# Key Issues in Sovereign Debt Restructuring

**A Working Group Report**

Group of Thirty, Washington, DC

30 Working Group Report

*All members of the Working Group served in their personal capacities. The views expressed in this report do not necessarily reflect the views or policies of their respective institutions, nor does publication of the report by the Group of Thirty imply an endorsement of the views expressed herein.*

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*Published by*
Group of Thirty©
*Washington, DC*
2002

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# Foreword

At its Spring 2002 plenary meeting hosted by the Banco de España in Madrid, the Group of Thirty discussed recent proposals aimed at strengthening the framework for sovereign debt restructuring. While no consensus emerged on the issues, there was agreement on the need to explore the issues more thoroughly and provide a balanced assessment of the various proposals. Therefore, the Group organized a colloquium in New York on July 15, 2002 to identify the key issues involved in sovereign debt restructuring .

Participants in the meeting included Geoffrey Bell of Geoffrey Bell and Associates, Jack Boorman of the International Monetary Fund, Andrew Crockett of the Bank for International Settlements, Gerd Haeusler of the International Monetary Fund, John Heimann of Merrill Lynch, Peter Kenen of Princeton University, Jacques de Larosiere of BNP Paribas and Ernest Stern, recently retired from JP Morgan Chase, with written input provided by Guillermo Ortiz of the Banco de Mexico and David Walker of Morgan Stanley International. Zanny Minton Beddoes of *The Economist* served as rapporteur for the meeting; prepared a structured draft of the discussion, which identified the issues to be addressed and the working group's approach to them; and incorporated comments from the working group to produce this paper.

The Group of Thirty wishes to thank the working group members and Ms. Minton Beddoes for their work in preparing the draft; Merrill Lynch & Co. for hosting the colloquium; and Gerald Corrigan of Goldman Sachs, Mark Walker of Cleary, Gottlieb, Steen & Hamilton and Stephen Case of Davis, Polk and Wardwell for their advice and input on aspects of the draft paper.

While the paper accurately represents the range of opinions expressed, consensus did not emerge on all points and it should not be assumed that every participant agrees with every statement in the working group report. Likewise, the report does not reflect an official view of the Group of Thirty, collectively or individually.

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# I. Introduction

Over the past decade, dramatic changes in international capital markets—particularly the growth of bond financing –have not been matched by a corresponding evolution in procedures for restructuring sovereign debt. Today’s typical sovereign borrower issues many types of bonds, often in several legal jurisdictions. These bonds are traded and held by a variety of market participants with different interests and time horizons, from hedge funds to retail investors. As a result, a sovereign’s creditors are numerous, diverse, and difficult to organize There is no comprehensive framework for restructuring bond-based sovereign debt.

This situation is costly both for debtor countries and the global financial system as a whole. Sovereign debt crises will always be painful, but the lack of a comprehensive framework for restructuring sovereign debt can make them especially difficult to resolve. When a sovereign debt crisis occurs, or seems imminent, the international community has been faced with the unpalatable choice between large bailouts (Mexico 1995) or chaotic default (Russia 1998). The lack of a clear and predictable framework may also discourage debtors from dealing with their problems promptly.

A clearer procedure for debt restructuring could therefore improve the international financial system. Properly designed, it could ease the resolution of crises and might even help prevent them. Sovereign borrowers, in particular, might be more willing to address deteriorating debt profiles promptly if they were more confident that debt workouts would be negotiated rapidly and in an orderly manner. The pressure for large official-sector crisis lending might be reduced. Greater certainty about how debt crises would be resolved could encourage higher private-sector flows to emerging economies. Badly designed debt restructuring procedures, however, could have big negative consequences for the asset class of emerging-market debt. They could therefore discourage future private-sector flows and substantially raise borrowing costs for emerging economies.

In order to reduce the uncertainty surrounding sovereign debt crises, a new framework for debt workouts must address the following issues:

- *Who initiates a restructuring*?

  Should the decision to enter into workout procedures lie exclusively with a debtor government? Should the IMF have a role in determining whether a restructuring is necessary?

- *How are creditors organized*?

  Debt workouts require collective decisions by thousands of disparate creditors. How should creditors be represented during the restructuring process? How should voting be organized and who gets to vote? How large should be the supermajority of creditors required to approve a restructuring agreement that is binding on all creditors?

- *What prevents litigation by dissident creditors?*

  Orderly restructuring procedures need to protect a debtor from creditor litigation during the restructuring process. They must also protect the debtor from litigation by holdout creditors who are unhappy with the outcome of a workout.

- *What debt is covered*?

  Sovereign governments issue a variety of debt instruments to several types of creditor. Should the procedure cover only foreign debt or should it require equivalent treatment for domestic debt? Should it include only bonded debt or also syndicated loans and bank credits?

- *How is fair treatment between creditors ensured?*

  To be acceptable to creditors a debt workout procedure must provide equitable treatment to diverse creditors. That requires a system for comparing debt instruments of different types and maturities

- *How are disputes resolved*?

  Disputes could arise amongst creditors as well as between creditors and the debtor. An effective workout procedure requires a means of resolving them.

