7

Seniority of Sovereign Debts

A formal insolvency regime typically sets out, in general terms, how different types of claims on a distressed private firm will be treated in a restructuring and the order of payment in the event of outright liquidation. Bankruptcy law usually indicates that equity is junior to debt: Debt gets paid first, and if debt cannot be paid, debtholders may take control of the firm. Back taxes get paid ahead of most private debts. Different kinds of debts may have different levels of priority—for example, debts backed by collateral are treated better than unsecured debts. These rules tell a firm's creditors where their claims stand in the pecking order.

In contrast, no formal rules of priority lay out how different types of claims on a distressed sovereign will be treated. Nor does a court have the power to force a sovereign government to respect any rules of priority.[1] The difficulties of taking effective legal action against a sovereign—discussed in depth in chapter 8—can give the sovereign the ability to discriminate in favor of some classes of claims. Different creditors will argue that their claims should be given priority. As a result, the relative standing of various claims on a sovereign government is often ambiguous. The priority that the sovereign opts to grant different types of debt may not match creditors' prior expectations.

1. In some countries, certain public entities are subject to an insolvency regime. Municipalities in the United States, for example, are subject to Chapter 9 of the US bankruptcy code. Municipal bankruptcy regimes may even explicitly declare that public employee wages and some public expenditures are senior to financial liabilities. US states are not subject to an insolvency regime. However, some state laws may set out the relative seniority of various claims. Here, too, some spending items linked to the provision of public services may have formal priority over debt claims.

Priority can be absolute or relative. Absolute priority means that claims at the top get paid in full, those in the middle get paid in part, and those at the bottom get nothing. Relative priority assures only those at the top of the priority structure better treatment than those at the bottom. Nobody may get paid in full. In corporate bankruptcy, the rules of absolute priority—the ranking of claims in the event of liquidation—determines the bargaining power of different participants during the restructuring negotiations, and thus drive the relative priority accorded to different claims. No comparable rules of absolute priority cast a shadow over a sovereign restructuring. Since a sovereign in default usually is unable to grant absolute priority to many—if any—creditors, the debate is usually over relative priority.

Most sovereigns do respect a number of informal rules, avoiding total chaos. The priority traditionally granted to creditors like the IMF, the World Bank, and other multilateral development banks (MDBs) is almost always respected, in part because these international financial institutions (IFIs) usually refinance their maturing debt rather than demand full payment after a default. In some cases the IMF may go beyond simply refinancing its existing debt and provide new debtor-in-possession (DIP) financing during a crisis.[2] Different external-law bonds are usually treated roughly equally: The structure and payment mechanics of a typical international bond make it hard for a sovereign to restructure one bond issue while sparing another. However, these informal rules still leave plenty of sources of contention. Should the sovereign's debt to private external creditors be treated better, or worse, than its debt to other governments? Should the sovereign's external bonded debt be treated differently than its external bank loans? Should foreign-currency debts held by domestic creditors be treated better or worse than, or the same as, those held by external creditors? Should debt held by domestic banks be treated on different terms in a restructuring? Should the IOUs from pension and wage arrears be treated better, or worse, than other domestic debts?

This chapter examines the current debate about the relative treatment of various types of sovereign debt—a debate that can be interpreted as arguments about the priority structure that a bankrupt sovereign should put in place in the absence of any binding, formal rules of priority. It is divided into three broad sections. The first defends both the informal priority currently given to IFI debt and the principle that Paris Club creditors should condition their restructuring on a "comparable" restructuring of debts owed to private creditors.

The second section discusses the most difficult and controversial issue in most sovereign restructurings: the relative treatment of domestic and external debt.

2. The term "debtor-in-possession (DIP) financing" comes from Chapter 11 of the US bankruptcy code.

The third section examines proposals to introduce a more formal priority structure into the sovereign debt market, whether to limit the risk of debt dilution or to make debt restructurings more orderly. We conclude that it is not possible to develop an enforceable system that substantially improves on the status quo.

Our focus on the issue of priority reflects our sense that the debate on sovereign debt restructuring has been framed too narrowly. Too much attention has been placed on the potential of the shift from syndicated bank loans to international bonds to give rise to new forms of collective action problems. Too little attention has been placed on the far bigger issue of deciding who is in and who is out of the restructuring. It is worth noting that proposals to create an international bankruptcy mechanism for sovereigns—discussed in depth in chapter 8—would not necessarily clarify the relative seniority of different claims on a sovereign. The IMF's proposal, for example, did not cover domestic debt and allowed a sovereign to leave some unsecured external debt out of its restructuring.

We have little doubt that difficulties in reaching agreement on the priority that should be given to different classes of debt are likely to be a far more important impediment to the rapid resolution of a severe sovereign debt crisis than holdout litigation. But we also believe that the obstacles to creating a formal priority structure—and then forcing a sovereign to abide by it—are almost certainly too large to overcome. The real challenge is finding ways to make the current ad hoc and informal priority regime work better. Here, as elsewhere, we believe that incremental steps—more flexible Paris Club restructuring terms for middle-income countries and greater understanding of the case for restructuring domestic and external debt on different terms—is more likely to tangibly improve the debt restructuring "architecture" than more radical reforms.

Relative Treatment of Different Sovereign Claims

A sovereign "bankruptcy" is distinguished by the diversity of different claims on the sovereign's resources as well as by the absence of any authority that has the power to supervise the restructuring. The various potential claims on a distressed sovereign are worth reviewing in detail.

Direct Sovereign Debt Obligations, External and Domestic. External creditors often include private-sector creditors (banks, bondholders, and others), other governments (Paris Club members and others), and multilateral creditors (such as the IFIs). Domestic banks and pension funds are often important domestic creditors. Debts owed to multilateral creditors traditionally have been given priority. Some form of collateral may back—either fully or partially—some external debt, but most external debt is likely to be unsecured.

Contingent Liabilities. The banking system typically is the most significant source of such implicit liabilities. This is true even in the absence of a system of deposit insurance formally backing the banking system, as the government typically guarantees most bank liabilities in a crisis. The implicit liabilities deriving from pay-as-you-go social security systems can also be important. Retirees promised a retirement benefit in return for the social security taxes they paid while working have a clear claim on the sovereign's future tax resources.

Arrears on Wages, Pensions, and Social Payments. A sovereign often stops paying its workers and pensioners in full before falling into broad-based default. Ecuador, for example, stopped paying teachers and policemen before it stopped paying its external debt, and Argentina started paying workers with quasi-currencies before it stopped making debt payments. After the default, those who were not paid in full before the default usually want the money that they are owed.

All these financial claims compete with one another and with other "stakeholders" for a share of a sovereign government's ongoing revenues. Creditors cannot force a sovereign that has defaulted to cut domestic spending, to raise taxes, or to devote all of its revenues to service its debts. Consequently, the treatment that a sovereign should grant to debt service relative to other spending priorities—defense, police, education, and pensions—is among its key decisions following a default.

The diversity of claims on the sovereign makes deciding who gets paid and who does not, and who takes a large haircut and who takes a smaller haircut, intrinsically difficult. Still, a bankrupt sovereign does need to reach agreement with all those holding financial claims to end its crisis, and the terms of these agreements will create—at least ex post—a de facto priority structure.

International Financial Institutions

A sovereign typically pays debts owed to the IFIs even if it is not servicing its other external debts. The effective seniority of IMF and MDB claims is not a matter of legal right. Formally, IMF and World Bank loans are just like any of the sovereign's other unsecured debt. However, sovereigns typically have paid the IFIs even when they are not paying other unsecured creditors, giving the IFIs effective "preferred creditor status." Bilateral official creditors have always respected the IFIs' preferred position: Indeed, the historical willingness of bilateral creditors to restructure their claims in order to assure payment to the IFIs has been central to the conception of the IFIs' preferred status. A sovereign's desire to maintain its future access to emergency financing and a good working relationship with the other governments that provide the IMF with its financing pro-

vides a powerful incentive to follow the convention of paying the IMF even if the sovereign defaults on its other debts.

A number of private investors, however, are questioning the "preferred" status of the IFIs. Argentina, for example, owes a substantial sum to the IMF and the MDBs, and private creditors ask why all unsecured external creditors, including the IMF and the World Bank, shouldn't take a haircut when the sovereign cannot pay.[3] Some argue that the risk of losses would discipline the IMF and prevent it from making large loans to risky countries.

These arguments should be rejected. The IMF is not as a private lender seeking profitable lending opportunities, but a public institution responsible for stabilizing the international financial system. The IMF's preferred status is central to it ability to perform its two key roles in the international financial system: It acts as a proxy for a true lender of last resort, lending significant sums to countries facing a temporary liquidity problem, and as a proxy for a sovereign bankruptcy court by providing new financing to a sovereign undergoing a restructuring. In both cases its financing is tied to an agreement with the crisis country's government on a framework for policy changes, which effectively lays out the country's plan for emerging from distress.

The IMF's preferred status lets it lend when private creditors will not, even though it has to guard against losing the taxpayers' funds it manages. A classic domestic lender of last resort lends against collateral. A sovereign government, in contrast, typically has limited ability to offer collateral: Its core asset is some combination of its commitment to future fiscal adjustment and its commitment to buy foreign exchange that the rest of the economy will generate in the future. The priority granted to the IMF provides it with the security needed to lend large quantities at reasonable rates against such intangible assets.

Without effective seniority, the IMF would have to act more like a private lender and pay more attention to maintaining a diverse portfolio, severely crimping its ability to lend large sums to major emerging economies.[4] It would need to lend to a sovereign at high market rates in order to avoid systematically losing money[5] and would be less able to put

3. Argentina owes about $40 billion to the IMF, the World Bank, and the Inter-American Development Bank. It owes between $80 billion and $90 billion to international bondholders, but domestic investors hold a large share of Argentina's international bonds. International investors truly hold perhaps only $40 billion to $50 billion. The complexities of Argentina's restructuring are discussed in detail later.

4. No private lender would be willing to have its exposure exclusively in relatively high-risk debtors such as Turkey, Brazil, Argentina, and Uruguay without some assurance that its debts would be given priority. Five countries currently account for 86 percent of the IMF's nonconcessional lending.

5. The IMF's Articles of Agreement require it to lend on terms that do not put its resources at risk.

money in when other creditors are pulling money out. Since we believe, as discussed in chapter 6, that there is a need for an international source of emergency liquidity—appropriately priced and linked to appropriate policy adjustments—we also believe that payments to the IMF need to continue to be given priority over payments to other external creditors.

The IMF performs a second role in the international financial system. During a sovereign debt restructuring, an IMF program acts as a surrogate—sometimes an imperfect surrogate—for the supervision that a bankruptcy judge provides during a corporate reorganization. Sovereign bankruptcy certainly is very different from corporate bankruptcy, and the IMF's role also clearly differs in many ways from that of a bankruptcy judge. The IMF has leverage because it lends, not because it can put an end to a "reorganization" process and either push the country into liquidation or force a change in the country's "management." Consequently, the IMF will have, unlike a bankruptcy judge, its own money on the line in the crisis country. If the IMF did not have money—or the ability to put additional money—on the line, then it would not have had the ability to influence the policies adopted by a sovereign government in default. Classically, senior lenders care the least about a borrower's policies: The lender's seniority assures it payment no matter what (Gelpern 2004). The IMF, in contrast, should use the leverage created by its preferred status to perform its public policy role of laying out a framework for the country's macroeconomic policies after a default.

