THE INTERNATIONAL MONETARY FUND'S PROPOSAL FOR SOVEREIGN DEBT RESTRUCTURING

AN AUSTRALIAN ASSESSMENT

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I. INTRODUCTION

An effective bankruptcy regime brings many benefits to an economy including equity and systemic stability. This article analyses why the benefits are especially needed at the international level. In particular, if sovereign states are without a bankruptcy regime, the international financial system will remain crisis-prone to the detriment of debtors and creditors. The proposal of the International Monetary Fund (IMF) for a sovereign debt restructuring mechanism and other related proposals will be discussed and a more ambitious proposal canvassed. The article will also explore why this issue is of critical importance to Australia's security and regional interests.

II. HISTORICAL BACKGROUND

At the 2002 Commonwealth Games in Manchester, if Ian Thorpe had been a state his medal tally of six gold and one silver would place him tenth, after Scotland and immediately ahead of Nigeria.[1] If by some extraordinary turn of fate Ian Thorpe loses all his money, he may be made bankrupt. But Scotland and Nigeria cannot. With respect to Scotland this would probably not be an issue as the prospect of bankruptcy for Scotland is so remote. But the inability of Nigeria, Indonesia or Argentina to be made bankrupt may well be a matter of grave concern because the absence of a sovereign bankruptcy regime has led to more people dying than during Hitler's holocaust. This is a big statement that best be justified.

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[1] "Final Medals Tally", Sydney Morning Herald, 6 August 2002, 33.

Any explanation for the appalling mortality linked with international financial errors must start in 1973 when OPEC discovered the delights of being a cartel and the price of oil quadrupled almost overnight. While OPEC states were depositing their oil receipts in the banks,[2] the banks accelerated their lending to developing states to smooth out the oil price shock, namely, to allow them to keep buying oil without having to tighten their belts and depress economic growth, and the developed states faced two options to afford the oil – earn more or spend less. As with individuals, spending less is rarely an attractive option so they chose to earn more, or, in their context, export more. To do so they needed importing states with the money to buy from them, which they ensured by encouraging their banks to lend more to developing states in a process Philip Wellons termed "passing the buck."[3]

It was a neat trick. All other things being equal, the oil price rise would have plunged Europe and North America into recession. But things were not equal. Britain, France, Germany and the United States formulated a plan to increase their exports to avoid a recession by encouraging lending to their principal markets[4] and their plan worked. More capital flowed south and the increased imports it funded staved off recession in the developed states. In other words, the developed states enjoyed strong economic growth, the OPEC states enjoyed ever-increasing credits with the world's major banks and the developing states "enjoyed" ever-increasing debits with the world's major banks.

This could not last. David Rockefeller, Chairman of Chase Manhattan Bank, said so on the front page of the Wall Street Journal in June 1974.[5] However, his warnings fell on deaf ears. Bankers preferred to

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[2] For more information see Buckley RP, Emerging Markets Debt (1999, Kluwer Law International, London).

[3] Wellons PA, Passing the Buck - Banks, Governments and Third World Debt (1987, Harvard Business School Press, Boston).

[4] Ibid.

[5] Rockefeller was quoted as saying that "[c]hannelling massive flows of oil dollars from dollar-rich to dollar-poor countries once seemed easily manageable. But now it looks more troublesome": see Stabler, "Mideast Oil Money Proves Burdensome", Wall Street Journal, 6 June 1974, 1, 29. In his view, "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": ibid.

listen to Walter Wriston, Chairman of Citibank, considered the most charismatic banker of his time.[6] Wriston had pronounced that "[c]ountries never go bankrupt"[7] and this statement influenced more lending decisions than any analysis by a credit committee and any Rockefeller warning.

Wriston was quite correct legally but was spectacularly wrong substantively. This was because states could not become bankrupt legally without a body of rules under which they could be declared to be so.[8] Throughout history states had become substantively bankrupt with typically horrendous results for the living standards and human rights of their more vulnerable citizens. Since Wriston's approach was far more profitable than Rockefeller's, at least in the short to medium term, 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 triggered a cessation of capital flows to all of Latin America and Africa plunging the two continents into crisis. Unhappily, the Debt Crisis, managed under the structural adjustment programs the IMF imposed on the debtor states, exacted a horrifying human toll.[9] According to figures compiled by UNICEF, over 500,000 children under five years old were dying each year in sub-Saharan African and Latin America in the late 1980s due directly to the effects of the Debt Crisis and its management.[10]

A very partial solution to the Debt Crisis was crafted in the first half of the 1990s for much of Latin America under the Brady Plan but it was never really resolved for much of sub-Saharan Africa. Accordingly,

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[6] He has been quoted as disagreeing with Rockefeller in the same article, stating, "The Great Crisis...ain't going to happen": ibid.

[7] See Buckley RP, Emerging Markets Debt (1999, Kluwer Law International, London) 14.

[8] Fletcher IF, The Law of Insolvency (1996, Sweet & Maxwell, London) 4-6.

[9] From 1981-1986, the real gross national product (GDP) per capita fell 10% in Mexico, 16% in Argentina and 27% in Bolivia: James, "Deep Red – The International Debt Crisis and Its Historical Precedents" [1987] The American Scholar 331, 340.

