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RENEGOTIATING THEIR SOVEREIGN  
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## **Why Are Developing Nations So Slow to Play the Default Card in Renegotiating Their Sovereign Indebtedness?**

Ross P. Buckley\*

*Before 1982 sovereign debtors regularly defaulted on their debts. Since the debt crisis that commenced in that year, sovereign defaults have been rare and usually quite quickly remedied, even though crises have been occurring with increasing frequency. This article seeks to answer why there might have been this change, and whether it is in the debtors' interests.*

The party with the most power in any negotiation is the party that needs the negotiated result the least.<sup>1</sup> To display this power, a party must be willing to walk away from the negotiating table. As the House of Lords has found, each party “[is] entitled, if he thinks it appropriate, to threaten to withdraw ... or to withdraw in fact, in the hope that the opposite party may seek to reopen the negotiations by offering him improved terms.”<sup>2</sup>

Yet, in sharp contradistinction to the historical pattern, in the past twenty-five years developing nation debtors have been consistently reluctant to stop servicing

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<sup>1</sup> Roger Fisher and William Ury, *Getting to Yes: Negotiating Agreement Without Giving In* 19–40 (Houghton Mifflin 2d ed 1991); Hilary Astor and Christine Chinkin, *Dispute Resolution in Australia* 82–83 (LexisNexis Butterworths 2d ed 2002); and Henry J. Brown and Arthur L. Marriott Q.C., *ADR Principles and Practice* 104, 113 (Sweet & Maxwell 2d ed 1999).

their debt, to default, even when doing so might well have increased their power in the renegotiation of their debt. Why might this be so? And has this been a productive approach to debt renegotiation? This article seeks to answer these two questions.<sup>3</sup>

In seeking these answers the best place to begin is with some history.

## I. HISTORY OF SOVEREIGN DEBT CRISES

Sovereign debt crises are nothing new. Spain in the sixteenth century and France in the eighteenth are the most commonly cited examples. The sixteenth century King of Spain would sporadically receive shipments of bullion and treasure from his overseas empire. He used these to finance fighting in Italy, France and Holland. Alas, engaging in a war is like building a house, it usually costs more than you intended and can afford. The Spanish King made up the difference by borrowing from banking houses. Periodically, he could not afford the repayments and there was, in modern parlance, a combination of rescheduling and debt relief—maturities were extended indefinitely and interest rates were greatly reduced. This happened more than once—in 1557, 1575, 1596, 1607, 1627 and 1647 to be precise. Yet the bankers had lent so much that their fortunes were linked umbilically to those of the Hapsburg

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<sup>2</sup> *Walford v Miles*, 2 AC 128, 138 (H.L.(E.)1992).

<sup>3</sup> Before doing so, a threshold point must be made. This article looks at the reluctance of debtors to cease servicing their debts. Under most loan agreements and bonds, nonpayment of interest or principal is a ground upon which a creditor can declare a debtor in default, but default is not an automatic event. Being in default under one financing agreement will typically trigger cross defaults under other agreements, and thus this is something creditors wish to control. See Kathleen M. H. Wallman, *The Politics of Default: Politically Motivated Sovereign Debt Default and Repudiation*, 20 Tex Intl L J 475, 477 (1985). This article does not use “default” in this technical sense. This is a discussion of default in the lay sense, of failing to honour one’s obligations under a loan agreement or bond.

Empire and thus they continued to lend. The sixteenth century debt crisis lasted a century.<sup>4</sup>

In the eighteenth century, France funded its repeated and costly wars with England by borrowing from Swiss and Dutch bankers. After almost a century of a similar pattern of defaults, reschedulings and debt relief, the limits of the lenders were reached and the loans stopped. The French monarchy collapsed a few years later.

The history of Latin American debt crises coincides with the rise of independent nations in the region in the 1820s. Latin American nations, except Brazil, engaged in large bond issuances in London in the 1820s. By 1828 all were in default.<sup>5</sup> A pattern soon emerged in lending to Latin America. Once the previous default had been resolved, and as soon as capital became abundant again in Europe, it would find its way to Latin America, usually by Europeans purchasing Latin bonds. Within a decade, the debtors would be unable to service the bonds and would default. Capital flowed south in the 1860s. The collapse came in 1873. It flowed to Argentina in the 1880s, and led to the crisis of 1890. It again went to the region in the 1920s, and with the Great Depression, almost 70 percent of Latin American sovereign dollar-denominated bonds and almost 90 percent of municipal, provincial, and corporate bonds were in default by the mid 1930s.<sup>6</sup>

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<sup>4</sup> Harold James, *Deep Red: The International Debt Crisis and Its Historical Precedents*, 56 *Am Scholar* 331, 334–36 (Summer 1987). Modern national names are used for convenience to describe geographical regions.

<sup>5</sup> See Carlos Marichal, *A Century of Debt Crises in Latin America* 43 (Princeton 1989); see also, generally, Frank Griffith Dawson, *The First Latin American Debt Crisis: The City of London and the 1822–1825 Loan Bubble* (Yale 1990).