The economic argument for the preferred status of IMF lending to a country undergoing a debt reorganization therefore parallels in part the economic argument for giving seniority to "new money" in bankruptcy. Granting seniority to new financing is necessary if a distressed firm is to remain viable during its reorganization. So long as the firm is worth more as an ongoing entity than if it were to be liquidated, such seniority serves the interest of existing creditors. IMF financing also can help to reduce the fall in output following default, helping other creditors.[6] But the analogy to DIP financing actually understates the case for providing the IMF with seniority. IMF financing is important because access to new money not only can avoid larger falls in output but also provides the hook that lets the international community shape the policies of a sovereign government in distress or default.[7]

6. See IMF (January 2003b) for a discussion of the role IMF financing and an IMF program could play in a sovereign debt restructuring. It is striking that the IMF has not sought to play this role in Argentina.

7. The argument for the seniority of MDB lending is more complicated, since most MDB loans are not provided during financial distress. The general argument for MDB seniority rests on the need to find a way to finance, at low cost, the development of very poor countries. The MDBs can only lend to risky countries at low rates, for long terms, and on an unsecured basis because of the priority that is traditionally given to the repayment of this debt.

Eliminating the IMF's preferred creditor status would do far more harm than good, but private creditors are right to note that the IMF has not always played its role in the international financial system well. Argentina is a case in point. In 2001, the IMF provided emergency liquidity support to a country that, in our judgment, was too indebted to have a reasonable chance of avoiding a restructuring. Argentina's need to repay, over time, the additional IFI debt it took on in the course of 2001 no doubt reduces, at the margins, the amount that the country's other external creditors can expect to recover in a restructuring. Of course, successful rescues also help a country's long-term creditors. Without its preferred status, the IMF would not have lent as much to Argentina. But it also would not have lent as much to Brazil, Turkey, and Uruguay.

In Argentina, the IMF also has had difficulty in performing its second role in the international financial system: defining a macroeconomic program for a country in default. Argentina's fall 2003 agreement with the IMF did not define the amount of primary fiscal adjustment Argentina needs to do beyond 2004 to repay all its creditors. Rather, the program left the job of negotiating Argentina's fiscal adjustment path to Argentina's private creditors. The funds Argentina owes the IMF have hamstrung the IMF and no doubt diminished its leverage. The IMF's major shareholders who—at least in 2003—did not always back the IMF in its negotiations with Argentina have also weakened the IMF's leverage. Eliminating the IMF's preferred status would not solve these problems. Rather the solution is to find ways for the IMF to use more effectively the leverage that comes from its ability to lend when others will not.

The burden that priority payments to the IFIs places on a distressed debtor should not be exaggerated. The IMF and MDBs typically are repaid in full only because they are patient enough to allow a country many years to recover before demanding repayment. They may even provide new money to cover interest payments in some cases.[8] This is another way the IFIs do not act like private lenders. Private lenders lend for short terms so that they have the option of getting out if conditions turn sour. The IMF's short-term lending is repaid only if the borrowing country is in decent economic and financial shape. Of course, defensive lending to reduce the risk of the debtor defaulting on the IMF—and also on the MDBs, because an IMF program is a prerequisite for MDB lending—is hardly ideal. It ties up the IMF's balance sheet and can lead to watered-down policy conditionality, reducing both the IMF's credibility and its ability to lend to

8. IMF resources are at risk of default in the present system. A few countries, such as Sudan, have defaulted on their IMF lending, though this happens rarely. The heavily indebted poor countries (HIPC) process allows very poor countries to reduce their debt to multilateral lenders (IMF and World Bank) as well as their bilateral debt. Middle-income countries are expected to pay the IMF and World Bank back in full over time, even if they default on their private debts—and, in general, they do. Russia is a case in point.

other countries. The IMF is effectively "bailed in" if its short-term catalytic lending fails, as its short-term loans are rolled over to avoid formal arrears. Rather than getting absolute priority, the IMF and other IFIs often have to struggle to convince the crisis country to continue to pay interest on the country's multilateral debt.

Paris Club Debt and Private External Debt

The major bilateral creditor countries—OECD countries like the United States, Japan, the United Kingdom, and France—meet regularly in Paris to coordinate the restructuring of their debts to debtor countries. These bilateral creditors are commonly called Paris Club creditors.[9] A debtor seeking to restructure the debt it owes Paris Club creditors is asked to seek a "comparable" restructuring from its other external creditors—be they bilateral creditors that are not part of the Paris Club or private lenders. Not surprisingly, the Paris Club has been a lightning rod for complaints about the official sector's bail-in policies—in part because Paris Club creditors had significant exposure in the initial bond restructuring cases of Pakistan, Russia, and Ecuador.[10]

Private creditors accuse the Paris Club of being secretive, arbitrary, unfair, politically biased, and unwilling to even talk to private investors (IIF 1999b, Caplen 2000, and Booth 2001). These complaints can be separated into two critiques. One critique argues that the Paris Club should not ask a debtor to seek a comparable restructuring of the debtor's outstanding international bonds in order to facilitate the development of private capital markets. A second critique calls on the Paris Club to do a better job of coordinating its restructuring with private debt restructuring. The first critique is wrong. The second has a grain of truth but is also based on a number of misconceptions.

Why should the Paris Club condition its restructuring on a comparable restructuring by other external creditors, including private creditors? The answer is simple: so as not to subordinate its taxpayers' claims to those of other creditors and, in the process, subsidize payments to bondholders or other groups of creditors. The bilateral creditors who meet in the Paris Club do not lend to other sovereigns on the expectation that their debts would be systematically subordinated to the sovereign's other external debt, apart from debts owed to the IFIs. When most private lending to emerging-market sovereigns came from banks, the Paris Club conditioned its restructuring on the debtor's willingness to seek a comparable

9. See Reiffel (2003) for a detailed history and analysis of the Paris Club and its procedures.

10. The Paris Club also had significant exposure in Indonesia, but bondholders did not. Indonesia's creditors—largely Japanese banks—did not protest the Paris Club's requirement that Indonesia seek a comparable rescheduling of their claims. Indonesia's bonded debt was judged de minimis, and the Paris Club did not insist that it be included in the restructuring.

restructuring of its external bank loans. The banks met in a club of their own—the London Club (which often meets in New York, despite its name)—to coordinate their own restructuring. Bonds were typically left out of these restructurings because the country's bonded debt was too small to be worth the trouble (bonds were considered *de minimis*), not because the Paris Club agreed to give these claims priority. As international banks got out of the business of providing medium- and long-term sovereign financing and as sovereigns turned to the bond market to raise money, continuation of long-standing Paris Club policy implied that the Paris Club would ask countries to seek to restructure their bonded debt on comparable terms. The markets could and should have expected it.[11]

The argument that comparability is illegitimate because political rather than strict commercial considerations motivate official bilateral lending lacks merit. Some bilateral lending certainly has been motivated as much by a desire to aid a country as to be paid back with a profit. Other bilateral loans really are not even foreign aid so much as export subsidies. But even in private-sector lending, the obligation to repay is independent of the reasons the lender made the loan. A financial conglomerate that makes a loan to win investment-banking business still has a valid claim. The interest rate the US government charges on its bilateral lending is intended to reflect the risk of the taxpayer not being repaid, not the costs of systematically subsidizing bondholders.[12]

The fact that Paris Club creditors have legitimate reasons for insisting that a sovereign in distress treat all unsecured external debt comparably does not mean that they always have the leverage to assure that all such debt will in fact be treated comparably. Indeed, sovereign debtors often stop paying official bilateral creditors well before they stop paying private creditors, effectively treating Paris Club debt as junior debt. Strategic nonpayment on Paris Club debts often helps a sovereign pay private creditors in full and on time. For example, Nigeria accumulated over $23 billion of arrears to the Paris Club in the 1990s while paying its Brady bonds and other bonds in full.[13] Ecuador was able to issue a new eurobond in 1997, when it was in arrears to the Paris Club. Sovereign debtors know that going into arrears to bilateral creditors has few immediate consequences. As a rule, bilateral lenders do not litigate to recover payment. However,

11. Some in the markets thought that the perceived difficulty of restructuring bonds would lead the Paris Club to exempt bonds from Paris Club conditionality.

12. After the credit reform, the charge is set in the Interagency Country Risk Assessment (ICRAS) process.

13. Former Nigerian President Sani Abacha and his clan are reported to have $2 billion in their private accounts ("Sani Disposition," *The Economist*, September 7, 2000); he and other Nigerian insiders are rumored to hold a substantial sum of Nigeria's external sovereign debt in his private accounts. Nigeria's long-standing desire to pay its private debt while not paying bilateral debt was not simply the product of its belief in the sanctity of private contracts.

most countries eventually find that they cannot finance themselves indefinitely by running arrears to the Paris Club. When a country approaches the IMF for financing, the Paris Club creditors—who also have the most votes on the IMF Executive Board—can insist that any IMF lending take place only in the context of a general restructuring of all the country's external debt.

Implementing the Paris Club's policy of linking its own restructuring to a comparable restructuring by other external creditors raises a host of difficult practical questions. How can two sets of creditors reach agreement with the debtor on terms that treat both sets "comparably" while also recognizing their distinct preferences? This question does not just arise between the Paris Club and private creditors or even just in sovereign restructurings. Different groups of creditors in a corporate restructuring may also have different preferences and want different restructuring terms. In a wide range of restructurings, banks and retail investors put a higher premium on preserving the face value of their claims than professional money managers, who care more about the bond's market value than its face value.

