (Appendix Table 4).

7. As noted in the paper, all bonds (sovereign, nonsovereign, international, or domestic) do not contain the sharing clauses that are typically found in syndicated loans.

B. Brady Bonds

8. Brady bonds, which are a type of international sovereign bond, also include interest and principal collateral, which are designed to provide bondholders with partial protection in the event of a default. Principal collateral, however, cannot be released ahead of original maturity. An acceleration of the bond would therefore not allow holders to gain access to the collateral, though it would allow holders to try to improve the terms of the bond, seek additional credit enhancements, and/or facilitate settlement through the attachment of assets. Interest collateral typically covers only one or two semi-annual coupons. In practice, it may be more difficult to muster the support required to gain access to the collateral following a default (which requires the support of 50 percent of principal), than it would be to accelerate the principal (which requires the support of only 25 percent of principal). Because principal collateral cannot be accessed ahead of the final maturity, and because interest collateral can only be released after a default (which could trigger acceleration of principal), any protection afforded by collateral is likely to be limited.

C. Attachment of Assets

Sovereign assets amenable to attachment[3]

9. Foreign sovereign immunity protects a foreign state and its agencies and instrumentalities from the jurisdiction of a domestic court, including jurisdiction to attach assets in aid of execution of judgment. In virtually every country, a foreign state may irrevocably grant an unlimited waiver of immunity from the jurisdiction of the court to determine liability.[4] However, with regard to *unwaivable* immunity from attachment of assets, foreign sovereign immunity laws vary considerably, and in some instances it may be difficult to predict how they would be implemented. Some legal systems, particularly the American and the British, have enacted statutes that specify the law in some detail, although even in these jurisdictions many questions remain. In other jurisdictions, less detailed statutes or case law only prevail. These laws allow waivers of immunity to attachment of certain assets, but not to others. Such assets are discussed below.

10. *The state*—Most international sovereign bonds have been issued by the state (i.e., the government) rather than the central bank. In the United States and the United Kingdom, immunity over all assets that are the property of a foreign state can be waived, unless they are embassy buildings or military equipment, or unless they are bank accounts that support strictly diplomatic or military operations. Accordingly, buildings such as state-owned trade centers, or foreign exchange (including claims or rights to foreign exchange) owned by the state and used generally to finance its nondiplomatic or nonmilitary activities, if located in these jurisdictions, are likely to be vulnerable to attachment once a judgement has been secured in any jurisdiction. While in general the property owned by a separate legal instrumentality of the state, such as planes or ships of a state-owned airline or shipping company, would not

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[3]See Legal Aspects of Standstills and Moratoria on Sovereign Debt Payments and Their effect on Actions by Creditors (EBS/96/26, 2/22/96), "Legal Remedies in the Event of a Sovereign Default" by R. Gordon and M. Milenkovich, in *5 Current Legal Issues Affecting Central Banks* (R. Effros ed. in press), and "Sovereign Immunity and Central Bank Immunity in the United States" by E. Patrikis, in *1 Current Legal Issues Affecting Central Banks* (R. Effros ed. 1992).

[4]In addition, even if immunity is not waived, most foreign sovereign immunity laws (Japanese law being a noted exception) automatically deny immunity from jurisdiction if the cause of action against the foreign state involves a commercial act. They also deny immunity from attachment of assets that are part of a commercial activity that is the subject of the suit. This is an exception that is not generally relevant to bond defaults because it would apply only to the actual proceeds of the initial borrowing, which presumably would have been disbursed long before any default.

generally be attachable, in certain circumstances the separate "corporate veil" might be pierced, and ownership of the assets attributed directly to the state, and therefore made vulnerable to attachment. Special rules ensure that the corporate veil is respected in the case of central banks.

11. In jurisdictions other than the United States and the United Kingdom, these general principles also appear to apply, but the lack of clear statutory or case guidance makes the full extent of the protection of sovereign immunity less certain. Such uncertainty could provide opportunities for aggressive plaintiffs to seek to create new laws expanding the rights of judgment creditors to attach sovereign assets.