[10] UNICEF, "The State of the World's Children, 1989", reproduced in part in the Statement of Dr Richard Jolly, Deputy Executive Director for Programs, 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 US Financial System", 101st Congress, 1st Session, 4 January 1989, 158, 160.

one may extrapolate the mortality identified by UNICEF over many years in that blighted part of the world. By extending it to older children and adults, it is easy to see why the Holocaust's appalling death toll of approximately five million begins to pale by comparison.[11] More recently in the Asian economic crisis, in 1998 alone the GDP of Malaysia, Korea, Indonesia and Thailand shrunk by 5.7-13.7%, while in those four states including the Philippines over 10 million people dropped below the poverty line during 1996-1998.[12] However, an effective sovereign bankruptcy regime could have avoided a substantial amount of this human suffering. An effective bankruptcy regime would have brought many benefits at the national and global levels.

III. NATIONAL BANKRUPTCY REGIME

At the national level, the principal benefits and purposes of a bankruptcy system are generally enunciated in broad terms, namely, 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).[13]

In the English context, Professor Roy Goode identified four objectives of *corporate* insolvency law: (a) restoring the company to profitable trading, (b) maximising returns to creditors, (c) providing a fair and equitable system for the ranking of claims, and (d) identifying the causes of company failures and imposing sanctions for culpable

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[11] The death toll in the Nazi Holocaust from 1940-1945 is commonly estimated at approximately 5 million: du Preez P, Genocide: The Psychology of Mass Murder (1994, Bowerdean Pub Co, London) 47.

[12] Armijo, "The Political Geography of World Financial Reform: Who Wants What and Why?" (2001) 7:4 Global Governance 14.

[13] This is how the leading Australian text on bankruptcy expresses the purposes of bankruptcy law: see Rose D (ed), Lewis: Australian Bankruptcy Law (1994, Law Book Company Limited, Sydney) 1. Oddly enough, the purposes of insolvency laws often receive scant attention in the literature. The classic Australian text on liquidation is McPherson, The Law of Company Liquidation (A Keay (ed), 4th ed, The Law Book Company Limited, Sydney) and its English counterpart is Fletcher IF, The Law of Insolvency (1996, Sweet & Maxwell, London). McPherson's text addresses purposes in similar terms to Roy Goode and Fletcher's text is silent as to them.

management.[14] In Australia, the most thorough analysis of the principles that should underpin and guide a modern insolvency law is found in the 1988 Australian Law Reform Commission Report on the General Insolvency Inquiry of 1988, more commonly known as the Harmer Report.[15] The report identified the following nine principles that should govern any insolvency regime (corporate or personal):[16]

(a) The fundamental purpose of an insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies.
(b) The regime should provide mechanisms for both debtor and creditor to participate with the least possible delay and expense.
(c) Insolvency administration should be impartial, efficient and expeditious.
(d) The law should provide a convenient means of collecting or recovering property that should properly be applied toward payment of the debts and liabilities of insolvent persons.
(e) There should be equality among creditors.
(f) The end result of insolvency, particularly as it affects individuals, should be relief from the financial liabilities and obligations.
(g) Insolvency law should, so far as is convenient and practical, support the commercial and economic processes of the community.
(h) Insolvency law should harmonise with general law.
(i) Cross-frontier insolvencies should be facilitated.

(a) Fairness Aspects of Bankruptcy

Virtually all of the Harmer Report principles related to fairness and efficiency. The two generally cited purposes of bankruptcy, to treat creditors fairly and give debtors a fresh start, were also all about fairness. However, what was missing from the analysis was any notion that an effective insolvency regime would improve dramatically the

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[14]Goode RM, Principles of Corporate Insolvency Law (1997, Sweet & Maxwell, London) 25-28.
[15] Harmer Report (1988, Australian Government Publishing Service, Canberra) 45. See also Goode RM, ibid 3.
[16] See Harmer Report, Volume 1, 15-17.

allocation of credit within an economy, thus making the economy more stable. This could be termed the "systemic" aspect of bankruptcy because any economy as a system would be unstable without a bankruptcy regime. This marked benefit of bankruptcy appeared to be overlooked generally in literature on Australia's bankruptcy system.

(b) Systemic Aspect of Bankruptcy

The fairness aspects of bankruptcy are crucial and their absence has resulted in millions of deaths around the world. As such, a bankruptcy system's advantages are arguably even more important and critical at the global than at the national level. This is because the more immediate risk of loss under a global bankruptcy regime tends to moderate capital flows to developing states. The systemic advantages will help to ensure that capital flows are more appropriate to the needs and capacities to repay respective debtors. Financial crises will be less frequent and less severe[17] and if there is a crisis the workout will proceed more rapidly and equitably, thus reducing the workout costs to creditors and debtors.

IV. RESOLUTION OF THE GLOBAL DEBT CRISIS

The earlier reference to the potted history of the Debt Crisis in the 1980s illustrates two points:

(a) the creditors were prepared to keep extending credit, far beyond reasonable levels, because the absence of bankruptcy mechanism meant they expected to be repaid by the debtor states through increased taxes and reduced social services; and
(b) the creditor state governments encouraged this excessive extension of credit because it served their short-term interest in recession avoidance.

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[17] Excessive capital inflows played a major role in the Debt Crisis of 1982, the Mexican tequila crisis of 1995, the East Asian Economic Crisis of 1997 and Russia's meltdown in 1998: see 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; Buckley, "An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors" (2000) 15 Banking and Finance Law Review 431.

