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First World Governments and Third World Debt

FIRST MEXICO, THEN Asia, then Russia and Brazil. Now Argentina and Turkey. As always when financial crises occur, questions arise about whether first world governments should change their role in the restructuring of third world debt, by restructuring the multilateral international financial institutions (IFIs), creating an international bankruptcy court, or adopting one of the many other proposals for reforming the international financial architecture.[1]

Kenneth Rogoff and I wrote a series of papers addressing these and related issues between 1988 and 1992:[2]

—In 1988 we argued that the existence of the official creditors led to increased emerging-market and developing-country debt, because private creditors would be able to count on the official creditors to pay back part of their loans.[3] In 1990 we further claimed that the existence of the official

Many of the ideas in this paper were developed jointly over the years with Kenneth Rogoff, to whom I owe an enormous debt. Of course, he is not responsible for the views expressed here. Also, I wish to thank Eduardo Borensztein, Peter Henry, Michael Tomz, and Jeromin Zettelmeyer for their valuable comments.

1. Among the serious efforts to combine an economic model with a policy prescription for such reform are Wells (1993), Bhattacharya and Detragaiche (1994), and Klimenko (2002). There have been many more op-ed-level proposals, of varying quality. See Eichengreen (1999) for a summary of some of the better-known ones.

2. See Bulow and Rogoff (1988a, 1988b, and 1990) and Bulow, Rogoff, and Bevilaqua (1992).

3. Many papers since then have adopted this moral hazard argument, which derives from the formal model in Bulow and Rogoff (1989b). One prominent paper in this group is that by Dooley (1995), who argues that the international debt crisis of 1982 can best be understood as a prolonged negotiation between commercial banks and their own govern-

creditors made debt renegotiation more difficult and complex, by hardening the positions of debtors and creditors.

—In 1990 we argued that the legal infrastructures of the industrial countries were being used to lend developing countries more money than the underlying economics warranted. We maintained that it would be better if creditors were forced to rely much more on debtor-country legal structures to create a level playing field for equity and foreign direct investment.

—In 1988 and 1992 we argued that official creditors, defined broadly as a group, are at best equal in seniority and possibly even junior to private creditors.[4]

These arguments underlay the reform proposals that we made in our 1990 paper. Rogoff reiterated many of these views shortly before becoming chief economist at the International Monetary Fund (IMF). Similarly, my views have not changed. The proposals we made then still make sense today:

—Multilateral loans should largely, and in some cases completely, be replaced by aid.

—The United States should repeal the relevant portion of the Foreign Sovereign Immunities Act of 1976, and the United Kingdom the part of the 1978 State Immunity Act, that allows developing countries to waive their immunity when they borrow money abroad. That is, to the extent possible, jurisdiction over a sovereign's debts should be in its own courts. This would include the debt of banks that are nationalized during debt crises.

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ments over who would bear the economic losses generated by loans to developing countries.

4. "These numbers do not square with the official view that obligations to the IMF and the World Bank are senior claims. If anything it is probably more appropriate to think of a debtor country's outstanding World Bank and IMF debts as a measure of past foreign aid from those agencies" (Bulow and Rogoff, 1988b, p. 689). The later incarnation of this view (Bulow, Rogoff, and Bevilaqua, 1992) originally went by the more evocative title, "Is the World Bank Bankrupt?" See Frankel and Roubini (2001) for a recent paper that argues convincingly that loans by the Paris Club (the official bilateral creditors) are junior. There are, of course, differences among official creditors. Within the group, the general belief is that the IMF comes first, and the World Bank second, followed by other multilaterals and bilaterals. Private creditors will not, however, care about relative seniority among official creditors that does not affect the overall bargaining position of private versus official creditors.

—The IFIs should be kept out of the international bailout business.[5]

—The aid should be disbursed through an International Citizenship Fund and focused on issues that involve externalities, such as environment and education, rather than on macroeconomic structural adjustment.

In the context of our 1990 proposal, I would be extremely cautious about proposals for either a real or a metaphorical international bankruptcy court. Such proposals run the risk of moving some sovereign obligations from debtor-country courts to external jurisdictions, making it even harder for industrial-country governments to avoid getting enmeshed in resolving these crises. Proposals to coordinate creditors through collective action clauses, such as those suggested by Under Secretary of the U.S. Treasury for International Affairs John Taylor or already existing in U.K. law, or through mechanisms that also coordinate different classes of creditors, as suggested by the IMF's First Deputy Managing Director Anne Krueger, have some appeal in simplifying the renegotiation bargaining problem. Countries may well want to adopt such provisions within the context of their domestic restructuring laws. But the key step is to coordinate as much of the bargaining as possible under the auspices of the debtor's own legal system.

Whereas in 1990 our proposals were treated as quite radical, they no longer seem so today. The Meltzer Commission has now advocated aid in place of loans, and the White House and the Treasury have called for dramatically increasing the proportion of aid in official financing for developing countries, particularly the poorest.[6] Similarly, our 1988 moral hazard view of official lending is at least widely debated, if not fully accepted.[7] Still, these proposals are worth reviewing after twelve more years and several more debt crises.

Of course, opening up their agricultural and other markets to developing-country goods is probably the best thing rich countries can do

5. Occasions may still arise when one government or group of governments will choose to bail out another, as the United States successfully bailed out Mexico in the 1990s, but in the context of our overall plan it would be much less likely.

6. The Meltzer Commission (formally, the International Financial Institutions Advisory Commission) was established by the congressional Joint Economic Committee in 1998 and issued its report in 1999 (www.house.gov/jec/imf/meltzer.htm). On the administration's views see, for example, Treasury Secretary Paul O'Neill's remarks at the World Economic Forum, February 1, 2002, at www.treas.gov/press/releases/po974.htm.

7. Roubini (2000) provides an extensive discussion of this and other issues.

to support good governments in poor countries and aid development.[8] Elimination of quotas, antidumping rules, and other nontrade barriers, plus provision of aid to any decent government of a third world country equal to the tariffs collected from that country, would all be steps in the right direction. Ultimately, the real goal of any debt policy should not be to maximize capital flows, but to foster trade and encourage *efficient* investment.