<sup>6</sup> Marichal, *A Century of Debt Crises* at 95, 96, 99, 120, 149–50; Darrell Delamaide, *Debt Shock: The Full Story of the World Credit Crisis* 53–54 (Doubleday 1984); Marilyn E. Skiles, *Latin American International Loan Defaults in the 1930s: Lessons for the 1980s?* 1, 15 (April 1988) (Research Paper No 8812, Federal Reserve Bank of New York) (on file with author).

The two principal exceptions to this region-wide default were Argentina and Venezuela. Argentina sold off much of its gold reserves to service its national government bonds although it had to default on many of its provincial and municipal bonds. Venezuela had prepaid most of its debt before the Great Depression and did not default. Nonetheless, as it turned out, capital flows did not resume to Argentina or Venezuela any earlier than they did to other Latin countries that defaulted on all of their sovereign indebtedness.

Argentina honoured its national obligations to the letter throughout the 1930s and 40s. It never took advantage of the substantial concessions that would have been forthcoming in the face of threats of default and that were extended to Brazil.<sup>7</sup> Argentina repaid its national debts, in full, in gold, and yet when capital did flow to the region, Argentina did not receive access to it any earlier than its neighbours or at preferential interest rates.<sup>8</sup> Argentina did the right thing in the 1930s and 1940s for no reward.

In the overwhelming majority of sovereign debt crises, from the sixteenth century to the mid-twentieth century, sovereign debtors defaulted on their debts.

Defaulting on the debt is a less radical suggestion than it might, on the surface, appear. The moral legitimacy of the loans, often pushed onto nations by overenthusiastic bankers, and often accompanied by bribes of debtor nation officials, is often questionable. The human suffering entailed by putting debt service before the

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<sup>7</sup> Marichal, *A Century of Debt Crises* at 218–19 (cited in note 5).

<sup>8</sup> Jeffrey D. Sachs, *Introduction*, in Jeffrey D. Sachs, ed, *Developing Country Debt and the World Economy* 1, 23 (Chicago 1989); Marichal, *A Century of Debt Crises* at 218 (cited in note 5); and Peter H. Lindert and Peter J. Morton, *How Sovereign Debt Has Worked*, in Sachs, ed, *Developing Country Debt* 225, 231–32 (cited in note 8).

nutrition and health of a nation's people are often appalling; and Jeffrey Sachs, at least, advocates defaulting. Sachs is one of America's most distinguished macroeconomists and special advisor to UN Secretary General Kofi Annan on the millennium development goals project. He is hardly a radical. Yet recently, in addressing an African leaders gathering he said, "If they won't cancel the debt—and I'm stretching here—I would suggest that you do it yourselves."<sup>9</sup>

Nonetheless, default, of late, has been relatively rare.

## II. RELATIVELY RECENT SOVEREIGN DEBT CRISES

Massive amounts of capital flowed into Latin America in the 1970s. In August 1982 the debt crisis commenced when Mexico announced it could no longer service its debts and banks stopped lending to the entire region.

However, Mexico has serviced its loans from 1982 to date. Throughout the 1980s it did so with money advanced specifically for that purpose by its creditors (creditors in effect capitalized interest payments by lending the new money to make them), and in 1995, it did so with funds extended by the US—but nonetheless Mexico has serviced its debts.<sup>10</sup>

Indeed, virtually all of the Latin American debtors have serviced all of their debt since 1982. The only exceptions of which I am aware are Peru and Brazil in the 1980s and Ecuador in the late 1990s.

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<sup>9</sup> Daphne Eviatar, *Spend \$150 Billion per Year to Cure World Poverty*, NY Times 44 (Nov 7, 2004).

<sup>10</sup> See Peter H. Lindert, *Response to Debt Crisis: What is Different about the 1980s?*, in Barry Eichengreen and Peter H. Lindert, eds, *The International Debt Crisis in Historical Perspective* 227, 250–51 (MIT 1989).

In 1985, Alan Garcia came to power in Peru as its new President and promptly announced that Peru would limit its debt service payments on medium and long-term debt to 10 percent of exports. Bankers protested vehemently. They saw this as a dangerous precedent and strove to isolate the nation and brand it a pariah.<sup>11</sup> Other debtors declined to follow Peru's lead.

On February 20, 1987 Brazil announced that it was temporarily suspending interest payments on about sixty-seven billion dollars of private foreign debt and effectively freezing about fifteen billion dollars of short term credits and money market deposits by foreign banks. The Brazilian finance minister noted that since 1983 Brazil had paid forty-five billion dollars in interest and received only eleven billion dollars in fresh funds.<sup>12</sup>

The international banking community was shocked. Brazil's GDP had risen 5.7 percent, 8.3 percent and 8.2 percent in 1984, 1985 and 1986<sup>13</sup> respectively and it appeared to be leading the region into recovery. Brazil stressed the moratorium was temporary, and interest repayments were resumed in early 1988 and arrears repaid in late 1988.<sup>14</sup> Nonetheless, Brazil used this payment interruption wisely and bought

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<sup>11</sup> Peter Montagnon, *Debt: An Impasse that Is Difficult to Resolve*, *Fin Times* 3, Peru (special supplement) (Sept 26, 1986).