12. ***The central bank***—In some cases, it is the central bank that issues bonds. As with those issued by the state, bonds issued by central banks typically contain comprehensive waivers of sovereign immunity against attachment of assets in execution of judgment, although some do not. For example, bonds issued by the central banks of the Czech Republic, Hungary, Nigeria (issued in exchange for Promissory Notes), Romania, Slovakia, and Tunisia all include comprehensive waivers, while notes issued by the Central Bank of Colombia explicitly exempt the official reserves from attachment. In most jurisdictions, this would mean that any foreign exchange assets owned by the bank would be vulnerable to attachment in execution of a judgment of default. The effect of a comprehensive waiver of a central bank's immunities on creditors' ability to obtain legal remedies in the event of a judgment of default is illustrated by the Zambian case (see Box 2 of the main paper).

13. In the event of impending default of a state borrower, it may be possible to transfer title of its foreign exchange assets to the central bank, or vice versa, providing that certain criteria are met. If both state and central bank are in default, however, it would be difficult to find a "safe haven" to hold title to such assets. For this reason it is particularly unwise for both state and central bank to have outstanding bonds. The problems that can arise are illustrated by the Zambian case, where both state and central bank are judgment debtors, although on unrelated loans (see Box 2 of the main paper).

INTERPRETATION OF ARTICLE VIII, SECTION 2(b) OF THE FUND'S ARTICLES OF AGREEMENT [1]

1. It has been suggested that Article VIII, Section 2(b) of the Fund's Articles of Agreement may provide authority to the Fund to effect a mandatory stay of certain enforcement actions against a defaulting sovereign debtor.

The first sentence of that provision reads:

> "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

2. Under Article XXIX(a), "[A]ny question of interpretation of the provisions of this Agreement arising between any member and the Fund or between any members of the Fund shall be submitted to the Executive Board for its decision." Therefore, the Executive Board of the Fund has the power to adopt authoritative interpretations of the Articles. The only recourse against such decisions would be an appeal to the Board of Governors (Article XXIX(b)), whose decision would be final. There would be no recourse to a national or international court against a Fund interpretation of its Articles.

3. Accordingly, it is open to the Fund to interpret Article VIII, Section 2(b) and the Fund has already exercised that power (Decision no. 446-4, June 10, 1949).[2]

a. Meaning of interpretation

4. What is an interpretation of the Articles? One might think that an interpretation could take the form of a decision by the Fund that a particular situation meets the conditions required by Article VIII, Section 2(b), i.e., that the contract at hand is an "exchange contract which involves the currency of a member and is contrary to the exchange control regulations of that member maintained (or imposed) consistently with the Fund Agreement."

5. However, this type of decision would not be an interpretation of Article VIII, Section 2(b), but only a finding—based in part on factual considerations—that Article VIII, Section 2(b) is applicable.

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[1]The text of this Appendix is derived from EBS/96/26 (2/22/96).

[2]*Selected Decisions and Selected Documents of the International Monetary Fund*, Twenty First Issue, p. 378.

6. As generally understood and confirmed by the practice of the Fund, an interpretation is an abstract statement of law, clarifying the meaning of a provision, and whose application to individual cases will require factual findings. For instance, an interpretation by the Fund could state that loan agreements are exchange contracts when they involve payment to nonresidents or in foreign currency, but it would be the responsibility of the national courts to determine, as a matter of fact, whether a particular contract actually constitutes a loan agreement involving payments to a nonresident or in foreign currency. Therefore, an interpretation by the Fund could never give a complete assurance that the intended result would be achieved, because factual findings would remain a prerogative of national courts. However, there is at least one aspect where a finding by the Fund should be given special weight, namely, the finding that a particular exchange control regulation is consistent or inconsistent with the Fund's Articles, because this finding would be made by the Fund in the exercise of its jurisdiction under the Articles.[3]

b. Issues raised by an interpretation

7. Assuming that an interpretation of Article VIII, Section 2(b) is envisaged, three issues would have to be considered:

- the contents of the interpretation;
- its authority in national courts; and
- the weight given in national courts to the Fund's findings of consistency with the Articles.

(i) Contents of the interpretation

8. The interpretation would have to clarify various aspects of Article VIII, Section 2(b) on which conflicting views have been expressed. For instance, does the provision apply to exchange control regulations that are in force when the exchange contract is entered into or to those that are in force at the time of suit? When is a currency "involved" in an exchange contract: is it when it is the currency of payment or when the contract affects the member's balance of payments? In particular, two main difficulties would have to be resolved. First, the interpretation would have to clarify that a loan agreement is an exchange contract within the meaning of Article VIII, Section 2(b) if it provides for payment to nonresidents or in a foreign currency. Second, it would also have to state that a moratorium imposed by a sovereign debtor in the performance of its own financial obligations is an exchange control regulation within the meaning of Article VIII, Section 2(b).