My strategy in this paper will be to begin with short discussions of what makes sovereign debt different from other debts and of the differences between the claims of private and official creditors. I then apply my analysis of those topics to the policy recommendations listed above.

Differences between Sovereign Debt and Other Debt

It is perhaps instructive to compare sovereign lending with three other kinds of financial contracting: corporate debt, municipal debt, and consumer debt. Although developing-country sovereign issues may be most analogous to corporate junk bonds in terms of likelihood of default, the current reorganization process for sovereign debt is in some ways closer to what occurs in consumer bankruptcies.

The biggest differences between corporate and sovereign debt restructurings relate to matters of collateral and control. Most sovereign debt is not collateralized, whereas all corporate debt has either a specific or a general claim against some pool of assets. Furthermore, in a corporate bankruptcy, regardless of whether the firm's management chooses to put the firm in bankruptcy or whether, upon a default, creditors force the issue, management risks losing control of the firm. If it does not come up with a suitable reorganization plan within a period of months, the court can give the creditors a chance to offer an alternative, which management will then be forced by law to live with. Indeed, management may find

8. More broadly, debt problems are only symptomatic of the bigger problems of the brain drain and capital flight from developing countries. Compare this with the situation 100 years ago, when brainpower and money were migrating from the developed world (Europe) to the fringe (the United States). Alan Taylor (1998) questions whether the marginal product of capital is really higher in developing countries. If it is not, capital will flow to the rich countries even in the absence of property rights issues. For example, the Arab oil-exporting countries would be much wealthier now if they had invested more of their surpluses of the 1970s and 1980s in Western capital markets and less in domestic capital expenditure.

itself displaced by the creditors. Finally, a company may be liquidated or sold out of bankruptcy.

One thing that corporate bankruptcies do have in common with sovereign restructurings is that the process is not speedy: an average of 16.4 months from 1982 to 1999 for cases that would typically seem simpler than the default of a country.[9] To avoid these delays, much restructuring takes place in the shadow of the bankruptcy courts. Because bankruptcy is an expensive proposition, one would not expect it to be used unless debtors and creditors differ significantly in their perceptions about what they would receive in court, perhaps because of asymmetric information.

Needless to say, there is nothing remotely comparable to these corporate bankruptcy procedures in the world of sovereign debt. This is true even in the case of debt issued by a state-controlled enterprise: when the distressed debt of a Chinese state-owned enterprise is renegotiated, the issue of turning over control of the firm to the creditors will not be on the table. But at least in those cases there are assets to fight over. With general obligations of the state there are no tangible assets; there is only the fact that a default may harm the country's ability to trade and its operation of its domestic financial system. The comparison between corporate and sovereign debt is thus extremely tenuous.

Municipal bond issues in the United States have an exceptional repayment record over many decades.[10] Over 1940–94 fewer than 1 percent of all issues, by either number or volume, experienced even a technical default. Thus the section of the bankruptcy code that deals with municipal bankruptcy, Chapter 9, has not been tested very much. Municipal securities are held by households, mutual funds, banks, insurance companies, and others.[11] Outstanding obligations totaled 16 percent of GDP in 2001, although debt-income ratios obviously vary widely across issuers. The tax laws create incentives for municipal debt to be held by residents of the state in which the issuing municipality is located; as a result, "munis" are sold at interest rates below those on U.S. Treasury bonds. Indeed, there is no reason for anyone other than domestic taxpayers to hold them.

9. McHugh (2000, p. 68).

10. Data from the Bond Market Association at www.bondmarkets.com/research/defaults.shtml.

11. Data from the Bond Market Association at www.bondmarkets.com/research/munios.shtml.

In contrast, most (but not all) "external" sovereign debt is held by foreign taxpayers. Furthermore, because of the inherently risky nature of developing economies, sovereign debt typically has junk bond status. By looking at the average spread over Treasuries and making some heroic assumptions, one can estimate a half-life for default of various sovereigns (table 1). Such a calculation shows that the market deems most developing countries to be more likely than not to default with at least a 50 percent write-down over the next decade.

The basic point is that munis are sold in an environment where, because of the identity of the bondholders, the low interest rates, and the strength of creditor rights, defaults occur infrequently. Sovereign credits are essentially junk bonds, and it is crazy to buy or sell them without realizing they are very likely to be restructured. Indeed, table 1 suggests that the number of defaults in the last ten years may have been in line with market expectations.

Some badly conceived municipal projects and contracts have led to efforts to void those contracts, but they are the exceptions that prove the rule. The most famous example is the Washington Public Power Supply System Projects 4 and 5 bonds, issued to build nuclear power plants that never got off the ground. Communities that had guaranteed a portion of this debt managed to have the courts overturn their obligations.[12] California is similarly trying to extract itself from some bad energy contracts it signed last year, on the grounds that it was misled by the manipulative supply decisions of some power plant owners into thinking there was a market shortage. One could argue that the proceeds of many loans to third world governments were used in ways that did not benefit the populations of those countries, and in those cases it is not surprising that there is no political consensus to repay.[13] In prominent U.S. defaults or de facto defaults that were not tied to specific project finance, such as those of Orange County, California, in 1994 and New York City in 1975, creditors were repaid in full.

12. The bonds for projects 1, 2, and 3, which produced completed plants, were repaid in full. I have no opinion whether the decision in the case of projects 4 and 5 was proper.

13. For example, the citizens of Argentina might not see the merit of repaying loans made from 1976 to 1983 to prop up the military dictatorship of those years. Nor might they wish to repay the loans taken out over the last year or two to support failed economic policies, although in this case the moral argument for default would be considerably less clear.

