A Leap of Faith for Sovereign Default: From IMF Judgment Calls to Automatic Incentives

Adam Lerrick

Official policy, whether national or global, always lags behind the realities of the marketplace. In times of major transition, it lags behind real policy, informal and unstated, as it responds to crisis on the ground. Formal codification follows.

More than three years of default in Argentina since December 2001 have proved that current events cannot be forced into the mold of past experience. The good old ways from the good old days are no longer relevant to a modern settlement of troubled sovereign debt.

Lenders have changed. A fraternity of regulated commercial banks with homogeneous holdings has morphed into an impersonal and fluid array of investors with divergent claims—all in competition for the biggest slice of the pie. Small individual bondholders that have entrusted retirement savings at 100 cents on the dollar must vie with hedge funds and holdouts that accumulate bonds at distressed prices and measure time horizons in months.

Borrowers have changed. Financial debt is no longer seen as a fixed obligation but must be weighed against the government's "social debt" to provide a better quality of life for its people. Emerging nation leaders are seeking emancipation from the dictates of IMF policies even at the price of a loss of official monies.

International banks have changed. The industry has consolidated into fewer and larger universal financial institutions. Behind the fictitious Chinese Walls hides a mass of conflicts: responsibility to investors to whom bonds were sold; a role as investment banker and adviser to borrowers; proprietary trading positions; and protection of

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Adam Lerrick is the Friends of Allan H. Meltzer Professor of Economics and Director of the Gailliot Center for Public Policy at Carnegie Mellon University, and a Visiting Scholar at the American Enterprise Institute. He is the head of the negotiation team of ABRA, the largest foreign creditor in the Argentine debt restructuring.

assets and subsidiaries held captive. All are interactions with the same defaulted government. No longer major lenders, for all their size and past authority, the large banks have lost their voice in the settlement of debt.

Technology has changed. Negotiations need not consist of years of stale sandwiches and warm Coca-Cola around a centralized conference table. Instead, decentralized mechanisms can collect and transmit information from a larger universe to permit the debtor to "discover the price" of restructuring in a matter of months.

The balance of power has changed. With the demise of bailouts, the International Monetary Fund no longer dominates the discussion between sovereign borrowers and their private sector lenders. A single anachronism lingers. An IMF judgment call on "good faith efforts" controls the flow of official funding and obstructs a "good resolution" of default. It means uncertainty for the markets, false hopes and confusion for creditors, resentment among debtors, and delay in settlement.

Amid a revolution in the way debt restructuring can be handled in "real time," process must keep pace with substance.

A Fading Role for the IMF

In the 1980s and 1990s, the IMF was a hands-on arbiter and banker that controlled the debt restructuring process. This was welcome to borrowers and to their private sector creditors alike. An outsider with a chariot-load of money would magically descend upon the stage. Investor losses would be lessened. Debtor costs of adjustment would be mitigated. In short, the deus ex machina of a bailout.

An IMF adjustment program was underwritten with large-scale IMF loans. These highly subsidized official sector funds freed up cash to pay the nation's private creditors. A fiscal surplus decreed by the IMF fixed the level of resources to be set aside to service the country's total debt. Payments in full to official lenders were predetermined; private creditors, who played no role in setting values, simply received the remainder. All that was left for the private sector was to structure cash flows to match the fixed residual payment capacity.

This approach ended in December 2001 when the IMF refused to provide new monies to Argentina that would, in effect, have gone to pay private creditor claims. Much of the Fund's leverage was lost. When the IMF sat down with Argentina to negotiate the fiscal surplus, the rules of engagement had changed.

After almost two years of seeking a 4.5 percent surplus, all the IMF could extract was 2.7 percent, just enough to cover official sector and domestic senior debt claims. Holders of defaulted bonds were left to negotiate their own settlement. A new policy was formed on the ground: a two-stage fiscal surplus condition.

Initially, the Fund sets the surplus necessary to service only the debt to the official sector (OS). The task of negotiating the surplus required to service the restructured debt to private creditors (PS) is now in the hands of the private sector. The final fiscal surplus condition (FS) in the IMF program would be defined as

$$FS = OS + PS.$$

This new equation makes concrete G-7 statements that the official sector has no role in the negotiations between sovereign borrowers and their private lenders.