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[3]The GATT recognizes the authority of the Fund to make such findings: Article XV(2).

9. The first point would contradict the interpretation now prevailing in the courts of the United States and the United Kingdom.

10. The second point would probably contradict the well-established position in the Fund that a default is not a restriction.[4]

11. Given the continuing difference of opinion on the meaning of "exchange contract" both among national courts of different countries and in doctrinal opinions, an interpretation by the Fund would be desirable. However, when such an interpretation was discussed in a Fund seminar in 1988, the conclusion was that the Fund should not try to impose its views on national courts in this matter. One of the arguments against adopting any interpretation was that, even if it were adopted, it would probably not be binding on the jurisdictions that have adopted a narrow interpretation (see below).

12. Whether a moratorium law can constitute an exchange control regulation is a totally different issue. Clearly, the Fund does not regard a sovereign debtor's default as an exchange restriction within the meaning of the Articles, because a restriction is imposed on another party, while a default is only a debtor's failure to discharge a financial obligation (either by lack of adequate resources or by a deliberate decision not to pay). Therefore, defaults on current payments are not regarded as inconsistent with Article VIII, Section 2(a) and are not subject to Fund approval. It may be noted in this respect that the White Plan for a Stabilization Fund of April 1942, which was one of the preparatory documents of the Bretton Woods Conference of 1944, included an obligation for members of the future Fund "[n]ot to permit any defaults on foreign obligations of the government or Central Bank without approval of the Fund." This provision later disappeared, while the proposed provision prohibiting restrictions and controls over foreign exchange transactions survived, after a number of amendments, to become Article VIII, Section 2(a). Accordingly, an extension of the Fund's jurisdiction to defaults as restrictions would not be possible.

13. While it is established that a default is not a restriction, the issue here is not whether a sovereign debtor's default would be regarded as a restriction but whether it could constitute an exchange control regulation. The concept of "exchange control"—which was associated with restrictions but as a separate concept in the White Plan—has never been defined by the Fund. In the practice of the Fund, exchange controls are understood as a broad concept not limited to, but including, restrictions. For instance, a verification procedure for authorizing current payments is an exchange control measure, not a restriction, but, if it gives rise to arrears, it constitutes a restriction. The reason is that exchange controls and restrictions share a common element: they are constraints imposed by a sovereign authority on persons or assets within its jurisdiction. Therefore, in its descriptions of exchange controls, the Fund does not

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[4]Moreover, to the extent that the repayment of the loan would constitute a capital movement, the second point would contradict the position of German courts that capital movements are outside the scope of Article VIII, Section 2(b).

include sovereign debtors' defaults, because they are either involuntary or self-imposed measures. This would remain true even if the default was formally based on a legislative act prohibiting payments by the executive branch, because both the legislative and executive branches are organs of the debtor itself. In this respect, there is no substantive difference with a private corporate debtor which either does not have the resources to discharge its liabilities or whose organs decide to suspend its payments. This may have been the reason for the White Plan to make a distinction between "defaults" on the one hand and "restrictions and controls" on the other. Therefore, an objective interpretation of Article VIII, Section 2(b) would not support the conclusion that a sovereign debtor's default on its external debt constitutes an exchange control regulation.

14. Given this conclusion, would it still be possible to find ways to give effect under Article VIII, Section 2(b) to such a default? Two cases may be envisaged.

First Case: the sovereign debtor's liabilities are denominated (i.e., payable) in local currency. Then, a payment in local currency will discharge its obligations. Once the payment has been made, a prohibition to convert and transfer the proceeds of the payment would constitute an exchange restriction, not a default. If the payment was a current payment (amortization of loan), Fund approval would be required. If it constitute a capital movement (bullet payment), no approval would be required. Therefore, assuming Fund approval in the first hypothesis, Article VIII, Section 2(b) would apply. The only issue would be whether this provision also applies to capital movements; this point could be clarified in an interpretation.