Table 1. Estimated Half-Life of a Default on Sovereign Debt[a]
Units as indicated

Country	*Average interest rate spread[b] (basis points)*	*Half-life of default (years)*		
		50 percent write-down	*75 percent write-down*	*100 percent write-down*
Argentina	778	5.1	7.4	9.6
Brazil	827	4.9	7.0	9.1
Bulgaria	997	4.2	5.9	7.6
Colombia	637	6.1	8.9	11.6
Ecuador	1,645	2.8	3.9	4.9
Mexico	581	6.7	9.6	12.6
Morocco	554	6.9	10.1	13.2
Nigeria	1,545	2.9	4.1	5.2
Panama	412	9.1	13.3	17.5
Peru	572	6.8	9.8	12.8
Philippines	897	4.6	6.5	8.4
Poland	290	12.6	18.6	24.6
Russia	2,248	2.2	3.0	3.8
South Korea	230	15.8	23.3	30.8
Turkey	648	6.0	8.7	11.4
Venezuela	1,005	4.1	5.9	7.6

Sources: Fischer (2001) and author's calculations.
a. The half-life of a default is the number of years ahead where the chance of a default having occurred reaches 50 percent. Here it is calculated as ln(2) / E[default rate], where the expected default rate is the average interest spread divided by that spread plus the expected write-down.
b. Over U.S. Treasuries of comparable maturity.

As noted above, in some respects developing-country debt resembles U.S. consumer debt more than corporate debt. One similarity is that the amount of debt required to create a significant possibility of default seems in some ways low. It is worth recalling the arguments made in the mid-1980s, in the early days of a previous international debt crisis. Theorists argued that the debt crisis was akin to a bank run: that countries were capable of repaying in full over the long run, since their debts amounted to only a few months' income, but lacked the liquidity to pay all creditors immediately.[14] Of course, it turned out that a debt of four or six months of national income is a very burdensome debt, much as a $20,000 credit card debt can be very burdensome to a family with a $40,000 income. By some measures, repayment should seem easy for developing-country debtors if there is the will to repay. For example, Argentina despite its recent woes has twice the average income per capita of Brazil, or of Latin America

14. See Sachs (1984) for an excellent exposition of this view.

and the Caribbean as a whole, and almost four times the income per capita of Thailand. Even a negative flow of 5 percent of GDP or more would still allow much higher consumption than neighboring countries enjoy. But reality is different. A long-term stream of payments of that magnitude is a sure recipe for political crisis and default.

Consumer debt in the United States is characterized by competitive lending, high interest rates, and commensurately high default rates. When countries demand renegotiation of their debt, they tend to obtain relief similar to that available with a Chapter 13 filing under the U.S. bankruptcy code.[15] Under this chapter, the debtor keeps all its property, stretches out its debt, and may have its debt reduced. There is protection for cosigners and against foreclosure and wage garnishment, creditors may be separated by class, and the debtor may file repeatedly. The debt does continue to exist, however.[16]

The private bankruptcy system obviously involves trade-offs between allowing parties to freely engage in any contracts they wish and a (perhaps paternalistic) desire to limit debtors' ability to get themselves too deeply and too permanently in a hole. With sovereign debt the issues are subtly different. Loans are taken out by heads of state, who are not always acting in the best interests of their population. The question then arises, To what extent should we allow outside enforcement technology—say, the laws of the United States and the United Kingdom—to enable third world governments to borrow more than they could manage otherwise? From the other direction, any international bankruptcy system is constrained in the ability to enforce judgments against debtors.

Differences between Official and Private Creditors

In addition to these differences between private and sovereign debtors, there are some important differences between private and sovereign cred-

15. One important difference is that Chapter 13 filings are limited to $1 million in debt, and unsecured debt is limited to less than $250,000.

16. The alternative form of consumer bankruptcy is Chapter 7. Here debt can be erased completely, although creditors may still be able to claim future inheritances. Some debts such as mortgages do survive, and cosigners can be stuck unless they similarly file. Chapter 7, under which more than 70 percent of all filings occur, can only be used once every six years, and such filing obviously causes severe damage to one's credit rating.

itors. One good example relates to what is called the "moral hazard" problem in international debt, which is worth comparing with the moral hazard talked about in other contexts, such as the U.S. savings and loans (S&L) crisis of the late 1980s and early 1990s. In that crisis the moral hazard problem was that S&Ls had an incentive to round up deposits and put the money in risky investments: heads the S&L wins, tails the government insurer loses. Of course, there was also a great deal of corruption in the S&L collapses,[17] but the important thing was that the moral hazard problem was seen as being on the side of the borrowers (in this case the S&Ls) rather than their guaranteed depositors.

When people today speak of the moral hazard problem in international lending, the primary focus appears to be in the other direction: on the lenders. The implication is that *of course* countries will borrow as much as possible, and the existence of the IFIs as a possible source of bailout funds means that countries will find it easier to borrow than should be the case. It is the private lenders whose actions are changed by the existence of the IFIs, because they have incentives to make loans that could not be justified based on the likely use of the funds.

This characterization implies that the IFIs are effectively junior to private creditors, and very likely to go unpaid in any meaningful economic sense. That is, when a debt crisis arises, we generally see the private creditors egging the IFIs on to bail out the debtor. If there is a moral hazard problem, we know that it would be better, from an efficiency standpoint, if the IFIs could precommit not to bail out countries in distress. Looking back, the competitive banks are probably making loans that earn zero economic profits. Therefore the IFIs facilitate excessive lending.[18] If there is no agency problem within the borrowing country, it benefits from these excessive loans, which it does not have to take, and the banks are breaking even at least.[19] Therefore the cost to the IFIs must be greater than or equal to the inefficiencies created.

17. See Akerlof and Romer (1993).

18. As argued in Bulow and Rogoff (1988a). A provocative recent paper examining the moral hazard problem is Jeanne and Zettelmeyer (2001), who argue that the real cost of moral hazard is borne by domestic taxpayers.

19. Jeanne and Zettelmeyer (2001) argue that the IFIs increase countries' ability to borrow, but because the loans are not always used well, the countries may lose from the increased borrowing capacity. In this case the (larger) inefficiencies from the excessive loans are split between the country and the official creditors.

But why do the private creditors support the making of bailout loans? If the IFIs are senior creditors, this is difficult to understand. Private loan covenants may prohibit a debtor from awarding new creditors anything better than pari passu terms and even limit the amount that can be borrowed on that basis. They do not demand that the debtor do its best to borrow as much as it can from a senior creditor. So what is going on?