To find a resolution to that crisis, the international banks engineered the socialisation of irrecoverable debts owed by private sector borrowers. The IMF played a role, acquiescing in and at times directing, the process. After the Debt Crisis broke in 1982, the banks required all loans, corporate and sovereign, be brought under the sovereign guarantee as a way of facilitating rescheduling negotiations. This took place, which simultaneously improved the banks' security dramatically. The largest banks benefited most from this strategy as they held the highest proportion of loans to the less creditworthy private sector. This was not surprising as they were also in charge of the rescheduling negotiations.[18]

In East Asia in 1997, the great majority of the debt was to the private sector but this did not stop the taxpayer from bearing the burden eventually. The IMF-led bailouts, invariably described as the bailouts of Indonesia or Thailand or Korea, were in fact long-term loans to those states that had to be used to repay their short-term creditors. Therefore, the loans became state debts even though the bailouts were of the creditors, not the debtor states at all.[19]

More recently, in Argentina in late 2001, the IMF refused to extend further credit to this state believing the Argentine economic programs to be unsustainable. As commercial lenders followed suit, Argentina was denied access to capital and defaulted on its external debt of some US$132 billion. Initially, the government reset the exchange rate at 1.4 pesos to US$1 but after intense pressure from the United States and the IMF the peso was allowed to float resulting in an overnight drop of more than half to a rate of 2.1 pesos to US$1.[20] The government also implemented the so-called "assymetric pesofication" under which dollar-denominated bank loans and deposits were re-denominated in pesos. Banks were required to convert their assets (such as loans) into pesos at a rate of 1 to 1 and their liabilities (such as deposits) into pesos at a rate of 1.4 to 1. When this generated massive losses for the banking

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[18] Buckley RP, Emerging Markets Debt (1999, Kluwer Law International, London) 43.

[19] Calomiris and anor, "Fixing the IMF" (Summer 1999) 56 The National Interest 88.

[20] Gaudin, "Thirteen days that shook Argentina – and now what?" (March/April 2002) 35 NACLA Report on the Americas 6.

sector the government sought to compensate it for these losses by a massive issue of government bonds of necessarily doubtful value.[21]

As the borrowers' indebtedness was now in pesos it was reduced significantly – a gift for small borrowers and a monstrous gift for the large corporations that in anticipation of such a crisis had borrowed some US$26 billion in the preceding year and shipped much of it abroad.[22] Thus, the circle was completed in the usual way in emerging markets crises with the ultimate burden falling on the public purse by way of government bonds being issued to compensate the banks for their pesofication losses. In the words of Pedro Pou, President of the Central Bank of Argentina until mid-2001:[23]

> The government has transferred about 40% of private debt to workers...We are experiencing a mega-redistribution of wealth and income unprecedented in the history of the capitalist world.

The existence of an effective global sovereign bankruptcy regime in the 1970s would have led to far less capital flowing south and the real prospect of massive loan losses would have sharpened the banker's mind. When Rockefeller said that these loans were unsustainable the bankers should have listened because if he was right they were set to lose billions.

In the national systems, this systemic effect of bankruptcy is usually taken for granted. If an Australian bank makes a poor credit decision and lends to a borrower who subsequently becomes insolvent, most of the money will be lost absent security. The bank has no right to garnish the borrower's wages for the rest of their life to recover the funds. Imagine for a moment if wages may be garnished for life. Will this affect credit decisions? There is still the equity and social responsibility arguments against advancing credit to those who are unlikely to be able to afford to repay it. Are these arguments enough to curtail lending? Or does nothing focus a banker's mind like the prospect of losing money?

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[21] Ibid; "Latin Banks: Eyes on Brazil" (19 August 2002) 8:1 Emerging Markets Monitor 12.
[22] Gaudin, "Thirteen days that shook Argentina – and now what?" (March/April 2002) 35 NACLA Report on the Americas 6.
[23] As cited in Gaudin, ibid.

Adam Smith is lauded above all else for his discovery of the "Invisible Hand",[24] namely, the mechanism in a capitalist system by which, if a person chooses to do what rewards him or her most, the process will allocate resources effectively and maximise the welfare of all. With no prospect of bankruptcy, lenders do not bear the full implication of poor lending decisions and excessive extensions of credit therefore become likely.

This is the system that exists at present globally. When states have unsustainable debts, they must typically repay them. The alternative is a highly destabilising default that may deny the state access to commercial capital for many years to come. The debts are serviced through higher taxes and lower social services in states that are already poor, states in which lower social services translate into malnutrition, inadequate housing, inadequate or non-existent health care, unsafe water supply and so forth. The debts of effectively bankrupt states are repaid at the expense of the most basic human rights of their own citizens. This is akin to a debtor's imprisonment for highly indebted states.

The Latin American states are still struggling to service the debt incurred in the 1970s during the Debt Crisis. Although those debts have been restructured, reduced, and transformed into Brady bonds, the bonds are still some 15-20 years away from being fully repaid. In the interim, they must be serviced together with much of the debt incurred since the 1970s. Debt is therefore a lifetime sentence for poor states where the state's salary, in the form of foreign exchange earned from exports, is effectively garnished for up to 30 years.