Second Case: the sovereign debtor's liabilities are denominated (i.e., payable) in foreign exchange. If the contract is governed by the law of the debtor (which is rather unlikely), a possible solution would be to amend the law in order to provide that all payments shall be made in local currency. Then, once payment has been made, the same approach as in the first case can be used: prohibition to convert and transfer the proceeds.[5] The problem here is whether all foreign courts would agree to apply the debtor's law modifying the currency of payment. If the contract is governed by a foreign law, a unilateral decision to alter the substance of the sovereign debtor's obligation would probably not be recognized by a foreign court, unless perhaps the law is sufficiently general (applicable to the debts of all residents) to be regarded as nondiscriminatory and the foreign court is willing, as envisaged, for instance, in the

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[5]*In French v. Banco Nacional de Cuba*, 23 N.Y. 2d 46, 242, N.E. 2d 704 (1968), the New York Court of Appeals denied recovery on Cuban government certificates of indebtedness and initially payable in U.S. dollars, after a Cuban decree ordered their conversion into Cuban peso denominated certificates and prohibited the conversion of payment proceeds into foreign currency, on the ground that the certificates were governed by Cuban law. The Act of state doctrine was also invoked by the court. See also the cases cited above on the German and Hungarian "moratorium" laws and their effects on the debts of nonsovereign debtors.

Rome Convention of June 19, 1980, to give effect to the public policy of another state.[6]

15. In conclusion, it appears that, although an interpretation of Article VIII, Section 2(b) can be envisaged, it would raise very serious objections both from the standpoint of those who have applied a different interpretation (on the first point) and from the standpoint of an objective reading of the Articles (second point). Assuming that these obstacles are overcome, even more serious problems would have to be faced when implementing the interpretation.

(ii) **Authority of the interpretation**

16. There is no doubt that an interpretation of the Articles of Agreement by the Fund under Article XXIX is as binding on its members as the rule being interpreted, since it is declaratory of existing law. Nor is there any doubt that, when joining the Fund, each member has deposited "an instrument setting forth that it...has taken all steps necessary to enable it to carry out all of its obligations under this Agreement." (Article XXXI, Section 2(a)). Therefore, since Article VIII, Section 2(b) constitutes an obligation for each member to have its courts declare certain exchange contracts unenforceable, an interpretation by the Fund of this provisions would automatically or through some pre-established procedure become binding on the courts.

17. In a few countries, the existing legislation would seem to provide a procedure for the recognition of the Fund's interpretations. For instance, in the United Kingdom, an Order in Council may be adopted "for carrying into effect ... any of the provisions of the Fund Agreement as to the unenforceability of exchange contracts."[7] On the basis of this provision, Article VIII, Section 2(b) was given the force of law in the United Kingdom by Order in Council, but the language seems broad enough to cover also interpretations of Article VIII, Section 2(b).

18. In other countries, there are no special rules, but there is a practice of either publishing official documents in a government publication or communicating official interpretations of international agreements through the foreign ministry to national courts. However, whether such a publication or communication would be sufficient to make a Fund interpretation binding on the courts remains to be seen. In those countries where international law is part of the legal system, the courts could be expected to recognize the binding effect of a Fund interpretation. In those other countries where international law does not become the law of the land unless it is specifically enacted into law, an interpretation by the Fund might be

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[6]Art. 7 of the Convention (in force since April 1, 1991), but this Article has not been introduced into the domestic legislation of all states that have ratified the Convention (e.g., Germany).

[7]Bretton Woods Agreements Act, 1945, Section 3(1).

regarded only as persuasive and subject to the court's final determination. For instance, in the United States, while the Federal Communications Commission has ruled that an authoritative interpretation by the Fund of Article IX, Section 7 was binding upon it, there has been no similar decision on Fund interpretations by state or federal courts. Although U.S. courts have in effect not contradicted Fund interpretations, they have not stated that these interpretations were binding upon them.[8] We understand that in Canada an Act of Parliament would be required to make an interpretation binding on the courts. In this respect, it appears that countries that have adopted a dualist system, where international law has no direct effect on private litigation before their courts, will require particular measures to give effect to an interpretation by the Fund.

19. Therefore, even if an interpretation of Article VIII, Section 2(b) were adopted by the Fund, additional steps would still have to be taken to make it effective. In countries where parliamentary action is required, particularly those whose financial interests would likely be most affected, the interpretation may well remain ineffective.