One possibility is that by "seniority" the IFIs simply mean that, in the event of default, the other official creditors will supply new loans, or subordinate their own claims to a sufficient degree, or both, so that in an accounting sense the IFIs will be repaid without a substantial real cost to the private sector. If this is the case, the appropriate economic analysis is to amalgamate all official loans and treat official debt as junior to private sector loans.

Another possibility is that seniority is complicated. In the simplest finance model with no debt covenants, seniority is simply a question of when a debt is due: the borrower makes its payments as long as it has money and defaults when it runs out, leaving the remaining creditors with nothing.[20] The empirical implication of such a model is that those who get paid the most when debt is valued at a sharp discount are the ones who are really senior. Creditors like the IFIs, who disproportionately make loans when everyone else wants to take money out and disproportionately get paid off when there are, effectively, other creditors willing to buy them out at face value, are economically junior. This is so even if the IFIs have a priority claim in a "liquidation."

One can put it another way: Assume that a payment from an IFI is used to directly pay off part of the loans of the debtor country's private creditors. This would have to be a good deal for the private creditors, even if the IFIs have a priority claim on all future repayments. But IFI debt is rarely very large; even in Argentina today it is only a month's income and about 15 percent of total debt.[21] If, going forward, this debt were really to be treated as senior, it would have almost no default risk, and there would

20. Of course, in real life the borrower could threaten to default on a creditor whose loan has come due, and the creditor might then prefer to take partial payment, with the rest of its claim deferred, rather than force a bankruptcy. Furthermore, a seniority claim in bankruptcy in such a situation would lead to the creditor being able to negotiate a better deal.

21. Again, the private creditors will not care if IFI debt bumps other official debt in priority, so long as it does not hurt the repayment priority of private claims.

be almost no net transfer to the private creditors of a new IFI loan. In fact, private creditors who were not sharing proportionately in the repayments generated by the new loan would theoretically object to it. Furthermore, if new IFI loans really bump private credits in seniority, then the Brady Plan deals amounted to little beyond pure debt forgiveness by the private creditors. The Brady deals involved the banks accepting a reduction in their nominal claims against the country and accepting the existence of new IFI loans in return for having the proceeds of those loans used as collateral for the bank debt. But if the IFI loans were senior to the private debt, and fairly certain to be repaid, the private creditors lost virtually as much from the creation of new senior debt as they gained from the new collateral. So the debt forgiveness would have been virtually uncompensated.

Despite all this, it is difficult to make an empirical case that the IFIs are junior to private creditors. As with deposit insurance before the S&L debacle, hardly any debt to the IMF or the World Bank has ultimately defaulted. Bulow, Rogoff, and Alfonso Bevilaqua could not find any difference in official and private creditor seniority.[22] Olivier Jeanne and Jeromin Zettelmeyer also argue that the IFIs have a strong record of being repaid.[23] On the other hand, it is quite possible that the repayments we have seen have been motivated by the small size of most IFI loans, their below-market interest rates, and the prospect of more official creditor funds. For example, if a country believes that ultimately it will be able to borrow 300 percent of a gradually increasing quota from the IMF, it may choose to make repayments on a debt of 100 percent if that is a prerequisite for borrowing more a year or two later. With larger debts, the logic of repaying now in order to borrow more later becomes more tenuous; thus we may learn a fair amount from Turkey and Argentina about where the official creditors stand.[24]

Policy Recommendations

The above analysis supports the following recommendations for policy concerning sovereign debtors in distress.

22. Bulow, Rogoff, and Bevilaqua (1992).

23. Jeanne and Zettelmeyer (2001).

24. As argued in Bulow and Rogoff (1989a), if the IMF were motivated strictly by repayment, repaying debt to establish a reputation for repayment would not work. But if the

Aid, Not Loans

All multilateral loans should be replaced with aid. Doing so would improve accounting transparency by essentially unbundling aid and loan programs, leaving loans to the private sector, and making it easier for first world governments to stay out of debt renegotiations. Combined with the proposal to shift all litigation and enforcement to debtor-country courts, a shift from loans to aid would probably improve the industrial countries' image in the developing world, because the industrial countries would no longer get enmeshed in having to ask for transfers that go the "wrong way" (from poor countries to rich ones).

GREATER ACCOUNTING TRANSPARENCY. The primary "advantage" of the current system of IFI loans is lack of transparency, which allows Congress to use Alice-in-Wonderland accounting. The IMF and World Bank work slightly differently from each other. The World Bank is highly leveraged. Of its $189.5 billion of subscribed capital, only $11.5 billion has been paid in, and of that only $7.9 billion is available for lending. Countries that are highly likely to pay up if there is a call on the remaining capital are responsible for $103.6 billion of that capital.[25] The United States has contributed $2.0 billion in paid-in capital since 1944 and is on the hook for $30.0 billion in unpaid subscriptions.[26] Only the paid-in capital shows up in the U.S. federal budget. Thus, in an accounting sense, the World Bank has only "cost" the United States $2 billion in its entire history. Yet we are effectively guaranteeing about $30 billion worth of developing-country debt.

The World Bank has a credible claim on about $130 billion (including paid subscriptions available for lending, calls from rich countries, and $20 billion in retained earnings) to offset $115 billion in outstanding

IFIs will mechanistically make bigger and bigger loans to debtors who have repaid in the past, it makes sense for those borrowers to repay the early, small loans and default only when they finally get a loan that hits their credit limit.

25. This is the amount callable from those member countries that are also members of the Development Assistance Committee of the Organization for Economic Cooperation and Development (World Bank, 2001, pp. 18–19).