Preferred Creditor Status: A Matter of Money

Official sector loans are a gift to developing nations and their private lenders. Under normal market conditions, IMF and development bank financing offers subsidized interest rates 5–10 percent per annum below what the private sector charges. In a crisis, the differential between IMF and market interest rates has risen to levels in excess of 100 percent per annum.

There exists a silent compact among sovereign debtors, their private sector creditors, and the IMF. As long as the value of these subsidies exceeds the losses imposed on private lenders in a restructuring, it remains profitable for private lenders to accept the "preferred creditor status" of multilateral lenders.[1]

The Fund prides itself that there has never been a default on its books. In reality, as loans become due, the IMF times a new matching loan that rolls over financing without regard for risk or return. This is "debt reduction" by the official sector.

For example, the value of the interest subsidy in a 15-year loan, carrying a concessional interest rate 6 percent below market levels, is approximately 45 percent of the loan's nominal amount at a 10 percent discount rate. Therefore, when the official sector "maintains its exposure" for an additional 15 years and rolls over existing debt at the same subsidy rate, its claims have been effectively reduced by 45 percent. The shorter the actual maturity, the smaller the losses of the official sector. The longer the maturity, the greater the debt relief. Stretching the rollovers for 100 years under these conditions, the effective debt reduction is capped at 60 percent.

[1]The IMF and multilateral development banks consider their claims to be senior in priority of payment to debts owed to private-sector lenders and, therefore, the institutions are "preferred creditors."

When losses demanded of private investors are less than those absorbed by the official sector, the private sector profits. When private sector losses exceed the official sector's effective debt reduction, the market will move to challenge the "preferred creditor status" and demand an equal sharing of debt write-offs. The greater the excess demanded of private creditors above the effective reduction in official debt and the larger the share of official sector debt in the nation's total debt, the greater the gain from challenging the preferred status.

The "Good Faith Efforts" Condition: Subjective and Subject to Influence

Coping with sovereign default is treated at the IMF with delicacy, and with good reason. The official term is "lending into arrears" and the Fund's refusal to do so would trigger financial starvation—loss of all of the heavily subsidized funding on which many sovereign borrowers depend, not only from the IMF but also from its sister institutions, the World Bank and the regional development banks.

Until 1989, the Fund was prohibited from providing resources to a government "in arrears to its private creditors." To permit IMF freedom of action, the ability of industrialized nations to exert moral suasion over their commercial banks that were the dominant lenders was harnessed to force acceptance of restructuring agreements that allowed new flows of official funds.

As banks with strengthened balance sheets became less compliant and much of the debt migrated to nonregulated and hence less accommodating investors, the IMF faced a dilemma. If all financing was withheld until a restructuring of the debt was agreed, excessive power was in the hands of private creditors. If large-scale financing was supplied to governments in default, the incentive for the debtor to conclude a deal was destroyed. The compromise was to permit IMF lending while borrowers were in arrears on bank loans as long as negotiations were under way.

It was in 1999 that the "good faith efforts" criterion emerged in IMF code. Bonds had supplanted bank loans as the dominant source of private sector funding for sovereign borrowers. Commercial banks with vested interests in developing nation economies and under the influence of industrialized nation regulators had been replaced by an unruly and impersonal universe of market investors.

The new condition specified that a government in default must make "good faith efforts to reach a collaborative agreement with its [private sector] creditors" in order to receive continued funding from the official sector. It was designed to protect debtors from unreasonable creditors, protect creditors from unresponsive debtors, and, most of all, to protect the IMF's influence over the process and the outcome.

In stark contrast to the strict quantitative standards spelled out in all other Fund loan conditions, the tests of "good faith efforts" are purposely subjective to permit decision, case by case. Vague terms of "reasonable" period of time, "meaningful" dialogue, and a "sufficiently" representative committee of creditors allow unlimited latitude in IMF discretion. Subjective conditions are bad conditions because they lead to the uncertainty that unsettles markets.