Private creditors' complaints that the Paris Club initially did not make great efforts to explain how it went about assessing comparability have merit, but a number of misconceptions have complicated the debate on the relative treatment of Paris Club debt and private bonds. The first misconception is that different restructuring terms imply the absence of comparability. In some cases, private creditors have agreed to reduce the face value of their claims while Paris Club creditors have not. However, different terms can reflect the need to craft restructuring terms to match the preferences of different creditors—not discriminatory treatment. For example, private creditors considered par Brady bonds (no face value debt reduction, low coupon) "comparable" to discount Brady bonds (face value debt reduction, higher coupon) in Brady restructurings.[14]

A need to minimize the budgetary costs that Paris Club creditors incur in a debt restructuring heavily (almost certainly too heavily) drives the

14. Private-sector representatives often ask for reverse comparability, with the Paris Club matching private-sector debt reduction if the private sector restructures before the Paris Club. Private creditors, of course, are free to hold up their own agreement on the sovereign until the sovereign is able to reach agreement with the Paris Club on terms that the Paris Club accepts and that private creditors judge comparable. Private creditors, however, have been unwilling to delay a deal with mark-to-market gains to increase their leverage vis-à-vis the Paris Club. In any case such tactics would be unproductive. The Paris Club has different preferences and constraints than private creditors, and it should not agree to debt reduction simply because private creditors are willing to do it. As a matter of policy, Paris Club creditors should not agree to restructuring terms unless they are confident of getting the necessary budget funds to pay for the restructuring and budget funds are too scarce to be allocated solely on the basis of the amount of debt relief private creditors provide. Rather budget funds should be allocated on the basis of broader public policy objectives (including helping the world's poorest).

club's preferences. The accounting and budget rules for Paris Club debt restructuring usually do not require that its creditors discount future cash flows at market rates. Paris Club creditors often can avoid taking a budgetary charge even when they reschedule claims at relatively low interest rates for very long terms, because they can use a discount rate on the new claims that does not reflect an objective assessment of the expected probability of repayment. Consequently, Paris Club creditors have an institutional preference for the equivalent of the "par" option. Apart from a few exceptions, the Paris Club generally does not provide debt reduction for middle-income countries.[15] However, few private creditors would prefer the terms of a typical Paris Club debt restructuring to those of the private deal, even when the Paris Club does not agree to debt reduction. When valued at market discount rates, Paris Club restructuring terms usually imply significant reduction in the NPV of the creditors' claims.[16]

Moreover, Paris Club loans include a series of features not present in private debt contracts. Paris Club debts effectively have an embedded option that allows the debtor to roll over principal and capitalize interest at its own discretion—since the debtor can stop paying these debts with little consequence. Paris Club creditors do not litigate and never panic. A private debt contract with no legal enforcement rights and similar embedded options would trade at a deep discount. These features imply that a Paris Club restructuring can be comparable to a private debt restructuring even when the terms differ—no private creditor would be willing to provide credit to a sovereign at the terms, risk features, and spreads that official bilateral creditors provide.

The second misconception is that private creditors in Russia and Ecuador restructured their debts on substantially more generous terms than the Paris Club. The relative treatment of Paris Club and private debts can be assessed in different ways: Private creditors, not surprisingly, have tended to emphasize those ways of looking at comparability most favorable to their arguments. In Russia, holders of Soviet-era external debt (restructured in the London Club) did agree to do more than the Paris Club. However, comparability needs to be assessed by looking at how Russia treated all of its external private debts, including its Russian-era eurobonds. Since the high-coupon eurobonds were altogether excluded from the restructuring, the overall treatment of Russia's private external debt was comparable to that of Russia's Paris Club debt. In Ecuador, a fair assessment of comparability requires looking at all the terms of the restructuring—cash sweeteners, maturity, coupon, and the treatment of collat-

15. Poland, Egypt, and former Yugoslavia are the most notable examples.

16. Paris Club creditors' preferences often reflect the projected budgetary cost of the restructuring, which differ from calculations of the NPV using market rates. Paris Club agreements are commitments to restructure on the proposed terms, but the actual execution of the restructuring depends on each country's budget rules.

eral—not just the face value of Ecuador's new bonds. Once adjustments are made for the debt reduction that stemmed solely from the early release of collateral on two of Ecuador's Brady bonds, it is not obvious that uncollateralized private creditors offered more debt relief than Paris Club creditors. For example, the holders of Ecuador's 2002 and 2004 eurobonds were able to trade their existing claims at par for new high-coupon eurobonds maturing in 2012.[17] Private creditors tend to overlook cases like Pakistan, where the terms of the private restructuring were more favorable than those of the Paris Club restructuring. The Paris Club has been firm in insisting on the principle of comparability but flexible in interpreting its precise meaning.

Nonetheless, real differences—some of which are quite technical—make it difficult to coordinate the Paris Club and private restructurings:

- The Paris Club typically restructures only those payments coming due during the country's IMF program (in Paris Club terminology, the "consolidation period"). This can result in a series of restructurings of Paris Club claims rather than a comprehensive restructuring of the entire stock of Paris Club debt, which tries to address the country's problems once and for all. The Paris Club agrees to a comprehensive restructuring of a country's entire debt stock only after the country has completed a three-year IMF program. Private-sector debt restructurings, in contrast, typically restructure the entire "stock" in a single restructuring to avoid repeat restructurings. While bank restructurings in the 1980s often were implicitly conditioned on the completion of an IMF program, bondholders generally have made an IMF program a condition for the execution of their restructuring.
- There are no well-understood rules on how to allocate available near-term cash flow among different creditor groups. The Paris Club's flow rescheduling model requires the country to allocate cash flows among creditors in proportion to the amounts they have coming due during the IMF program period. Paris Club creditors use this method to apportion payments among themselves. They turn to this method most naturally for apportioning payments between Paris Club and private creditors. This method tends to favor creditors with large arrears (often Paris Club creditors, because countries typically go into arrears on Paris Club debt before private debt) or with principal payments coming due during the consolidation period. Private creditors do not

17. Holders of uncollateralized Brady bonds did not get as good a deal as holders of the 2002 and 2004 eurobonds, and holders of the uncollateralized portion of partially collateralized Brady bonds did agree to substantially alter the profile of their uncollateralized payments to Ecuador's benefit. However, all arrears on bonded debt were also settled in cash, while arrears to the Paris Club were settled in large part with new debt.

necessarily follow a similar rule. They often base restructuring terms on aggregate amounts outstanding, not the amount coming due.

- Paris Club processes are built around an assumption that the Paris Club restructuring precedes the restructuring of the debts of both other bilateral and private creditors. The Paris Club uses its rules to decide what share of the sovereign's near-term cash flow it should take, leaving the remainder for other creditors to divvy up among themselves using their own rules. This process breaks down when private bondholders restructure before the Paris Club, as has been the case in some recent restructurings.[18]
- The Paris Club has its own arcane system for according informal seniority within the Paris Club in order to facilitate new lending. A country's initial restructuring sets a cutoff date, and in theory lending after the cutoff date is senior to old lending in the event of future payments difficulties. This can become a problem if a country ends up going back to the Paris Club, because the original cutoff date does not change. Private creditors do not have a comparable system or any comparable complications. (In the 1980s, "new money" that bank creditors provided was initially kept out of the restructuring, but over time this practice disappeared.)

There is value in improving dialogue between the Paris Club and private creditors, so that both groups better understand how the other operates and the sources of their different preferences. Indeed, the Paris Club has been taking steps to increase its transparency, after private creditors correctly pointed out that it was difficult to find information on how the Paris Club operates or on the amount of debt a country owed to Paris Club creditors.[19] However, the need to improve coordination does not mean that the Paris Club creditors should accept private demands to ne-

18. The difficulties in allocating near-term cash flows are a manifestation of the general difficulties created when one major group of creditors does a "flow" restructuring—i.e., it only restructures those claims coming due in a defined period (Paris Club creditors do not accelerate their claims)—and another group of creditors does a "stock" restructuring—i.e., it restructures the entire stock of outstanding debt. The prorated distribution of cash flows according to claims coming due in the consolidation period works reasonably well if all creditors are doing flow restructurings but less well if one creditor group is restructuring the entire stock. In practice, the Paris Club has been willing to interpret this rule flexibly.

19. The Paris Club set up a Web site, www.clubdeparis.org, that provides information about its activities, rules, upcoming cases, and claims being restructured. The Paris Club (or another international body) could do more—for example, a more systematic registry of all Paris Club bilateral claims might be useful to investors. Certain Paris Club procedures are arcane, and the flexibility that is consistent with Paris Club procedure—changing cutoff dates, for example—is not always obvious. More public information about its procedures and rules might help everyone avoid misunderstandings.

gotiate restructuring terms on a case-by-case basis with a committee of private creditors.

The inherent difficulty in negotiations between governments and private financial firms means that there is a high risk of the "negotiations" resulting in a slower and more contentious process without necessarily producing substantially different outcomes.[20] Unless private creditors want to lobby their legislatures for budget funding to pay for debt concessions, general Paris Club policies will dictate the club's restructuring terms. Most restructurings follow the basic Paris Club procedures: normal terms (i.e., substantial maturity extension at favorable interest rates but no debt reduction) for middle-income countries, Houston terms for poorer countries, and HIPC terms for those that qualify for it. It takes a political decision to provide a high-profile country with special treatment.[21] The Paris Club is not a formal organization so much as an ad hoc group of rotating creditors, with rules and procedures to enable relatively low-level technical experts to handle a large number of cases reasonably efficiently. It is not currently set up for high-profile negotiations with private creditors.[22]

This is not to say that the Paris Club's specific practices do not need to change. For example, it is worth discussing how to better balance "flow" and "stock" considerations in allocating available near-term cash flows among various creditor groups.[23] There is a case for favoring creditors who have been discriminated against before the restructuring and thus favoring those with large arrears (typically the Paris Club). There is also a case for providing more cash to creditors who place the highest value on cash (market creditors) and who are most willing to agree to real debt reduction in return for higher upfront cash payments.

The standard market critique that the Paris Club is a political wild card whose actions cannot be predicted, ironically, is not the strongest critique of the club. The Paris Club's biggest problem is that its restructuring terms

20. Once the IMF defines the amount available for debt service and rules are agreed upon on the distribution of upfront cash, restructuring terms cannot be in sharp contrast to comparability and medium-term sustainability.

21. Special considerations were made for countries such as Poland, Egypt, and Serbia. Key creditors have already committed to give Iraq special treatment.

22. France hosts the club and by convention both chairs its meetings and provides its secretariat, but the French secretariat cannot speak for all Paris Club creditors. Private creditors would need to negotiate with the individual governments that make up the Paris Club, barring a major reorganization.

23. We believe a widely understood rule—like some variant of the proportionality principle used in recent cases—would ultimately provide a more predictable and fair distribution of the burden than a formal negotiating process, given the Paris Club's need to operate with a framework defined by established rules and principles. All groups of creditors would need to reach an informal understanding that both Paris Club and private claims are rescheduled and/or paid in cash in proportion to the outstanding claims of both groups, either the overall amount outstanding or the portion of claims coming due in a defined period.

are too predictable and fail to take the specific circumstances of the country sufficiently into account. Paris Club rules reserve outright debt reduction—which requires scarce budget resources—for the poorest countries. Middle-income countries get substantial cash flow relief but no debt reduction. The absence of deep debt reduction from holders of either Ecuador or Russia's external bonded debt undermined private-sector complaints about the absence of Paris Club debt reduction in either country.[24] Argentina, however, is seeking deep debt reduction from its private creditors. Since Paris Club exposure in Argentina is small, the absence of outright reduction by Paris Club creditors won't undermine the country's overall solvency, but it still highlights how general rules can result in suboptimal outcomes in specific cases. Fortunately, the G-7 has recognized that the Paris Club may need to be more flexible in some middle-income countries (Serbia and Iraq are obvious examples) and has called on it to rely less on preset terms and more on debt sustainability analysis to figure out how much relief a country truly needs (Group of Seven 2003b). It remains to be seen how the Paris Club will use this new flexibility—and whether private creditors will push the Paris Club toward restructuring terms that help them more than the crisis country.