V. SOVEREIGN BANKRUPTCY REGIME

A sovereign bankruptcy regime was only an idea until the IMF embraced it in a signal speech by Anne Kreuger, First Deputy Managing Director of the IMF, during the National Economists Club annual dinner in Washington DC in November 2001.[25] The IMF's

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[24] Cannan E (ed), Adam Smith: An Inquiry into the Nature and Causes of the Wealth of Nations (1937, The Modern Library, New York) 423.

[25] Krueger A, "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring", a speech delivered at the National Economists' Club

proposed scheme, limited as it was, drew strong critical reaction from creditors and the United States Treasury. This led the IMF to revise its initiative considerably. As a result, what is the IMF proposing now?

(a) The IMF Proposal

The IMF developed its Sovereign Debt Restructuring Mechanism (SDRM) proposal to address the two problems it identified. The first was the absence of "adequate incentives for orderly and timely restructuring of unsustainable sovereign debts."[26] The general consensus was that debtor governments in developing states tended to postpone the restructure of their debt until much later than what would be deemed optimal from the perspective of their own citizens and creditors.[27] The prospect of IMF rescue packages strongly supported

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Annual Members' Dinner, Washington DC, 26 November 2001 at <www.imf.org/external/np/speeches/2001/112601.htm> (visited September 2002) (Krueger I). The proposal was substantially modified in a later speech: Krueger A, "New Approach to Sovereign Debt Restructuring", a speech delivered at the Conference on "Sovereign Debt Workouts: Hopes and Hazards", Institute for International Economics, Washington, DC, 1 April 2002 at <www.iie.com/papers/krueger0402.htm> (visited September 2002) (Krueger II). Finally, the proposal was restated in Krueger A, "Preventing and Resolving Financial Crises: The Role of Sovereign Debt Restructuring", a speech delivered to the Latin American Meeting of the Econometric Society, Sao Paolo, Brazil, 26 July 2002 at <www.imf.org/external/np/speeches/2002/072602.htm> (visited September 2002) (Krueger III). For discussion on the Krueger proposals see White M, "Sovereigns in Distress: Do They Need Bankruptcy?" 1:2000 Brookings Paper on Economic Activity 20.

[26] See Krueger I.

[27] See Mohamed El-Erian's comments reported in Smallhout, "Critics Attack IMF's Standstill Proposal", (January 2002) 393 Euromoney 110. As Anne Krueger stated: "Like a patient with a toothache avoiding a trip to the dentist, a debtor country will all too often delay a necessary restructuring until the last possible moment, draining its reserves and increasing the eventual cost of restoring sustainability. Creditors suffer too, as the fear that some may be unfairly favored in a disorderly workout depresses the value of claims on the secondary market and, at worst, may block agreement on a necessary restructuring. All this can leave the international community with the unpalatable choice of accepting a disruptive and potentially contagious unilateral default, or bailing out private creditors and thereby contributing to moral hazard": see Krueger II. Or in Barry Eichengreen's words: "Why are governments prepared to impose extraordinary hardships on their constituents to avoid a [debt restructuring]": Eichengreen, "Crisis resolution: Why We Need a Krueger-Like Process to Obtain a Taylor-Like Result" (2002) at <http://emlab.berkeley.edu/users/eichengr/POLICY.HTM> (visited September 2002).

the preferred tendency to be late in restructuring.[28] The second problem identified by the IMF was the lack of a bankruptcy type mechanism. Without such a mechanism, when a debtor state is in serious financial trouble the IMF has to choose between a default (which would be highly disruptive to the debtor and potentially destabilise the entire international financial system) and a bailout of private creditors. In Krueger's words, this "contribut[ed] to moral hazard".[29] Therefore, the IMF put forward a proposal during 2002 with four principal elements:[30]

(a) Majority restructuring to circumvent the collective action problems that are particularly prevalent with bond financing and to remove the free-riding and rogue creditor problems.
(b) No stay on creditor enforcement, but a rule by which amounts recovered are deducted from a creditor's eventual entitlements.
(c) Protection of creditor interests by a restraint on the debtor paying non-priority creditors and by an IMF assurance of good economic conduct by the debtor to give the creditors an assurance the debtor will pursue policies that protect asset values and restore growth.
(d) Seniority for new lending, so as to attract it to the state.

The IMF's proposal does not provide the details and much remains to be worked out. For example, there are questions on who will authorise the stay on creditor enforcement and what are the terms of a stay. The

[28] Eichengreen, ibid.
[29] See Krueger III. "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: Calomiris, "The IMF's Imprudent Role as Lender of Last Resort" (Winter 1998) 17 CATO Journal 275. A classic example of moral hazard is the United States Savings and Loan crisis brought on by lax prudential supervision and government insurance of S&L deposits: Eichengreen B and anor, "Capital Account Liberalization: Theoretical and Practical Aspects", IMF Occasional Paper, No 172, 1998 at 43-44). Another example is Russia's economic collapse in 1998 exacerbated by a massive inflow of foreign capital in reliance on Russia's geo-political significance ensuring an IMF bail-out of creditors: Buckley, "The Essential Flaw in the Globalisation of Capital Markets: Its Impact on Human Rights" (2001) 32 California Western International Law Journal 119, 125.
[30] These are drawn from: Krueger A, "A New Approach to Sovereign Debt Restructuring", 2002 at <www.imf.org/external/pubs/ft/exrp/sdrm/eng /index.htm> (visited October 2002); and IMF, "Proposals for a Sovereign Debt Restructuring Mechanism (SDRM): A Factsheet", January 2003, available at <www.imf.org/external/np/facts/sdrm.htm> (visited March 2003).