<sup>12</sup> *Brazil calls the Shots*, 662 *Intl Fin Rev* 677 (1986); Charles F. McCoy, and Peter Truell, *Lending Imbroglia: Worries Deepen Again on Third World Debt as Brazil Stops Paying*, *Wall St J* 1 (Mar 3, 1987); and Robert A. Pastor, *The Debt Crisis: A Financial or a Development Problem?*, in Robert A. Pastor, ed, *Latin America's Debt Crisis: Adjusting to the Past or Planning for the Future?* 5, 14 (Lynne Rienner 1987).

<sup>13</sup> Morgan Guaranty Trust Company of New York, *LDC Debt Realities*, *World Fin Markets* 2 (June/July 1987).

<sup>14</sup> Brazil paid \$356 million on February 2 and \$520 million on March 3, 1988. See Peter Truell, *Bolivia Buys Back Nearly Half of Its Debt to Banks at a Fraction of the Face Value*, *Wall St J* 23 (Mar 18, 1988). Brazil repaid the balance of outstanding interest in the fourth quarter of 1988. See Philip T. Sudo, *Chase Announces Plan to Fortify LDC Reserve*, *Am Banker* 3 (Jan 24, 1989); see also Peter Truell, *Big Banks See Bonanza in Fourth Quarter: Brazil's Catch-Up on Interest Payments Is Main Reason*, *Wall St J* 8 (Oct 26, 1988).

back significant amounts of its debt on the secondary market at prices that were severely reduced by its moratorium.<sup>15</sup>

Since the debt crisis was partially resolved by the Brady Plan in the early 1990s, there have been nine major national debt crises.<sup>16</sup> In late 1997, Indonesia, Korea and Thailand were swept up in the East Asian economic crisis. Then, from 1998 to 2001, Argentina, Ecuador, Turkey, Pakistan, Ukraine and Russia all endured their own crises.

Of these nine nations, only three defaulted on their debts: Argentina, Ecuador and Russia. The other six all restructured their indebtedness and managed to avoid defaulting.

In the East Asian economic crisis that erupted in July 1997, each sovereign debtor met all of its obligations and many of the obligations of its corporate sector. Under the terms of the IMF-organized bailouts, sovereigns typically brought all short-term debt, including that of corporate borrowers, under their sovereign guarantee. The former short-term debt of the country and its private sector corporations became long-term sovereign debt owed to the international financial institutions and other official creditors.<sup>17</sup>

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<sup>15</sup> Ross Buckley, *Debt Exchanges Revisited: Lessons from Latin America for Eastern Europe*, 18 Nw J Intl L & Bus 655, 680–81 (1998).

<sup>16</sup> For a consideration of the Brady Plan, see Ross P. Buckley, *Turning Loans into Bonds: Lessons for East Asia from the Latin American Brady Plan*, 1 J Restructuring Fin 185 (2004).

<sup>17</sup> Ross P. Buckley, *A Tale of Two Crises: The Search for the Enduring Reforms of the International Financial System*, 6 UCLA J of Intl L & Foreign Aff 1 (2001); Ross P. Buckley, *An Oft-Ignored Perspective on the Asian Economic Crisis: The Contribution of Creditors and Investors*, 15 Banking & Fin L Rev 431 (2000). On the highly questionable practice of the socialisation of private sector indebtedness, see Ross P. Buckley, *The Rich Borrow and the Poor Repay: The Fatal Flaw in International Finance*, 19 World Poly J 59 (2002).



In Ecuador's case, a banking crisis in 1998 led to a run on the banks in early 1999. In September 1999 the government decided to default on its Brady bonds and eurobonds and to restructure its domestic debt. After about a year a debt exchange using exit consents was implemented for all the Brady bonds and eurobonds and debt service was resumed.

In August 1998 the Russian government imposed a three month moratorium on private sector payments on external debt, extensive capital and exchange controls and a freeze on some bank deposits.

Argentina's default is the largest sovereign debt default in history. Argentina's aggressive approach is instructive, and will be considered in some detail. Before I do so, however, it is worth noting that the Ukraine, Pakistan, and Turkey were able to manage their way through their crises using various combinations of capital and exchange controls, bond exchange offers, floating of exchange rates, and debt restructurings.<sup>18</sup>

### III. THE ARGENTINE EXPERIENCE

The years from 1991 to 1998 were prosperous times in Argentina with GDP per capita increasing an exceptional 44 percent.<sup>19</sup> Argentina enjoyed its highest rates

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<sup>18</sup> For an analysis of the crises in Ecuador, Russia, Pakistan and Ukraine, and their resolutions, see International Monetary Fund, *Sovereign Debt Restructurings and the Domestic Economy Experience in Four Recent Cases* (Feb 21, 2002).