Domestic Versus External Debt

The treatment of domestic debt is often the most contentious issue in a sovereign debt crisis. Sovereigns facing a deep crisis, like Argentina now or Ecuador in 1999, rarely leave either domestic or external claims entirely out of a restructuring. Consequently, the substantive policy issue is whether these two categories of debt should be restructured on similar terms or domestic debt should be given some priority.

What Is "Domestic" Debt?

The absence of a simple definition of the difference between domestic and external debt is one sign of the complexity of this issue. The standard economic definition is based on the principle of residency. External debt is any debt held by a foreign resident, regardless of debt instrument's governing law or currency of denomination. A local-law, ruble-denominated Russian treasury bill held by foreign investors, consequently, counts as external debt. Conversely, a dollar-denominated, New York–law eurobond held by a Turkish bank should be considered as domestic debt. Another economic definition uses the currency of denomination to define the difference between domestic and external debt.

24. External investors who bought Russia's domestic GKOs clearly did take substantial losses.

The legal definition, in contrast, focuses on governing law. Domestic debt is defined as debt governed by domestic law, regardless of whether the debt is denominated in local or foreign currency or whether a foreign or domestic resident holds it. Conversely, debt governed by foreign law is defined as foreign debt, even if a domestic resident holds it. Phrases like "domestic banks hold lots of the country's external debt" implicitly rely on governing law to define what constitutes external debt (IMF August 2002).

In most countries, domestic residents still hold a larger fraction of the domestic-law debt than foreigners, and nonresidents still hold a larger fraction of the foreign-law debt. As markets become more integrated, however, foreigners are increasingly investing in domestic-law debt and domestic residents are increasingly buying the country's foreign-law debt. The banking systems of Turkey and Lebanon hold a substantial fraction of these countries' New York-law eurobonds—as did Argentina's banking system before the November 2001 eurobonds-for-guaranteed-domestic-loans swap. In other cases—the United States today and Russia in 1998—foreign investors hold large quantities of a country's local-law, local-currency debt.[25]

The difference between the legal and economic definitions of domestic and external debt can complicate the discussion of the relative treatment of domestic and external creditors. If foreign investors hold the country's external-law debt, and domestic investors hold the domestic-law debt, it is technically easy to offer different restructuring terms to holders of domestic and external debt. Payments on domestic-law debt are usually made inside the crisis country and are harder for holders of foreign-law debt to stop. If both domestic and foreign residents hold the same external-debt instrument, offering different terms to residents and nonresidents is more difficult.[26] It typically requires a multistep process. Argentina's November 2001 "bonds for loans" swap, for example, was designed to appeal to domestic holders of the country's eurobonds (foreign investors typically could not hold a domestic-law loan). Once most domestic residents exchanged their foreign-law bonds for a new domestic instrument, it was possible to treat the new domestic instruments differently than the original bonds.

25. In practice, it is difficult to track who holds a sovereign's external-law bonds. Many countries simplify the calculation of their country's external debt by just assuming that all external-law bonds are held externally. As a result, the reported external debt of some countries exceeds the amount that nonresident investors truly hold. This was particularly true with Argentina.

26. The sovereign often does have the ability to offer different terms to external and domestic investors if they both hold the same domestic debt instrument—e.g., Russia offered international investors holding its GKOs different terms than domestic investors. The legal leverage of external investors in domestic debt markets varies dramatically from country to country.

To simplify the discussion of the relative treatment of domestic and external debt, we assume that residents hold all domestically issued debt and nonresidents hold all foreign-issued debt—that is, there is no difference between the economic and the legal definition of external debt. We recognize that this is only a rough approximation of a much more complex reality.

Treatment of Local-Currency Debt

Local-currency debt is subject to devaluation risk on top of default risk, as well as the risk of exchange controls restricting an investor's ability to convert local-currency payments into foreign currency. Either a sharp currency devaluation or an unexpected burst of inflation is likely to reduce the real value of fixed-rate domestic-currency debt in the event of a crisis, even in the absence of a debt restructuring. Consequently, a "comparable" restructuring of domestic-currency and foreign-currency debt usually implies offering different terms to holders of domestic-currency and foreign-currency debt. However, even if local-currency debt has to be restructured on terms that take into account the risk of further devaluation or future inflation, the question remains whether domestic-currency claims should be restructured on terms that differ substantially from those offered to external investors holding foreign-currency claims. Here the issue for domestically held local-currency debt and domestically held foreign-currency debt is the same.

Equal Treatment for Domestic and Foreign Debt?

Treating all the sovereign government's unsecured creditors equally has obvious intuitive appeal. The underlying logic that justifies attempts to treat Paris Club and private external debt "comparably" seems to apply to the treatment of domestic and external debt as well. Why should unsecured external creditors agree to subordinate their claims to those of unsecured domestic creditors?

Two economic arguments potentially justify discriminating in favor of domestic debt. First, the "pain" of the domestic debt restructuring is part of the overall pain domestic residents bear in a crisis, and the restructuring process should aim to balance the overall domestic adjustment effort with the restructuring of external claims on the country. Domestic residents feel the pain associated with economic contraction, falling real incomes, and fiscal tightening while foreign creditors do not. Consequently, greater concessions from foreign creditors can be consistent with a balanced allocation of the overall "pain" between domestic residents and external creditors. The second argument is more direct: The local banking system often holds domestic debts disproportionately, and a domestic

debt restructuring that leads to a banking crisis typically reduces the value that external creditors can expect to receive.

The first argument highlights the need to distinguish between the adjustment effort *foreign investors* and *domestic agents* make, not between the relative treatment of foreign and domestic creditors. The domestic residents in a crisis country would bear a substantial burden even in the unlikely event that their financial claims on the government were not restructured. Domestic fiscal adjustment requires an increase in taxes and cuts in public spending and services. Higher direct taxes (such as income taxes) and indirect taxes (such as consumption/sales taxes) and reductions in public salaries, public pensions, and public services all result in lower income for domestic residents. Also, residents mostly bear the falls in output, employment, and consumption needed to improve the country's external balance. Falls in the local-currency value of a wide range of real and financial assets, such as equity and real estate, also tend to have a bigger impact on residents than nonresidents, because residents typically hold more such assets than foreign investors.[27]

In most cases, however, the financial claims of domestic residents also are restructured. A government that can no longer act as a lender of last resort to the banking system often has to freeze deposits, turn short-term deposits into long-term bonds, implement capital controls and otherwise restrict access to domestic financial assets. Frozen deposits and other domestic debts are often restructured in ways that imply a fall in their real value. Indeed, reductions in the real value of domestic debts can be thought of as just another way of taxing residents. The tax—formally called a capital levy—is imposed on the value of financial assets rather than on current income or spending.

Assessing whether domestic residents and foreign investors are making a "comparable" contribution to crisis resolution therefore requires looking beyond the relative treatment of domestic and external debt and examining the many other ways in which domestic residents contribute to crisis resolution. Of course, there is no single, unitary domestic agent that bears all domestic costs. The distribution of the domestic adjustment burden among domestic taxpayers, domestic beneficiaries of public spending, and domestic holders of financial assets is usually at least as contentious as the relative treatment of external and domestic debt. Conceptually, though, it is still possible to separate the adjustment costs domestic agents bear from the concessions foreign investors make.

A truly *insolvent* country cannot pay its foreign debt in spite of making the maximum feasible domestic adjustment. Foreign investors, therefore, have to bear the full residual burden to restore solvency. The improvement

27. The real value of other local currency–denominated financial assets (like those a debt contract creates between two citizens) can also fall, though a fall in the real value of private contracts can benefit debtors even as it hurts creditors.

in the country's fiscal position that can be generated by reducing the value of domestic public debt—effectively a tax on financial wealth—should be thought of as part of the maximum feasible domestic adjustment. Just as other types of domestic adjustment have limits, so does the amount of adjustment that can come from a haircut on the domestic debt. From this point of view, the ideal debt restructuring process would start by determining how much domestic pain/adjustment is economically necessary—as well as how much is politically/socially feasible—to put the country back on a sustainable growth and fiscal path. This in turn would determine the debt relief needed from external creditors. The discussion about domestic debt restructuring should be part of the internal debate over who within the society should bear the needed domestic adjustment cost, not part of the discussion over external debt restructuring terms.

It is worth noting that domestic debt reduction has only a limited impact on the economy's overall capacity to generate the foreign exchange for external debt service. Payment of the government's external debt requires (1) that the economy as a whole generate the needed foreign currency and (2) that the government raise enough money domestically to buy this foreign currency. A haircut on domestic debt would reduce domestic financial wealth, leading to lower consumption and imports. However, this is a very indirect way of generating the needed external adjustment. Of course, smaller domestic debt payments mean that the debtor can use more tax revenue to purchase the foreign exchange needed to make external debt payments. But large domestic haircuts may lower the amount of domestic fiscal adjustment that is politically sustainable even as those haircuts reduce domestic financial claims on that fiscal surplus. Domestic residents who have taken large financial haircuts on their domestic debts may not be willing to accept additional sacrifices (higher taxes/lower government services) to pay foreign creditors (see box 7.1 for an elaboration).

Difficulties That Domestic Banks Create

The argument that a domestic debt restructuring is a form of domestic taxation that redistributes domestic resources within the economy and therefore should be considered a form of domestic adjustment hinges on rather abstract questions of equity. The banking sector's heavy domestic debt holdings more commonly justify the different treatment of domestic and external debt.

Banks are almost always highly leveraged: A bank's owners put up capital, and the bank takes in short-term deposits and invests the resulting funds in longer-term financial assets. The mismatch between a bank's promise to return depositors their funds on demand and its longer-term and often illiquid assets adds to the financial fragility inherent in a high degree of leverage. If the value of the financial assets the bank holds falls

Box 7.1 Different haircuts for domestic and external creditors

Consider the following illustrative and hypothetical example. A government has a debt-to-GDP ratio of 100 percent, with domestic creditors holding one half and foreign creditors the other half. This debt is unsustainable, and the country formally defaults. At the time of default, the country was not running a primary surplus. All agree the government needs to tighten its belt, but it cannot achieve a primary surplus of more than 4 percent of GDP. All also agree that the long-run growth rate of the economy will be 3 percent and that the long-run real interest rate will be 11 percent. The differential between the real interest rate and the growth rate is 8 percent (11 percent minus 3 percent), which—in conjunction with a primary balance of 4 percent—implies that the debt-to-GDP ratio should be reduced to 50 percent.