(iii) Findings of consistency with the Articles

20. It would seem that the Fund is best qualified to determine whether a particular exchange control measure is consistent or inconsistent with the Articles, and experience shows that, when a national court consults the Fund on that issue, the Fund's advice is followed. However, as in the case of an interpretation, the reason may be simply that the Fund's opinion is persuasive rather than binding.

21. The issue of the persuasive or binding effects of a finding by the Fund was addressed by the American Law Institute in the Third Restatement of the Foreign Relations Laws of the United States (Section 822): "A statement by the Fund that a particular control is not maintained or imposed consistently with the Articles of Agreement is conclusive; a statement that the control is maintained or imposed consistently with the Articles of Agreement is entitled to great weight, but the court will make the final decision."

22. The position of the American Law Institute is rather characteristic of an unsympathetic view toward the application of Article VIII, Section 2(b) and, in that respect, reflects a more general attitude illustrated in U.S. courts by decisions such as the Zeevi case.[9] Sir Joseph Gold assessed the position of the Institute as follows: "The assumption continues to be that the advice of the Fund need not be sought in all cases. If the advice is sought, the distinction now is based on the content of the Fund's statement. If the Fund states that an exchange control regulation is not maintained or imposed consistently with the Articles, the statement is

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[8]See Gold, *Interpretation by the Fund*, IMF Pamphlet Series, No. 11, 1968, pp. 31-39.

[9]*J. Zeevi and Sons, Ltd., et al., v. Grindlays Bank (Uganda) Ltd.*, 37 N.Y. 2d 220, 333 N.E. 2d 168 (N.Y. 1975), *cert. denied* 423 U.S. 866 (1975).

conclusive. If the Fund states that the regulation is consistent, the court may override this statement. No reason is given to defend the logic of this distinction. If there is logic in the distinction, it appears to be that under both propositions the plaintiff is favored. The interest of the foreign member is not decisive under the second proposition. The legal and practical objections to the court's authority to override the Fund's determinations, whether they are of consistency or of inconsistency, that have been advanced in the discussion of the topic in Draft No. 5 apply to Draft No. 6 as well. The courts are to administer the Articles; they may even decide that they do not approve a restriction that has been approved by the Fund. Perhaps the horrid dreams of Zeevi have frightened the drafters here too."[10]

23. As can be seen, the many roadblocks to using Article VIII, Section 2(b) through an interpretation in order to give effect to a moratorium are so substantial as to be probably overwhelming.

c. **Selective application of the interpretation**

24. An authoritative interpretation of Article VIII, Section 2(b) would strengthen the position of the debtor in that its exchange control regulations would be recognized in the courts of other countries when they are consistent with the Fund's Articles, but some may think that this protection is not always justified. There may be cases, for instance, where Fund approval is required to make the restriction consistent with the Articles. In those cases, it would be sufficient for the Fund to withhold approval in order to avoid making Article VIII, Section 2(b) applicable. In other cases, however, such as capital transfers, Fund approval is not required for the consistency of the restriction with the Articles because Article VI of the Fund Agreement allows members to impose such restrictions as they see fit. Therefore, an interpretation of Article VIII, Section 2(b) requiring the recognition of such restrictions could benefit sovereign debtors which are not even negotiating with their creditors.

25. In order to avoid such a result, various suggestions have been made. For example, it has been suggested that the interpretation would apply on a case by case basis, that is, only in those cases where the Fund would decide that it should apply. The obvious objection to this approach is that the Fund could not in good faith decide that what it regards as the correct interpretation of its Articles would not apply uniformly in all cases. Otherwise, the courts would probably conclude that the so-called interpretation did not constitute an interpretation within the meaning of Article XXIX and would disregard it. Another suggestion was that, when the finding of consistency is made by the Fund for purposes of Article VIII, Section 2(b), the Fund could apply criteria other than those prescribed by the Articles. For example, the Fund could decide that a restriction on capital movements, which is authorized by Article VI, is or is not consistent with the Articles, depending on the circumstances, for the application of Article VIII, Section 2(b). The objection to this approach is that Article VIII, Section 2(b) refers explicitly to consistency of exchange control regulations "with the

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[10]Gold, *The Fund Agreement in the Courts*, Vol. III (1986), p. 710.

provisions of this Agreement." This can only mean that there is a single concept of consistency with the Articles, which determines both the legality of the measure under the provisions of the Articles and the applicability of Article VIII, Section 2(b).