<sup>19</sup> Miguel A. Kiguel, *Structural Reforms in Argentina: Success or Failure?*, 44 Comp Econ Studies, 83, 84 (2002) (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.

of growth since the 1920s and inflation was completely under control.<sup>20</sup> Argentina significantly improved its banking system, more than doubled its exports, increased infrastructure investment through privatizations and otherwise privatized a broad range of industries, experienced significant growth in oil and mineral production, and achieved record levels of agricultural and industrial output.<sup>21</sup> Argentina was a darling of the IMF and financial markets, and was toasted as “the best case of ‘responsible leadership’ in the developing world.”<sup>22</sup>

Nonetheless at the end of 1998 Argentina entered a severe recession. The timing was dictated in part by external factors, such as the Asian economic crisis and the Russian crisis which together severely limited capital flows to emerging market economies. The principal cause, however, was the one-to-one peg of the peso to the US dollar that, in time, had led to the peso becoming severely overvalued and to Argentina’s exports becoming increasingly uncompetitive.

The economic implosion that followed was severe in the extreme. The government had to close the banks to retain funds in the country. Citizens unable to access their savings to buy food rioted in the streets and broke into supermarkets. Argentina entered the worst economic crisis in its history<sup>23</sup> and possibly the worst

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<sup>20</sup> Id.

<sup>21</sup> Id at 100–01. This is not to suggest that many of the privatizations were not deeply problematic. It is always a profound challenge to realize appropriate prices for the privatization of major businesses and assets in emerging market nations; the main reason being that the range of potential purchasers is not wide and the risk of very favourable prices for well-connected purchasers. The scrupulous and rigorous public accountability procedures that would militate against the latter risk are rarely present. There is much to suggest that many of the privatizations of the 1990s in Argentina were deeply undervalued.

<sup>22</sup> *Chaos in Argentina*, The Nation 3, (Jan 21, 2002). See also Interview with Lance Taylor, *Argentina: A Poster Child for the Failure of Liberalized Policies? Interview with Lance Taylor*, 44 Challenge 28 (2001).

<sup>23</sup> Kiguel, 44 Comp Econ Studies at 83 (cited in note 19); Martin Crutsinger, *IMF Grants Argentina Debt Extension*, Associated Press (9 May 2002).

peace-time economic crisis in world history.<sup>24</sup> On one estimate, total domestic financial assets shrunk from US\$126.8 billion in March 2001 to US\$41.5 billion in March 2002.<sup>25</sup>

For a period Argentina was virtually ungovernable, with a succession of presidents in two weeks. However, it emerged from this period with a government firmly resolved to stand up to the international financial community in general and the IMF in particular.

Argentina's initial workout offer to creditors in September 2003 was unprecedentedly aggressive. It called upon creditors to forgive 75 percent of the US\$94.3 billion in bonds and other debt and all the interest that had accumulated since Argentina's default in December 2001.

Wiping out accumulated interest meant the net present value of Argentina's offer was only 10 percent of total outstanding indebtedness.<sup>26</sup> The response of creditors was predictable: improve the offer or be frozen out of capital markets for a very long time.

Argentina's initial offer was to exchange the 152 different bond issues held by its 500,000 bondholders in six different currencies into a mix of three bonds: par bonds with no reduction in principal but deeply reduced interest rates, discount bonds

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<sup>24</sup> Duncan Green, *Economics: Debate: Let Latin America find its own path*, The Guardian 21 (Aug 5, 2002).

<sup>25</sup> Business Monitor International, *Economic Outlook, Argentina Quarterly Forecast Report, 2002* (2002).

<sup>26</sup> *The End of the Affair?* Economist.com (Feb 20, 2004), available online at <[http://www.economist.com/agenda/displaystory.cfm?story\\_id=2440367](http://www.economist.com/agenda/displaystory.cfm?story_id=2440367)> (visited Mar 20, 2005); and J.F. Hornbeck, *Argentina's Sovereign Debt Restructuring*, CRS Report for Congress (Oct 19, 2004)

with a 63 percent cut in face value and relative low interest rates for the first ten years, rising to 8.51 percent thereafter, and a limited amount of peso denominated, inflation adjusted quasi-par bonds. GDP-linked payments were also attached to all bonds so that, if in any year, Argentina's GDP growth exceeds 3 percent, then 5 percent of the growth above 3 percent will be used to pay extra dividends on the bonds in pesos.<sup>27</sup>

President Nestor Kirchner described this offer as “unmovable”<sup>28</sup> and Argentina refused to amend it for many months. Nonetheless, on June 1, 2004 an enhanced offer was made to recognise past due interest, but without reducing the size of the reduction in principal demanded.<sup>29</sup>

In late 2004, Argentina again improved the offer so that nearly eighty-two billion US dollars of bonds would be eligible for conversion into nearly forty-two billion US dollars in new bonds with lower interest rates and much longer maturities. While this looks like an offer to honour about 50 percent of outstanding debt, there is no provision to honour the twenty-three billion dollars in past due interest, so Argentina's offer represents more than a 60 percent discount—a “haircut” of unprecedented proportions for lenders to a middle-income country. At the time of writing, this offer was still with creditors.