One solution would be to cut everyone's debt in half, so that of the 50 percent of GDP in new debt, one half is held domestically and the other half externally (scenario 1). The domestic haircut is a form of taxation—a capital levy—that is imposed on domestic financial assets. Suppose that domestic investors, who are also taxpayers, decide that they would prefer to spread their losses over time (scenario 2).[1] They consequently agree to pay higher taxes to produce a larger surplus to avoid reducing the face value of the debt they hold. If foreigners take the same haircut as before, the country's debt-to-GDP ratio falls from 100 to 75 percent. Domestic investors still hold debt worth 50 percent of GDP, while foreigners now hold debt equal to 25 percent of GDP. The primary balance required to stabilize the debt ratio is higher, since the debt level is higher—6 percent of GDP. Formally, scenarios 1 and 2 treat both domestic and external investors the same, even though the second scenario does not impose a haircut on domestic creditors. In both cases, foreigners hold debt equal to 25 percent of GDP after the restructuring, and 2 percent of GDP is allocated to service this external debt. Domestic investors are also agreeing to the same losses: A large domestic haircut implies that the full burden of domestic adjustment is being born upfront in the form of a capital levy

(box 7.1 continues next page)

a little, then bank capital can be written down and depositors can be kept whole without any injection of taxpayer funds. If the fall in the value of the bank's assets exceeds bank capital, in theory, depositors need to take a haircut. Yet they rarely do. Banks play a key role in the payments system, and an uncontrolled bank run triggered by fears of losses among depositors is economically devastating. Consequently, the government almost always steps in to protect bank depositors from losses in the event of a systemic crisis, even in the absence of formal deposit insurance.

Governments typically bail out banks by giving them—perhaps in exchange for a portion of the banks' equity—a government bond of sufficient value to balance the banks' liabilities and assets. These long-term bonds are a way of protecting deposits from losses by shifting the losses onto future taxpayers. If the domestic banking system holds a large amount of domestic debt and the government wants to protect depositors from losses, a haircut on domestic debt implies the issuance of more domestic debt to bail out the banks. Consequently, imposing an equal haircut on foreign bonds and the domestic bonds held by local financial institutions only increases the amount of new domestic debt that the government will have to issue to fi-

Box 7.1 *(continued)*

while a larger primary surplus implies that the same loss is spread over time.[2] The size of the primary balance devoted to service the foreign debt determines the size of the foreign haircut, regardless of how domestic losses are allocated over time.

Let us take the discussion a step further. Suppose that foreign creditors convince the country that a 50 percent haircut on their debt is too much, and the country agrees to impose a proportional haircut of 25 percent on both foreign and domestic creditors. The debt ratio then falls to 75 percent: Foreign creditors hold debt equal to 37.5 percent of GDP, as do domestic creditors. A primary balance of 6 percent of GDP is now required to sustain the higher debt burden that emerges from a smaller haircut (scenario 3). Relative to scenario 2, the country is running the same 6 percent primary balance, and external creditors are taking a smaller haircut. This is possible because domestic investors are in effect agreeing to accept larger losses. Half of the 6 percent primary balance, or 3 percent of GDP, is devoted to servicing the foreign debt, relative to only 2 percent of GDP in the previous two scenarios. In scenarios 2 and 3, the country is running a 6 percent of GDP primary balance, but the 6 percent primary balance in the second scenario was predicated on the need to spread the *domestic* losses in the first scenario over time, not on the need to do more domestic adjustment to service external debt.

1. Here we assume that the average domestic creditor is equivalent to the average domestic taxpayer. This is true on average, but individual differences imply only some domestic redistribution.

2. On an NPV basis, a 50 percent haircut and a primary balance that increases from 0 to 4 percent leads to an equivalent loss to domestic residents as a primary balance goes from 0 to 6 percent and no haircut.

nance the bank bailout. Reducing the value of banks' holdings of domestic government bonds—so long as explicit or implicit government deposit insurance fully backs the banks—provides almost no debt reduction for the government.[28] If depositors cannot take losses and bank capital is exhausted, then taxpayers have to bear the burden of bailing out the banks.

In theory, the effective haircut that foreign investors suffer is equal in the following two scenarios:

- Foreign investors are discriminated against in the debt restructuring and receive worse terms than domestic banks holding the same bonds;
- Foreign investors are not discriminated against, and both domestic banks and foreign investors receive the same terms, but a much higher average haircut is required since the resulting bank bailout will re-

28. The same argument holds if the haircut is imposed on the government debt holdings of pension funds whose benefits are defined. Unless the government wants and can impose a capital levy on the workers who are entitled to these assets, any haircut on these claims will become another liability for the government.

quire the government to issue new debt to protect bank depositors from losses.

The advantages appearing to treat all creditors the same and then recapitalizing the banking system have to be balanced against the advantages of avoiding the bankruptcy costs associated with a systemic bank restructuring. Restructuring all debts avoids protecting both wealthy domestic holders of domestic debts and the banks' equity owners from the pain of a restructuring. However, pushing the entire banking system into insolvency through a comprehensive restructuring is also costly. Restructuring all debt on equal terms increases the odds of a deposit run.[29] It is easier for the government to tell depositors not to worry if banks' debts are being excluded than to explain that it will issue more debt to make up any losses in the banking system from a debt restructuring.

One could certainly argue that domestic depositors should bear some of the burden in a sovereign debt crisis and that the government should improve its own solvency by imposing a capital levy on the financial wealth of all bank depositors. While domestic debt is rarely restructured on the same terms as external debt, domestic debt is usually restructured in severe crises, and bank depositors often take losses. Deposit freezes, forced conversion of foreign-currency deposits into local-currency deposits (pesification) and of deposits into longer-term bonds (at a market value well below par), and caps on the interest rates provided to frozen deposits are all ways of imposing a haircut on bank deposits.

The choice between imposing a tax on bank depositors and asking external creditors for additional debt relief illustrates well the basic arguments for giving more favorable treatment to domestic debts. Bank depositors are likely to see their real incomes fall no matter what as domestic output falls and may also bear most of the burden of the tax increases and spending cuts needed to improve the government's fiscal position. As long as the amount of pain that domestic agents, including bank depositors, are willing to take is limited, only the country's nonresident creditors can bear the residual adjustment burden. Of course, this creates problems when there is a large gap between the amount of "pain" domestic agents

29. From an intertemporal perspective, a country's ability to service its defaulted external debt is independent of whether the depositors accept a capital levy or not. A haircut or capital levy on deposits results in immediate losses for domestic residents. If there is no deposit haircut, then the banks will have to be recapitalized with recapitalization bonds that have to be serviced over time through higher taxes/revenues. From an intertemporal point of view, the domestic burden of an immediate capital levy on deposits should be equal to the discounted value of the higher future taxes needed to pay for bank recapitalization (leaving aside distribution effects). Consequently, external creditors should not necessarily care how the country decides to resolve the insolvency of its banking system. If the average taxpayer is also the average depositor, this intertemporal shift of the burden has no domestic distributional consequences. Realistically, some redistribution of wealth will occur in the two alternative scenarios, as individual depositors may differ from the average taxpayer.

are willing to bear—whether through more fiscal adjustment or a deeper domestic debt restructuring—and that international investors are willing to accept. Unless the two sides reach agreement on how to apportion the economic loss, no deal is possible. Deals where creditors pretend that they will be paid what they think they deserve at some point in the future and where debtors pretend that these payments can be made without any additional adjustment carry a high risk of sowing the seeds for future trouble.

The final balance between domestic adjustment of all sorts and external debt relief will reflect the economic, political, and legal leverage of all parties in the process. Chapter 8 emphasizes that the legal leverage of external creditors is limited so long as the debtor is willing to incur the economic costs (loss of external market access and difficulty attracting new domestic as well as external investment) of prolonged default. Domestic creditors may not have greater legal leverage but typically do have greater political leverage: Any elected government is likely to prefer prolonged external default to a prolonged domestic bank holiday. Domestic creditors also are a far more likely source of new financing than external creditors. Finally, domestic creditors often—though not always—have less diversified portfolios than the average international investor.[30] They consequently often have a greater stake in the outcome of the restructuring.[31] The equilibrium between domestic and external adjustment—and the relative priority attached to paying different sets of claims—will reflect the government's perception of the relative costs and benefits of all these factors.

A Real World Example: Argentina

Argentina offers a concrete example of many of the issues already discussed.

- *blurring the lines between domestic and external debt before the crisis*. Argentina entered its crisis with a relatively large stock of external-law bonds and a relatively small stock of domestic-law debt. Domestic banks, pension funds, and individual Argentines were large holders of Argentina's external-law bonds. During its crisis, Argentina con-

30. An investor holding a diversified portfolio of emerging-market debt can absorb large losses at one point in time in one emerging-market economy without necessarily taking overall losses. Indeed, studies (such as a recent one by Klingen, Weder, and Zettelmeyer 2004) suggest that over long horizons, emerging-market investors receive on average returns equal to a risk-free rate asset such as US Treasury bonds. In 2001, returns on the emerging-market bond index (EMBI) were positive despite Argentina's default.

31. There are cases, though, where some external investors have a less diversified portfolio than some domestic investors. A retail Italian investor that put—unwisely—all its savings into Argentine bonds may have more "Argentine" exposure than a wealthy Argentine with a large offshore bank account, of which only a small proportion was invested in Argentina's external debt.

verted much of its external-law debt into domestic-law debt through a "eurobonds for guaranteed loans" swap and added to its domestic-law debt by issuing new compensation bonds (Bodens) to make up for the banks' losses. Domestic investors, however, are estimated to hold at least 40 percent of Argentina's remaining external-law bonds.

- *difficulties assessing equity: When should the clock start?* During the latter part of 2000 and throughout 2001, Argentina could not raise funds abroad. However, it could still place significant quantities of new external-law bonds with its domestic banks and pension funds. Funds raised domestically—along with IMF lending—helped to finance interest payments as well as the repayment of maturing principal on the portion of Argentina's external-law debt that was held abroad. Domestic residents were effectively forced to increase their exposure to the government of Argentina even as international bondholders were reducing their exposure. After Argentina's default, however, the domestic debt holders that accepted the restructuring terms implicit in the "pesification" have been paid while the external-law bonds remain in default. External creditors can complain that Argentina has given preference to domestic debt after its default; domestic creditors can legitimately respond that Argentina's crisis started well before its external default and that the "clock" should have started ticking when funds raised domestically were used to pay external creditors.

- *limiting the banking system's losses after a sovereign default.* Argentina's crisis was so severe that it was impossible to protect bank depositors from any losses. After Argentina's default, its domestic-law debt, including the guaranteed loans that were created in a "bonds for domestic loans" swap only weeks before, was redenominated from dollars into pesos by government decree. Even though domestic bank deposits were converted into pesos at a relatively favorable 1 to 1.4 peso exchange rate and then indexed for inflation, depositors clearly have taken losses. Those who kept their claims in the banking system after the deposit freeze was lifted now have a deposit worth about 60 cents rather than a dollar—and those who pulled their funds out at the height of the crisis often took larger losses. Yet there is also little doubt that Argentina has put a higher priority on resolving its domestic banking crisis than on resolving its external-debt crisis and has sought to limit the scale of losses domestic depositors have borne. The banks' domestic debts have been serviced according to the new restructuring terms while other debt has remained in default. The government also has issued new debt (Bodens) to avoid the need for depositors to take larger losses as a result of Argentina's household and corporate debt crisis.

