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Sovereign Bankruptcy

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Sovereign Bankruptcy

Abstract
A bankruptcy regime is an essential element of all national domestic financial systems. It is essential for reasons of fairness, and of systemic stability. However there is presently no bankruptcy regime for nations. The international financial system is experiencing increasingly frequent, and severe, financial crises. Presently the only options available to the IMF in dealing with a nation without the capacity to service its debt are to permit a destabilising and destructive default, as with Argentina in 2001; or to undertake a massive bail-out, as in East Asia in 1997. Such bail-outs pose their own systemic problems, and these two policy options are inadequate. An alternative to default or bail-out is needed, and that alternative is bankruptcy.

Keywords
sovereign bankruptcy, sovereign debt, international finance

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SOVEREIGN BANKRUPTCY

*Ross Buckley**

A bankruptcy regime is an essential element of all national domestic financial systems. It is essential for reasons of fairness, and of systemic stability. However there is presently no bankruptcy regime for nations. The international financial system is experiencing increasingly frequent, and severe, financial crises. Presently the only options available to the IMF in dealing with a nation without the capacity to service its debt are to permit a destabilising and destructive default, as with Argentina in 2001; or to undertake a massive bail-out, as in East Asia in 1997.[1] Such bail-outs pose their own systemic problems,[2] and these two policy options are inadequate.

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It is a pleasure to contribute to this *festschrift* for two of the true pioneers of Australian legal education. David Allan pioneered the teaching of credit and security in particular, and banking and finance law generally, in Australia. Before his efforts at Monash in the 1960s this field was, at best, considered peripheral. David changed all that. In a very real sense, all of us who have taught and researched in the field in the three decades since then have built on the foundations he laid.
Mary Hiscock has also been a pioneer. She pioneered the teaching of international trade law in this country. She was also one of Australia's first full-time female law teachers and paved the way for the many women who have contributed so richly since then. I was privileged to develop and teach a new course in Civil Remedies at Bond jointly with Mary in the late 1990s and benefited from her extraordinary enthusiasm and energy.

1 The IMF has proposed a Sovereign Debt Restructuring Mechanism but work on it has been shelved for the time being, see text accompanying n 50. Work is underway on the adoption of collective action clauses in sovereign bond documentation, and on the adoption of a Voluntary Code of Conduct on Sovereign Debt Restructuring. Both initiatives have a long way to go, and each is only a very partial response. For information on both initiatives, see International Monetary Fund, "Progress Report to the International Monetary and Financial Committee on Crisis Resolution", September 3, 2003. See also note 47.

2 Such bail-outs in fact bail out the debtor nation's short-term creditors, and thus give rise to severe moral hazard: see Anne Krueger, *Preventing and Resolving Financial Crises: The Role of Sovereign Debt Restructuring* (Speech to the Latin American Meeting of the Econometric Society, Sao Paolo, Brazil, July 26 2002) http://www.imf.org/external/np/speeches/2002/072602.htm; accessed on September 26, 2002. "Moral hazard" describes any system that protects parties from the consequences of their actions and thus holds out inducements to seek to profit from misbehaviour: C.W. Calomiris, 'The IMF's Imprudent Role as Lender of Last Resort', 17 Cato Journal, Winter 1998, at 275.

An alternative to default or bail-out is needed, and that alternative is bankruptcy. So, to see where to go on this issue, let us take a look at where we have come from.

A Brief History of Recent Sovereign Debt Crises

Any analysis of sovereign debt crises in modern times must start in 1973.[3] OPEC discovered the delights of being a cartel and quadrupled the price of oil.[4] Banks accelerated their lending to developing countries to 'smooth out the oil price shock', i.e. to allow developing countries to keep buying oil without having to tighten their belts and depress economic growth. The OPEC nations deposited their oil receipts in the banks.[5] And the developed nations had a choice of two options to afford the oil – they could earn more or spend less. As with individuals, spending less is rarely an attractive option. So the nations chose to earn more, i.e. export more. To do so they needed other nations to have more money to buy their exports. This they ensured by encouraging their banks to lend more to developing countries in a process Philip Wellons termed, "passing the buck".[6]

It was a neat trick. All other things being equal, the oil price rise would have plunged Europe and North America into recession. But all other things were not equal -- the governments of Britain, France, Germany and the US formulated a plan to increase their exports and avoid a recession by encouraging lending to the poorer countries -- and the plan worked. More capital flowed south and the increased imports it funded staved off recession in the developed countries.[7]

The developed nations enjoyed strong economic growth. The OPEC nations enjoyed ever-increasing credits with the world's major banks; and the developing nations 'enjoyed' ever-increasing debits with the world's major banks.

It could not last. The Chairman of Chase Manhattan Bank, David Rockefeller, said so, on the front page of the Wall Street Journal, in June 1974.[8] However,

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3 For an excellent analysis of the first Latin American crisis, see Dawson, FG. *The First Latin American Debt Crisis: The City of London and the 1822-1825 Loan Bubble* (1990).

