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When countries go bust

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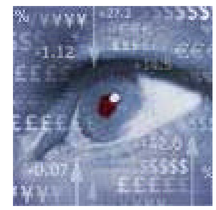
Argentina shows the need for sovereign bankruptcy procedures



WHAT do Kenneth Lay, chairman of Enron, and Domingo Cavallo, Argentina's economy minister, have in common? Both were once lionised on Wall Street. And both now see their respective charges collapse, because creditors have lost confidence. At least Enron can declare bankruptcy and seek protection from its creditors; Argentina has no such shelter.

If the International Monetary Fund has its way, that could change. Anne Krueger, number two at the Fund, recently suggested that a country whose debts were “truly unsustainable” should have a mechanism for restructuring them, in rather the same way that companies can file for bankruptcy.

The idea is that a troubled country would get temporary legal protection when it suspended payments on its debt, in return for promising to negotiate with its creditors in good faith and, meanwhile, to follow sound economic policies. During the “standstill” period, exchange controls could be introduced to reassure creditors that money was not fleeing the country. Lenders would get an incentive to provide new “working capital” by giving new debt seniority over old. And minority creditors would be bound to go along, once enough creditors had agreed.

The notion of such a sovereign bankruptcy procedure is not new. This is the first time, though, that it has been advocated so openly by the IMF top brass. Crucially, America, along with Canada and Britain, is also interested.

There is little argument that the present system for dealing with troubled debtors is inadequate. In the debt crisis of the 1980s, when the governments of developing countries owed debts mainly to banks, creditors were corralled around a table by the IMF and cajoled into accepting roll-overs and, eventually, debt reduction. But the growth of private capital flows during the 1990s has made such an informal approach unworkable. Creditors have grown in number, largely because of an increase in the use of bond finance. Debtors have grown, too, as private companies in emerging economies have joined governments in borrowing abroad. And debt instruments have become vastly more complex.

Recent crises have produced a welter of responses. In cases where bank debt is the chief concern (eg, South Korea in 1997), creditors have been pushed into providing more cash, with the same sort of arm-twisting as in the 1980s. Where bonds are the problem, unilateral default has been one outcome: Russia, famously, shook financial markets when it defaulted on its domestic debt in 1998. Ecuador's similar default in 1999 did not rock the world, but it did cause economic pain at home. Another outcome of bond-based crises has been a rise in the scale of IMF lending, as the Fund has tried to provide cash to shore up confidence in troubled economies and to stop default. Mexico's rescue in 1995 worked; Argentina's bail-out this year has not.

The appeal of sovereign bankruptcy is that it may eliminate the need for huge IMF bail-outs, with their attendant risk of inciting reckless lending, and at the same time avoid the legal morass of unilateral default. In theory, both creditors and debtors would benefit from clear rules about the procedure for debt restructuring—so long as the rules strike a balance between the rights of debtors and creditors. A bankruptcy regime that is too lenient is sure to dry up inflows to emerging markets.

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Putting all this into practice is hard. Many proposals on sovereign bankruptcy have gone nowhere, partly because the details are devilishly tricky to work out. Simple parallels with domestic bankruptcy soon fall apart. Who, for instance, is the impartial adjudicator—the international equivalent of a domestic judge? The IMF is presumably best-equipped to decide whether a country's economic policies make sense, so it should play a central role. Yet the Fund is also a creditor, and an organisation with political masters. It will not be seen as impartial.

Another problem is how to ensure that a debtor country is negotiating in good faith, and actually pursuing sensible economic policies. Unlike a domestic bankruptcy judge, an international arbiter can hardly threaten to strip a country of its assets or forcibly change its “management”. And, unlike a company, a country's capacity to pay external creditors is often a matter of politics as much as economics.

These conceptual problems should not be insurmountable. But the bankruptcy idea is often dismissed as politically or legally infeasible in any event. The hurdles are certainly high. Creating a bankruptcy mechanism under the auspices of the IMF would entail a change in the Fund's articles of agreement, or maybe a change in the laws of all its member countries. In America, changing the Fund's articles would certainly require congressional assent. Congress would not easily be persuaded to sign on to a deal that overrode the sanctity of commercial contracts under American law.

Still, many other changes to the international system, such as forgiving the debts that deeply impoverished countries owe to the Fund and the World Bank, were long dismissed as infeasible; yet eventually they happened. Ms Krueger is surely right to suggest that there are better options than today's stark choice between bail-outs and chaotic default. Much will depend on what now happens in Argentina. The more painful, protracted and chaotic is Argentina's default, the greater the desire for changes to the system. Mr Cavallo acknowledged this week that a system for sovereign bankruptcy would “undoubtedly be useful”. It will sadly come too late for him.