- *the difficulty in solving a debt problem by default if domestic banks hold large amounts of debt.* Ironically, while the government of Argentina defaulted in part because it had too much debt, its default has resulted

in an increase in its overall debt stock. Since Argentina's debts have increased by more than its capacity to pay, it has divided its debt into two categories—one group that has been given priority and another that has not. Argentina paid the IFIs, the banks' pesified guaranteed loans (before being restructured twice, these claims were international bonds) as well as the new Bodens thoroughout its crisis. It has been in default on bonds held by external investors and by Argentina's pension funds since early 2002. (An exchange offer for these bonds is expected in the fall of 2004.)

- *the difficulties in resolving a systemic banking crisis*. Argentina had both a sovereign crisis and as a result of its private firms' extensive dollar-denominated debts, a systemic corporate crisis. Argentina moved preemptively to solve its domestic corporate payments crisis by converting domestic bank loans into pesos at a favorable 1 to 1 exchange rate. The gap between the 1 to 1 conversion rate on banks' loans and the 1 to 1.4 conversion rate on deposits initially resulted in large paper losses in the banking system, but the government subsequently picked up most of the tab by giving the banks new bonds to compensate them for their losses in this "asymmetric pesification." Many have criticized the asymmetric pesification. However, those who blame pesification or asymmetric pesification for the financial chaos of the crisis are confusing cause with effect. Almost all Argentine households and firms had more dollar debt than they could pay following the devaluation. Systemic corporate and banking crises are always costly, and the restructuring process itself is almost always politicized. Large financial losses need to be apportioned among important domestic constituencies: domestic depositors, domestic taxpayers, beneficiaries of government spending, domestic banks, and domestic businesses.[32]

The last point is worth exploring in more depth, because the cost of Argentina's domestic banking and corporate crisis has dramatically increased Argentina's debt stock. There are two distinct issues. First, could a different way of resolving Argentina's domestic crisis have reduced the overall losses associated with its crisis? Second, could losses have been allocated in a different way, so that Argentina's taxpayers—and perhaps its external creditors—picked up a smaller tab?

In our view, the large losses of Argentina's banking system—losses that the banks' owners, bank depositors, or taxpayers had to absorb—are not primarily the result of pesification or even the asymmetries of the pesification process. Any banking system that has lent to domestic borrowers in dollars—or another external currency—takes large losses in the event

32. In Argentina, external investors owned many local banks and local utilities with large dollar debts—a fact that would have complicated any process for resolving the country's domestic crisis.

of a major currency depreciation. Argentina had a particularly large problem because its domestic dollar debts were unusually large and its export sector was unusually small (Goldstein and Turner 2004). It is, of course, impossible to know for sure if the losses from pesification are larger, smaller, or equal to the losses that would have occurred if dollar claims had remained in dollars and been restructured. Yet there is good reason to believe that keeping all bank loans in dollars would have been as costly, in aggregate.

Indeed, if all domestic loans had been kept in dollars and the peso/dollar exchange had still fallen from 1 to 3 (or even a bit less), almost all the financial assets of the banking system—loans to the government, provinces, households, and firms—would have fallen into default.[33] This would have put immeasurable strain on the banking system, the domestic bankruptcy system, and many small firms and households. The resulting restructuring process would have been both lengthy and costly. Individual debt renegotiation is slow: Large domestic Argentine firms who borrowed from abroad and thus did not benefit from pesification generally were still in default at the end of 2003—two years after the crisis. Moreover, it is unrealistic to believe that the government would not have been drawn into the process of renegotiating household mortgage and small business loans. Some across-the-board solution was clearly needed for small borrowers, and deciding who should get how much relief—and who should bear the associated costs—would have been politically paralyzing even if the debts had initially remained in dollars.

Another option would have been to keep domestic loans in dollars but to reduce all dollar debts by a fixed percentage. This option, however, is not all that different from pesification. One to one pesification is similar to a two-thirds haircut of the face value of all domestic dollar debts. Argentina could have kept debts in dollars and imposed a smaller haircut. However, there is no guarantee that this would have reduced overall losses.[34] In the face of a deep recession, less debt relief would have implied some additional firms and households could not service their debts.[35] The

33. Pesification prevented domestic loans to the government and provinces from falling into default, though the new debt carries a low interest rate. Households, consumers, and small businesses whose debts were pesified are generally paying on their peso debt. Argentina's banking system still has problems—the yield on government debt is low, and probably below the average long-run cost Argentine banks will need to pay on their deposits. Many big Argentine firms also remain in default. They cannot resume payments on their domestic debts before reaching agreement on restructuring terms with their external creditors.

34. Pesifying both domestic loans and deposits at a 1 to 1.4 rate would have reduced the size of the across-the-board haircut—and probably resulted in a higher ratio of nonperforming loans. Pesifying both domestic loans and deposits at a 1 to 1 rate would have provided borrowers the same relief but imposed bigger losses on bank depositors.

35. Remember that the revenues of domestic firms without export revenues increased in line with the growth of nominal domestic GDP, so pesification did not necessarily reduce the real value of their debts by two-thirds.

marginal cost of pushing additional households and firms into bankruptcy should not be underestimated: Bankruptcy itself is costly, and an unresolved debt overhang can destroy value. Some firms that paid their pesified debts in full—and effectively paid their original dollar debts in part—would not have paid anything at all for an extended period. Providing debt relief through one to one pesification produced winners and losers (sometimes arbitrarily); it was done in a haphazard way and like all across-the-board solutions, provided some debtors with more relief than they needed and others with less. However, the scale of Argentina's domestic debt problem was such that it is not clear that any alternative solution would have reduced the overall size of the financial loss—though undoubtedly it could have produced a different set of winners and losers.[36]

The second question is the distribution of the resulting loss. It is hard to see how more of the loss could be passed on to the Argentine banks' owners. The restructuring process effectively wiped out all of the banking system's existing capital and inflicted large losses on the banks' owners (often major international banks).[37] The government has had to issue new bonds to the banks to offset the losses created by the asymmetries in the pesification process precisely because foreign bank owners otherwise would have walked away, leaving the government in control of almost the entire banking system. If providing less debt relief to domestic debtors would have led only to larger losses from nonperforming loans, as we have argued, then reducing the costs that taxpayers picked up would have required shifting more of the costs on to domestic depositors. The "asymmetric" part of asymmetric pesification was a way of limiting the domestic

36. Indeed, the Argentine pesification was not substantially different from the US decision to repudiate the gold clause when the country went off the gold peg in 1931, and the dollar depreciated against gold by two-thirds. The US Supreme Court upheld the repudiation of the gold clause in 1935. Without such repudiation, large segments of the corporate and business sectors whose debts were contractually linked to the value of gold would have gone bankrupt. Argentina "dedollarized" its domestic debts, and the United States "degoldized" its domestic debts. See Kroszner (1998) for more details.

37. The overall impact of the steps Argentina has taken to restructure its banking system on the interest of the banks' foreign owners is complicated, since some steps helped the banks' owners and hurt others. While the asymmetries in pesification initially imposed large losses on the banks' owners, but the banks subsequently have been largely, though not yet fully, compensated for the effects of asymmetric pesification. Some banks are probably better off with pesified deposits, a performing pesified loan, and a compensation bond than a nonperforming, dollar loan, and dollar deposits. Foreign-owned banks may have been hurt more by the freeze on utility tariffs, which has damaged the financial health of many of their most important clients, than by asymmetric pesification plus compensation. Moreover, the government's overall approach to the resolution of the banking crisis undoubtedly has had a large and often unexpected impact on the competitive position and balance sheets of different banks. The government has not used the crisis to close, consolidate, intervene, or otherwise restructure a number of publicly owned banks that went into the crisis in poor financial condition, and bank regulators have not forced the closure of weak, domestically owned private banks.

depositors' losses by having taxpayers pick up the difference between the conversion rate on bank deposits and bank loans. Asymmetric pesification is not all that different from reducing all dollar deposits by a smaller percentage than all bank loans, with taxpayers making up the difference.

Politically, though, it seems unlikely that it would have been possible to increase the losses borne by domestic bank depositors through a different domestic bank restructuring process. Most bank depositors do not believe that they are the beneficiaries of Argentina's system of assigning priority. Rather, they believe that they have taken unwarranted losses because the banks failed to honor their dollar deposits in full. This highlights our broader argument: If Argentina had kept the bank deposits in dollars (or converted dollar deposits into peso deposits fully indexed to the dollar), depositors would have borne fewer upfront losses while the government of Argentina would have had an even larger bank bailout bill. Rather than taking losses upfront, Argentines would have spread the banking system's losses over time, through higher taxes and less government spending to pay for the bank bailout. On the other hand, had the banks not been recapitalized through the compensation process and had depositors taken a larger haircut, depositors would have less financial wealth, the government of Argentina would have a smaller domestic debt stock, and Argentina would have less need to either reduce government services or increase taxes to pay its debts.

External creditors argue that they—and not future Argentine taxpayers—are currently being asked to pay some of the cost of the bank bailout: Argentina is asking external creditors to agree to a large haircut to make Argentina's debt stock compatible with its current fiscal effort. This argument has a grain of truth but also makes a number of assumptions that should be laid out explicitly. A larger deposit haircut helps external creditors only if there is no offsetting reduction in the size of the primary surplus that Argentines are willing to run. Less domestic debt and the same primary adjustment imply that more of the primary adjustment would be available to provide the fiscal resources (though not the foreign exchange) needed to support a higher level of external debt service. However, it is entirely possible that a bigger domestic haircut would result in a reduction in Argentina's political willingness to adjust, a smaller primary surplus, and no more resources for external debt service.

Concluding Remarks on Domestic Debt

A sensible system of priorities should recognize that domestic and external debt have a number of important economic differences and that this may call for different—and sometimes better—treatment of certain domestic financial claims. Domestic debt restructuring is effectively a tax on one kind of domestic financial wealth and should be considered part of

the internal adjustment the debtor needs to make to restore itself to solvency, not part of the external debt restructuring. However, our argument for treating domestic debt differently from external debt is not an argument that the debtor should avoid making any domestic adjustments. The overall domestic adjustment effort that the bankrupt country makes and the concessions external creditors provide should be balanced. A bankrupt sovereign that pushed all the costs on its external creditors to avoid any domestic adjustment would obviously fail to provide the needed balance. The case for treating domestic debt better is that domestic residents are adjusting in other ways, not that external creditors should spare a crisis country's residents from any painful domestic adjustment.

The economic case for treating domestic debt differently than external debt is particularly persuasive if the financial system holds a large share of the domestic debt. The economic disruption associated with the total collapse of the domestic financial system is well worth avoiding. However, there are also limits to how much the sovereign can favor the domestic banking system. Domestic debts often need to be rescheduled to address liquidity problems, and if the domestic debt stock is large, then domestic holders of government debt also will likely need to accept a reduction in their financial wealth as part of the overall domestic adjustment required to restore sustainability. If domestic banks hold all the government's debt, then it is obvious that domestic debt the banks hold cannot be fully protected from losses.

