A *Brief* History of Default

The role of restructuring in the debt ecosystem.

By Edwin M. Truman

Barry Eichengreen, Asmaa El-Ganainy, Rui Esteves, and Kris James Mitchener present a valuable, detailed account of the evolution of public debt instruments and institutions that many either don't understand or take for granted. They distinguish between the debt of central and sub-national governments, debt sold in the domestic and foreign markets, and debt denominated in domestic and foreign currency. The boundaries of this changing landscape are fuzzy.

The authors emphasize the evolution of government borrowing to finance a growing list of national objectives, starting with wars. Globalization of the sovereign allowed governments to expand their access to longer-term finance in the late nineteenth and first decades of the twentieth centuries. The focus shifted to bank loans in the 1970s and 1980s before reverting to the bond model in the early 1990s.

In Defense of Public Debt focuses primarily on issuers rather than investors, and—as befits the title—on borrowing rather than default. Default, however, is part of the public debt ecosystem. In the domestic market, the government borrower makes the rules, and can change them *in extremis.* In foreign markets, sovereigns enjoy substantial immunity from debt enforcement. Investors in sovereign debt issued abroad have limited legal recourse when the borrower defaults. Their principal tool is to make life difficult for the borrower by trying to stop or seize payments. The offshore sovereign debt market has witnessed a century-long dance between issuers and borrowers with shifting appetites and legal leverage. That dance is in the background of the borrowing drama described in the book.

The wave of sovereign defaults in the Great Depression led to the development and refinement of various collection mechanisms. Gunboat diplomacy gave way to bondholder protective associations and coordinated contract reforms. Sovereign borrowers were shut out of the post-war bond markets until they settled with their creditors, which took decades in some cases.

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In the late 1960s, many developing countries that had ridden the postwar commodity boom began to tap international financial markets again. International banks developed the syndicated loan market for longer-term lending. This market took off in the 1970s in the context of the international financial imbalances associated with the rapid rise in energy prices. It is a popular myth that deposits of oil exporters in international banks sustained the development of this market into the 1980s. In truth, the major oil-producing countries parked their earnings in international banks only temporarily before investing them in higher-yielding assets. Deposits by oil exporters helped boost the syndicated loan market in its early days, but by the early 1980s, when the global debt crisis erupted, banks were getting most of their funding from market sources.

In August 1982, Mexico asked its bank creditors for a debt "standstill" to be followed by a rescheduling on the advice of International Monetary Fund Managing Director Jacques de Larosière and Federal Reserve Chair Paul Volcker. This linguistic device avoided the declaration of an outright default.

Until the launch of the Brady plan in 1989, banks were called upon to help fill the external financing gaps of the major borrowers by extending and rolling over their claims. Under the Brady plan, they had the added option of reducing the value of their claims; most banks chose that exit option. In a gradual, case-by-case process, the banks exited their longer-term claims on countries in return for tradeable Brady bonds. The bonds helped pave the way for developing countries to return to the international bond market for their primary financing needs.

The 1980s debt crisis was managed largely via an extralegal process of informal negotiations involving the borrowing countries, their bank creditors, the authorities in the major countries, and the international institutions, primarily the International Monetary Fund. In a forthcoming *Financial History Review* article on lessons from the 1980s, I highlight that for much of this period contracts remained in the background.

In late 1994, Mexico again returned to the center ring of the international financial circus. It was on the verge of default on its Tesobonos, short-term peso-denominated debt instruments issued under Mexican law and indexed to the U.S. dollar. The $40 billion Mexican rescue cobbled together by the U.S. authorities was ultimately successful—but its astounding size was controversial. Paul Volcker called to ask me, "What do you think you are doing?"