26. Therefore, once an interpretation of Article VIII, Section 2(b) is adopted, it would not be possible to apply it selectively.

d. **Conflicts with other treaties**

27. The applicability of Article VIII, Section 2(b) cannot be considered in isolation, as if no other international agreement could affect the outcome of a dispute between a sovereign debtor and its creditors. Since accepting the obligations of the Fund's Articles, many Fund members have entered into other international agreements that tend to be more demanding than the Fund's Articles with respect to the liberalization of current payments or capital movements. Therefore, it is quite possible that a particular measure, which would be consistent with the Fund's Articles and give rise to the application of Article VIII, Section 2(b), be at the same time inconsistent with another international agreement entered into more recently by the state of the forum. In that case, assuming that the subsequent treaty is self-executing, it would prevail over Article VIII, Section 2(b) and prevent its application by the court. Consequently, as between parties to the treaty, the interpretation of Article VIII, Section 2(b) would have no practical effect.[11]

[11]The treaty would not, however, affect the continued application of Article VIII, Section 2(b) in the parties' relations with other Fund members (see, e.g., Article 234 of the Treaty of Rome establishing the European Economic Community).

Appendix Table 1. Fund Arrangements with Members with Unresolved Arrears to Commercial Bank Creditors Negotiating Brady-Type Debt and Debt-Service Reduction Operations, 1989-96

Country	Commercial debt restructuring prior to 1989 (1)	Amount outstanding or restructured (mill. US$) 1/ (2)	Date of: Emergence of commercial bank arrears (3)	Date of: Fund-supported adjustment program 2/ (4)	Date of: Agreement in principle (5)	Date of: Concluding restructuring agreement (6)	Duration of Fund lending into arrears (months) (7)=(5)-(4)	Duration of Fund lending into arrears (months) (8)=(6)-(4)
Argentina	Yes	19,397	Apr. 1988	Nov.10, 1989	Apr. 7, 1992	Apr. 7, 1993	35	47
Brazil	Yes	40,600	Feb. 1987	Jan.29, 1992	July 9, 1992	Apr.15, 1994	6	28
Bulgaria	No	6,186	Mar. 1990	Mar.15, 1991	Nov.24, 1993	July 28, 1994	31	40
Costa Rica	Yes	1,456	1986	May 23, 1989	Nov.16, 1989	May 21, 1990	5	11
Côte d'Ivoire	Yes	2,575	1986	Sept.20, 1991	Nov.22, 1996	...	62	...
Dominican Rep.	Yes	776	May 1989	Aug.28, 1991	Feb. 1994	Aug.30, 1994	29	36
Ecuador	Yes	4,522	Late 1980s	Dec.11, 1991	May 2, 1994	Feb.28, 1995	28	37
Jordan	No	736	1989	Feb.26, 1992	June 30, 1993	Dec.23, 1993	16	21
Nigeria	Yes	5,500	1986	Jan.9, 1991	Dec. 1991	Jan. 1992	8	12
Panama	Yes	1,914	1987	Feb.24, 1992	May 5, 1995	July 17, 1996	38	52
Peru	No	4,157	1983	Mar.18, 1993	Oct.27, 1995	Mar.7, 1997	31	47
Philippines	Yes	4,473	1983	May 23, 1989	Sept. 1991	Dec. 1992	28	42
Poland	Yes	9,989	Late 1989	Feb. 5, 1990	Mar.10, 1994	Oct.27, 1994	25	33
Venezuela	Yes	19,700	Mid/late 1980s	June 23, 1989	Mar.20, 1990	Dec.18, 1990	9	17
Vietnam	No	338	Early 1980s	Oct. 6, 1993	May 17, 1996	...	31	...
Minimum		338					5	11
Average		8,154					25	33
Maximum		40,600					62	52

1/ Excludes past interest due and includes debt structured under new money options for Panama, Poland, and Venezuela.
2/ Approval date of first Fund arrangement following the 1989 revision of financing assurances policy. Argentina, Bulgaria, Côte d'Ivoire, Dominican Republic, Ecuador, Panama, Philippines, Poland, and Vietnam all had one or more subsequent arrangements before agreement in principle was reached on a restructuring deal.

