DECLARING SOVEREIGN DEFAULT

(PAPER: ECON. 826)

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JANUARY 23RD, 2004.

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Sovereign default is an issue that has demanded a lot of attention in recent years, and rightly so. By the time the infamous debt crisis of the 1980s had ended and was considered resolved to a great extent, in the early 1990s a new wave of events took place that left the international economic framework in a state of chaos.

Starting with the Mexican debt crisis in 1994-1995, characterised by self-fulfilling debt runs[1], the late 1990s saw a chain event of such crisis. In 1997, the world saw the crumbling of the East Asian miracle; these economies collapsed one after the other in what seemed like a domino effect. Soon after the crisis spread to Russia in its contagion effect and we saw the Russian default in August 1998. The advent of the new century saw yet another country collapse under this wave. The currency and banking crisis of Argentina resulted in its declaring a large-scale debt default, propelling millions of its citizens into conditions of poverty. The turn of events since the early 1990s has thus brought back the subject of sovereign debt crisis to centre stage.

To fully understand the subject of sovereign debt crisis and possible declaration of default we should understand the forces that propel such a crisis to develop in the first place. Deepak Lal in his essay "The Structure of International Capital Markets"[2] outlines some of the common features in the various sovereign debt crisis experiences since the 1980s. Firstly he states that it is noteworthy that all debt crises in the past two decades have been associated with sudden withdrawal or reduction of bank lending. Secondly these crises have hit countries whose exchange rate regimes have

[1] Rogoff and Zettelmeyer, 2002, "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001," IMFWP.
[2] Lal, 2003, "The Structure of International Capital Markets" in Sovereign Debt, Origins, Crisis and Restructuring (London, Chameleon Press Limited).

been characterised by some sort of adjustable peg which, is in itself subject to speculative attacks under increasingly globalised capital markets. He argues that only fully flexible exchange rate regimes are able to deal with volatility of today's globalised markets. Thirdly the debt crisis of the 1980s and those experienced by some countries in the 1990s were the result of "inappropriate domestic macroeconomic and structural policies". Lastly he argues that these financial crises have been exacerbated to a great extent by the problem of "international moral hazard" created largely by the IMF's[3] policies. The IMF bailouts to the private sector create a moral hazard problem resulting in excessive risk taking by these parties and trapping the countries in a vicious circle.

These are broad based similarities in the crises, encompassing the crises the experienced in the last two decades. However if these crises are looked at individually it seems that the debt crisis of the 1980s is quite different from those experienced by most countries since the mid 1990s.

The Latin American debt crisis of the 1980s can be described as an offshoot of the OPEC oil shocks of the 1970s which indirectly propelled commercial banks into the world of international credit markets, advancing loans to sovereign nations. Countries like Argentina and Brazil which were oil importers resorted to commercial bank loans which were available at very low interest rates to cover balance of payment shortfalls and to limit the domestic cost of adjustment[4]. Other countries especially oil exporters resorted to commercial bank borrowing for financing development projects or fiscal deficits on the basis of their newly created wealth. Events took a volte-face when the US Federal Reserve raised interest rates and paying off this short term, floating rate debt became a huge issue for the borrowing parties. Mexico in 1982 was the first

[3] International Monetary Fund
[4] McGovern, 2003, "Different Market Windows on Debt: Private Sector Credit from the 1980s to the Present" in Sovereign Debt, Origins, Crisis and Restructuring (London, Chameleon Press Limited).

country forced into rescheduling its bank debt facing extreme difficulties in rolling over its liabilities. This resulted in a severe and sudden freeze of credit lines to the entire region and initiated a wave of sovereign defaults all over the region[5]. Quickly Argentina and Brazil followed and the global financial system stood at the threshold of utter disaster. Some of the largest US banks now faced the threat of insolvency as they had loans to the defaulting countries amounting to more than 170% of their primary capital[6].

In contrast, the debt crises of the 1990s were different in nature. For one thing debt owed to foreign commercial banks was only one type of debt instrument used among money. Sovereigns now faced lenders that ranged from local banks and pension funds, commercial banks, insurance companies to non-financial companies and mutual funds etc. Various types of debt instruments overtook the conventional instruments. Debt instruments were now a widely traded commodity and took the form of foreign or local currency loans and notes, foreign or local currency bonds, foreign or local currency structured debt, derivatives and options, and collaterized bond and debt obligations etc[7]. The debt crisis when it hit these sovereigns thus took various new dimensions. It was not the result of any one external shock to the economy resulting from some world economic crisis. It would be precipitated thorough an amalgamation of otherwise small events. Local currency crises resulting from the breakdown of pegged exchange rate regimes led to higher foreign currency debt obligations and in some cases precipitated a payments crisis. Similarly corporate and banking sector crisis as in Argentina 2001 could translate into a larger crisis involving not only the collapse of the financial and exchange rate regime but also to an ultimate debt crisis. Due to the developments in the global financial markets, the

[5] Ray, 1998, Development Economics, (New Jersey, Princeton University Press).
[6] McGovern, 2003, "Different Market Windows on Debt: Private Sector Credit from the 1980s to the Present" in Sovereign Debt, Origins, Crisis and Restructuring (London, Chameleon Press Limited).
[7] Ibid pg. 78.

domestic financial markets have increasingly become interlinked with international financial markets and are thus prone to any shock or volatility experienced by the latter.