4 For the best analyses of the debt crisis of 1982, see Marichal, C., *A Century of Debt Crises in Latin America* (1989); Eichengreen & Lindert (eds), *The International Debt Crisis in Historical Perspective* (1989); Griffith-Jones, S (ed), *Third World Debt - Managing the Consequences* (1989); Kuczynski, P-P, *Latin American Debt*, (1988); Pastor, RA (ed), *Latin America's Debt Crisis - Adjusting to the Past or Planning for the Future?* (1987); and Sachs, JD (ed). *Developing Country Debt and the World Economy* (1989).

5 For more on this, see RP Buckley, *Emerging Markets Debt* (1999).

6 P.A. Wellons, *Passing the Buck - Banks, Governments and Third World Debt* (1987).

7 Ibid.

8 Rockefeller was quoted as saying, 'Channelling massive flows of oil dollars from dollar-rich to dollar-poor countries once seemed easily manageable. But now it looks more

Rockefeller's warnings fell on deaf ears. Bankers preferred to listen to Walter Wriston, Chairman of Citibank, and the most charismatic banker of his time.[9] Wriston had pronounced that 'Countries never go bankrupt'[10] and this statement was to influence more lending decisions than any analysis by a credit committee and any warning by Rockefeller.

Wriston was legally quite correct and substantively spectacularly wrong. Countries cannot legally become bankrupt without a body of rules under which they may be declared to be so.[11] But throughout history countries have become substantively bankrupt, typically with harsh consequences for the living standards and human rights of their more vulnerable citizens. But Wriston's approach was far more profitable, at least in the short to medium term, than Rockefeller's, and so the capital kept flowing south, for another eight long years, until August 1982, when Mexico announced it could no longer service its debts.

Mexico's insolvency stopped capital flowing to all of Latin America and Africa and this plunged the two continents into crisis. This debt crisis, as managed under the structural adjustment programs of the IMF, exacted a horrifying human toll. According to UNICEF, over 500,000 children up to the age of five years were dying each year in sub-Saharan African and Latin America in the late 1980s directly due to the effects of the debt crisis and its management.[12] A partial solution to the debt crisis was crafted in the early-to-mid 1990s for much of Latin America under the Brady Plan, but the debt crisis has never really been resolved for much of sub-Saharan Africa. Accordingly, one can extrapolate the mortality identified by UNICEF over many years in that blighted part of the world.

This potted history of the debt crisis of the 1980s makes two points:

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troublesome ... My own view ... is that the process of recycling through the banking system may already be close to the end for some countries, and in general it is doubtful this technique can bridge the [payments] gap for more than a year or at the most 18 months.' See C. Stabler, "Mideast Oil Money Proves Burdensome", *The Wall Street Journal,* June 6, 1974, at 1 & 29. Of course, other bankers were of a different view.

9 And who, incidentally, was quoted as disagreeing with Rockefeller, in the same article, saying, 'The Great Crisis ... ain't going to happen'. And Wriston enjoyed a higher reputation in the market than Rockefeller!

10 As cited in Buckley, op cit n 5 at 14.

11 Ian F Fletcher, *The Law of Insolvency* (1996) 4-6.

12 UNICEF, 'The State of the World's Children, 1989', reproduced in part in the Statement of Dr Richard Jolly, Deputy Executive Director for Programmes, United Nations Children's Fund, before the House Committee on Banking, Finance and Urban Affairs hearings on the 'International Economic Issues and Their Impact on the U.S. Financial System', Jan 4, 1989, 101st Congress First Session, 158 at 160.

1. The creditors were prepared to keep extending credit, far beyond reasonable levels, because the absence of a bankruptcy mechanism meant they expected to be repaid by the debtor nations increasing taxes and reducing social services to their people.
2. The creditor nation governments encouraged this excessive extension of credit because it served their short-term interest in avoiding a recession.

The East Asian economic crisis was a different type of crisis. The debt crisis of 1982 had been a crisis of excess consumption fuelled by excess indebtedness. In contrast, the fiscal and monetary policy settings of the East Asian countries were reasonable, and indeed prudent.[13]

This latter crisis was the result of a number of factors including (i) fixed exchange rates, tied to an appreciating U.S. dollar when the currency of the countries' principal competitor, Japan, was depreciating; (ii) weaknesses in the local financial sectors and their prudential regulation so that local banks were able to borrow heavily abroad and relend the proceeds domestically without hedging the foreign exchange risks (i.e. relying utterly on the peg of the local currency to the Dollar to hold); (iii) crony capitalism which further eroded the effectiveness of prudential regulation; (iv) excessive capital inflows facilitated by premature liberalisation of local financial sectors; and (v) a region-wide loss of confidence.[14]

The consequences of the Asian economic crisis for the poor of the region were harsh.[15]

Most recently, Argentina has plunged into a severe crisis. The years from 1991 to 1998 were prosperous in Argentina as foreign capital flowed in and Argentina's economy performed strongly.[16] In these years, Argentina significantly improved

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13 In the words of Laurence Meyer, a member of the Board of Governors of the US Federal Reserve System, "By conventional standards, the monetary and fiscal policies of the developing Asian economies prior to the crisis were largely disciplined and appropriate. … consumer price inflation … was relatively subdued [and] fiscal policy also appears to have been disciplined … Therefore, another important lesson of the Asian crisis is that sound macroeconomic policies alone do not preclude crises.": LH Meyer, "Lessons from the Asian Crisis: A Central Banker's Perspective", *Levy Economics Institute Working Paper No.* 276, August, 1999.