IMF's proposal is also limited in that it falls short of the court-enforced bankruptcy procedures found in all developed economies.

Since first proposing the SDRM mechanism, the IMF has changed its position in two important aspects:

(a) In response to criticism of the conflict inherent in being both a creditor and fulfilling some of the judicial functions inherent in the SDRM, such as determining whether a debtor is entitled to a standstill, the IMF has reduced its role significantly and given control over major decisions in the restructuring process "to the debtor and a super-majority of creditors, not to the Fund."[31]

(b) In response to the championing of the extensive use of collective action clauses (CACs) in bond documentation by the current United States administration (termed the "contractual approach" by Krueger),[32] the IMF has adopted a "twin-track" approach of supporting both the CAC's extensive use and the SDRM's statutory approach.[33]

Both changes are sensible. The conflict inherent in the IMF's two roles is stark and should be ameliorated as far as possible. Likewise, since CACs do no harm but some good, the IMF should support them. However, the problem with CACs is not that they will not help, but that they will not solve the problem. In this sense, the United States is wrong to support them as a solution for the sovereign insolvency problem, because that problem is so much greater than merely one of collective action among creditors.

The IMF has continued to attract criticism for its unwillingness to extend the SDRM to debts owed to it. However, it argues that its role is not as commercial lender seeking profit, but instead, it is a creditor that lends at concession rates when others will not. There is some substance to this position, and as it has pointed out, sovereign creditors have adopted the same stance with even less justification.[34] Notwith-

[31] See Krueger II.

[32] Krueger III.

[33] Ibid.

[34] Ibid. "Official debt" is that extended by multilateral institutions such as the IMF, the World Bank, other development banks and sovereign creditors. Traditionally poor states try everything within their power not to default on official debt on the basis that

standing the substance of the IMF's claim, to push forward a debt relief mechanism while exempting one's own claims from it does not exhibit tremendous moral leadership. Nonetheless the IMF's SDRM initiative is a major step in the right direction. Although this may be so, the United States, including the other G-7 states following its lead, rejected the IMF approach and proposed an alternative instead.

(b) United States Treasury Proposal

The United States Treasury proposal uses debt documentation and CACs. What does this mean? CACs are clauses in debt documentation by which creditors agree in advance to accept a majority determination, usually a super-majority of 75% of creditors, to vary the terms of the debt. This removes many of the collective action problems inherent in bond debt where hundreds or thousands of creditors may hold the bonds. It prevents the free-rider problem in which small creditors may allow others to restructure the debt and then insist on repayment in the full under the original terms. A debt workout with CACs in bonds is therefore preferred since it is more workable in practice.

Bonds issued under United Kingdom law typically contain such clauses but those issued under New York law do not. In practice, the same sovereign issuers may issue in both markets. The leading research on this shows that CACs tend to lower the borrowing cost for more credit-worthy issuers but raise it for less credit-worthy issuers.[35] Presumably the more credit-worthy would benefit from being able to take advantage of a more orderly restructuring process if it becomes necessary, whereas for less creditworthy issuer any provision that makes a rescheduling easier is resisted.[36]

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such lenders are lenders of last resort when other sources of funds dry up.

[35] Eichengreen B and anor, "Would Collective Action Clauses Raise Borrowing Costs?" NBER Working Paper No w7458, 1999 (issued January 2000) at <papers.nber.org/papers/w7458> (visited September 2002); ibid, "Would Collective Action Clauses Raise Borrowing Costs? An Update and Additional Results", NBER Working Paper No w7458, 2000, 4 at <papers.nber.org/papers/w7458> (visited June 2002). See also White M, "Sovereigns in Distress: Do They Need Bankruptcy?" 1:2000 Brookings Paper on Economic Activity.

[36] Eichengreen B and anor, "Would Collective Action Clauses Raise Borrowing Costs? An Update and Additional Results", NBER Working Paper No w7458, 2000, 4 at <papers.nber.org/papers/w7458> (visited June 2002).

The G-7 states want to see CACs made mandatory in all sovereign bond contracts as an alternative to the SDRM approach and if they would help they should be advocated. However, this proposal misses the point on two fronts:

(a) CACs will not remove the need for a sovereign bankruptcy regime.[37] They will facilitate rescheduling but will not afford major debt relief when major debt relief is what is needed to give a debtor state a fresh start and permit it to honour the human rights of its people.
(b) The debt workout for the Debt Crisis spanned the period 1983-1994[38] – a lost decade of development in Latin America and Africa – and it faced relatively few collective action problems.

In the Debt Crisis, the debts were loans by a relatively small number of banks, not bonds held by many creditors. The banks were highly susceptible to the moral persuasion of their respective central banks, and it was this pressure, and this pressure only, that eventually led to the Brady Plan and some relief for debtors. Unfortunately, a decade was too late for most debtors and collective action problems were only a small part of the problem. The United States proposal assumed implicitly that they were most of the problem. As such, it would be tempting to believe that the United States proposal conveniently and cynically treated the collective action problems as being most of the problem so as to avoid dealing with the real issues.