- *Will access to new financing be assured?*

  Sovereign debtors will need access to new capital during the restructuring process. Traditionally, this has been provided by the official sector. Ideally, workout procedures should offer the possibility of obtaining such financing from the private sector to the extent possible by ensuring that new capital is senior and excluded from the restructuring. However, experience indicates that new money from private sources will probably not be sufficient.

While it would bring clear improvements, a debt workout procedure that addressed these issues would not remove all the challenges and uncertainties involved in sovereign debt crises. Most important, it would not resolve the basic problem of deciding whether a country has an unsustainable debt burden and, if so, deciding the size of the creditor haircut required to restore sustainability. In a corporate bankruptcy setting, the determination of a sustainable debt burden is relatively easy. A company's capacity to pay its creditors can be gauged from projections of future cash flow. In the case of sovereign debtors, the decision is harder. Sovereign debt sustainability depends on more than simply economic criteria. A sovereign debtor's fiscal resources, for instance, could be used to pay creditors or spent on education, health, and other basic social services. Judgements about debt sustainability will always need to be made on a case-by-case basis. That is why debtors and creditors alike must look to the IMF for leadership in negotiating adjustment programs, determining balance-of-payments viability, and thus providing an overall framework for the resolution of sovereign debt crises.

Nor is an agreed restructuring framework likely to address all debt-related problems facing an emerging-market borrower. Two important types of debt stand out: official debts (those owed by an emerging-market sovereign to foreign governments and international financial institutions) and private debt (the foreign-currency debts of private banks and firms in an emerging economy).

Procedures already exist for restructuring official debts owed to foreign governments (through the so-called Paris Club), but there is currently no agreed framework for restructuring sovereign debt owed to multilateral institutions, except in the case of highly indebted low-income countries. The Paris Club process may need to be re-examined in order to make it dovetail with the restructuring of privately-held debt. The SDRM could also be structured to include bilateral official debt. The merits of restructuring multilateral debt is a more difficult issue. Multilateral financial institutions are currently preferred creditors since they supply capital to emerging-market sovereigns when no one else will.

In some recent cases, debt owed by the private sector has played an important role in triggering or compounding financial crises. In the Asian crises of 1997-98, for instance, there was little concern about the countries' sovereign debt, but much concern about the foreign-currency debt owed by the private sector. In principle, effective domestic bankruptcy laws are the mechanism to deal with private-sector debts. But while local currency debts are effectively covered, there may be issues surrounding resolution of claims denominated in foreign currency.

Finally, a more satisfactory framework for restructuring sovereign debt cannot decisively resolve the ongoing debate about what is the appropriate level of access to IMF resources. Better debt-restructuring procedures may reduce the pressure for IMF lending to distressed sovereign debtors, but they will not remove it entirely. Nor is it always appropriate to do so: IMF lending can prevent a short-term liquidity crisis from developing into a full-fledged sovereign debt problem. The question of whether to limit access to IMF lending more strictly, and under what circumstances to permit exceptions, is an important, and separate, issue in international financial reform. In short, debt workout procedures offer an improvement on the status quo, not a panacea.

The debate about how best to improve debt workout procedures has been galvanized in recent months. The painful collapse of Argentina, the biggest sovereign default to date, has spurred discussion. So, too, has Anne Krueger, first deputy managing director of the International Monetary Fund. In November 2001, Ms Krueger proposed a bold statutory mechanism for sovereign debt restructuring that mimicked several provisions of domestic bankruptcy law. It would be introduced by amending the Articles of Agreement of the IMF, and would give the Fund a central role in debt workout procedures.

After her initial proposal was greeted with considerable scepticism, Ms Krueger offered a revised version in April 2002. In this modified approach, all important decisions in the debt restructuring process would be made by a supermajority of creditors. Though the mechanism would still be introduced through an amendment to the IMF's Articles of Agreement, it would not statutorily enhance the powers of the IMF.

The main response to Ms Krueger's proposal has been a sharp revival of interest in contractual restructuring procedures based on collective-action clauses. These clauses, which facilitate debt workouts by providing for majority decision-making by bondholders, have traditionally been included in bonds issued under British law. By custom, they are generally not included in bonds issued under NewYork law.

Also in April 2002, the United States Treasury proposed a reform strategy that expanded upon traditional collective action clauses. It called for the voluntary introduction of a new package of clauses into sovereign debt instruments. This package of "contingency" clauses would not only provide for majority decision-making by bondholders (as traditional collective action clauses do), but would describe how debtors could initiate a debt workout (an "initiation clause") and what procedures should be followed thereafter (a "procedural" clause). In April 2002, the G7 group of industrial countries endorsed a twin-track approach to reform. Contingency clauses should be developed and put into place as soon as possible. Meanwhile, the IMF is to continue refining its statutory reform proposal.

This twin-track approach makes sense. In principle, both the statutory and contractual strategies are capable of introducing greater certainty into the sovereign debt restructuring process—though, as this report makes clear, they would do so in different ways and with different consequences. (That is why care must be taken that the details of the two reform strategies are complementary and do not undermine each other).