14 See generally RP Buckley, "An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors", (2000) 15 *Banking and Finance Law Review* 431.

15 In Malaysia, Korea, Indonesia, Thailand and the Philippines, over 10 million people dropped below the poverty line from 1996 to 1998: Leslie Elliott Armijo, "The Political Geography of World Financial Reform: Who Wants What and Why?", in (2001) Vol 7 No 4 *Global Governance* (special issue on the New International Financial Architecture) at 14.

16 GDP per capita increased an exceptional 44% between 1991 and 1998: Miguel Kiguel, 'Structural Reforms in Argentina: Success or Failure?', Comparative Economic

its banking system, more than doubled its exports, increased infrastructure investment through privatisations and otherwise privatised a broad range of industries, experienced significant growth in oil and mineral production and achieved record levels of agricultural and industrial output.[17] Argentina was a darling of financial markets and of the IMF and was toasted as 'the best case of "responsible leadership" in the developing world'.[18]

Nonetheless at the end of 1998 Argentina entered a severe recession. The timing was dictated in part by the 1997 Asian economic crisis and the August 1998 Russian crisis severely restricting capital flows to emerging markets economies.

Notwithstanding eight years of prodigious growth in the 1990s, Argentina is now undergoing the worst economic crisis in its history[19] and possibly the worst peace-time economic crisis in world history.[20] How did this happen? The principal causes are threefold: the peso-dollar peg; massive inflows of foreign capital facilitated by the almost complete liberalisation of Argentina's capital account;[21] and the corruption that is endemic in Argentine society.[22]

Studies, XLIV No. 2 (Summer 2002) 83 at 84; percentage calculated from Figure 1. There was a brief hiatus in the growth during 1995 in response to the Tequila effect: the contagion from Mexico's crisis in late 1994 and early 1995: id at 94-95.

17 Kiguel, ibid at 100-101. This is not to suggest that many of the privatisations were not deeply problematic. It is always a profound challenge to realise appropriate prices for the privatisation of major businesses and assets in emerging markets nations for the range of potential purchasers is not wide and because of the risk of very favourable prices for well-connected purchasers. The scrupulous and rigorous public accountability procedures that would mitigate against the latter risk are rarely present. There is much to suggest that many of the privatisations of the 1990s in Argentina were at a deep undervalue.

18 'Chaos in Argentina', The Nation, January 21, 2002, 3. See also 'Argentina: A Poster Child for the Failure of Liberalized Policies? Interview with Lance Taylor', Challenge, Nov-Dec, 2001, 28.

19 Kiguel, op cit n 16 at 83; Martin Crutsinger, 'IMF Grants Argentina Debt Extension', Associated Press Online, 09/05/02.

20 Duncan Green, 'Let Latin America find its own path', The Guardian, August 5, 2002. On one estimate total domestic financial assets shrunk from US$126.8 bn in March 2001 to US$41.5 bn in March 2002. If this is correct it is one the most massive destructions of wealth anywhere in the world in the past thirty years. See Business Monitor International, Economic Outlook, Argentina Quarterly Forecast Report, 2002.

21 Feldstein, 'Argentina's Fall', 81 Foreign Affairs, March-April, 2002, 8; and 'Argentina: A Poster Child for the Failure of Liberalized Policies? Interview with Lance Taylor', Challenge, Nov-Dec, 2001, 28.

22 A minor factor that contributed to the crisis was the privatisation of Argentina's social security system in 1994. This meant the nation could no longer count social security revenues as revenues, and had to move them off the budget. This led to substantial budget deficits that would not have existed under the former system of accounting for these revenues. To remain compliant with IMF targets, Argentina then had to reduce public expenditure to reduce its deficit which in turn contributed to the downturn. See

The peso-dollar peg had effectively stabilised inflation. However the peg led to a progressive overvaluation of the peso that stifled exports and promoted imports. The capital inflows, in typical Latin American fashion, were used to finance budget and current account deficits.[23] Argentina thrived in the 1990s on borrowed money. Borrowing to finance budget deficits is particularly problematic because this use of the funds will not generate the foreign exchange to service or repay the debt.

Finally, corruption played its insidious role in rendering Argentina's economy profoundly inefficient by increasing transaction costs and by diverting capital flows from their intended destination into the private accounts of politicians, senior civil servants and leaders of industry.[24]

The recession deepened into a severe crisis in late 2001 when the IMF refused to extend further credit to the nation, believing its economic programs to be unsustainable. Commercial lenders followed this lead, Argentina was denied access to capital and defaulted on its external debt of some US$ 132 billion. The government was forced to float the peso, and it sunk.

An effective sovereign bankruptcy regime could have ameliorated a substantial amount of the human suffering in Africa and Latin America in the 1980s, and more recently, in Asia and Argentina. An effective bankruptcy regime brings many benefits at the national level, and would do so at the global sovereign level.