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<sup>27</sup> *Argentina Details Plan to Swap Debt*, World Bank Press Rev (Nov 2, 2004), available online at <<http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,date:11-02-2004~menuPK:278083~pagePK:34392~piPK:34427~theSitePK:4607,00.html>> (visited Mar 20, 2005).

<sup>28</sup> *The End of the Affair?* (cited in note 26).

<sup>29</sup> Hornbeck, *Argentina's Sovereign Debt Restructuring* (cited in note 26)

The following ten reasons have supported Argentina's strong and aggressive approach to its debt negotiations:<sup>30</sup>

1. Argentina has few assets abroad, so there is little that plaintiffs can do but be patient.

2. Having defaulted, Argentina has no standing to preserve in the capital markets and nothing more to lose. Prior to default most sovereigns will go to great lengths to preserve their standing in the financial markets and preserve their access to reasonably priced capital, however, once a sovereign borrower has defaulted, it no longer has standing to seek to preserve. It has nothing to lose.<sup>31</sup>

3. While shut off from global capital, Argentina's economy has powered forward—growing at the rate of 8.4 percent in 2003 and with growth in 2004 predicted by the IMF to be 8.1 percent. While access to global capital will probably be required eventually to recapitalise the banking sector, the cessation of the need to service foreign borrowing is right now a blessing.

4. If Argentina can sustain its strong economic growth of 2003 and 2004, it may well be able to attract home some or much of the estimated \$100 billion of flight capital that Argentines presently hold abroad.<sup>32</sup>

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<sup>30</sup> See *id.*

<sup>31</sup> *The End of the Affair?* (cited in note 26).

<sup>32</sup> *Id.*

5. Throughout the 1990s Argentina was IMF's poster child. It can legitimately claim that its crisis in 2001 arose from following policies either suggested or endorsed by the IMF.

6. The IMF has admitted it erred in guiding Argentina in the 1990s. A recent audit by the Independent Evaluation Office of the IMF into the Fund's role in Argentina in the 1990s has found that the Fund's "surveillance underestimated the vulnerability that could arise from the steady increase in public debt, [when] much of it was dollar-denominated and externally held."<sup>33</sup> In short, the IMF's own audit has found that Argentina borrowed too much, and the IMF acquiesced in this and other policy errors.<sup>34</sup>

7. Argentina has for a sustained period stuck to its commitment to use no more than 3 percent of its primary budget surplus to finance a long term debt restructuring—and has managed to gain the implicit approval of the IMF as "official arbiter" to this approach.<sup>35</sup> It may have been assisted in attaining IMF support for this stance because some 15 percent of the Fund's total lending is to Argentina,<sup>36</sup> an extraordinary concentration of risk that banking regulators would never accept for a commercial bank. As the Fund's loans are immune from the reduction in principal, the debt relief improves their recoverability.

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<sup>33</sup> *Watchdog faults Argentina, but also IMF*, 33 IMF Survey 229, 230 (Aug 9, 2004).

<sup>34</sup> See Independent Evaluation Office (IEO) of the IMF, *Report on the Evaluation of the Role of the IMF in Argentina: 1991–2001* (July 2004) available online at <<http://www.imf.org/External/NP/ieo/2004/arg/eng/index.htm>> (visited Mar 20, 2005).

<sup>35</sup> Hornbeck, *Argentina's Sovereign Debt Restructuring* (cited in note 26); Michael Casey, *The Economy: IMF Chief Presses Argentina on Spending, Debt*, Asian Wall St J, A8 (Sept 2, 2004)

<sup>36</sup> *Argentina and the IMF: Which Is the Victim?* Economist 63, 63 (Mar 6, 2004)

8. Argentina owes \$195.5 billion in bonds and loans, a staggering amount by any measure. It has “made a reasoned case that its debt is simply too big to repay.”<sup>37</sup>

9. The statistics support President Kirchner’s contention that he will not service the debt from the “suffering and hunger of the people.”<sup>38</sup> Argentina’s poverty rate, 27 percent in 1999, had doubled by 2003 to 54.7 percent. Per capita GDP, US\$7,800 in 1999, had fallen by more than half by 2004 to \$3,800, and debt that represented 47.4% of GDP in 1999, was 140% of GDP in 2004.<sup>39</sup>

10. Standing up to the IMF has served to make President Kirchner “extraordinarily popular at home.”<sup>40</sup>

Argentina’s debt negotiations deal with roughly \$104 billion of debt: \$81 billion of principal and \$23 billion of past due interest. The balance is comprised of some \$6.7 billion of official debt owed to Paris club creditors, \$32.7 billion owed to the International Financial Institutions (IFIs) such as the IMF and World Bank, and some \$52 billion owed to Argentine investors and banks that was reduced in 2001 and then further devalued when ‘pesified’ in 2002. The Argentine government, quite reasonably, argues that default to the IFIs is not an option. The holders of the debt that has been pesified have already contributed enormously—to their severe economic

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<sup>37</sup> Hornbeck, *Argentina’s Sovereign Debt Restructuring* at 13 (cited in note 26).