26. World Bank (2001, p. 18). Of the U.S. subscription, only $7.7 billion can be paid without congressional action, but the general counsel of the U.S. Treasury has rendered an opinion that the entire amount is backed by the full faith and credit of the United States.

debt.[27] This calculus is what gives the World Bank its triple-A credit rating. It is quite different from the standard for measuring the financial soundness of a commercial bank, which would be whether retained earnings and paid-in capital, which total about $30 billion in the World Bank's case, are enough to offset potential losses on its loan portfolio. If the market really viewed the World Bank as a senior creditor almost sure to get repaid, its capital and reserves would enable it to greatly increase its lending without ever having to ask the member countries for an increase in subscriptions.

Remarkably, the IMF manages to outdo the World Bank at keeping its finances out of the U.S. budget. The United States has an IMF quota of 37.1 billion SDRs.[28] However, the budgetary impact of this quota or even of its use by the IMF is zero, "because the United States receives an increase in its international monetary reserves corresponding to any transfer of dollars under the U.S. quota subscription. The United States can use these interest-bearing reserves to meet a balance of payments financing need."[29] Similarly, the IMF's 1962 General Arrangements to Borrow and its 1997 New Agreements to Borrow do not "result in any net budget outlays because such financing results in an equivalent increase in U.S. international reserve assets in the form of a claim on the IMF."[30] That is, for accounting purposes IMF quotas are treated the same way as deposits held in a U.S. commercial bank.

Indeed, a naïve reader of the U.S. government budget would think that its international financial programs are a real money-spinner for the federal government. As table 2 shows, for every year since 1985 the U.S. budget has shown negative outlays for international financial programs, offsetting over 40 percent of the budget impact of international development and human assistance.[31] Enron would be proud. The analogy is to federal deposit insurance, which for decades and through several credit crunches was able to book profits, until the $160 billion loss in the 1980s and the 1990s.[32]

27. The World Bank also has about $38 billion in undisbursed loans and has guaranteed a relatively trivial amount of other loans.

28. An SDR, or special drawing right, is now worth about $1.26.

29. *Budget of the United States Government, Fiscal Year 2002, Appendix,* p. 1027.

30. *Budget of the United States Government, Fiscal Year 2002, Appendix,* p. 1027.

31. *Budget of the United States Government, Fiscal Year 2002, Historical Tables.*

32. See Federal Deposit Insurance Corporation (1997, p. 39).

Table 2. U.S. Government Outlays for International Affairs, by Subfunction, 1985–2001

Millions of dollars

Year	*International development and humanitarian assistance*	*International security assistance*	*Conduct of foreign affairs*	*Foreign information and exchange activities*	*International financial programs*	*Total*
1985	5,409	9,391	2,043	805	–1,471	16,176
1986	4,968	10,499	2,270	917	–4,501	14,152
1987	4,319	7,106	2,208	1,000	–2,985	11,649
1988	4,703	4,500	2,729	1,051	–2,513	10,471
1989	4,836	1,467	2,886	1,106	–722	9,573
1990	5,498	8,652	3,050	1,103	–4,539	13,764
1991	5,141	9,823	3,282	1,253	–3,648	15,851
1992	6,133	7,490	3,894	1,280	–2,689	16,107
1993	5,827	7,639	4,325	1,352	–1,896	17,248
1994	7,049	6,642	4,557	1,398	–2,564	17,083
1995	7,599	5,252	4,192	1,417	–2,026	16,434
1996	6,160	4,565	3,761	1,187	–2,177	13,496
1997	6,054	4,632	3,919	1,173	–550	15,228
1998	5,446	5,135	3,262	1,159	–1,893	13,109
1999	5,654	5,531	4,162	1,227	–1,331	15,243
2000	6,518	6,387	4,709	817	–1,215	17,216
2001[a]	7,027	6,320	6,721	860	–3,467	17,461
Sum, 1985–2001	98,341	111,031	61,970	19,105	–40,187	250,261

Source: *Budget of the United States Government, Fiscal Year 2002, Historical Tables.*

a. Estimated.

Yet an examination of IMF lending practices shows clearly that this is not an institution that depends on its loan portfolio for its financial stability. IMF member quotas total 212.4 billion SDRs, composed of a "reserve tranche" (hard currency that members have on deposit with the IMF) of 46.7 billion,[33] callable quotas of 109.6 billion SDRs in usable currencies, and callable quotas of 56.0 billion SDRs in other currencies.[34] The IMF has some equity resources and holds some gold that is worth about $20 billion more than its face value. Yet total loans outstanding are only 53.5 billion SDRs, or about $68 billion. That is, the IMF has been constraining its lending to the amount of hard-currency deposits its members have on deposit, not even borrowing against the additional funds on call to make more loans. The United States is effectively on the hook for something over a quarter of the IMF's loans, or about $18 billion.

Thus IMF and World Bank accounting has enabled the United States to effectively guarantee almost $50 billion in developing-country debt while recording expenditures of only $2 billion in fifty-eight years' worth of federal budgets.[35] It would have been entirely reasonable for the United States to give at least another $50 billion in foreign aid—in fact, much more than that—to developing countries over the years. Perhaps the off-balance-sheet accounting has made IMF and World Bank accounting more feasible politically. But U.S. citizens, if anything, overestimate the

33. It may be instructive to contrast the positions of three countries with the IMF. Argentina has a quota of 2.1 billion SDRs and loans outstanding from the IMF of 11.2 billion SDRs. This is met by a zero reserve tranche position and 13.3 billion SDRs worth of callable local currency. Turkey has a quota of 1 billion SDRs and loans outstanding of 9.7 billion SDRs. It balances this with reserve tranche holdings of about 100 million SDRs and 10.6 billion SDRs worth of callable local currency. The United States has a quota of 37.1 billion SDRs, composed of a reserve tranche of 10.9 billion SDRs and the equivalent of 26.2 billion SDRs on call.

34. These quotas are "collateralized" either by deposits of the country's currency with the IMF or by the issuance of a nonnegotiable zero-interest note. Were it necessary to actually deposit currency, a country like Panama, which uses the U.S. dollar as its currency, would be unable to get money out of the IMF.