The Benefits of Bankruptcy Regimes

At the national level, the principal benefits and purposes of a personal bankruptcy system are generally enunciated as being to divide the assets of an insolvent debtor fairly and rateably between its creditors, and to allow an insolvent debtor the opportunity to make a fresh start free from the burden of accumulated debt (provided the debtor has not engaged in dishonest or otherwise improper financial conduct).[25] Sir Roy Goode has identified four objectives of *corporate* insolvency law: restoring the company to profitable trading, maximising returns to creditors, providing a fair and equitable system for the ranking of claims and identifying the causes of company failures and imposing sanctions for culpable management.[26] The other literature on the topic is in similar terms.

Larry Rohter, "Giving Argentina the Cinderella Treatment", *The New York Times*, August 11, 2002, section 4, p 14, col 1, citing Joseph Stiglitz.

23 Kiguel, op cit n 16 at 101.

24 Paul W Rasche, "Argentina: test case for a new approach to insolvency?", *Studien von Zeitfragen*, January 5, 2002; Ernest Sweeney, "Argentina: the Current Crisis in Perspective", vol 186, issue 4 *America*, Feb 11, 2002, 19; and Naomi Klein, "Revolt of the wronged", *The Guardian*, March 28, 2002.

25 Dennis Rose QC, *Lewis Australian Bankruptcy Law*, (1994) at 1.

26 RM Goode, *Principles of Corporate Insolvency* Law, Second edition (1997) at 25 -28

What is missing from the literature is the notion that an effective insolvency regime will improve dramatically the allocation of credit within an economy, and thus make the economy more stable.[27]

The fairness aspects of bankruptcy are important. Internationally their absence has cost millions of lives. However, notwithstanding this appalling mortality, the credit-allocation advantages of a bankruptcy system may be even more important at the international level. This is because the more immediate risk of loss under a global bankruptcy regime would tend to moderate capital flows to developing countries. An effective global sovereign bankruptcy regime in the 1970s would have led to far less capital flowing south. The real prospect of massive loan losses would have sharpened banker's minds. When a Rockefeller said these loans were unsustainable, bankers would have listened, for if he was right they were set to lose billions.

This credit-allocation effect can help to ensure that the capital flows are more appropriate to the needs and capacities to repay the respective debtors. Financial crises would thus be less frequent and less severe.[28] Furthermore, in the event of a crisis, the workout would proceed more rapidly and efficiently and thus the workout costs to creditors and debtors would be reduced.
We take this credit-allocation effect of bankruptcy for granted in domestic systems. If a bank makes a poor credit decision domestically and lends to a borrower who subsequently becomes insolvent, absent security, most of the money will be lost. Without the prospect of sovereign bankruptcy, lenders do not bear the full implication of poor lending decisions internationally and thus excessive extensions of credit are likely. When nations have unsustainable debts, they typically must repay them, as there is no alternative, save a highly destabilising default that will deny the nation access to commercial capital often for many

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27 The latest edition of the classic Australian text on liquidation, Keay A (ed), 4th ed)), *McPherson's Law of Company Liquidation*, enunciates purposes in much the same terms as Sir Roy Goode, and Ian Fletcher's classic English text, *The Law of Insolvency* (1996) is silent on the issue. The most thorough Australian analysis of the principles that should underpin and guide a modern insolvency law is to be found in the Australian Law Reform Commission Report, *General Insolvency Inquiry*, (ALRC 45, 1988). That report identified nine principles that should govern any insolvency regime (corporate or personal) but did not address the credit-allocation benefits of such a regime. Likewise, Vanessa Finch's excellent new book, *Corporate Insolvency Law: Perspectives and Principles* (2002) does not investigate the credit-allocation effects of an insolvency regime, although she touches on some related matters in chapter 4, and specifically at 143-44.

28 Excessive capital inflows played a major role in the Debt Crisis of 1982, the Mexican crisis of 1995, the East Asian Economic Crisis of 1997 and Russia's meltdown in 1998: see RP Buckley, "A Tale of Two Crises: The Search for the Enduring Lessons of International Financial Reform", (2001) 6 *UCLA Journal of International Law and Foreign Affairs*, 1; and Buckley, op cit n 14.

years. The debts are serviced through higher taxes and lower social services in countries that are already poor -- countries in which lower social services translate into malnutrition, inadequate housing, inadequate or no health care, unsafe water supplies, etc. The debts of effectively bankrupt nations are repaid at the expense of the most basic human rights of their own citizens. We still have something very like debtors' prisons for highly indebted nations. The Latin American nations are still struggling to service the debt that was incurred in the 1970s in the debt crisis. That debt has been restructured, reduced, and transformed into Brady bonds, but the bonds are still some fifteen to twenty years away from being fully repaid, and in the interim must be serviced, along with much of the debt incurred since the 1970s. Debt is a lifetime sentence for poor countries. The countries wages, in the form of foreign exchange earned from exports, are effectively garnished for up to thirty years!