In light of the above, on 28 September 2002 the national members of the International Monetary and Financial Committee Meeting of the IMF agreed to proceed with the "twin-track approach" of seeking to implement the IMF's SDRM proposal including the United States Treasury initiative of mandating the use of CACs.[39] The SDRM proposal always needed the United States' support as its implementation needed the IMF's constituent documents to be amended. In turn, this needed a 75% majority vote in favour including

[37] White M, "Sovereigns in Distress: Do They Need Bankruptcy?" 1:2000 Brookings Paper on Economic Activity.
[38] Buckley RP, Emerging Markets Debt (1999, Kluwer Law International, London).
[39] Transcript of a Press Conference following the International Monetary and Financial Committee Meeting, 28 September 2002, Washington DC at <www.imf.org/external/np/tr/2002/tr020928.htm> (visited September 2002).

the United States' vote since it could veto the change. At present, it seems that the implementation of the SDRM initiative is on track and following more broad consultation, development and refinement, the IMF's Board of Directors is due to present it in April 2003.[40]

(c) A Comprehensive Proposal – A Global Bankruptcy Court

The comprehensive approach would be to create a sovereign bankruptcy court applying a highly developed body of rules and procedure, very much like the International Criminal Court that commenced on 1 July 2002. Such a court and rules would require years of careful planning and negotiations and be implemented by a treaty between states.[41] Presently, no international court has jurisdiction over disputes between a sovereign state and the citizens (such as banks or bondholders) of another sovereign state in civil suits and although the International Court of Justice exists it deals only with disputes between sovereign states pursuant to Article 93 of the United Nations Charter.[42]

A preferred proposal, which is closer to the domestic law in most states, is that developed by the Jubilee framework.[43] This envisages a bankruptcy procedure based on Chapter 9 of the United States Bankruptcy Code dealing with municipal bankruptcies that is enforced by an *ad hoc* independent panel of experts convened for a specific

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[40] Crutsinger, "IMF Plan would let countries declare bankruptcy", Sydney Morning Herald, 30 September 200, 8; IMF, "Proposals for a Sovereign Debt Restructuring Mechanism (SDRM): A Factsheet", January 2003, available at <www.imf.org/external/np/facts/sdrm.htm> (visited March 2003).

[41] The two principal models discussed widely for any such transnational law are Chapters 9 and 11 of the United States Bankruptcy Code. Professor Kunibert Raffer argued strongly that Chapter 9 provided the best available precedent for international sovereign bankruptcies: Raffer, "Solving Sovereign Debt Overhang by Internationalising Chapter 9 Procedures" (2002) Studien von Zeitfragen, at <www.studien-von-zeitfragen.net/Weltfinanz/RAFFER_1/raffer_1.HTM> (visited September 2002).

[42] White M, "Sovereigns in Distress: Do They Need Bankruptcy?" 1:2000 Brookings Paper on Economic Activity 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 Buckley, "Now We Have Come to the 'ICSID' Party: Are Its Awards Final and Enforceable?" (1992) 14 Sydney Law Review 358.

[43] Pettifor, "Resolving International debt crises – the Jubilee Framework for international insolvency", January 2002 at <www.jubileeplus.org/analysis/reports/jubilee_framework.html> (visited September 2002).

proceeding. This is a more ambitious proposal than the IMF's SDRM initiative and thus less likely to come to pass. Nonetheless, Chapter 9 is the better long-term model for any sovereign bankruptcy regime.[44] In any case, if the IMF's SDRM initiative is implemented, it should be only the first step towards a proper sovereign bankruptcy regime similar to that found in Chapter 9.

VI. THE CHALLENGES OF REFORM

Creditors believe that the lack of a global sovereign bankruptcy regime works in their favour. This is the main reason why banks argue vociferously against an international bankruptcy regime when they accept, and indeed welcome, such regimes nationally. As stated by William Rhodes, Senior Vice-Chairman of Citibank:[45]

> [T]he 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 appears incorrect. National bankruptcy regimes greatly enhance certainty that in turn generally serves to attract lenders and investors thus diminishing borrowing costs. As such, there is no reason it should be any different on the international level. 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 states, their prospects and bank profits. Debtor states suffer with no new capital and ever increasing debt loads and banks also suffer as in most cases they have to keep advancing new funds for years to enable the debtor states to meet their interest payments.

The history of the past 50 years shows that debtor states usually continue to service their debts even when they are functionally

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[44] Ibid. See also Raffer, "Solving Sovereign Debt Overhang by Internationalising Chapter 9 Procedures" (2002) Studien von Zeitfragen, <www.studien-von-zeitfragen.net/Welt finanz/RAFFER_1/raffer_1.HTM> (visited September 2002) note 42; Rasche, "Argentina: test case for a new approach to insolvency?" Studien von Zeitfragen, 5 January 2002.

[45] Hartcher, "US reigns in IMF with tough debt rules", Australian Financial Review, 22 April 2002.

bankrupt states and can only do so by borrowing and sink deeper into debt. In practice, states repay loans by increasing taxes while correspondingly reducing spending on health, education and nutrition. This reaches a point, especially with poor states, where such reduction in spending leads to unconscionable hardship. The most impoverished of states today spend four times more in debt servicing than on health, education, sanitation and other basic needs, and the total external indebtedness of developing states is almost US$2.5 trillion.[46]

National bankruptcy regimes seek to ensure the maximum return to creditors while ensuring the debtors have food, housing and the capacity to work. Humane and more enlightened states tolerate nothing less and debtors' prisons were in fact rejected centuries ago.[47] If a survey were conducted in Australia today, few would prefer a world where a debtor's wages could be garnished for life or the debtor imprisoned if he or she did not work and could not service the debt. Yet, at the international level, a very different system is being tolerated and even accepted.