Appendix Table 2. Fund Arrangements with Members with Unresolved Arrears to Commercial Bank Creditors Negotiating Debt Operation Supported by the IDA Debt Reduction Facility, 1989-96

Country	Commercial debt restructuring prior to 1989 1/ (1)	Amount outstanding or restructured (mill. US$) (2)	Date of: Emergence of commercial bank arrears (3)	Date of: Fund-supported adjustment program 2/ (4)	Date of: Concluding restructuring agreement (5)	Duration of Fund lending into arrears (months) (6)=(5)-(4)
Albania	No	371	1989	Aug. 26, 1992	Aug. 25, 1995	36
Bolivia	Yes	170	Early 1980s	Dec. 1, 1989	May 19, 1993	57
Cameroon 3/	No	813	1988	Dec. 20, 1991	...	...
Congo 4/	Yes	615	Early 1990s	Aug. 27, 1990	...	...
Ethiopia 5/	No	230	n.a.	Oct. 28, 1992	Jan. 12, 1996	38
Guinea 4/	Yes	95	Early 1980s	Nov. 6, 1991	...	...
Guyana	No 8/	69	1982	July 13, 1990	Nov. 24, 1992	27
Guyana II 6/	No	50	n.a.	July 13, 1990	...	...
Mauritania 4/ 7/	No	53	Late 1980s	May 24, 1989	September 16, 1996	87
Mozambique	Yes	124	June 1984	June 1, 1990	Dec. 1991	18
Nicaragua	Yes	1,099	Feb. 1983	Sept. 18, 1991	Dec. 22, 1995	50
Niger	Yes	111	1989	Dec. 12, 1988	Mar. 1991	26
São Tomé & Principe	No	11	1986	June 2, 1989	Aug. 1994	62
Senegal 4/	Yes	71	Mid 1980s	Mar. 2, 1994	Dec. 24, 1996	34
Sierra Leone	Yes	233	Early 1980s	Mar. 28, 1994	July 13, 1995	15
Tanzania 4/	No	547	n.a.	July 29, 1991	...	...
Togo 4/	Yes	50	1988	May 31, 1989	...	...
Uganda	No	152	Mid 1980s	Apr. 17, 1989	Feb. 26, 1993	46
Minimum		10				15
Average		270				41
Maximum		1,099				87

1/Outside the framework of the IDA debt reduction facility.
2/ Approval date of first Fund arrangement following the 1989 revision of financing assurances policy. Albania, Congo, Guyana, Mauritania, Nicaragua, Niger, Senegal, and Togo had one or more subsequent arrangements before restructuring deals were concluded.
3 Negotiations on debt restructuring deal currently dormant.
4/ Negotiations on debt structuring deal ongoing.
5 The 1996 debt restructuring deal for Ethiopia included commercial bank debt, suppliers' credits, and other commercial credits.
6 Pipeline debt under the External Payment Deposit scheme.
7 The 1996 debt restructuring deal for Mauritania was a partial operation that covered about half of outstanding arrears.
8/ Only a deferment agreement was reached for 1985 and 1986.

Appendix Table 3. Indicators of Access to International Capital Markets by "Brady" Countries, by Instrument 1/