A lot of proposals have come up since the 1970s for bankruptcy procedures for sovereigns. It should be considered why are countries obliged to pay back their debt and why default should never be considered as an option or should be avoided at all costs. The main incentive for countries to pay back their debt is to ensure future access to credit as by defaulting they lose their good reputation in the credit market[8]. This argument however has been criticised by many; Stiglitz in his book *Globalization and its discontents* points out that if capital markets are assumed to be working well they would be forward looking *i.e.* "in assessing what interest rate to charge they look at the risk going forward (pg. 202)." Thus a country that defaults and in doing so gets rid of its debt overhang is now in a better position to grow and repay its additional borrowing. Thus efficiency would require that if default is the only option for a sovereign it should not be discouraged or prevented as it is by international institutions especially the IMF. Moreover both Stiglitz (2002) and Aggarwal and Granville (2003) point out that countries that have defaulted in the past have had access to credit soon after the crisis and capital flows have resumed after a short period of recession. Extensive criticism of IMF bailouts and other policies that have worsened crises have brought up the subject of a possible solution to the problem to the forefront again.

The Rogoff and Zettelmeyer paper does a literature review of the bankruptcy reorganisation principles for sovereign debt crises. They outline in chronological order proposals for debt restructuring mechanisms and measures that would prevent

[8] See Aggarwal and Granville, 2003, Sovereign Debt, Origins, Crisis and Restructuring (London, Chameleon Press Limited) and Stiglitz, 2002, Globalization and Its Discontents (New York, W.W. Norton and Company).

sovereign default. All literature discussed in their paper aims to change the incentives of the creditor particularly in regards to (a) the moral hazard problem associated with bailouts, (b) free riding whereby some creditors holdout in debt rescheduling arrangements and initiate a litigation process to get maximum personal gains, and © the collective action problem where different classes of creditors are unable to cooperate with each other under the strained circumstances of an imminent sovereign default.

Rogoff and Zettelmeyer classify their literature review into two types of proposals: contractual and statutory. The latter proposes creation of new rules or institutions through changes in international or national law through which holdouts could be prevented after majority consensus, new financing could be given seniority and sovereigns could be given some degree of protection against litigation during payments moratoria or during negotiations[9]. The formal category of proposals on the other hand focuses on the way contracts between parties are written, these focus more on the approach of *bailing in* the creditors, "encouraging the creditors and sovereigns to adopt collective action clauses in bond contracts, allowing a qualified majority of creditors to amend bond terms[10]. Interestingly the IMF has now officially formulated a policy for sovereign debt restructuring that is an amalgamation of both these approaches. The "Sovereign Debt Restructuring Mechanism, 2001" or SDRM as it more commonly known explains the new IMF policy. SDRM is essentially a statutory proposal under which the debtor country would come to IMF requesting a temporary standstill on its debt repayments. After approval from the Fund the country would enter into negotiations over the rescheduling or restructuring of its loans with its

[9] Rogoff and Zettelmeyer, 2002, "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001," IMFWP.
[10] McGovern, 2003, "Different Market Windows on Debt: Private Sector Credit from the 1980s to the Present" in Sovereign Debt, Origins, Crisis and Restructuring (London, Chameleon Press Limited).

creditors. The Fund would have the authority to revoke the stay if the sovereign concerned does not implement corrective measures or does not negotiate in good faith[11]. However in 2002 the authority of endorsing a sovereign's request for a standstill and the revoking of stay was taken away from the Fund itself and a panel of majority of creditors was proposed who would act collectively[12].

The debate over the right way to go about these things has come a long way since the 1970s but it is not over yet. A lot of people have objections to the Krueger proposal. Some like Deepak Lal argue that there is no justification for any kind of public intervention, as international capital markets are in themselves extensions of domestic stock markets and if interventions in the latter are inconceivable the rationale for looking for means to avoid the volatility of international capital flows and the bubbles that periodically occur in them is inherently flawed[13].

This argument shows that the spectrum for debate is still very wide and continues to evolve with time. Perhaps the next crisis will lead to a more coherent consensus over this issue.

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[11] Rogoff and Zettelmeyer, 2002, "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001," IMFWP.
[12] Krueger, 2002, "A New Approach to International Debt Restructuring."
[13] Lal, 2003, "The Structure of International Capital Markets" in Sovereign Debt, Origins, Crisis and Restructuring (London, Chameleon Press Limited).

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