In practise, there is little likelihood of rapidly introducing statutory reform, as it would require the agreement of a large majority of the IMFs members. Moreover, even if it could be put into practise immediately, the statutory approach carries higher risks. A statutory change is more likely to have unforeseen negative consequences on market participants than a contractual change that is designed in cooperation with market participants, and introduced gradually and voluntarily. Given this risk, the immediate focus is, rightly, on making the contractual approach effective.

Unfortunately, considerable legal and practical obstacles need to be cleared before contingency clauses can constitute an effective procedure for sovereign debt workouts. The contents of such clauses need to be agreed upon. Debtor countries must be persuaded to introduce them in all new debt issues. Even if contingency clauses were introduced in all new bonds, there would still be a large stock of debt without such clauses. If debt workouts are to be improved quickly, this debt stock problem must be solved. This report examines the challenges of introducing contingency clauses and, where possible, suggests solutions.

# II. Evaluating the options

## The Statutory Route

Proposals to create international debt workout procedures by statute are not new. Over the past two decades several academics have proposed far-reaching statutory solutions, such as the creation of an international bankruptcy court. However, Ms Krueger was the first high-ranking official at the IMF to advocate a statutory solution publicly.

Her initial proposal for a Sovereign Debt Restructuring Mechanism (SDRM) in November 2001 was to amend the IMF's Articles of Agreement in order to create a "framework" that offered a debtor country legal protection from creditors who stood in the way of a necessary debt restructuring—provided that the debtor country negotiated in good faith, treated creditors equally, and pursued appropriate economic policies. A debt standstill would be activated if a request by the debtor country were endorsed by the Fund. During the restructuring negotiations, creditors would be legally prevented from disrupting negotiations by demanding repayment through national courts. Once a supermajority of creditors agreed to a restructuring plan, individual creditors would be legally bound by it.

In response to widespread scepticism that her initial plan placed too much power in the hands of the IMF, Ms Krueger offered an extensively revised version in April 2002. This enhanced the role of creditors considerably. In the revised SDRM a supermajority of creditors—

across the full range of a country's credit instruments—would be statutorily empowered to approve an initial stay of payments, which would automatically defer litigation. A standing creditor organization would facilitate the speedy organization of creditor voting. Alternatively, Ms Krueger suggested, the debtor country could declare a debt standstill (either with IMF approval or unilaterally) and receive legal protection for 90 days. Any extension of this stay on payments would have then to be agreed by a supermajority of creditors.

As before, a supermajority of creditors would have to approve the final restructuring agreement. Though the SDRM proposal does not specify the size of the supermajority, a range from two-thirds to 85 per cent of all creditors has been suggested. In principle, a supermajority of creditors could also protect the seniority of new financing. This would allow a troubled sovereign debtor access to fresh capital during the restructuring process.

The SDRM also includes the creation of a dispute resolution forum. This body would be legally separate from the IMF, and designed in a way that maximized its independence, competence, diversity and impartiality. It would notify creditors that a debtor had requested restructuring, identify claims and publicize the dates, procedures and places for voting. It could also resolve disputes on the verification of claims and the integrity of the voting process.

Even in the revised SDRM, the IMF have would have an important implicit role—since creditors would be unlikely, for instance, to agree to extend a debt restructuring period if the debtor country did not have an economic program with the Fund. But, contrary to the fears of many market participants, there would be no explicit increase in the Fund's legal authority.

The statutory nature of the SDRM offers a number of advantages. First, there would be no transition period. Once agreed, the SDRM would automatically apply to all outstanding debt as well as all future debt issuances. Second, its application would be uniform and universal. As an Amendment to the IMF's Articles, the SDRM would apply to the debt of all IMF members, regardless of whether they had voted in favor or not. Creditors could not shop around to find jurisdictions where they could pursue their claims in court[1] .

Nonetheless, statutory change of this magnitude would be a radical and risky step. Mandating a universal change in debt restructuring procedures could have unforeseen consequences. If creditors, for instance, perceived that the SDRM made default too easy for debtors, they might become extremely reluctant to lend to emerging-market sovereigns at all. The impact on both borrowing costs and the scale of future private sector flows to emerging economies could be extremely negative. Moreover, the practical feasibility of several components of the SDRM remains uncertain. The proposal to statutorily declare new private debt senior to old debt, for instance, may be hard to put into practise. Would banks have to make higher provision for such new loans to sovereigns in default? Could pension funds provide such new "senior" financing after rating agencies had downgraded the sovereign debtor?

In any event, this reform will not be easily achieved. Amending the IMF's Articles of Agreement requires the agreement of three fifths of the IMF's membership with 85% of the voting power. That means the SDRM could not be introduced without the assent of the United States. The United States Congress is extremely unlikely to agree to an amendment that, in effect, abrogates the legal rights of American creditors.

Moreover, the SDRM proposal has, so far, been greeted with scepticism by many IMF members. A particular concern of emerging economies is that such a mechanism could reduce their access to private sector finance. Even if this scepticism is reduced as the IMF refines the SDRM further, the process of reaching agreement will take several years. The SDRM will not be ready for use in any sovereign restructuring in the near future.