Concerned central bankers launched a discussion about the implications of the Mexican case for the international financial system. The discussion led to the establishment of a Group-of-Ten Working Group on the resolution of sovereign liquidity crises under the chairmanship of Jean-Jacques

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Rey of Belgium. The 1996 report discussed the inclusion of collective action clauses in sovereign bonds and endorsed a market-led process to take this idea forward. The authors of *In Defense of Debt* cite research that dates these clauses to nineteenth-century market innovations, and they were already in bonds issued under English law. The 1996 endorsement of collective action clauses was not a mandate. Finance officials took pains to emphasize reliance on market mechanisms. Nonetheless, buy-side investors and financial industry groups, including the Institute of International Finance, initiated a public campaign against collective action clauses.

Sovereign bonds were not central to the Asian financial crisis (1997–1998). In Thailand and Indonesia, much of the external debt was issued by the private sector. Korea became an exception. Because most of the country's external financial liabilities were short-term Korean bank debt to foreign banks, the crisis was stanched using the 1980s approach of a standstill strongly encouraged by their home-country authorities, followed by a restructuring.

Pressures mounted for more burden-sharing, or what came to be called "private sector involvement," in sovereign debt workouts alongside official rescues. In April 1998, the G-10 finance ministers and central bank governors solemnly "stressed the urgency of finding innovative approaches to achieving closer and faster involvement of the private sector in crisis management and resolution in order to contain the risk of moral hazard" for both borrowers and lenders. As the apparent leader of the bailout brigade, the United States bore the brunt of these pressures. Even as U.S. officials sought to water down the most strident communique language, we were sympathetic on balance and resolved to take the initiative.

In early 1999, the U.S. Treasury, after extensive internal debate, advocated extending the so-called "comparability of treatment" principle of the Paris Club of official bilateral creditors to sovereign bonds. The principle commits the sovereign debtor to seek terms comparable to those of the Paris

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Club from all its creditors, except the major multilateral institutions. Comparability had been applied to commercial bank and bilateral official debts owed to non-Paris Club creditors in the past; Pakistan's Paris Club debt rescheduling presented an opportunity to extend the principle to tradable securities. Pakistan was singled out to play this break-through role even though its external debt to bondholders was only 3.3 percent of its total external debt and less than 10 percent of its debt to Paris Club creditors. Ecuador soon followed, breaking the taboo against rescheduling the Brady bonds.

Despite this break-through, pressure for a rules-based, bankruptcy-style approach continued. Although the United States played a leading role in the promotion of private sector involvement, we also sought to maintain flexibility to respond to changing economic, political, and market circumstances. The G-7 statement at the Cologne summit in June 1999 was two-edged in stating, "In a world of increasingly open capital markets we need to shape expectations so that private-sector creditors know they will bear the consequences of the risks they take, and to reduce the risk of financial market contagion." In September, the G-10 "reaffirmed the principle that debtors should honor their obligations and contracts and that no one category of private creditors should be regarded as inherently privileged relative to others in a similar position." Finally, a compromise two-paragraph statement on private sector involvement was endorsed at the IMF meetings in Prague in September 2000. Sovereign debt crises should be handled primarily via consensual discussions backed by bilateral and multilateral leverage.

It took the Argentine crisis of 2001 and IMF Deputy Managing Director Anne Krueger's proposal for a formal Sovereign Debt Restructuring Mechanism for the official sector and market participants to coalesce behind the contractual approach centered on collective action clauses. Mexico took the lead in February 2003 and issued bonds with majority amendment collective action clauses in the U.S. market. That watershed event helped tip the balance in the sovereign debt resolution toward more formal legal processes and away from informal negotiations and moral suasion.

In the 2020–2021 pandemic, the restructuring backwater of the sovereign debt ecosystem has reverted to requiring comparable treatment of bonds in the implementation of the G-20's Common Framework for Debt Treatment beyond the Debt Service Suspension Initiative for low-income countries. As of September 2021, bonds have been restructured only in the case of Chad. But if post-pandemic debt accumulation culminates in external financial crises on a wide scale, these and other old and refurbished tools will be called on to contain them. ◆