The absence of an international bankruptcy regime means populations starve and live without adequate shelter, health care and education. Meanwhile, their state's wealth goes to servicing loans. Why is it that what is considered unacceptable within any developed state is considered acceptable by the international financial community when the debtor is a poor, borrowing state? A plausible explanation seems to be that banks prefer the present arrangement under which, when a crisis occurs, the poor in developing states are consigned to the debtors' prisons of poverty, ill-health and ignorance[48] in order to allow their

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[46] The total external indebtedness of developing states in 2000 was US$2,492 billion: see World Bank, 2002 World Development Indicators 198 at <www.world bank.org/data/wdi2002/economy.pdf> (visited September 2002).

[47] An excellent analysis of the history of the early common law remedies against debtors, including imprisonment for debt, can be found in Rose D (ed), Lewis' Australian Bankruptcy Law, (1994, Law Book Company Limited, Sydney) 7-10.

[48] In developmental terms, virtually everyone agrees that the 1980s was a lost decade in Latin America due to the Debt Crisis: for example, see Anne Krueger's view in Krueger III. From 1982-1989, no progress was made on debt relief or on meaningful ways forward for debtor states. As a result, the continent's poor went hungry, its young poor went uneducated and its infrastructure crumbled, as states continued to service an overwhelming debt burden. To make matters worse, new loans were entered into to service the debt that increased the total indebtedness accordingly. The

states to repay their debts to the banks. Initially, the G-7 states opposed the IMF's SDRM proposal and supported the more limited, contractual United States approach. In this regard, they were acting at the behest of their banks.[49] If this were true, it would seem that they did not learn the lessons of history or appreciate the benefits of a more enlightened approach.

The Debt Crisis of 1982 was resolved in part by the Brady Plan during the early 1990s under which loans were converted into bonds with principal or interest discounted by 35%. History has proven that the Plan's debt relief 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. This permitted many banks to sell their exposure to investors comfortable with such risk and freed up their 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.[50]

In opposing the IMF's SDRM proposal, the banks had it wrong from two perspectives, namely, their own and the debtors'. Now that the member states of the IMF have resolved to support the twin-track approach of mandating collective action clauses and pursuing the SDRM initiative,[51] it is hoped that this reflects a genuine shift in perspective by the international commercial banks and is not merely a grudging recognition that the writing is on the wall. In the end, creditors and debtors alike will be the benefactors of a more stable

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debt gridlock of the 1980s was in no one's long-term interests and damaged the debtors more than the creditors: see Marichal C, A Century of Debt Crises in Latin America (1989, Princeton University Press, Princeton, NJ), 237; Buckley RP, Emerging Markets Debt (1999, Kluwer Law International, London) 34-36.

[49] Blustein, "IMF Crisis Plan Torpedoed," Washington Post, 3 April 2002, E-1; "G-7 Finance Ministers Adopt Financial Crises Action Plan" at <www.fin.ge.ca/news02/02-034e.html> (visited June 2002).

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

[51] Crutsinger, "IMF Plan would let countries declare bankruptcy", Sydney Morning Herald, 30 September 200, 8; IMF, "Proposals for a Sovereign Debt Restructuring Mechanism (SDRM): A Factsheet", January 2003, available at <www.imf.org/external/np/facts/sdrm.htm> (visited March 2003).

international financial system with a formal debt workout procedure in place for sovereign debt crises.

VII. CONCLUSION

The work of the Institutional Economists, such as Douglass C North, sheds much light on why a bankruptcy regime is such a boon for Australia and other developed states and yet so difficult to implement globally. According to North,[52] successful economic systems are predicated on three essential bases:

(a) Systems of formal rules that reward people for their efforts.
(b) Norms of behaviour that support the rules, and support compliance with the formal rules.
(c) Effective enforcement mechanisms for the rules.

Almost every developed state including Australia has these elements in place with respect to bankruptcy and representing the various statutory regimes. There is broad community acceptance of the notion and principles of bankruptcy, strong adherence to the rule of law in the community and an independent court system that enforces the rules effectively.

Internationally, none of the above is present since there is no formal system of rules for sovereign bankruptcy. Even the IMF proposals are mere ideas at this stage and not nearly as developed as dispositive rules. There is no uniform model law, no international treaty and no rules specification that would or could govern in such a regime. There are, as yet, no widely accepted norms of behaviour beyond the general adherence of the international creditor and debtor communities to the rule of law. It is far from clear if the international financial community, in particular, accepts that bankruptcy is the appropriate mechanism by which to resolve sovereign insolvencies. The intellectual and political battles still have to be fought to persuade creditors that what works and what justice demands domestically is also what will work and what justice demands internationally for states.

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[52] Summary of a speech by Douglass C North delivered at Chicago-Kent Law School, Chicago, October 1999.