Given these are the human consequences of sovereign insolvency, and given that Adam Smith, the 'father' of economics as we know it, could see so clearly that it would at times be necessary for nations to declare themselves bankrupt,[29] why has there never been put in place any means for a country to do so?

Why Is There No Global Sovereign Bankruptcy Regime?

The answer to why there is no global sovereign bankruptcy regime has at least three elements to it:

1. The lack, before the 1980s, of an overarching need for a sovereign bankruptcy regime.
2. The profound difficulties of creating international institutions and gaining widespread implementation of treaties.
3. The perceived interests of the creditors.

Each element will be considered.

Absence of an Overarching Need, Until Relatively Recently, for a Sovereign Bankruptcy Regime

Significant international financial crises are becoming far more frequent, and more severe, as the growing interconnectedness of markets means that national crises, that once would have been limited to that one country, now routinely

29 "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor": Adam Smith, *The Wealth of Nations*, Book V, Chapter III, p 468 in the Edward Cannan edition, 1976.

spread throughout their region, and often to the other emerging markets of the world.

In the 'good old days', developing countries had financial crises intermittently and need for a supranational institution to deal with them was less pressing – the crises were insufficiently frequent to warrant it and were often quite limited in their geographic spread. Yet, the proliferation of crises in the past twenty years[30] means today that, for the first time in history, any such institution would, if it were to exist, be consistently busy.

There are reasons for this recent proliferation of crises. The principal one is the convergence of financial markets under globalisation. Until the 1970s most national financial systems functioned as relatively self-contained units: savings within an economy funded investment within that economy. The internationalisation of finance since that time has meant ever-increasing capital flows, particularly portfolio capital flows of commercial banks and institutional investors, between nations.[31] The spread of modern telecommunications has meant information travels quickly between nations and capital can react quickly to adverse developments in a country. All in all, contemporary capital flows swiftly into developing nations when prospects look good and there is a surplus of liquidity in the developed world, and flows out even more swiftly when storm clouds gather,[32] or prospects in the developed nations' markets look better.[33] In the title of a recent book by the insightful emerging markets banker, Michael Pettis, our contemporary international financial system, particularly as it relates to developing nations, is "The Volatility Machine".[34]

Difficulties of Creating International Institutions

History teaches us to never underestimate the difficulty of establishing an international institution. Witness the abortive history of the precursor to the

30 For instance, there have been significant financial crises in Mexico in 1994-95, East Asia in 1997, Russia in 1998, Ecuador (and to a lesser extent Brazil) in 1999, Argentina in 2001, etc.

31 In 1970 the capital that moved around the globe to support trade in goods and services far exceeded that which moved to support direct and portfolio investment. More recently capital flows have outweighed trade flows by a factor of over 60 to one: P. Sutherland, *Managing the International Economy in an Age of Globalisation*, The 1998 Per Jacobsson Lecture, the annual meeting of the IMF and the World Bank (Oct., 1998). By institutional investors, I am referring to mutual funds, pension funds, and other managers of other people's money.

32 RP Buckley, "International Capital Flows, Economic Sovereignty and Developing Countries", *Yearbook of International Economic and Financial Law 1999* (2001), 17.

33 For instance, there were substantial capital outflows from emerging markets in the halcyon days before the "Tech-wreck" in April 2001.

34 M Pettis, *The Volatility Machine*, (2001).

United Nations, the League of Nations, and the International Trade Organisation. The story of the League of Nations is well known. That of the ITO is perhaps less well known.

The ITO was to be the third Bretton Woods institution, to accompany the IMF and the World Bank. These three institutions were the brainchildren of John Maynard Keynes and Harry Dexter White – the Englishman and American charged with shaping the international economic architecture after World War II (whose proposals were adopted at the conference at Bretton Woods, New Hampshire). Keynes and White had fresh in their minds the experience of the Great Depression that had dominated most of the inter-war years. They foresaw the need for a regime of fixed exchange rates to promote international trade, a monetary fund to assist with the implementation and operation of that regime, a development bank to assist with rebuilding Europe after the war and then to aid the development of poor countries, and a trade organisation to ensure the liberalisation and promotion of international trade. The IMF and World Bank came into existence, but due to subsequent US opposition the International Trade Organisation was never formed, and only the treaty it was to administer, the General Agreement on Tariffs and Trade, was implemented.

The scale of accomplishment in establishing the IMF and World Bank should itself not be undervalued. It took a global cataclysm, preceded by the Great Depression, to summon the political will to make those ideas reality.

Fifty years was roughly the gestation time also for the International Criminal Court that came into being in The Hague on July 1, 2002. The Nuremburg War Crimes Tribunal was an ad hoc international criminal court formed for the purpose of trying the Nazi war criminals of WWII, and at that time the need for a standing court was recognised and articulated. The realisation of that idea took 56 years. An international sovereign bankruptcy regime would have saved millions of lives in the 1980s, and so the need for it was critical, but the idea wasn't seriously considered until the mid-1990s. Let us hope history is not a firm guide to the gestation periods of such organisations, and we don't have to wait until 2050 for a sovereign bankruptcy regime.