35. The United States has also given away a few billion dollars by allowing the IMF to issue SDRs to all members in proportion to their quotas. (Effectively the IMF prints hard currency and hands it out.) A proposal on the table for the last few years would allow the IMF to issue about another $25 billion worth of SDRs to members, which would effectively cost the United States another few billion (taking into account the share of the SDRs that would effectively be dollars, less the allocation of SDRs to the United States), but so far the United States has vetoed this proposal.

extent of U.S. foreign aid, and therefore a more transparent accounting might lead to a more open-handed policy.

UNBUNDLING. Subsidized loans are effectively a bundle of loans and subsidies. Why combine the two, and why should rich-country governments be in the loan business? What possible benefit could they derive from being owed money by developing countries? If a country finds it in its best interest to use its aid money to buy loan insurance, just as many municipalities in the United States buy private municipal bond insurance, they will be welcome to do so. Doubtless the banks in some countries that currently own third world debt will find it preferable, from a tax and accounting standpoint, to hold safe bonds and issue Argentina debt insurance, rather than buy Argentinean debt directly.

Those who believe that the IFIs have a superior enforcement technology would argue that countries could not use equivalent subsidies to purchase loan guarantees that would enable them to borrow as much as with IFI loans. But if IFIs are even better than first world courts at enforcing repayments, then, as Jeanne and Zettelmeyer argue, that may be all the more reason to keep them out of lending.[36]

More important, it should be understood that IFI loans are a significant component of U.S. foreign aid policy. Why hand out this money in such an ad hoc manner? Should Argentina and Turkey get disproportionately large shares of the non-Middle East aid that the United States hands out this year? Maybe, but such a decision requires careful thought. Lower-income countries that are not in the midst of a debt crisis might be as worthy or more worthy of aid.

GREATER SCOPE FOR PRIVATE AID. Another advantage of grants is that they make it much easier to direct funds to private organizations.[37] Under the current lending arrangements, most IFI money goes to governments. A grant policy would allow money to go to governments and nongovernmental organizations, depending on where the expected benefit was greater.

ESCAPE FROM RENEGOTIATION. A pure aid policy might help the IFIs avoid getting trapped into participating in debt crises, especially if almost all debt comes under the jurisdiction of the debtor's domestic courts. But even without a change in jurisdiction, countries would no longer renegoti-

36. Jeanne and Zettelmeyer (2001).

37. This point was made by Michael Kremer in the general discussion at the conference.

ate simply to avoid a default to the IFIs, and financing would be slightly more transparent.[38] For example, a default by Argentina would lead to a dramatic decline in the World Bank's accounting equity-to-loans ratio, which it uses to determine its "risk-bearing capacity," or ability to issue loans without calling its callable capital. Therefore, under the current system, it may be necessary for another IFI or official creditor to give Argentina the money to repay its World Bank debts so that the World Bank will not have to call capital for the first time in its history.

Move Debt Jurisdiction to the Debtor's Courts

The United States' Foreign Sovereign Immunities Act and the United Kingdom's State Immunities Act enable borrowers to use the U.S. and U.K. courts, respectively, as a commitment vehicle for repaying debts. Undoubtedly, part of the growth in sovereign lending since the mid-1970s should be "credited" to the trend these acts started of moving jurisdiction over sovereign commercial transactions to first world courts. But as Rogoff and I argued, this is not a good thing. If the modern view of the moral hazard problem is right—that countries will borrow as much as they can, and the concern is with lenders making uneconomic loans—a good way to stop this is by having a country's debt enforceable only in its own courts. Furthermore, because the option exists to use the tougher, industrial-country courts, countries today are penalized if they issue debt under their own jurisdictions, because doing so may signal a greater likelihood of default.

If domestic courts had jurisdiction, foreign lenders would basically be in the same boat as domestic creditors. To raise money from abroad, the country would therefore have to create conditions that would cause residents to bring their capital home. Countries with democratic governments investing in economically sound projects should still be able to borrow, because it seems likely that loans for such projects would be repaid. The

38. One amusing story has to do with Egypt's debt to the United States. Under the Brooke-Alexander amendment, the United States is prohibited from providing foreign aid to a country that is more than a year in arrears on its debt to the United States. This led in 1990 to an emergency $163 million cash grant to Egypt to make sure it would not miss its payment before the United States had a chance to cancel its outstanding military debt, and thus become ineligible for billions in foreign aid (John Kifner, "Gulf Price Tag for Egypt: $2 Billion Loss to Economy," *New York Times,* September 4, 1990, p. A10). Similarly, a congressional resolution ensures that foreign aid to Israel in any year will exceed the amount that Israel owes to the United States in debt payments that year.

risks of lending to unpopular dictatorships and corrupt governments for uneconomic uses would become vastly greater, which is good. Seizure of a country's foreign assets could take place only with the agreement of the country's own courts. Countries could still get into debt crises, but they would negotiate their way through them under the terms of their own laws.

As part of this proposal, nationalized banks would fall under the jurisdiction of the sovereign's courts. Creditors would be able to use first world courts to go after assets held by banks incorporated in the first world and owned by the sovereign, but any liabilities of the sovereign to the banks would have to be adjudicated in the debtor's courts. In this way, crises such as South Korea's, where the bulk of liabilities came from the government taking over bank debt, would also fall under domestic law.[39]

One concern might be that eliminating rich-country courts as a prop would eliminate most sovereign lending to developing countries, and we would return to the days of 1950–75, when essentially all private capital inflows to the developing world were in the form of equity (foreign direct investment or portfolio investment). But another view is that the change would simply level the playing field between sovereign debt and other forms of private investment.[40] Perhaps overall lending would go down, but if one compares developing-country growth rates in the last twenty-five years with those in the previous twenty-five, there is not a prima facie case that opening the capital markets in this particular way has been beneficial.[41]

Of course, those who believe that the primary "collateral" for sovereign lending is reputation should hold the view that this proposal would not matter much. The fact that, in recent years, some more timid versions of this proposal have been criticized for their likely impact on borrowing capacity is an indication of some acceptance of the Bulow and Rogoff

