

**Economist.com****FINANCE & ECONOMICS****Emerging markets****Dealing with default**

May 8th 2003 | WASHINGTON, DC
From The Economist print edition

**Developing countries are issuing new bonds that should make it easier to clear up or head off defaults**

GEORGE BUSH'S Treasury Department has a mediocre reputation in international economic circles. Mr Bush's first Treasury secretary, Paul O'Neill, was known more for gaffes than for gravitas. His affable successor, John Snow, has been too busy trying to sell Mr Bush's tax cut at home to show much interest in matters abroad. On the international scene, Team Bush pales in comparison with Robert Rubin and Larry Summers, Bill Clinton's Treasury secretaries. Yet the Bush administration may have more influence on one of the most pressing questions in international economic policy than the Clinton crew ever did: how can the debts of developing countries be restructured?

John Taylor, the top international man in Mr Bush's Treasury, has long touted a market-based approach to dealing with sovereign-debt crises. He is sceptical of the International Monetary Fund's proposal for a "sovereign-debt restructuring mechanism" (SDRM), which would create, in essence, a watered-down international bankruptcy court. Mr Taylor prefers to encourage solutions to debt problems by persuading emerging economies to introduce "collective-action clauses" in their bonds.

Should the risk of default loom, these clauses would prevent smallish minorities of creditors from blocking restructuring deals to which large majorities had agreed. In theory, they should make defaults easier to deal with. They have long been used in bonds issued in London under English law, but have never been widespread in the much bigger New York market. During the Clinton era, there was a lot of talk about encouraging emerging borrowers to use collective-action clauses, but no action, largely because developing countries were worried that such clauses would raise their borrowing costs.

A collective change of heart

In recent months all this has changed. The IMF's proposal was shelved indefinitely at the Fund's spring meetings, and collective-action clauses have sprung to life. In February, Mexico—long a vocal critic of the notion—issued \$1 billion of 12-year debt that included such clauses in New York. On April 29th, Brazil sold \$1 billion of similar bonds. In perhaps the most important test of Mr Taylor's ideas, Uruguay is offering to swap much of its debt for new bonds containing collective-action clauses. According to Michael Chamberlin of the Emerging Market Traders Association in New York, there is now such momentum behind bonds with these clauses that they will “become the norm”.

Why have borrowers changed their minds? One reason is fear. Once the SDRM was mooted—a far worse idea than collective-action clauses in borrowers' eyes—the thought that it might be put into effect focused minds on the search for a market-based alternative. American pressure also played a part: the Treasury made no secret of its preference for the new clauses. And then self-interest led Mexico to go first. It hoped that by starting the ball rolling it would brand collective-action clauses as a sign of a good credit, rather than of weakness.

On the investors' side, the belief that they might balk at collective-action clauses seems to have been unfounded. Far from requiring a premium, they oversubscribed Brazil's issue several times. One Wall Street insider says that the clauses were “a footnote” to the recent issues, which investors barely noticed.

Will the new-style bonds really make defaults easier to clear up? Uruguay's restructuring may provide the first test. Two years ago, the country was an investment-grade borrower, with a reputation as a well-run, small financial centre, the Switzerland of Latin America. It has been hammered by a long recession, the fall-out from Argentina's financial crisis and a plunging peso. Uruguay has around \$11 billion of public debt outstanding, and now stands on the brink of default.

To give itself some breathing room, the Uruguayan government made investors an offer on April 10th: would they care to swap \$5.1 billion of old bonds for new ones with longer maturities? Of the existing debt, \$3.5 billion was issued abroad. If they agree, investors will suffer no loss of principal, but Uruguay's amortisation payments will be deferred for five years. The interest rate on the new bonds will also be far lower than the yields at which the country's debt now trades. To entice bondholders to accept the deal, the Uruguay government is offering some cash up-front. It has also devised cunning ways of making the existing bonds much less attractive if the deal goes ahead.

Investors have until May 15th to sign up. If 90% or more give their assent, the deal will go ahead automatically. If less than 80% agree, it will fail and Uruguay will almost certainly default. If between 80% and 90% say yes, the government will choose the outcome. Most market participants reckon that the swap will go ahead.

Less clear, however, is whether the extension of Uruguay's debt maturity will be enough to solve the country's debt problems. Although the swap is heavily backed by money from the IMF and other financial institutions, Uruguay will still have to maintain tight control over its fiscal policy and to engineer—or hope for—a return to economic growth. Michael Mussa of the Institute for International Economics, a Washington think-tank, a former chief economist at the IMF, gives the deal a 50% chance of averting a later restructuring. He argues that, in order to bump up the probability that the restructuring would put an end to Uruguay's debt problems, investors would probably have had to accept a bigger hit. They would have been highly unlikely to take that.

Look what happened next door

Doubters point to Argentina. In June 2001 it too went through an IMF-backed pre-default restructuring, which proved insufficient to prevent a chaotic default later. However, Uruguay's chances look better. Unlike Argentina then, Uruguay may be past the worst of its economic problems. Argentina's debt swap involved no losses for investors: in return for deferring maturities, they were paid a handsome interest premium. In the Argentine deal, a lower proportion of the country's debt was covered than in the Uruguayan arrangement. And Argentina's debt swap, unlike Uruguay's, made no effort to make any future restructuring smoother.

Indeed, the design of the Uruguayan bonds goes beyond collective-action clauses. There is also a mechanism allowing the votes of holders of different bonds to be added together in a future restructuring of the debt. Thus an individual bond can be restructured if 75% of bondholders agree; a series of bonds can be restructured even if only two-thirds of the holders of one bond agree, provided that 85% of all bondholders are on board.

With luck, these mechanisms will never be needed, as Uruguay's period of grace allows it to grow out of its debt troubles. But if Uruguay stumbles again, and needs to negotiate with its creditors once more, then the worth of collective-action clauses will be tested—as will the value of Team Bush's ideas.

Copyright © 2004 The Economist Newspaper and The Economist Group. All rights reserved.