Perceived Interests of Creditors

We do not have a global sovereign bankruptcy regime because the creditors believe its absence works in their favour. The banks have argued vociferously against a bankruptcy regime internationally when they accept, and indeed welcome, them nationally. Why? In the words of William Rhodes, Senior Vice-Chairman of Citibank,

> *"the existence of a formal bankruptcy mechanism, whether invoked or not, would cause uncertainty in the markets, deter potential lenders and investors, and drive up the countries' borrowing costs".*

This is nonsense. National bankruptcy regimes greatly enhance certainty and this serves generally to attract lenders and investors and thus diminish borrowing costs and there is no reason it would be any different internationally. In the words of the IMF, "in the domestic context, the existence of a bankruptcy law makes debt markets more efficient. … The same principle should hold for international capital markets".[35]

On the other hand, there is no formal structure for the resolution of sovereign debt crises and each crisis typically casts a pall for many years on debtor country prospects and bank profits. Debtor countries suffer with no new capital and ever increasing debt loads and banks suffer as in most cases they have to keep advancing new funds for years to enable the debtors to keep paying interest.[36]

William Rhodes is the world's most experienced banker in sovereign debt restructurings. He speaks as he does, presumably, because banks like the present arrangement under which, when a crisis hits, the poor in developing countries are consigned to the debtors' prisons of poverty, ill-health and ignorance[37] so that the loans made by the banks can be repaid.
The G-7 nations, at the behest of their banks, initially opposed the IMF's SDRM proposal and supported the far more limited, contractual approach of the U.S. The G-7 nations' banks[38] appear unable to learn the lessons of history or appreciate the benefits to themselves of a more enlightened approach.

The debt crisis of 1982 was resolved in part by the Brady Plan of the early 1990s under which the loans were converted into bonds with principal or interest

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35 See IMF, "Proposals for a Sovereign Debt Restructuring Mechanism (SDRM) A Factsheet", January, 2003, available at http://www.imf.org/external/np/exr/facts/sdrm.htm, accessed on March 6, 2003, at D.5.

36 Buckley, op cit n 5, 33-34.

37 In developmental terms, virtually everyone agrees that the 1980s was a lost decade in Latin America due to the Debt Crisis. No progress was made between 1982 and 1989 on debt relief or meaningful ways forward for debtor nations, and so the continent's poor went hungry, its young poor went uneducated, and its infrastructure crumbled, as nations continued to service an overwhelming debt burden (usually through new loans which simply increased the total indebtedness). The debt gridlock of the 1980s was in no one's long-term interests but damaged the debtors far more than the creditors. See C Marichal, *A Century of Debt Crises in Latin America* (1989) at 237; and Buckley, op cit n 5, at 34-36.

38 Paul Blustein, "IMF Crisis Plan Torpedoed," *Washington Post,* April 3, 2002, p E-1; and *G-7 Finance Ministers Adopt Financial Crises Action Plan*, (visited 15 June 2002) <http://www.fin.ge.ca/news02/02-034e.html>

discounted by 35%. History has proven that the debt relief in the Plan was necessary to allow Latin American economies to grow again and restore capital flows to the region. The Plan also gave the banks readily tradable bonds, rather than illiquid loans, that permitted many banks to sell their exposure to investors comfortable with risk, and free up their own capital to move on and undertake new business. The Brady Plan proved to be a huge boon to banks, yet at the time they resisted it strongly, and only agreed to it under enormous pressure from their own national banking regulators.[39]

The banks, in opposing a global sovereign bankruptcy regime, have got it wrong, again, when measured purely in terms of their self-interest.
So what would a global sovereign bankruptcy regime entail?

A Global Sovereign Bankruptcy Regime

The comprehensive approach would be to establish a sovereign bankruptcy court applying a body of rules and procedure.[40] Many writers have advocated the establishment of a global bankruptcy regime as a way of allocating losses more fairly between lenders and borrowers and of improving the efficiency of the system.[41] If implemented by a treaty between nations, such a court/tribunal and rules would require years of planning and negotiations; however, it could be implemented almost immediately if implemented by agreement between the creditors and debtors of one nation in difficulty and facilitated by the IMF.[42]

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39 RP Buckley, "The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993", (1998) 21 *Fordham International Law Journal* 1802.

40 Presently, no court has jurisdiction over disputes between a sovereign state and citizens (such as banks or bondholders) of another sovereign state – the International Court of Justice deals only with disputes between sovereign states: Michelle White, "Sovereigns in Distress: Do They Need Bankruptcy?", *Brookings Paper on Economic Activity*, 1:2002 at 21. Arbitral tribunals, such as those under the auspices of the International Centre for the Settlement of Investment Disputes (ICSID), do deal with such disputes, but are, of course, not courts. For more on ICSID, see RP Buckley, "Now We Have Come to the 'ICSID' Party: Are Its Awards Final and Enforceable?" (1992) 14 *Sydney Law Review* 358.

41 K Raffer, "Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face", (1990) *World Development* 18(2), 301; K Raffer, "International Debts; A Crisis for Whom?", in HW Singer & S Sharma, *Economic Development and World Debt*, (1989), 51; and see the research referred to in K Rogoff & J Zettelmeyer, "Early Ideas on Sovereign Bankruptcy Reorganisation: A Survey", *IMF Working Paper* WP/02/57.