That is why increasing attention is currently focused on contingency clauses as an alternative contractual approach to debt restructuring.

## Contingency Clauses

Collective action clauses have been a feature of bonds issued under English law since the late 19th century. These clauses allow a supermajority of bondholders (generally 75%), acting through a trustee, to restructure the bond's financial terms. The terms of this restructuring are binding on all creditors. An individual bondholder's right to bring legal action against a sovereign issuer is curtailed. Only the trustee may initiate litigation and any recoveries by the trustee must be shared pro rata among all bondholders. Importantly, the collective action clauses apply only to a specific bond issue. There is no legal procedure in existing collective action clauses for cross-issue aggregation.

Although traditional collective action clauses are permissible under US law for sovereign debt (but prohibited under the Trust Indenture Act for corporate debt), legal drafting conventions have ensured that they have never been widely used. Under New York practise any change to the financial covenants of sovereign bonds normally requires unanimous assent from all bondholders. As a result, any individual bondholder can bring legal action if a sovereign defaults. Since most sovereign debt is issued under New York law, this means that the majority of sovereign bonds do not include collective action clauses and require unanimous consent by bondholders to be restructured.

Mainstreaming collective action clauses has long been regarded as a useful means to improve debt workouts. The idea has been promoted by academics—notably Barry Eichengreen and Richard Portes (1995)—as well as the official community—notably the 1996 Rey Report prepared by the Group of Ten. Unfortunately, these recommendations have had little effect. Sovereign borrowers remain reluctant to introduce collective action clauses, ostensibly for fear of raising their borrowing costs. (The academic evidence suggests that for most borrowers, this concern is unfounded. Work by Mr. Eichengreen and Ashoka Mody (2000) suggests that creditworthy issuers have faced lower spreads on bonds issued under British law than on those issued under New York law. Less creditworthy borrowers, however, have faced higher spreads on UK-style bonds).

Creditor groups, too, were long sceptical of the proliferation of these clauses in foreign bonds. Recently, however, that opposition has softened. Six important private-sector groups recently announced that collective action clauses were a useful component of sovereign debt restructuring[2] .

The Group of Seven's current reform proposals, however, go beyond simply introducing traditional collective action clauses. They would introduce a standardized set of new contingency clauses that describe "as precisely as possible" what should happen in the event of a sovereign debt restructuring. Countries would be encouraged to voluntarily include the standardized clauses in their bond contracts and bank debt. In addition to a majority action clause, two other sets of clauses are envisaged:

A *procedural* clause that describes how creditors and debtors interact in the event of a restructuring. This clause would specify how creditors would be represented, what data a debtor would have to provide to the designated creditors' representative, and within what period of time. The designated creditor representative would have a formal role in negotiations with the sovereign debtor. Rather like the UK trustee-based approach, the legal rights in a restructuring would lie not with individual bondholders but with the creditor's representative (acting on the instruction of a certain fraction of bondholders).

An *initiation* clause that would describe precisely how the sovereign would initiate the restructuring process. It would provide for a so-called "cooling off period" after the sovereign had announced that it intended to restructure its debt and had suspended its debt payments. During that period, which might last for perhaps 60 days, the creditors would organize themselves in accordance with the procedural clause and would decide how they wished to proceed. They would, however, be barred temporarily from initiating litigation. At present, proponents of contingency clauses do not envisage the creation of a standing dispute-settlement body. If disputes arose between creditors, they would be resolved according to an arbitration process that itself would be described in the clauses.

Reform based on contingency clauses has a number of practical advantages. It is a decentralized and voluntary approach that requires no legislative change, international treaty or amendment to the IMF's Articles of Agreement. Creditors and debtors would simply be encouraged to introduce the package of clauses in bond contracts and bank loans. Contingency clauses do not require an expansion of the IMF's authority and are less bureaucratic that the SDRM. There would, for instance, be no standing dispute-settlement body. Creditors and debtors would be able to organize arbitration as necessary, under the general framework provided by the clauses. These clauses represent an incremental, rather than radical, reform to the status quo. That should make them more palatable to debtors and creditors alike. It also makes it easier to revise the reform process if problems crop up.

Despite these attractions, many questions remain unanswered. What precisely would the clauses say? What debt would be covered? More important, it is clear even at this early stage that a number of important problems must be overcome. Three, in particular, stand out.

### *Aggregation of claims*

Traditional collective action clauses apply only to the holders of a particular bond issue. Though this makes the restructuring of an individual bond easier, it does little to facilitate an overall debt workout where numerous bonds and other debt instruments are involved. Argentina, for instance, has more than 80 different bonds outstanding. Unless the contingency clauses offer a means to aggregate debt across issues they do not offer a big improvement on the status quo

### *Debt stock*

Unlike the SDRM proposal, a collective-action clause approach to reform would not affect the existing stock of debt. Yet the aggregation of claims across different instruments is impossible unless all sovereign debt includes standardized collective action clauses. Until the existing debt stock matures or is refinanced with new bonds that include contingency clauses, this approach will not create an orderly debt-restructuring procedure.