Whether the IMF can pose as an impartial referee of borrower "good faith" is open to question. Critics have focused on the Fund's conflicting role as arbiter and as the largest creditor in sovereign restructurings.[2] If sanctions were imposed, would the preferred creditor status and the balance sheet of the Fund be threatened? Among G-7 IMF Board members who must approve all funding, political pressures abound. Is good will vital to protect the large investments of their own big banks and utility companies in the crisis country and subject to its dictates? Can help be enlisted in the War on Terror while withholding funds?

In sum, the "good faith efforts" criterion is an imperfect proxy that distorts the restructuring process with perverse incentives. It rewards the image but not the goal. It excuses evasion and stands in the way of real resolution.

Automatic Financial Incentives: Reward Substance Not Semblance

Every month that a government in default can project the appearance of its good intentions generates massive savings for the nation's treasury. For Argentina, this has meant $700 million monthly in what would have been interest payments on bonds or a grand total of $25 billion since the default in December 2001. The size of the savings measures 20 percent of the nation's annual GDP. The other side of the coin is a direct economic cost to creditors for every day of delay; income ceases and interest payments are forgone that may never be recovered.

To equalize the cost of default between debtor and creditor, automatic financial incentives are needed to encourage governments toward a timely resolution of defaulted foreign debt. Every IMF financing should incorporate an accelerated schedule of principal

[2]The IMF acts as the representative of all multilateral official creditors.

repayment that is activated automatically in times of default. Each month, until the completion of the debt restructuring, an additional 3 percent prepayment of the original loan amount would be required. A 70 percent creditor acceptance rate would establish successful completion and the return to a standard IMF loan repayment schedule.

Automatic prepayment is a powerful motivator, doubly so when default renders private financing scarce. To replace highly subsidized IMF funding, international reserves and tax revenues must be depleted. Straightforward financial calculus will drive a straightforward process. No sham meetings without purpose. No debates with groups without ability to commit. No exhortation or pointless efforts by the official sector to plumb the soul of the minister of finance. No conflicts of interest from the dual role of creditor and judge. No aspersions to the integrity of governments. No uncertainty or confusion for the markets.

Toward a Modern Restructuring of Debt

Lending to governments is a tricky business. We no longer live in a time when the Navy is sent to collect on the bad loans owed to private sector lenders. When dealing with sovereign states, there is no collateral, no security, no ability to enforce the contract, and no ability to seize assets. Governments have only one rational reason to pay: there is more to gain from paying than from not paying.

There is now a grand total of $1.6 trillion in emerging market sovereign debt on the global books. Latin America accounts for a significant 27 percent, but its share in the financial markets is overwhelming—more than half of the $416 billion bonds held in investor portfolios. Dangerous debt levels of 80–100 percent of GDP that were endorsed by the IMF as recently as 2001 are now deemed unsustainable by the Fund. For economies dependent on agricultural and commodity exports, both of these low-margin and volatile, the current prescription is 20–40 percent.

After years of overspending by countries and overlending by capital markets, the international financial system faces adjustment. More restructurings, whether aggressive or amicable, will come. In the 1990s, the misguided bailout policy of the Clinton administration socialized the risk and privatized the return from emerging market lending. Investors, who once lined up to purchase promises to pay without any regard to the debtor's capacity to pay, must now scrutinize the creditworthiness of the borrower on a stand-alone basis.

The modern marketplace and modern technologies have transformed forever the parameters of debt restructuring. In the new lexicon, some familiar words will be stamped "archaic", others will expand their meanings. "Negotiation" will step out of the conference room to embrace all acquisition of information by the debtor to ascertain the demand curve for its offer. "Price discovery" will encompass centralized meetings, collection of information from individual creditors, and, even, a series of auctions over the Internet. "Codes of Conduct," adapted from the past, limit market opportunities and cannot be enforced.

Creditors are no longer a monolith with identical claims and identical needs. Those with common interests will unite. Instruments will be tailored to special investor demands. Incentives that reward early acceptance and penalize holdouts will become common practice. Effective protections for creditors who accept offers will guarantee equal or better treatment compared with bondholders who refuse. Lower acceptance rates will denote "success," and "completion" will be reached in stages.

In what will be a massive move from current debt levels to sustainable burdens, the official sector and the large banks that once controlled the restructuring process must stand aside. Interactions between debtor and creditor will produce a whole series of new solutions to match the reality on the ground.