39. Sovereign immunity would have to be limited to avoid fraudulent conveyance.

40. This view is expressed in Rogoff (1999).

41. At the conference, Edwin Truman claimed that most of the recent debt crises had other factors besides external foreign debt as their proximate cause—disputes involving Mexico's *tesobonos* were under the jurisdiction of domestic courts, for example. It is not clear to me whether the external holders of *tesobonos* were limited to using Mexican courts to obtain a legal remedy to default, but if they were, the implication is that a change to more sweeping domestic jurisdiction would not overly deter borrowing.

argument that reputation for repayment cannot support sovereign lending.[42]

Take the IFIs Out of the Bailout Business

The IMF and the World Bank get a bad rap. The staffs of these organizations are probably as good as or better than those of any other large official organization anywhere in the world. Alumni are highly sought after in the private sector for their expertise. Yet because they are perceived in the developing world as doing the bidding of the large creditor countries, and by some in the United States as a money sink, they have become a lightning rod for criticism. The debtors, at least, have a point: since the IMF is effectively paid for by the rich countries, it is natural to think of it as an agent of the creditor nations.[43]

Furthermore, the issue of asymmetric information creates concerns about IMF conditionality programs. Will such programs necessarily lead to good structural reforms, or will they merely lead to changes in unreliable reported data? The U.S. government engages in a considerable amount of accounting gimmickry even though it is only trying to fool its own citizens. In many crises—Mexico, Korea, Argentina—we discovered later that all sorts of things were going on that neither the IMF nor the U.S. Treasury knew anything about. We know from incentive theory that if we can measure progress in one dimension but not in another, we can get highly distorted results if we focus incentives in the measurable areas.[44]

42. Bulow and Rogoff (1989a, pp. 43–50) argue that countries will not repay debt strictly for "reputation for repayment" reasons, and that therefore borrowing must be supported by either legal sanctions or other reputational reasons. Wright (2001) provides a model in which creditors have an incentive to punish defaulting borrowers in order to preserve their own reputations, and thus make reputational lending feasible. Tomz (forthcoming) provides some fascinating historical evidence, including a debunking of the view that Argentina's 1930s debt repayments were due to the Roca-Runciman treaty governing beef exports to Britain.

43. I am reminded of the 1960s story of when, before they had a union, the baseball players thought of hiring a negotiator. Management said it was a good idea, and that if the players hired management's choice for the job, Richard M. Nixon, management would even pay Nixon's salary. See Miller (1991).

44. To take a classic example: if teachers are paid according to their pupils' performance on standardized tests, they may "teach to the test" instead of providing a broad learning experience (see Holmstrom and Milgrom, 1991).

If the IFIs were not themselves creditors effectively funded by rich-country governments, they might be widely valued by all sides as a source of information and advice. The IFIs might be able to collect and communicate information that would not be otherwise available to potential lenders. If I am wrong and there would not be a demand for the consulting services of these agencies, then they represent an inefficient use of a lot of high-quality human capital and should go out of business.

Create an International Citizenship Fund for Aid Grants

There may still be a role for the IFIs to make project grants to developing countries, as they do through the World Bank's International Development Association, if the rich countries decide that these grants provide an efficient mechanism for distributing aid. As aid organizations, they would no longer be as confined to providing funds to governments rather than nongovernmental organizations. But they should be moved out of the business of providing money for macroeconomic adjustment. This would also reduce the moral hazard problem.

The IMF has been heavily criticized for some of its adjustment programs. One can argue that it provides the backbone needed for a government to implement a politically unpopular program. But it is unclear why the rich countries should insist on controversial adjustment plans. Since most of the capital that a country can hope to attract will come from reversing the direction of flight capital and increasing private investment, there is already a strong market incentive to adopt sound macroeconomic policies, without IMF requirements. Furthermore, the self-interest of the rich countries probably lies much more in, say, the secular education of children in India and Pakistan than in those countries hitting macroeconomic targets. Our aid should be allocated accordingly.

Bargaining theory still has a way to go, but although there are models in which subsidies from a third party such as an IFI can increase the probability of efficient trade, this is only in the case when it is not common knowledge that there is the possibility of an efficient deal.[45]

45. See, for example, Myerson and Satterthwaite (1983). Some models incorporate a "Greek tragedy" phase, where everyone knows that there is an efficient deal to be made but neither side can propose the obvious settlement because doing so would be an out-of-equilibrium sign of weakness, but one might question the realism of those models.

Proposals for an International Bankruptcy Court

Bankruptcy is a last resort. The ideal restructuring mechanism would facilitate fast, efficient bargains, generally made in the shadow of the law rather than in the court itself. Even more important, the mechanism should encourage efficient investment and capital structures.

Over the last ten years, negotiators have moved down the learning curve with the current system. Recent debt crises have been settled more expeditiously than those of the 1980s. Shaking up the system could lead both debtors and creditors to "invest" in rent-seeking efforts to exploit the new rules, stretching out the negotiating process. This probably contributes to the view of some commentators that we should be wary of any change in the current system.[46]

The typical "international bankruptcy court" proposal really calls for a sovereign debt restructuring mechanism. The most recent proposals come from the U.S. Treasury and the IMF.[47] John Taylor's proposal that all sovereign debt contracts contain collective action clauses recognizes that sovereign borrowing has evolved from being principally borrowing from a somewhat cohesive group of banks to being principally borrowing from a noncohesive group of bondholders.[48] Individual bondholders may have an incentive to hold out even if a debt restructuring is efficient.[49] The Taylor proposal seems a very modest step in the right direction. Because such contract terms should be familiar from U.K.-based debt contracts, they might reduce the incentives for individual creditors to hold out without imposing the learning costs of a new system. On the other hand, those benefits would be reduced if collective action clauses could be interpreted differently in different legal venues. A second advantage of the Taylor plan is that, by requiring that all debtors use such contracts, it would eliminate the adverse selection signal that a debtor currently gives by borrowing under terms that make bankruptcy less costly. Finally, the Taylor plan does not appear to require significant changes in the current legal structure.