<sup>38</sup> *Argentina and the IMF* at 64 (cited in note 36).

<sup>39</sup> Hornbeck, *Argentina’s Sovereign Debt Restructuring* at 4 (cited in note 26).

<sup>40</sup> *Argentina and the IMF: An Amber Light*, *Economist* 34 (Jan 31, 2004).

detriment—to the resolution of this crisis.<sup>41</sup> This leaves the debt owed to other countries (Paris Club debt) and the debt held by foreign investors, that has not been pesified, to bear the pain of this restructuring.

The bad news is that even if creditors accept Argentina's current proposal, this would only reduce by \$50 billion Argentina's total debt of about \$180 billion. The remaining \$130 billion would represent 90 percent of current Argentine GDP—a dangerously unstable debt level. Kenneth Rogoff, formerly Chief Economist of the IMF, has recently concluded that a sustainable debt level for a nation like Argentina would be about 30 percent of GDP, or one-third of what Argentina will have, even if its current offer is accepted.<sup>42</sup>

However it is resolved, Argentina's case will set an important precedent as it is the most resolute and aggressive approach to debt renegotiations by a debtor in the past quarter of a century.

#### IV. WHY REPAY?

Before 1982 most sovereign debt crises led to default. After 1982 less than a quarter of nations in crisis have defaulted on their debt. Why might there have been this reversal of a well-established historical trend?

The immediately obvious answer would appear to be the effective repeal by the US and England of the sovereign immunity of sovereign borrowers. Between 1976 and 1978, the United States and the United Kingdom enacted legislation that

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<sup>41</sup> For general discussion, see Hornbeck, *Argentina's Sovereign Debt Restructuring* (cited in note 26).



introduced a new restricted version of sovereign immunity under which sovereigns engaged in commercial activities could waive their immunity expressly or impliedly.<sup>43</sup> This is relevant as virtually all sovereign loan agreements and bonds are governed by English or New York law. A United Nations study in the 1980s found that over 80 percent of the total value of emerging market loans were governed by agreements which incorporated an express waiver of immunity<sup>44</sup> and under the new legislation most of the other borrowings would have amounted to an implied waiver of immunity.<sup>45</sup>

Accordingly, certainly since 1982, legal action against recalcitrant sovereign debtors has been an option. However, it has never been one likely to yield a reasonable return.

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<sup>42</sup> Carmen M. Reinhardt, Kenneth S. Rogoff, and Miguel A. Savastano, *Debt Intolerance* 14–19, NBER Working Paper 9908 (2003), available online at <<http://www.nber.org/papers/w9908>> (visited Feb 24, 2004).

<sup>43</sup> In the US, the legislation was the Foreign Sovereign Immunities Act of 1976, codified at 28 USC §§ 1330, 1332(a)(2)–(a)(4), 1391(f), 1441(d), 1602–1611 (1994), and in the UK, the State Immunity Act of 1978. See also Joseph W. Dellapenna, *Suing Foreign Governments and Their Corporations* at 3–8, (Bureau of Natl Affairs 1988); Georges R. Delaume, *The Foreign Sovereign Immunities Act and Public Debt Litigation: Some Fifteen Years Later*, 88 Am J Intl L 257 (1994); Gary W. Larson, *Default on Foreign Sovereign Debt: A Question for the Courts?*, 18 Ind L Rev 959, 965 (1985).

<sup>44</sup> United Nations Economic Commission for Latin America and the Caribbean and United Nations Centre on Transnational Corporations, *Transnational Bank Behaviour and the International Debt Crisis* 12–13 (UN 1989).

<sup>45</sup> Under the US legislation, an implied waiver of immunity arises when a sovereign engages in (1) commercial activity in the US, (2) an act in the US in connection with commercial activity outside the US, or (3) an act outside the US in connection with commercial activity outside the US which act has a direct effect in the US. See 28 USC § 1605(a)(2) (1994); *Republic of Argentina v Weltover, Inc.*, 504 US 607 (1992) and Philip J. Power, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 Fordham L Rev 2701, 2727–32 (1996).

The conventional view is that nations have only two reasons to service their debts: the preservation of their reputation and potential access to capital markets, and the threat of sanctions.<sup>46</sup>

Creditors routinely threaten lawsuits when faced with a potential default, but, in truth, sovereigns typically have few assets outside their own jurisdiction that are liable to seizure in the event of default. I agree with Jerome Sgard when he says,

States, in fact, have only one single reason to respect their contractual liabilities: they have a long term interest in protecting their good reputation so as to be able to re-access capital markets in the future, at a reasonable interest rate.<sup>47</sup>

Sanctions are far more of a threat in theory than in practice. Law suits have arisen from Argentina's default, however while these may have been worthwhile for individual creditor plaintiffs, as a whole Argentina simply has far too few assets abroad for it to make any real difference to the nation, or its creditors as a whole, if execution was levied over all of them, and this is the situation of virtually all sovereign borrowers.