### *Lack of appeal*

Since emerging markets have proved reluctant to introduce traditional collective action clauses, they are unlikely to warm to an even broader package of clauses. Even if sovereign borrowers recognized that their introduction would improve the global financial system, there is a severe first-mover problem. Individual borrowers face the risk that creditors penalize issuers who establish better default procedures. Even if such clauses became common, sovereigns facing trouble would come under pressure to exclude such provisions on new instruments as a means of giving selected creditors effective seniority.

# III. Making Contingency Clauses Work

## Solving the Legal Issues

The contingency clauses that are being advocated do not exist. An important first task, therefore, is the legal drafting of model clauses. These clauses must describe more processes, in greater detail, than previous collective action clauses. Closer inspection suggest substantial legal obstacles must be overcome in each clause

***Procedural clause—*** The central purpose of the procedural clause—the specification of a clear process through which creditors and debtors interact—will require reconciling, or choosing between, different legal traditions.

Under UK law sovereign bonds are issued under a trust deed. Under a trustee system, an individual holder's rights are curtailed. The trustee not only has procedural responsibilities (such as organizing voting), but also has considerable legal standing. The right to litigate resides with the trustee (acting on behalf of a majority of bondholders) not with individual bondholders.

Sovereign bonds can be issued using a trust indenture under US law, though they rarely are. Even those few that are issued under trust indenture have different procedures and rights than those issued under the English system. Even in US trust indenture bonds it is a matter of convention that each bondholder has the unqualified right to initiate litigation individually to recover his share of principal and interest not paid. (Other rights, such as the right to sue for accelerated payments in the event of default, reside with the trustee).

Most bonds issued under US law, however, do not use a trust indenture. The most popular approach is to use a fiscal agency agreement. The fiscal agent, the agent of the debtor, simply collects money and pays the creditors. Enforcement rights remain with individual bondholders.

The proposed procedural clause assumes a role for the creditors' representative that is substantially larger than the role of a fiscal agent, and even than the role of a trustee in traditional collective action clauses. It implies a significant change from current legal practise. Two important processes—the verification of claims and the representation of creditors—need to be delineated. Moreover, the new clauses raise a number of practical concerns. Who would be the trustees, or their equivalent? Would the shift from a fiscal-agent system to the new system add ongoing costs to bond issues (extra lawyers fees, for instance)? Who would pay the additional costs?

***Initiation clause***—This clause causes the greatest concern for market participants, in large part because its scope—and purpose—have not been precisely defined. The ostensible goal of an initiation clause is to protect a sovereign debtor from litigation in the period immediately following the announcement of a debt restructuring. Many market participants argue that this is a non-problem. Though legally possible, litigation is extremely rare at this early stage.

In contrast, the negative implications of an initiation clause could be considerable.

There is a serious risk that it could trigger massive capital flight by domestic asset holders. To prevent this, capital controls would have to be introduced when the restructuring was announced. The spectre of capital controls could increase the volatility of capital flows since investors might flee a country at the first sign of trouble. To avoid this outcome, initiation clauses must be carefully drafted and narrowly circumscribed. Given the limited risks of litigation early on in a restructuring, they may not even be necessary.

***Collective action clause***—If the contingency clauses are to reduce the uncertainty surrounding workouts significantly, they must create a standardized approach which enables majority voting to be applied across bonds and syndicated loans. This requires:

- Identical contract language for each bond.

- A way to ensure that no one deviates from the standardized language.
- An agreed definition of economic interest that must be part of each standardized clause.

Since any slight drafting differences between contingency clauses in different bonds could become a source of potential disagreement between creditors, it will not be enough simply to create a "best-practise" template, as the US Treasury proposal suggests. The clauses will need formally agreed, identical, language that must be included in all new issues. One option is to adapt an open-ended indenture clause to serve as "off the shelf" language for all bonds.

Even if all bonds contained contingency clauses with identical legal language, cross-bond aggregation is still difficult if the legal reach of the supermajority for collective action is limited to a specific bond. Investors could, for instance, accumulate concentrated positions in a particular bond issue, putting them in a position to undermine the restructuring procedure or hold out for favorable treatment. Eliminating this risk means introducing cross-issue majority action clauses — clauses that are binding across all creditors across different classes of debt.

Such cross-debt majority action clauses would allow aggregation (though they, too, would risk being interpreted differently in different legal jurisdictions). But they raise new practical issues. First, comprehensive cross-issue aggregation cannot take place until all of the relevant debt instruments contain cross-issue majority action clauses. Second, organizing a vote of creditors across numerous issues and instruments is considerably harder than organizing it across one. All of the practical procedural considerations above apply in spades. More important, cross-issue aggregation requires a common definition of economic interest, in effect a procedure for weighting votes across instruments with different maturities and coupons, and denominated in different currencies. One option is to aggregate claims based on their par value adjusted for currency differences. Others may be possible, but without a standardized definition of economic interest, the cross-issue aggregation of claims is impossible. Finally, the existence of cross-issue aggregation clauses simply makes aggregation possible. It does not solve the important conceptual point of whether votes should, in fact, be aggregated across *all* debt instruments in every restructuring situation.