Because a cheaper, more efficient bankruptcy procedure will lead to a greater likelihood of bankruptcy for any given level of initial lending, the

46. The discussion paper in this symposium by Nouriel Roubini is an example.

47. The recent literature on these restructuring mechanisms was kicked off by Sachs (1995). For a review of the earlier literature, see Rogoff and Zettelmeyer (2002).

48. Taylor (2002).

49. As shown in Bulow and Shoven (1978).

Taylor plan might cause a reduction in initial lending. But given the current bias toward borrowing too much, caused by agency problems, moral hazard, and access to first world courts, such a change would also be positive.

Anne Krueger's most recent proposal goes further than Taylor's.[50] She points out that even if the creditors in an individual bond issue were bound by collective action clauses, sovereigns typically owe debts to many types of creditors, and one class could become a holdout. Although one could imagine a "super-collective action clause" pertaining to all debts, it might be difficult to persuade all debtors and creditors to always use such a clause. Also, there might be problems with the collective action voting procedure. For example, if the debtor issued enough bonds to its state-controlled banks, could it pass any plan it wanted?

Krueger proposes establishing a treaty obligation by amending the IMF's Articles of Agreement. She proposes an initial ninety-day stay on debt repayments for countries invoking the procedure, possibly with majority creditor approval but perhaps with approval by the IMF. A supermajority of the creditors could approve an extension of the stay as well as subordination of all existing claims to new private financing, if doing so seemed fruitful. Final approval of a restructuring agreement would again be left to the debtor and a supermajority of creditors. Although sovereign debt owed to domestic creditors may often need to be restructured, it would be dealt with on a case-by-case basis. It is unclear how the distressed debt of state-owned enterprises would be treated.

Although the Krueger proposal makes strides in the direction of eliminating the holdout problem, there would still be room for enormous creditor infighting. For example, short-term creditors will undoubtedly want their postbankruptcy claims also to be short term, or effectively senior, to the claims of long-term creditors. To the extent that Krueger's rules would change the game, in the short run they might make for longer rather than shorter debt negotiations. Still, her plan should be commended for clearly recognizing that sovereign defaults are likely to continue on a regular basis, and that therefore it makes sense to develop a postdefault procedure that will enable the majority of creditors to approve an efficient restructuring.

50. Krueger (2002).

The Krueger plan leaves much sovereign debt under the jurisdiction of a first world legal structure. This approach has two apparent advantages. First, it involves less change than the more radical Bulow-Rogoff reform. Second, however bad the bankruptcy institutions in the industrial countries may be, they are undoubtedly better defined than those in developing countries. But there are disadvantages as well. It would be better if all debt were consolidated in one court. Since internal debt, currency, and domestic bank deposits are all subject to domestic law, the only way to do this is to consolidate in the debtor country. The Krueger plan also does nothing to correct the disparate treatment of sovereign debt and foreign direct investment.

A debt crisis cannot be truly resolved until internal debt is restructured. Putting foreign and domestic creditors in the same boat may speed resolution by requiring any competing claims to be dealt with more directly. That is, the essential domestic restructuring will not necessarily be slowed by the inclusion of the external debt. Second, although debtors will still have reputational incentives to repay claims, the de facto lack of separation of powers in many countries would mean that the debtor would have great control over how much it repaid. So although the court system itself might be messy, bargaining in the shadow of the law might be relatively straightforward, in the sense that it would be clear to everyone that the debtor's costs of default are largely limited to reputational costs and to any damage to the domestic financial system.

Finally, the Krueger plan and, to a lesser extent, the Taylor plan leave both the first world courts and the IFIs in the middle of debt crisis negotiations. Because of their conflict of interest, it is easy to see why these institutions are not universally accepted in the third world as impartial arbiters of these debt claims. The inevitable outcome of any debt renegotiation is a proposal for resources to be transferred from the debtor countries to the creditors. It seems in the best interests of rich-country foreign policy to stay as far away from such negotiations as possible.

Conclusions

Third world countries are high-risk borrowers. It is inevitable that the securities they issue, including bonds, will go into default from time to

time. It is certainly a good idea to develop rules that accommodate these inevitable defaults. The proposals offered here are those that Kenneth Rogoff and I made during an earlier debt crisis. We want a system where foreign aid is separated from debt relief, and where a country's borrowing capacity is based on market factors, such as the strength of its own property rights system and the attractiveness of investment in the country. We do not want lending to depend largely on a country's ability to use foreign courts as a repayment commitment mechanism, or to use future IFI funds to subsidize current borrowing.

There has been some movement in the direction we suggested. President George W. Bush's proposals for increasing U.S. foreign aid, with greater emphasis on grants, are a step in the right direction. Such a change would also make it possible to have at least some IFI aid go to nongovernmental organizations when that seems most efficient.

By following an integrated program of switching the IFIs from loans to aid and switching jurisdiction over all future international debt to borrower-country courts, we would probably reduce the maximum amount that a country could borrow, although this might be partly offset by increases in other types of private investment that would no longer be crowded out by debt. Debt restructuring would likely surface at lower levels of debt. But in return the process might be less painful, because all foreign and domestic creditors could be treated under the same system. Certainly in the Mexican and Argentinean crises it would have been better if the countries had had to restructure a year earlier and had lacked the ability to borrow the money that helped them postpone and exacerbate their problems.

By making it necessary for debtors to rely on their own legal infrastructure in order to obtain loans, borrowing countries would have a greater incentive to develop reliable systems. The same qualities that are required to attract back flight capital and other private investment would be needed to attract sovereign loans.

The recent sovereign debt restructuring mechanisms proposed by John Taylor and Anne Krueger seem to be modest steps in the right direction. They have the potential of eliminating or at least reducing the free rider problem in external debt renegotiations, and they have the virtue of at least implicitly recognizing that restructurings are inevitable and must be prudently considered in the initial issuance of debt.

Sovereign debt crises are here to stay. Securities that pay 500 to 1,000 basis points more than the risk-free rate will sometimes go into default. Creditors should not be indignant, and debtors should not be surprised. We need a system that does not support excessive borrowing in the first place and that reduces the costs of restructuring. The ultimate goal is not to increase capital flows but to foster trade and encourage efficient investment.

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