42 The two principal models widely discussed for any such transnational law are Chapters 9 and 11 of the US Bankruptcy Code. Professor Kunibert Raffer has made a very strong case for why Chapter 9 provides the best available precedent for international sovereign bankruptcies: see Kunibert Raffer, "Solving Sovereign Debt Overhang by Internationalising Chapter 9 Procedures" (2002) *Studien von Zeitfragen*, at http://www.studien-von-zeitfragen.net/Weltfinanz/RAFFER_1/raffer_1.HTM

The proposal which is closest to the domestic law in most countries is that developed by the Jubilee Framework.[43] This envisages a bankruptcy procedure based on Chapter 9 of the US Bankruptcy Code (which deals with municipal bankruptcies) and enforced by an ad hoc independent panel of experts convened for a specific proceeding. Chapter 9 of the US Code is the best model for any sovereign bankruptcy regime.[44] It has worked effectively and efficiently in the bankruptcy of local municipalities within the U.S. and already deals with the issues peculiar to the bankruptcy of governments.

Under a Chapter 9 model, the decision upon whether to file for bankruptcy protection would be the debtors – as it is in domestic law -- provided they are unable to service their debts and have either obtained the agreement of creditors or tried and failed to work out a plan with them. A nation's incapacity to service debts would be defined by reference to an inability to provide certain minimal human rights to their people. This capacity to initiate bankruptcy proceedings would be no incentive to go bankrupt, just as it is not in domestic practice. Filing for protection would initiate an automatic stay, for a period, on creditors' claims. The claim for protection would be determined by an independent tribunal appointed by the creditors and the debtors. For instance, the creditors could appoint two members to the tribunal, the debtor nation could likewise appoint two members, and the four members could then jointly appoint a fifth, to serve as their presiding member.[45]

Developing nations, and the international financial system, would both be best served by a carefully crafted set of bankruptcy rules, based on Chapter 9 of the US Bankruptcy Law, and applied and enforced by independent tribunals.
Such a reform of the international financial system that created a permanent court would be a major step. However once a generally agreed set of bankruptcy rules for sovereign nations was drafted, they could be implemented on an *ad hoc* basis. A permanent court, with all its attendant machinery and expense, is not needed. It would be enough for the creditors and the debtor to appoint an *ad hoc* tribunal of eminent, disinterested jurists. Of course it is difficult to see the creditors and the debtor nation agreeing on such a course of action in the case of a major debtor such as Argentina, which would involve over US $100 billion of debt. It is almost impossible to expect creditors to trust such sums of money to an untried and untested process.

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accessed on September 3, 2002.

43 Ann Pettifor, " Chapter 9/11? Resolving International debt crises – the Jubilee Framework for international insolvency", February 2002, at www.jubileeplus.org/analysis/reports/jubilee_framework.html; accessed on September 26, 2002 and March 24, 2003.

44 See Raffer, op cit n 42; Pettifor, ibid; and Paul W Rasche, "Argentina: test case for a new approach to insolvency?", *Studien von Zeitfragen*, January 5, 2002.

45 Pettifor, ibid.

However it is neither necessary, nor probably desirable, to first apply this process to a major debtor. Far better, in fact, to treat of that which is more manageable – such as the bankruptcy of a micro-state, such as one of the Pacific Island nations,[46] or, at the least, of a much smaller and less indebted nation than Argentina.[47] On this scale, the benefits of a sovereign bankruptcy system could be explored, the costs of such a system quantified, and the challenges of such a system resolved.

Benefits of a Global Sovereign Bankruptcy Regime

So what advantages would a global bankruptcy regime with a highly developed, formal system of rules bring? Four come to mind.

1. The delays that occasion most sovereign debt workouts would be shortened, to the benefit of creditors and debtors.
2. The human suffering, and the state mandated infringements of basic human rights, that have accompanied the overwhelming majority of IMF Structural Adjustment Programs, would be dramatically ameliorated by the debt relief granted to sovereign debtors.
3. Capital flows to less credit worthy developing countries would be ameliorated by the prospect of national insolvency. Reckless lending and reckless borrowing would be constrained -- and this would be a good thing.
4. The international financial system would be more stable as capital would flow within it only after far more careful credit decisions than is now the case. This greater stability would benefit both creditors and debtors. In short, capital would tend to flow between economies more as it does today within economies (where the prospect of debtor bankruptcy plays its cautionary role).

The history of the past fifty years tells us that debtor nations usually continue to service their debts, even when as nations they are functionally bankrupt and can

46 Not that I wish to be taken to be wishing this fate upon any nation. Thanks to Andrew Elek, at the Financing for Development Seminar, Canberra, October, 2003, for the idea of initiating this process with far smaller nations.