Cross-issue aggregation goes further than the G-7 reform proposal currently envisages, and many market participants are deeply sceptical of the idea. Hence, contractual provisions designed to facilitate cross-issue aggregation may not suffice. There may be need for provisions to govern decisions regarding the appropriate extent of cross-issue aggregation. Otherwise inter-creditor disputes may arise regarding aggregation of creditor representation as well as the aggregations of voting—whether they should cover all debt instruments in every restructuring situation. The US Treasury proposes that such inter-creditor disputes be taken to arbitration as necessary, with the arbitration procedures provided for in the contingency clauses. That could prove difficult and contentious. It would be hard to define comprehensively the rules of arbitration in advance, and arbitration can be a lengthy process. It also risks inconsistent treatment, particularly if arbitration forums are in separate legal jurisdictions.

In short, the details of designing a voluntary contractual approach to debt workouts are complex. It will be challenge to enshrine clauses in sovereign debt that are detailed enough to create an orderly debt-workout, yet attractive enough for creditors and debtors to agree to introduce them.

### *Persuading Debtors to Introduce Contingency Clauses*

Sovereign borrowers' reluctance to introduce even traditional collective action clauses suggests broader contingency clauses are unlikely to be adopted spontaneously. But since the essence of the contractual approach to reforming sovereign debt workouts is to avoid statutory change, a variety of carrots and perhaps regulatory sticks will need to be used instead. The following options are frequently discussed:

***Leading by example***—Although the G7 group have long advocated traditional collective action clauses as a procedure for sovereign debt restructuring, only Canada and the United Kingdom have introduced collective action clauses in their own bonds. Since contingency clauses are a wholly new package of legal clauses, the benefits of leadership by example would be even greater. Though G7 example alone might not persuade emerging economies to include these clauses, it would rob them of a popular excuse for inaction.

Regulatory requirement In principle, regulators in the major markets where bonds are issued could require the inclusion of contingency clauses as a precondition for any issue. Though not a statutory change, this kind of requirement would represent a move away from voluntaryism. Some regulators, especially America's Securities and Exchange

Commission, have voiced concerns about such regulatory requirements. If some, but not all, market regulators were to require contingency clauses, there is a risk that bond issuers might simply move to a less rigorous regulatory environment. Sovereigns might choose to issue bonds in jurisdictions where regulators have not demanded contingency clauses. However, if the European Union, the United States and Japan all decided to require the inclusion of contingency clauses, that risk would be minimized. In short, regulatory requirements offer a promising route towards encouraging the introduction of contingency clauses and deserve broader international discussion. The Financial Stability Forum could be an appropriate forum.

Through the IMF This is the approach advocated by the US Treasury. There are several potential ways in which the IMF could encourage sovereign borrowers to introduce contingency clauses. One option would be to require that countries applying for IMF financing include in the policy commitments they make to the Fund a firm promise to introduce collective action clauses in all of their future bond issues. While it sounds attractive, this approach has several problems. First, it is too late. Sovereigns only come to the Fund when they are, or are about to be, in trouble. Second, it is unlikely to be credible. If a major sovereign borrower were to face crisis, it is difficult to imagine the IMF refusing to lend simply because that country had not introduced contingency clauses. Third, since weaker sovereigns tend to turn to the IMF, the use of conditionality would mean contingency clauses would be concentrated among weaker borrowers. That hardly sends a positive signal to the markets. And it will do nothing to convince investment grade borrowers that have no need for IMF resources to introduce contingency clauses.

Another possibility is to require contingency clauses as a prerequisite for access to the IMF's Contingent Credit Line (CCL). This facility, introduced in 1999, was designed to assist countries that had been hit by contagion from crises elsewhere. Since only countries with good economic policies are eligible for CCLs, contingency clauses could become part of a seal of good housekeeping. Unfortunately, since no country has, as yet, requested a CCL, this route seems implausible.

A third option is to offer countries with contingency clauses cheaper access to IMF resources. This approach runs into legal problems. The IMF is not legally able to charge different members different interest rates for the same loan facility. To create interest-rate differentials, the IMF would have to create separate facilities. A proliferation of new facilities would undermine the progress that the Fund has recently been making to simplify and streamline its lending.

A fourth option is to reduce gradually the cumulative amount of financing available from the IMF (presently set at 300 percent of a country's IMF quota) if a country fails to introduce standardized contingency clauses within, say, three years. It would also be possible to exclude such a country from access to the Supplemental Reserve Facility, which is the IMF's principal tool for offering large-scale financial assistance.

***Education*—**Considerable effort will be required to explain the purpose and benefit of contingency clauses to sovereigns, underwriters, investment banks and investors. Education alone will not ensure that these clauses are adopted, but it is a necessary complement to the other incentives above.