As with the threat of sanctions, the benefits of continued access to global capital markets can also be overstated. There are two reasons for this.

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<sup>46</sup> See, for example, Vivian Yue, *Sovereign Default and Debt Renegotiation* 4 (Nov 2004) (unpublished manuscript) (on file with author).

<sup>47</sup> Jérôme Sgard, *The Renegotiation of Sovereign Debts and the Future of Financial Multilateralism* 4 (2004) (unpublished paper presented at the Fifth Pan-European Conference of the Standing Group on International Relations, The Hague). This was the finding of Eaton and Gersovitz, in their seminal research into reputational models. Jonathon Eaton and Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis*, 48 Rev of Econ Studies 289 (1981).

The first reason, as Argentina's experience is demonstrating, is that the avoidance of the need to service current debt can often more than offset the benefits of new indebtedness. Certainly, from 1982 to 1990 Latin America repaid far more than it received in new credits.<sup>48</sup>

The second reason is that capital tends to flow again into regions when potential returns justify it and not otherwise. Financial markets make their decisions on the prospective return from an investment. A nation's payment history is but one factor to stir into the mix of issues likely to determine how profitable a new investment will be; and as Auerback has noted, the "apparent indifference of 'new money' creditors to a sovereign debtor's default history is not a recent phenomenon."<sup>49</sup>

In the resolution of the debt crisis, countries which serviced their debt continually, such as Mexico, were among the first to receive their Brady restructurings, while less cooperative debtors such as Argentina and Brazil had to wait two and four years, respectively. But international capital in the form of equity investment and eurobond purchases was flooding into both Argentina and Brazil long before their restructurings were implemented. And Peru, which did not service its debt fully for nearly a decade, eventually received a Brady-style restructure on better terms than more compliant nations because its debt-service record indicated that it had less capacity to pay. In short, history contradicts the finance community's constant claim that continued debt service is always in the debtors' interests.

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<sup>48</sup> Sachs *Introduction*, in Sachs, ed, *Developing Country Debt* at 10 (cited in note 8).

<sup>49</sup> Raymond M. Auerback, *Sovereign Debt — Default and Restructuring of Debts Owed to Private Creditor*, 18 J Intl Banking L & Reg 440, 442 (2003).

Furthermore, much international finance remains available irrespective of the outcome of debt renegotiations. Trade finance, project finance, suppliers' credits and official loans from the IFIs are always likely to remain available irrespective of a default. In the words of Norman Bailey in analysing the debt crisis in the 1980s, "debtor states will ... be able to do business if they are called into default. Such action will largely affect direct lending operations, but trade will continue."<sup>50</sup>

So, if lawsuits are unlikely to be a real deterrent to default, and continued access to global capital, while important, is not as important as creditors assert, why has there been this marked trend away from default—at least as a device to extract better terms from creditors in the inevitable renegotiation of the debt?

There is, of course, no definitive answer to this question. However a number of observations can be made. Firstly, the fact that history and analysis do not support the claim of the international financial community that full debt service is always in the debtor nation's interests does not mean the claim has not been made at every opportunity and has not been persuasive, particularly as it has often been reinforced by political pressure brought to bear by the U.S. and other foreign governments. Secondly, and even more significantly, the answer to this question has more to do with the personal perspectives, economic interests, and standing on the world stage of the elites of the debtor countries and the members of their governments and

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<sup>50</sup> Norman Bailey, Remarks in *Comity, Act of State, and the International Debt Crisis: Is There an Emerging Legal Equivalent of Bankruptcy Protection for Nations*, Proceedings of the 79th Annual Meeting, American Society of International Law 126, 130 (1987).

technocracies than it does with what would ultimately be in the best interests of the majority of their common people.<sup>51</sup>

Professor Luiz Carlos Bresser Pereira, a former Finance Minister of Brazil, testifying before a US Congressional Committee in 1989 about the Latin American debt crisis, identified a number of factors that contribute to the willingness of a significant portion of the elites in debtor countries to have their nation's honour their indebtedness. These factors, in his words, include:

“fear of retaliations by the banks, cultural subordination to the First World, willingness to be part of it, identification of the interests of the creditor countries with the interests of the banks, lack of information about the debates among the elites of the creditor countries about the debt, inability to size up the internal economic crisis in their own countries, identification of firm positions for debt reduction to radical or nationalist political attitudes.”<sup>52</sup>

All of these factors remain potent in influencing nations' choices. In particular, I would stress the influence on the individual decision makers of their own background. The educational qualifications and backgrounds of Finance Ministers and the senior technocrats in Finance Ministries in most developing countries, certainly in middle income ones, include a preponderance of doctoral qualifications from US and Canadian universities. These people have typically spent anywhere between three and

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<sup>51</sup> For a general discussion, see Sachs *Introduction* at 26–27 (cited in note 8). See also Stephany Griffith-Jones, *A History of Debt Crisis Management*, in Stephany Griffith-Jones, ed, *Third World Debt - Managing the Consequences* 9, 16–17 (IFR 1989).