Arguments in Favor of a Formal Debt Seniority Regime

The uncertainties about the relative priority accorded to different claims on a sovereign in the current sovereign debt restructuring process—uncertainties that are obvious in Argentina—have prompted a number of calls to develop a clearer system of priorities for sovereign claims.[38] Proponents of reform argue that a set of more defined priorities would improve on the current nonregime in several ways:

- First, the ambiguity in the current system makes it much harder to rapidly reach agreement on a needed debt restructuring. The system of priorities in a bankruptcy regime makes both the debt restructuring more orderly ex post and the relative treatment of different claims more predictable ex ante (Gelpern, 2004). In the absence of an agreed, enforceable system of priorities, different groups of creditors and the debtor have to agree (whether explicitly or by default) on the relative priority that should be given to different sets of claims before they can negotiate actual financial terms.

38. See Zettelmeyer (2003) and Gelpern (2004) for thoughtful discussions of seniority issues.

- Second, the current system risks encouraging hard-to-restructure debt contracts. Creditors can game the system by hoping the debtor will give informal priority to instruments that are legally hard to restructure.[39] Providing formal seniority to the various sovereign debt claims might allow the development of instruments that make debt restructuring less messy (Zettelmeyer 2003).
- Third, the lack of a formal seniority structure in sovereign debt can distort the sovereign's incentive to manage its debt wisely (Bolton 2003, Bolton and Skeel 2003, Paasche and Zin 2001). The absence of a first to lend, first to be paid—or first in time—priority structure can lead to sovereign overborrowing. The first creditor who lends to a sovereign debtor would prefer that the sovereign not take on any more debt, thus assuring that the initial creditor would have an exclusive claim on the sovereign's debt-servicing capability. Additional loans from other creditors dilute the value of the first creditor's claim unless every new loan results in an equal increase in the debtor's overall ability to pay. The first lender will anticipate this risk and therefore charge the sovereign more, while later creditors will charge less than they should because they can appropriate some of the sovereign's debt-servicing capacity from earlier creditors. The lender's inability to control later borrowing imposes an externality on earlier borrowing. If earlier claims had greater seniority than later claims, the spread on the initial debt would be lower and that on later debt would be higher. This would reduce a sovereign's incentives to overborrow.

Obstacles to the Creation of a More Defined System of Priorities

Difficulty in agreeing on the relative priority that should be given to different claims on the sovereign is certainly a major impediment to rapid agreement on a restructuring. Yet the conceptual and practical obstacles to creating an explicit seniority system for sovereign debt are profound.

Diversity of Sovereign Debt

The main obstacle is the sheer breadth and complexity of the financial claims on the sovereign and more broadly, the number of "stakeholders" that have an economic interest in how the sovereign's difficulties are resolved. Ranking the seniority of all the explicit claims on the sovereign (domestic and external debt and within external debt, the claims of dif-

39. The best example of this may be Nigeria's Brady bonds, which have several features that would make Nigeria usually vulnerable to the risk of litigation, should it default on its Brady bonds. On the other hand, Nigeria traditionally has had other reasons to pay its Brady bonds while running arrears to the Paris Club. Wealthy Nigerians, including former President Abacha's family, reportedly had large holdings of Nigeria's Brady bonds.

ferent groups of private and official creditors) is itself a daunting task. However, ranking explicit claims is not enough. There would still be a need to figure out the relative seniority of explicit and implicit debt—such as pension claims and guaranteed deposits—as well as the priority to be given to paying debt relative to supporting government spending and keeping taxes from rising. Specifying in advance the right balance between increasing taxes, reducing government spending, reducing current and future pension liabilities, imposing losses on depositors, reducing domestic debt, reducing external debt held by private creditors, and reducing external debt held by official—bilateral and multilateral—creditors is next to impossible.

The existence of so many creditors, claimants, and stakeholders makes the resolution of any sovereign debt and financial crisis eminently a political process that does not lend itself to simple legal rules. This is particularly true for ranking the sovereign's domestic liabilities, which, as discussed, can involve choosing between paying police salaries and paying bank depositors.

Is a Seniority System Enforceable?

A related issue is the enforceability of any formal seniority scheme. In the corporate context, a bankruptcy judge can use the power of the state to prevent discriminatory payments to junior claimants and can exercise considerable control over the distressed debtor's assets. No one has similar power over a sovereign in distress. As discussed in the next chapter, the difficulty in initiating successful litigation against a sovereign provides it with substantial freedom of action. This potentially includes the freedom to ignore a formal seniority scheme. The difficulties in enforcing a formal system of debt seniority are particularly acute with respect to domestic debts.

The inability to liquidate a sovereign and distribute the proceeds from liquidation according to defined rules of *absolute* priority is not the crucial barrier to the creation of a system of sovereign priorities. The bigger barrier is the absence of a supranational power that can enforce a system of *relative* priorities (Gelpern 2004). Domestic bankruptcy law can set out a priority structure for semisovereign public entities, including subnational governments that, like a sovereign, cannot be liquidated. US law allows creditors to seek a court order forcing a municipal debtor to increase taxes to fund debt service, even if this has been very hard to do in practice. However, there is a difference between a municipal debtor that is subject to national law and a sovereign.[40] Sovereign countries have a degree of independence that exceeds the legal independence of US states, and US states, unlike US municipalities, are not subject to federal bankruptcy law.

40. Black's Law Dictionary (6th ed., 1990) defines sovereignty as a "supreme, absolute and uncontrollable power by which any independent state is governed."

A sovereign not subject to external enforcement might nonetheless conclude that following an established system of priorities is in its own interest. Sovereigns do care about their reputation and failing to follow a generally accepted seniority system would likely damage their future ability to borrow. Sovereigns, for example, have found it in their interest to pay the IMF and World Bank even when this has required sacrifices, in part because of the reputational costs of trying to change the "rules of the game." If the formal ranking were enshrined in national laws, then a national court might be able to issue an enforceable legal order that stopped discriminatory payments to junior creditors if more senior creditors were not being paid. Of course, such a remedy would be effective only if the sovereign were making payments to more junior domestic debt holders. Senior creditors have few remedies if the debtor simply refuses to pay anyone. Finally, official creditors that currently lend to a sovereign in distress on the strength of their preferred status—notably the IMF—could use the leverage that comes from their new lending to strengthen incentives to respect a defined system of priorities. The IMF might be willing to lend into arrears if the country had defaulted on its debts but not if the country also "defaulted" on the established system of priorities.

Proposals for a More Defined System of Sovereign Priorities

Most proposals to make the priority given to different sovereign debts more explicit set aside the relative treatment of external and domestic debt and of private and official debt and instead focus on the creation of an explicit seniority regime for the sovereign's private external debt. This focus makes it much easier to define and enforce a clear system of priorities even as the more limited coverage limits the impact the new system of priorities would have on the restructuring process. A number of these suggestions warrant further examination.

Bolton-Skeel Proposal: First to Lend, First to Be Paid

Patrick Bolton and David Skeel (2003) have proposed the creation of a simple system of seniority where debt issued earlier would be senior to debt issued later. This "first-in-time" priority system would eliminate the incentives sovereigns have to dilute their capacity to pay existing debt by taking on additional debt. Such a proposal would no doubt achieve its intended objective of hindering overborrowing.

However, this particular proposal has shortcomings. First, it would fundamentally change the way sovereign debt trades in the secondary market. The date of issuance would matter more than the bond's residual maturity. This means, for example, that a new five-year bond would be worth less (because of its lower position in the pecking order) than a ten-year bond that was issued five years ago and that has a residual maturity

of five years. This would make constructing a sovereign yield curve difficult, since the standard yield curve implicitly assumes that all bonds that make up the curve have the same priority. Other technical issues to consider include the treatment of debt issued in voluntary debt exchanges for outstanding long-maturity debt. No doubt the markets could adjust to these new rules, but it may not be easy.

Second, junior creditors who are lending at a later point in time would have a strong incentive to find other ways of protecting themselves from losses. Markets adapt (Lipsworth and Nystedt 2001). Junior creditors may insist that their claims carry a short maturity. A first-in-time priority rule risks creating a bifurcated sovereign debt market, with some long-term senior debt that benefits from formal priority, some very short-term junior debt, and perhaps very little in between. Consequently, giving formal seniority risks creating incentives to increase the use of forms of debt that make rollover/liquidity crisis more likely.

Third, making the new system work would likely require additional rules. The first-in-time priority rule would have exceptions. For example, as will be discussed in detail in the next chapter, most bankruptcy regimes granted seniority to new financing to facilitate the operational and financial adjustments required by a distressed debtor that is undergoing a financial reorganization. Since the IMF performs an analogous role in the sovereign context, presumably it would continue to receive some form of priority. Indeed, the denial of IMF financing would likely be central to the enforcement of priorities in a world of sovereign states.

Moreover, other rules may be needed to protect the intent of the priority structure. For example, some bankruptcy regimes require that firms in the "zone of insolvency" be managed to protect the interest of senior creditors and even give them a claim on payments made to more junior creditors just before a formal bankruptcy declaration. The sovereign world has a similar problem. A country that runs down its reserves to pay short-maturity junior debt just before default effectively damages—by depleting its reserves—the interest of its long-term creditors in the process. However, so long as the sovereign has not missed a payment before formal default, the formal seniority granted to long-term debt issued far in the past offers creditors no protection against this risk. Taking steps to limit the risk of the sovereign acting against the interest of its senior, long-term creditors could require introducing an additional layer of complexity. A regime that did not limit the risk of a sovereign fully depleting its reserves by making payments to junior creditors before default would still work but with less effective protection for senior creditors.[41]

41. The same basic argument could be extended to other uses of the sovereign's reserves. Intervention in the foreign exchange market, for example, could deplete sovereign reserves before default, damaging the interest of long-term creditors—as could lender-of-last-resort lending to the domestic banking system facing a run out of dollar deposits.

Finally, a first-in-time rule makes it cheaper for a policymaker that inherits a low debt load to engage in a borrowing binge.[42] Consequently, a policymaker with a bias toward fiscal irresponsibility would have a strong incentive to issue as much cheap debt as possible early on. (Bolton and Skeel would give all debt issued in a given year the same priority.) At the limit, overborrowing would be accelerated rather than reduced. Problems with time consistency are an even bigger obstacle for other proposals to limit sovereign overborrowing. For example, some have suggested that a sovereign should commit to an upper limit on its debt stock (either absolute or a share of GDP) to lower borrowing costs. If the promise not to borrow above a limit actually lowered current borrowing costs, it might just encourage those policymakers to borrow more upfront (Zettelmeyer 2003). Realistically, though, there is no way to prevent later policymakers from exceeding the proposed limit.