### *Dealing with Debt Stock*

Even when a package of model contingency clauses is agreed and sovereign debtors are persuaded to introduce them in all new debt instruments, one big problem remains: the outstanding stock of existing debt that does not include these clauses. Although the average maturity of sovereign bonds is less than ten years, certain bonds have much longer maturities. A transition period—when new bonds with contingency clauses coexist will old-style bonds—could be lengthy. Since cross-issue aggregation will be impossible in these circumstances, a protracted transition would substantially reduce the effectiveness of contingency clauses

***Mass Conversion***—One way to solve this problem is through a pre-emptive bond swap. Sovereigns would simply swap their existing bonds for new bonds with contingency clauses. That will not be easy. Given how sceptical many sovereign borrowers are about introducing contingency clauses gradually in new bonds, it would be hard to convince them to undertake mass conversions of existing debt simply in order to introduce contingency clauses. The first-mover problem would be even bigger. Creditworthy countries, in particular, will be extremely reluctant to convert existing debt to new bonds that are easier to restructure.

Unless the mass conversion was mandatory (which, of course, would undermine the voluntary principle of the contingency clause approach), sovereign borrowers would demand substantial financial sweeteners to undertake such a conversion. In principle, official resources (from the IMF or other multilateral agencies) could be used to finance such mass conversions. However, subsidizing mass debt conversion by creditworthy borrowers is likely to be a controversial use of official resources.

***Conversion of debt stock during a workout*****—**An alternative approach is to convert outstanding debt stock into new bonds with contingency clauses at the start of a workout process. Both creditors and debtors have greater incentives to agree to clauses that facilitate debt restructuring when a restructuring is imminent. Both creditors and debtors have an interest in achieving a sustainable debt profile, and both benefit from a speedy workout.

A number of private-sector proposals are being developed to deal with this issue. One of the most fully elaborated is a two-part debt conversion scheme developed by Ed Bartholomew and Ernest Stern[3] of J.P. Morgan. Though this J.P. Morgan proposal was designed to facilitate an orderly workout of debt which did not include majority-action clauses (such as Argentina today), and not as a means to solve the debt stock problem in a systemic reform based on contingency clauses, it offers a means to do the latter when a sovereign has to restructure its debt. Because of the detailed analysis contained in this proposal, it is useful to analyze this approach.

***The J P Morgan Proposal***—Step one in the J.P. Morgan proposal is the issue of an "Interim Debt Claim" (IDC) by the debtor. This short-term security would create a common economic base for creditors and could thus serve as the basis for majority voting across what were originally different debt instruments. The IDC would contain provisions for debtor representation and majority action. (Once they are developed, it could contain model contingency clauses). In Step two, the actual debt restructuring—and determination of the creditor haircut—takes place when these IDC's are exchanged for new bonds. (Though the J.P. Morgan proposal does not specify this, the new bonds could also contain contingency clauses. Thus, all of the sovereign debtor's outstanding bonds could contain contingency clauses at the end of the restructuring).

The success of this proposal depends on persuading a high proportion of creditors to accept the initial IDC's—since any creditors who keep old-style bonds could upset the restructuring process by litigating their claims. Persuading bondholders to swap means making the IDC's as attractive as possible, while making the prospect of holding on to old bonds as unattractive as possible.

An upfront cash incentive would make IDCs more attractive. The J.P. Morgan proposal suggests that such a cash incentive might include accrued interest (up to the time of default) plus a premium of, say, 5% of the par value of the bonds[4]. Five percent of the par value of the bonds could be a sizeable sum: in Argentina's case it would be between $2 billion and $3 billion. If—as in Argentina's case—a distressed sovereign was unable to make such a payment, official financing from multilateral institutions could play a role (as it did in connection with the issuance of the Brady bonds).

IDCs would be liquid (since they would be a much larger issue than any individual bond), of short maturity, and would offer investors the same rate of interest as their previous bonds. The J.P, Morgan proposal suggests introducing two types of IDC—one with a high interest rate and one with 0% interest accrual. This would help create a market and would allow any previous interest rate to be replicated through a combination of the two IDCs

A further incentive to creditor participation would come from making the old bonds as unappealing as possible. One way to do this is by using "exit consents", whereby a majority of bondholders agree to remove all attractive non-financial covenants from the old bonds. (Under New York practise, it is only the financial covenants of a bond that are subject to unanimity requirements—see section two). There is a recent precedent for this: exit consents were successfully used by Ecuador in 1999 as part of the strategy to persuade creditors to accept its restructuring offer.

Once exit consents had been used, any bondholder that had refused IDCs would be left with old bonds that were illiquid and stripped of standard covenant protections.

Though this prospect would probably convince most creditors to accept IDCs, it would not eliminate the risk of hold-out litigation. A greater concern is that creditors would raise the hurdle for using exit consents, by demanding that future bonds have higher majorities for changing a bond's non-financial covenants than are presently common.

For this reason, among others, the J.P. Morgan two-step approach may not provide a permanent framework for restructuring sovereign debt. Nevertheless, it provides a mechanism for dealing with sovereign debt problems during the long period required to introduce contingency clauses into the existing stock of emerging-market debt, or to perfect and adopt the SDRM.