(In millions of U.S. dollars)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Argentina	0	0	0	121	839	2,141	**7,644**	6,284	7,721	15,701
Bonds	0	0	0	21	765	1,619	**6,308**	5,319	6,354	13,738
Loans	0	0	0	100	74	522	**1,336**	965	1,368	1,963
Brazil	0	0	0	0	1,837	3,650	6,455	**3,898**	7,606	11,414
Bonds	0	0	0	0	1,837	3,650	6,455	**3,898**	7,041	11,194
Loans	0	0	0	0	0	0	0	**0**	565	220
Bulgaria	0	0	255	0	0	0	0	**0**	0	0
Bonds	0	0	255	0	0	0	0	**0**	0	0
Loans	0	0	0	0	0	0	0	**0**	0	0
Costa Rica	0	0	0	**0**	0	311	0	50	5	23
Bonds	0	0	0	**0**	0	0	0	50	0	0
Loans	0	0	0	**0**	0	4	0	0	5	0
Cote d'Ivoire	0	0	0	0	0	154	0	0	0	12
Bonds	0	0	0	0	0	0	0	0	0	0
Loans	0	0	0	0	0	154	0	0	0	12
Dom. Rep.	0	0	0	0	6	0	0	0	0	0
Bonds	0	0	0	0	0	0	0	0	0	0
Loans	0	0	0	0	6	0	0	0	0	0
Ecuador	0	0	0	0	0	18	0	5	140	0
Bonds	0	0	0	0	0	0	0	0	10	0
Loans	0	0	0	0	0	18	0	5	130	0
Jordan	200	8	0	0	0	0	0	0	105	0
Bonds	0	0	0	0	0	0	0	0	50	0
Loans	200	8	0	0	0	0	0	0	55	0
Mexico 2/	169	1,808	1,350	**4,115**	6,567	9,251	13,751	8,234	10,629	19,640
Bonds	0	1,278	670	**2,487**	3,606	6,333	11,238	6,749	7,646	17,823
Loans	169	530	680	**1,628**	2,961	2,918	2,513	1,485	2,983	1,817
Nigeria	0	0	692	244	190	0	0	0	0	0
Bonds	0	0	0	0	0	0	0	0	0	0
Loans	0	0	692	244	190	0	0	0	0	0
Panama	0	0	275	58	38	0	80	8	799	**425**
Bonds	0	0	0	0	0	0	0	0	0	**75**
Loans	0	0	275	58	38	0	80	8	799	**350**
Peru	0	0	0	0	0	5	75	243	90	115
Bonds	0	0	0	0	0	0	20	100	0	0
Loans	0	0	0	0	0	5	55	143	90	115
Philippines	0	0	94	26	301	**1,259**	2,082	1,758	2,388	3,827
Bonds	0	0	0	0	0	**20**	1,274	1,264	1,059	3,307
Loans	0	0	94	26	301	**1,239**	807	493	1,329	520
Poland	0	0	163	0	236	105	236	362	727	580
Bonds	0	0	0	0	0	0	0	0	250	314
Loans	0	0	163	0	236	105	236	362	477	266
Uruguay 2/	0	0	0	0	0	**129**	140	200	221	145
Bonds	0	0	0	0	0	**100**	140	200	211	145
Loans	0	0	0	0	0	**29**	0	0	10	0
Venezuela	0	0	175	817	1,120	2,279	4,992	221	961	659
Bonds	0	0	0	263	577	766	2,938	0	356	532
Loans	0	0	175	553	544	1,513	2,053	221	605	127
Vietnam	0	0	0	5	20	20	27	238	508	303
Bonds	0	0	0	0	0	0	0	0	0	0
Loans	0	0	0	5	20	20	27	238	508	303
Total	369	1,816	3,003	5,385	11,155	19,015	35,481	21,501	31,901	52,821
Bonds	0	1,278	925	2,771	6,785	12,488	28,375	17,580	22,977	47,128
Loans	369	538	2,078	2,614	4,369	6,526	7,107	3,921	8,924	5,693

Source: DCBEL data base.

Bold: Year of financial closing.

__: Year of agreement in principle.

1/ Data covers private, sovereign and other public sector borrowers. Loans are commitments on medium- and long-term loans from commercial banks rather than disbursement.

2/ Avoided arrears to commercial creditors.

Appendix Table 4. Summary of the Terms of Sovereign Bond Contracts

	Applicable Law	Support Required for Acceleration of Principal	Cross Default	Sharing Clause	Collateral
Brady bonds	New York	25 percent of principal	Other Brady bonds and declaration of moratorium	No	Principal collateral: accessible at the end of 30 years (discount and par). Rolling 6-12 month interest collateral (discount, par and FLIRB) requires support of 50 percent of principal (Box 4).
Euro bonds	English, French or German	Varies. Typically 10 percent of principal, though ranges on individual issues from 0-25 percent.	Default on any other debt obligations exceeding specified amount.	No	None
Global bonds	English or New York	As for Euros	As for Euros	No	None
Samurai bonds	Japanese	Varies, usually ranging from 10-25 percent of principal	As for Euros	No	None
Memorandum item: Syndicated bank loans	Varies	Typically 50 or 66 percent of principal	As for Euros	Yes	None