Soros Proposal: International Deposit Insurance Agency

Other proposals would provide seniority to part of the external debt issued by a sovereign in order to limit the risk of a liquidity crisis. For example, George Soros (1998; "Avoiding a Breakdown: Asia's Crisis Demands a Rethink of International Regulation," *Financial Times*, December 3, 1997) proposed the creation of an international deposit insurance agency that would insure international investors' claims against default. Soros aims to reduce the risk of investor panics generating self-fulfilling crises of confidence. Fully insured claims would not have any incentive to run. To reduce the risk of moral hazard, Soros suggests that the amount of insurable claims be capped. The IMF would set the ceiling on insured borrowing, and debtor countries would pay the cost of this insurance scheme through an insurance fee.

This proposal has a number of problems.[43] If the insurance fee is actuarially fair and there are no informational failures, then the cost of issuing insured debt would not differ from that of issuing uninsured debt. A fully insured bond would be riskless and have no spread relative to other riskless international bonds. However, the insurance fee should be equal to the spread of that country's uninsured debt. Including the insurance fee, the cost of external borrowing for the country would remain the same.[44]

42. In the Alesina and Tabellini (1990) model of excessive deficits and debt, for example, the sovereign overborrows because a government that may not be in power in the future discounts the welfare of future taxpayers/generations too much.

43. See also Eichengreen (1999) for a thoughtful discussion.

44. If market prices are different from actuarially fair prices, then the debtor may gain or lose. Differences in the relative knowledge or ignorance about fundamental risks between the debtor and market providers of insurance may be a channel through which value is created. But one has to rely on externalities or informational failure to make such an argument.

Of course, setting the right fee structure would be difficult, and there could well be an implicit subsidy. The IMF also would have to protect against the risk that politically important countries would use their leverage to obtain a higher borrowing limit than their fundamentals warrant.[45]

The desire to limit the risk of runs motivated Soros' proposal for the international equivalent of deposit insurance. However, to truly eliminate the risk of runs, a debtor would have to be precluded from issuing uninsured debt in excess of the cap that was set on its insured debt. Uninsured claims would continue to have strong incentives to run.[46] Such debt might be more expensive to issue, and thus countries may issue less of it. Creditors, however, also would have strong incentives to make sure that they had the option to exit from such "uninsured" lending quickly and thus to lend only for relatively short terms. There is no guarantee that the risk of liquidity runs would be reduced—insured claims would not run, but uninsured claims would have strong incentives to get out quickly.

Soros suggested that one benefit of his proposal is that the explicit insurance provided to some claims would make it easier to deny a bailout to those claims that lacked insurance. However, this is not obvious. If letting the country default on its uninsured claims risked a deep crisis in a politically important ally—or risked triggering contagion to other countries that had issued large amounts of uninsured debt—in practice, the IMF or the G-7 might step in and bail out a country having difficulties with its uninsured debt.

The Soros proposal does try to provide seniority in a clear and transparent way and to charge a fair fee for the provision of insurance. Many other proposals to provide sovereign debt with some form of seniority through credit enhancements (collateral, guarantees, or other forms of insurance) are less transparent. These proposals are usually motivated by a desire to help a sovereign that is having difficulty placing unsecured external bonds—whether because of a run, growing doubts about its fundamentals, or unsettled global market conditions—raise additional external financing without generating the appearance of a bailout. They often use partial credit guarantees from the World Bank or other MDBs to engineer a class of semipreferred sovereign debt. These proposals, discussed in

45. A number of other difficult questions would also need to be addressed. For example, the rolloff of cross-border bank lines has been a major source of pressure on the sovereign's own reserves, as most sovereigns step in and protect the banks during a crisis. If the deposit insurance applied only to the sovereign's external borrowing, it would not stop all runs. If private banks were eligible, the insured loan would either need to be explicitly guaranteed by the sovereign, which would assume responsibility for supervising the bank, or the international deposit insurance agency would need to assume some regulatory functions.

46. This shortcoming is common to all proposals that guarantee (or provide collateral for) some claims on a sovereign but not others: Claims that are not guaranteed or enhanced still have an incentive to run.

chapter 6, can be viewed as proposals to introduce a more defined seniority system into a sovereign's external debt in order to help it raise money in times of distress.

If relative seniority has to be provided, it should be done transparently through a conditional IMF loan or a full guarantee from another preferred creditor. However, attempts to create implicit seniority hierarchies through clever financial engineering add more uncertainty into an already uncertain restructuring process.

Gelpern Proposal: Pick Your Own Priority Scheme

Anna Gelpern (2004) has proposed that sovereigns could choose their own system of priorities and make it public by enshrining it in domestic law or private contracts. Some US states have set through a democratic process—either state law or the state's constitutions—a clear structure of payment priorities. These priority systems usually grant absolute priority to some forms of public spending, such as public services and public employees' wages. Should a restructuring be necessary, creditors would negotiate over the tax receipts left over after these payments are made. Countries could, if they wished, create a similar priority regime. This reform would be a step in the direction of clarifying the priority various claims on the sovereign would have in the event of a restructuring. Gelpern does not recommend any particular set of priorities, only that a sovereign define in advance the priorities it thinks would be appropriate.

But even this modest reform may be very hard to implement. First, the number of stakeholders and claims that have to be ranked in a comprehensive priority structure is so large and complex that it may not be possible to set out a simple and efficient set of priorities. The contract setting out priorities may be impossible to write—particularly given all the contingencies that it might need to address explicitly. A simpler priority scheme may not be substantially more efficient than the current system, as many key disputes will not be resolved ex ante. Second, any self-chosen priority regime may not be time-consistent and enforceable. The country may conclude that it is not in its interests to follow its articulated priority structure in the heat of a crisis. The banking system, for example, may hold a large share of the country's junior claims, and following its articulated priority structure would therefore have substantial costs. The credibility of any self-chosen priority regimes will remain in doubt, since a country can always default on its self-chosen priorities. Third, a sovereign default and restructuring is more complex than even the restructuring of a US state's debts. Subnational entities, even sovereign states, usually don't issue their own currency, back their banking systems through deposit insurance, have large implicit liabilities from massive social security obligations for all their citizens (local public employee pension schemes are often fully funded), or have the ability to impose capital controls to limit tax-evading capital

flight. The priority structures of US states have not been tested by an actual restructuring—and may never be. The US government would probably not let a state like California default.

Incentives for a country to follow its own system of priorities could be strengthened by denying IMF lending to a country that does not follow its own system. But IMF enforcement has its own difficulties. The IMF's own prior exposure constrains its leverage—denying IMF financing to a sovereign that has defaulted on its own priority structure could result in a default on the IMF. Even setting aside the IMF's interests as a creditor, it may be better off using its limited leverage to improve a country's macroeconomic policy framework rather than forcing a country to stick to its priority structure. The details of the priority structure will likely be contested, and the IMF may even conclude, for example, that protecting the country's banking system is more important than religiously following any preexisting priority structure. The international community's interest, writ broadly, would be better served by helping the country recover rather than punish it for failing to live up to its self-defined system of priorities.[47]

Still, Gelpern's proposal has greater merit and fewer costs than proposals for more radical reform. It could force a sovereign to make its priorities in default explicit, and once priorities are made explicit, the reputational cost of defaulting on an articulated priority structure would be increased. Too many high-risk sovereigns prefer to think that default is unthinkable and that no contingency plan for a default is needed. Yet even if sovereigns are expected to lay out its intended system of priorities, the risk of a sovereign concluding that it is not in its interest to follow its self-chosen priority regime is real.

Conclusion

The absence of well-defined rules of priority clearly is a source of uncertainty for investors following a sovereign default. Sovereigns have substantial—though certainly not unlimited—freedom to determine ex post the priority structure that is in their interest. Investors who base investment decisions on the types of debt instruments that were favored in the previous restructurings will often be disappointed. Since holding patterns vary, the type of instruments that get relative priority also tends to vary. Look at the difference between Russia and Argentina's external bonds. Russia paid external bonds issued after the fall of the Soviet Union in full and on time even as it nearly wiped out the real value of its domestic debt and obtained significant concessions from holders of its Soviet-era exter-

47. Gelpern (2004) in the end recommends only that sovereigns be encouraged to lay out their own priority structures and that the IMF report on the sovereigns' adherence to their self-selected structures as part of its surveillance process.

nal debt. Argentina more or less has proposed doing the opposite. It is seeking a larger haircut from its external bondholders than it imposed—through a series of restructurings—on the domestic-law debt held by its banking system.

The core question in the debate on sovereign priorities is whether it is possible to develop a system that both can be enforced and substantially improves on the status quo. We are skeptical.

The current system has its own logic and its own norms. Experienced market participants know that the IFIs have effective priority as a result of the IFIs' role as providers of new money in a crisis and that this priority is sustained in part because the IFIs are typically willing to roll over their positions for some time. Savvy market participants also know that a sovereign is likely to go into arrears on Paris Club debt before it suspends payments on its privately held debt, since the risk of enforcement actions from Paris Club creditors is negligible. Long-term syndicated bank loans and international sovereign bonds are both likely to be restructured if the sovereign has significant amounts of bonds and loans outstanding. It is hard for a sovereign seeking deep debt reduction to exclude some of its international bonds entirely from the restructuring—one bond issue has no reason to agree to voluntarily subordinate itself to another bond issue. Claims to collateral are likely to be respected. Short-term external debt—including the claims of international banks on local private banks, which are more often than not implicit liabilities of a sovereign—lacks formal seniority but can often get out before the restructuring.

The biggest uncertainties arise as a result of domestically held debt—including foreign-law debt held domestically. The current rules of the game reflect the self-interest of sovereign governments. A government in default will almost always take action to limit the losses depositors bear. The gymnastics that Argentina went through to create a subset of performing domestic debt out of an initial debt stock that was heavy on international bonds are a case in point. Incentives to favor domestic debt are further strengthened by an expectation that it will be easier to regain access to domestic rather than international markets. A restructuring regime that grants the sovereign substantial discretion will almost always result in preferential treatment of debt held by banks or in the creation of performing bank recapitalization bonds to limit the size of any haircut on depositors. This is not bad: We have tried to show that treating the domestic debt restructuring as part of the broad domestic negotiation about how to apportion the burden of domestic adjustment has economic and political logic.

Even if these broad norms are followed, there is no shortage of residual uncertainty. However, a much clearer priority regime may not be possible to design or feasible to enforce, given the scale and complexity of the financial claims on a sovereign and the difficulties forcing a *sovereign* gov-

ernment to follow a priority structure, if it does not believe it reflects its interests. Even radical institutional change, such as the creation of an international bankruptcy regime, might not create a very precise system of sovereign priorities. It is hard to write rules sufficiently precise to avoid the need for interpretation, or rules that creditors would not contest the through the courts.[48]

What really matters is whether relative priority can be assessed ex ante with some reasonable degree of predictability and without an excessively large number of surprises. The current nonsystem could be codified over time. Yet even a real effort to make the existing rules of the game more explicit is unlikely to result in a true system of priorities that defines the relative treatment of all financial claims on the sovereign. Sovereign commitments to constrain their own freedom of action are only credible to a point. The current regime has costs, but its current fuzziness and ambiguity also may be inherent to any regime that deals with sovereign borrowers.

48. See Tarullo (2001) and Gelpern (2004) for the argument that any formal regime would need the authority to make new rules.