# IV. Conclusion

The history of corporate bonds suggests that if sovereign defaults are sufficiently painful and protracted, procedures to create greater order will eventually be developed. After all, England's majority action clauses were themselves introduced to improve upon chaotic corporate liquidations. America's amendments to bankruptcy laws in the 1930s (Chapter 11 etc.) were a statutory solution to create orderly corporate workouts.

Argentina's current predicament may provide the necessary catalyst at the sovereign level. After years of discussion, the prospects of action to create an orderly sovereign debt workout procedure have sharply improved recently. A consensus is growing that change is necessary. Both the official and private sectors are offering concrete suggestions for reform.

This consensus for change is welcome. So, too, is the increasing focus on the details of how exactly different reform proposals would be implemented. But, as this report has tried to point out, much remains to be done. Given the comprehensive nature of a statutory solution and the risk of unforeseen negative consequences on financial flows to emerging markets, the SDRM proposal is still in its early stages. Quite apart from the political task of developing a consensus in favor of such a large step, many details still need to be elaborated and refined.

Given these hurdles, the prime focus, both in the official sector and among market participants, is, correctly, on contractual reform. Improving the framework for debt workouts through the introduction of new contingency clauses in debt instruments has many substantive and political attractions. It is a voluntary and incremental approach to reform, with fewer risks than the statutory route. Unfortunately, as this report has pointed out, there are substantial difficulties on this path too. Once you get into details, the development and introduction of contingency clauses is no simple matter. Drafting the right clauses will be challenging, but is an urgent first priority. Ensuring their adoption will be even tougher.

Market-oriented debt conversion techniques, such as the J.P. Morgan proposal, provide an appealing framework for dealing with debt problems in the interim. They offer both a means to deal with immediate debt workouts, such as the looming Argentine case, as well as a useful mechanism to foster the introduction of contingency clauses. The lessons learned in applying such an approach could offer valuable insights for future reforms. Therefore, the next step towards a better framework for sovereign debt restructuring should be to pursue this course at the earliest opportunity.

# Tables

**Table 1**
**Key Elements of the SDRM**

| | |
|---|---|
| *Initiation* | A restructuring would be initiated by a supermajority of creditors. A standing creditor organization could be established to ensure that creditors could be organized to vote quickly. Alternatively, a debtor country might be able to declare a standstill with IMF approval (or even unilaterally) and receive legal protection for, say, 90 days. A supermajority of creditors would be required to extend it |
| *Creditor Organization* | A supermajority of all creditors across applicable debt would be required to approve the terms of any debt restructuring. The proposal does not specify the supermajority, but Ms Krueger suggested between 65% and 85% of all creditors. |
| *Litigation* | Creditors would be prevented from litigating during the restructuring negotiations. Once supermajority of creditors accepted final agreement, dissident creditors would be bound to it |
| *Coverage* | In principle, the statutory nature of the SDRM means all types of debt could be covered. Ms Krueger's proposal suggests including all sovereign debt owed to external private creditors—specifically, bonds and bank loans. On a case-by-case basis domestic debt could be included if necessary to reduce debtor burden to a sustainable level. The SDRM mechanism does not propose including debt owed to the IMF, but offers the possibility of including debt owed to other official creditors. |
| *Dispute Resolution* | Creation of new dispute resolution forum, separate from the IMF to verify creditor claims, administer the voting process and oversee its integrity. This body would also have the power to adjudicate disputes between creditors. |
| *New Financing* | Supermajority of creditors could agree to new financing whose claims were superior to those in restructuring process |

**Table 2**
**Key Elements of Contingency Clauses**

| | |
|---|---|
| *Initiation* | Details laid out in specific initiation clause. The debtor country would initiate a restructuring. Litigation would be barred for an initial cooling off period of, say, 60 days |
| *Creditor Organization* | A supermajority of creditors of a particular bond or bank loan required to approve terms of restructuring, as specified in the majority action clause. No explicit legal procedure for aggregation of claims across credit instruments |
| *Litigation* | Litigation barred during the initial cooling off period. Individual bondholders barred from litigation during or after restructuring. Specified creditors' representative has power to litigate when acting on instructions of majority of creditors. |
| *Coverage* | US Treasury suggests majority action clauses to be introduced in bond and bank debt. Only debt issues that specifically included such clauses would be covered. Existing debt stock unaffected |
| *Dispute Resolution* | Contracts to provide for an arbitration process. Details, as yet undefined |
| *New Financing* | Not addressed |

# End Notes

[1] In principle, countries could leave the IMF in order to avoid being bound by the SDRM. However, given the numerous other advantages of IMF membership, that is unlikely.

[2] The private-sector groups are the Emerging Markets Creditors Association, the Emerging Markets Traders Association, the Institute of International Finance, the International Primary Market Association, the Securities Industry Association, and The Bond Market Association

[3] Mr. Stern was a managing director at J.P. Morgan when this proposal was developed. He has since retired.

[4] In the case of Brady bonds, the collateral could be sold and the proceeds passed on to investors.

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