There is no existing court system to administer and enforce a global bankruptcy regime. The great difficulties in creating a global institution and the ambivalence or hostility shared by many developed and developing states towards supranational institutions, such as the IMF, mean that virtually no one believes that such a court could be created in the short to medium term. The history of the International Criminal Court's creation supports this view and the gestation of that court had taken more than 50 years since the genesis of that idea was first articulated during the Nuremburg War Crimes Tribunal after World War II. If this is any guide, the road ahead for the creation of a global bankruptcy court will be similarly long and winding.

So what advantages would a global bankruptcy court administering a highly developed, formal system of rules bring to the global scene? Five come quickly to mind:

1. Any decent court would not permit the socialisation of private irrecoverable debts, which the IMF had acquiesced in, and at times engineered. Courts tend to require those who incur debts to service those debts and not transfer them by stealth to other entities.[53]
2. The unconscionable delays that occasion most sovereign debt workouts would be dramatically shortened to the benefit of creditors and debtors.[54]
3. The appalling human suffering and state-mandated infringements of basic human rights accompanying the overwhelming majority of IMF Structural Adjustment Programs would be ameliorated dramatically.[55]

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[53] Buckley RP, Emerging Markets Debt (1999, Kluwer Law International, London) 43.

[54] Transcript of a Press Conference following the International Monetary and Financial Committee Meeting, 28 September 2002, Washington DC at www.imf.org/external/np/tr/2002/tr020928.htm (visited September 2002).

[55] James, "Deep Red – The International Debt Crisis and Its Historical Precedents" [1987] The American Scholar 331, 340: UNICEF, "The State of the World's Children, 1989", reproduced in part in the Statement of Dr Richard Jolly, Deputy Executive Director for Programs, 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 US Financial System", 101st Congress, 1st Session, 4 January 1989, 158, 160.

4. Capital flows to less creditworthy developing states would be ameliorated by the prospect of national insolvency, which would be a good thing.
5. The international financial system would be more stable because capital would flow within it only after credit decisions have been more carefully considered than the current practice. Capital would also tend to flow between economies more as it does today within economies. This greater stability would benefit both creditors and debtors.

A global bankruptcy court with a fully developed accompanying jurisprudence would be a tremendous asset to the world as it would moderate capital flows to developing states and provide an escape route when states suffer unsustainable debt burdens. However, this is unlikely to eventuate in the foreseeable future, which means that the IMF's SDRM is the best hope in the short to medium term. Excluding the first advantage in whole and the second and third in part, the SDRM could realise some of the advantages listed above, which would make it still worth while having the SDRM. Hopefully, it would be the first step towards the creation of an International Court of Sovereign Bankruptcy with its seat in The Hague next to the International Court of Justice and International Criminal Court.

Australia has particular reason to support the SDRM and the wider issue of a sovereign bankruptcy court. The reason is that these initiatives would give it a significant advantage in terms of regional stability. Its close neighbour to its immediate north is Indonesia, the world's most populous Muslim state and the fourth most populous state. Without putting a fine point to it, the maturity profile of Indonesia's sovereign debt appears alarming in the extreme because the repayments it would have to make in 2004-2006 to its creditors, mainly official,[56] seem to far exceed any potential capacity it has to pay. If this is correct, by 2005 Indonesia could be bankrupt in the sense that it would not be able to service its sovereign debt.

The traditional response to this kind of problem is to reschedule the debt, namely, spread the repayments out over a very long period and advance new money to enable the debt to be serviced. This kind of

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[56] Official debt is defined in n 35.

response, by advancing new money, simply capitalises the interest payments and adds them to the debt. The consequences of increasing and prolonging the debt burden on the debtor state have traditionally meant far less government expenditure on health, education and social programs with corresponding increases in political instability when the population resists the usually dramatic diminution in their living style and standards.

The consequences of such a restructuring are all but inevitable. In middle-income states such as Argentina, Brazil and Venezuela, the human suffering has been appalling and the political instability significant indeed.[57] On the contrary, Indonesia is not a middle-income state with a relatively long democratic tradition and instead is usually seen as a low-income state with a fractured, unstable political system whose population in many parts is suffering severely already.

It would not be surprising if Australia's political leaders view the IMF's SDRM proposal as irrelevant to its national interests. This is because Australia is not at risk and in need of the protection afforded by a bankruptcy regime. However, nothing could be further from the truth as Australia faces with two possible scenarios: Does it really want a disintegrating Indonesia on its doorstep, an Indonesia where the only stable, cohesive force seems to be the military? Or would it prefer a stable Indonesia under democratic rule, relieved of some or much of its debt burden through a bankruptcy procedure?

An effective sovereign bankruptcy regime is a necessity, and an urgent one. The IMF's proposal falls far short of a bankruptcy regime – it is merely an improved restructuring mechanism. However, it probably offers the only realistic prospect of progress in this area in the short to medium term. For this reason, it is an initiative the Australian government may choose to support.

The reform efforts however, must not stop with the IMF's SDRM initiative. This must be viewed as merely the first step on a journey to a

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[57] For instance, many hundreds of people died in 1989 in Venezuela in riots protesting against the effects of the IMF programs that accompanied the restructuring of their national debt. See Buckley RP, Emerging Markets Debt (1999, Kluwer Law International, London) 101.

global sovereign bankruptcy court. Only a true bankruptcy regime for nations will deliver internationally some of the financial stability we encounter within nations. The model for that regime exists, and has performed well. It is Chapter 9 of the US Bankruptcy Code. A Chapter 9 for nations must be the eventual goal of reform in this field.