47 Seeking agreement among creditors for the implementation of a bankruptcy response to sovereign insolvency will, in time, be greatly facilitated by the collective action clauses that are increasingly, at the urging of the U.S. Treasury Department, being included in sovereign bond documentation. Collective Action Clauses are the preferred U.S. policy response to the collective action problems facing creditors in sovereign debt workouts, but the clauses should serve the adoption of this approach to the problem just as well. For more on CACs see Lee C Buchheit and G Mitu Gulati, "Sovereign Bonds and the Collective Will", (2002) 51 *Emory Law Journal* 1317. For information on the adoption of CACs, see International Monetary Fund, "Progress Report to the International Monetary and Financial Committee on Crisis Resolution", September 3, 2003.

do so only by borrowing ever more debt.[48] Countries can always repay loans precisely because they can always increase taxes and reduce spending on health, education and nutrition – and at some point with poor countries such reductions in spending lead to unconscionable hardship.

National bankruptcy regimes seek to ensure the maximum return to creditors while ensuring the debtors have food, housing and the capacity to work. Humane nations tolerate nothing less. We rejected debtors' prisons centuries ago.[49] The absence of an international bankruptcy regime means people starve, and live without adequate shelter, healthcare and education, while their country's wealth goes to service loans. Why is it that what is considered unacceptable within any developed nation, is considered acceptable by the international financial community when it applies in other, poorer, borrowing countries?

A global bankruptcy court or tribunal with a developed jurisprudence would moderate capital flows to developing countries in good times and provide a way out from under unsustainable debt burdens for these countries in bad times.

The IMF has proposed its own approach to the problem of sovereign insolvency. The Sovereign Debt Restructuring Mechanism (SDRM) was first proposed in a signal speech by Anne Kreuger, First Deputy Managing Director of the IMF, in November, 2001.[50]

The SDRM is not a bankruptcy regime. In the IMF's words: 'We are not proposing a bankruptcy mechanism for countries, but simply a mechanism to facilitate debt workout negotiations between a debtor and its creditors'.[51] An SDRM would facilitate the co-ordination of sovereign debt restructurings, principally by

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48 Buchheit and Gulati, ibid.

49 An excellent analysis of the history of the early common law remedies against debtors, including imprisonment for debt, can be found in (Dennis Rose QC (ed)), *Lewis Australian Bankruptcy Law*, (1994) at 7-10.

50 Anne Krueger, "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring", a speech delivered at the National Economists' Club Annual Members' Dinner, Washington DC, November 26, 2001, http://www.imf.org/external/np/speeches/2001/112601.htm; accessed on September 25, 2002. The proposal was substantially modified in a later speech, Anne Krueger; *A New Approach to Sovereign Debt Restructuring*; http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/index.htm; accessed on September 26, 2002 (Speech at the conference "Sovereign Debt Workouts: Hopes and Hazards", Institute for International Economics; Washington, DC, 1 April 2002) http://www.iie.com/papers/krueger0402.htm. Finally, the proposal was restated in Krueger, op cit n 2. See generally, Michelle White, "Sovereigns in Distress: Do They Need Bankruptcy?", *Brookings Paper on Economic Activity*, 1:2002 at 20.

51 IMF, "Proposals for a Sovereign Debt Restructuring Mechanism (SDRM) A Factsheet", January, 2003, available at http://www.imf.org/external/np/exr/facts/sdrm.htm, accessed on March 6, 2003, at B.6.

mandating majority restructuring so as to circumvent the collective action problems that are particularly prevalent with bond financing and to remove the free-rider and rogue creditor problems.

Limited as it was, the IMF's proposed scheme drew strong criticism from creditors and the US Treasury, and in light of these criticisms, the IMF subsequently revised its initiative considerably. Nonetheless, at the Spring 2003 meeting of the Board of Governors of the IMF, the SDRM initiative was put on hold.[52]

Whether the SDRM is ever implemented, the need for an effective global bankruptcy regime for nations will not go away. The SDRM will serve to coordinate creditor behaviour and thereby speed up the negotiation of restructurings. However, the SDRM is highly unlikely to afford debtor countries the relief from unsustainable debt burdens that is required for them to resume their full participation in the global economy relatively swiftly, to the benefit of their own people and their creditors. In the words of one commentator:

> "In the absence of a strong push for a … global bankruptcy court, the losses to overall global economic efficiency from emerging market crises of liquidity quickly becoming crises of solvency (resulting in unnecessarily destroyed domestic economies), are likely to mount."[53]

Conclusion

Bankruptcy is an essential element of all domestic financial systems offering equity for debtors and creditors and stability for the system. An effective sovereign bankruptcy regime would provide the same benefits to the international financial system – benefits that will translate into massive reductions in human suffering. Sovereign bankruptcy is an idea whose time has come. Many years of education, lobbying and other hard work by civil society are now required to ensure it comes to pass.

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52 In these terms: "The Committee, while recognizing that it is not feasible now to move forward to establish the SDRM, agrees that work should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises. These issues include inter-creditor equity considerations, enhancing transparency and disclosure, and aggregation issues." Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, Press Release No. 03/50, April 12, 2003; available at http://www.imf.org/external/np/sec/pr/2003/pr0350.htm, accessed on April 23, 2003.

53 Armijo, op cit n 15.