<sup>52</sup> Hearings on the *Lesser Developed Countries' Debt Crisis* before the House Committee on Banking, Finance and Urban Affairs, 101st Cong, 1st Session 330, 339 (Jan 5, 1989) (statement of Professor Luiz Carlos Bresser Pereira, *Solving the Debt Crisis: Debt Relief and Adjustment*).

ten years in higher education in North America and this exposure usually influences their perspectives on matters financial.

Having given his list, Professor Bresser Pereira proceeded to emphasise one factor that he thought more important than the others:

“the elites in general in the debtor countries are certainly not the ones that suffer most from the debt crisis; on the contrary, part of them is taking advantage from the debt.”<sup>53</sup>

This certainly has not changed in the past 16 years. In the lead-up to the Asian crisis in 1997 the principal borrowers were corporations but a sizable proportion of these loans were repaid using the long-term sovereign loans advanced in the bailouts orchestrated by the International Monetary Fund. Therefore corporate debt became sovereign debt, and the governments of the debtors then sought to recover the funds from the corporations, usually with little success.

Likewise, in the debt crisis and the current Argentine crisis, the principal borrowers were governments, but the principal beneficiaries of the borrowing were the rich. The loans of the 1970s brought “magnificent returns to the rich”<sup>54</sup> in Latin America just as the loans of the 1990s did for the rich in Argentina. The share of income of the richest 10 percent of the population in all these countries increased, at times substantially, from these crises. Strong capital inflows in developing countries invariably benefit those able to make use of them and holding the assets likely to increase in value as a consequence of the extra economic activity. The capital

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<sup>53</sup> Id at 339.

<sup>54</sup> *Latin America Survey: The Other Obstacles to Change*, Economist (UK ed) (Nov 13, 1993)

outflows, when they come, fall most heavily upon the common people as the debts are often socialized (made into debts of the government) and then repaid through higher taxes, and reduced spending on health care, education and infrastructure.<sup>55</sup>

## V. CONCLUSION

This article set out to answer the questions why in the sovereign debt game debtors have been so reluctant in recent decades to play the default card, and to assess whether this reluctance has served them.

Various reasons have been identified here for this reluctance and virtually all of which can be ascribed to two factors: (1) the success of creditors in arguing that exclusion from global capital markets would be more wide-reaching, last for longer, and be more damaging to the debtor, than history attests it would; and (2) a democratic deficit in the debtor countries.

By a democratic deficit, I refer to the manner in which these nations are regularly governed in the interests of their elites, not their common people. Servicing foreign indebtedness is usually in the personal and economic interests of the elites in the debtor nations, but is often not in the interests of those who will typically have to be less healthy, less educated and less well nourished to enable the debt to be repaid.

The second question is whether this reluctance to default has served the debtors. Part of the answer will be provided by the eventual resolution of Argentina's crisis, although, at the time of writing, Argentina appears set to receive an

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<sup>55</sup> Buckley, 19 World Policy J at 59 (cited in note 17); Jorge Castaneda, *Utopia Unarmed: The Latin American Left after the Cold War* 5 (Knopf 1st ed 1993); Jerry Dohnal, *Structural Adjustment Programs: A Violation of Rights*, 1 Austl J Hum Rts 57, 72–74, 77 (1994); James, 56 Am Scholar at 340 (cited in note 4).

unprecedentedly large amount of debt relief. Certainly, Peru received extra debt relief in its Brady restructuring as its default was seen to indicate a reduced capacity to service its debt, and the resolution of Ecuador's default in the late 1990s was favourable for the debtor. So, to date, history supports the basic negotiation theory with which this article commenced: that the willingness to walk away from a negotiation will, on average, improve the result of that party.

Perhaps it is time for more debtor nations to follow Argentina's lead, and put the interests of their people ahead of those of the international financial community?

#### **POSTSCRIPT:**

In late February and early March of this year, 76 percent of Argentina's creditors accepted Argentina's offer to exchange its debt for bonds at the unprecedented discount of some 66 percent on a net present value basis. In the words of *The Financial Times*, "Argentina gambled, and the gamble paid off".<sup>56</sup> As this article went to press, negotiations were underway about what to do with the debt of the 24% of creditors who did not accept the offer. Argentina was threatening to never service that debt, although this is probably merely a negotiating stance.<sup>57</sup>

In any event, whatever the result of these subsequent negotiations, Argentina will emerge from its period as a defaulting debtor on the most advantageous terms ever secured by a middle-income country in debt restructuring history. On the basis of Argentina's experience the default card may well be worth playing, and playing forcefully.

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<sup>56</sup> *Argentina Sets A Dangerous Precedent: The IMF Should Set Tough Conditions for Further Lending*, *Fin Times* 20, (Mar 7, 2005).

<sup>57</sup> Andrew Balls and Adam Thomson, *Argentina in IMF Talks after Debt Exchange*, *Fin Times* 10 (Mar



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7, 2005).