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Gerhard Illing*

Bailing in the Private Sector

On the Adequate Design of International Bond Contracts

During the last decade, there has been a significant bias towards bond financing on emerging markets, with private investors relying on a bail-out of bonds by the international community. This bias has been a main cause of the recent excessive fragility of international capital markets. The following paper shows how collective action clauses in bonds contracts help to involve the private sector in risk-sharing. It argues that such clauses, as a market-based instrument, will raise the spreads for emerging market debt and so help to correct a market failure towards excessive bond finance. Recent pressure by the IMF to involve the private sector faces a conflict between the principle of honouring existing contracts and that of equal treatment of bondholders.

Involving the private sector in solving financial crises is now seen as a key step towards the successful reform of the so-called "International Financial Architecture". "Bailing in" has become a catchword in official statements.¹ Increasing pressure is put on bondholders to share the burden of rescheduling the debt of sovereign countries in distress. These moves are based on the feeling that international capital markets are biased towards bond financing. For a long time private lenders, relying on the sanctity of debt contracts, felt safe to invest their money in sovereign debt – trusting that they would either be lucky enough to get out first in the case of emergency or otherwise would be bailed out by international financial institutions.

Indeed, whereas bank loans were heavily affected by the Latin American debt crisis during the 1980s, there has never been a major default on bonds issued by sovereign debtor countries during the postwar period. Bonds appeared to be senior to bank debt. Their exemption from rescheduling was not based on a special legal status but was, rather, due to two other factors:

- the enormous practical difficulties involved in cutting a deal with a diffuse atomised number of often unknown bondholders;
- the negligible part bonds played in financing since the end of World War II.

The latter changed dramatically during the 1990s. In that period, emerging market financing was characterised by two trends: shorter maturity of bank loans and a shift away from direct bank lending towards equity and bond financing. At the beginning of the 1990s, long-term bank loans dating from the 1980s were restructured and then transformed into "Brady" bonds. Table 1 illustrates how bond finance was substituted for bank credit. This allowed banks to securitise risky loans.² The proportion of bond lending increased dramatically, changing the debt structure significantly. Bond markets became the main source of finance for emerging markets.³ This trend has been reinforced by the fact that international funds came to rescue investors during the Tequila crisis in Mexico in 1995. Many observers saw this as an open invitation for both debtor and creditor to free ride at the expense of international tax-payers.

¹ Stanley Fischer: Learning the Lessons of Financial Crises: The Roles of the Public and Private Sectors, IMF, Washington 1999.

² The same procedure is now being applied to Russian bank loans. The London club (a group of commercial creditors) agreed in February 2000 with Russia to restructure \$32bn (£19.8bn) of Soviet-era debt: after writing off 36 per cent of the principal, the remaining debt will be repackaged as Euro bonds with 30 years' maturity.

³ This trend for emerging markets is not restricted to public financing; the same is true for the private sector: "Between 1983-89 and 1990-98, the share of bonds in total financing rose from 27 percent to 46 percent, while the share of equities rose from 1 percent to 8 percent, with the share of loans falling from 72 percent to only 45 percent. This reflects the general trend toward securitized rather than bank-intermediated financing, the recently growing importance of new nonbank investors in emerging markets, and the limited secondary market trading of bank loans." IMF: The International Capital Markets Report 1999, p 103.

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Table 1
Debt Structure of Emerging Markets
(% of foreign debt)

	Bilateral Credit	Bank Credit	Bonds
1970	55.5	8.2	4.1
1980	32.9	33.6	5.0
1990	35.3	23.6	9.6
1997	37.0	12.3	21.2

Source: World Bank: Global Development Finance.

Table 2
Emerging Market Economies' External Financing
(net, billions of dollars)

	1996	1997	1998	1999 ^a	2000 ^b
External Financing (net)	335.5	304.6	200.6	160.6	202.2
Private flows	327.9	265.7	147.8	148.5	193.1
Equity Investment	125.4	141.0	131.5	155.8	153.5
direct investment (FDI)	91.7	115.3	117.9	138.8	119.8
Portfolio investment	33.7	25.7	13.7	17.0	33.7
Private creditors	202.5	124.7	26.2	-7.1	39.6
Commercial banks	116.8	33.5	-49.0	-39.1	-3.1
nonbank private creditors	85.6	91.2	65.2	32.0	42.7
Official flows	7.6	38.9	52.8	11.9	9.1
Multilateral Credit	6.6	29.0	36.4	4.0	9.9
Bilateral Credit	1.0	9.8	16.5	7.9	-0.8

^a estimated.

^b forecast.

Source: Institute of International Finance, 24. 1. 2000.

Both the shift towards shorter maturity of bank loans and towards bond financing contributed to the excessive fragility of emerging market finance at the end of the 20th century. As shown in Table 2, after the Asian and Russian crises in 1998, there was a dramatic reversal of the flow of private credit to emerging market economies.⁴ Private credit turned negative, whereas both long-term foreign direct investment (FDI) and official flows remained fairly robust. Spreads on emerging markets increased dramatically (cf. Figure 1).

The increase in bond issuance will be reflected in a rapid increase in redemption payments in the coming years. Private capital flows have become so big that potential financing gaps faced by emerging economies can no longer be expected to be covered by international rescue packages. As argued by Eichengreen,⁵ the IMF⁶ and the Council on Foreign Relations,⁷ creditors will in future hardly be able to avoid a heavier burden in periods of distress.

Both the IMF and the Paris Club (a voluntary group of official representatives of creditor governments

dealing with countries in financial distress) have recently made efforts to push for the participation of private debt holders. Countries in extreme debt overhang get strong signals that a debt rescheduling with private creditors is a condition for further support – much in the same spirit that official creditors in the Paris Club require “comparable” concessions from private creditors (as a burden-sharing quid pro quo) for their own debt rescheduling concessions. Ecuador, Pakistan and Ukraine became the first test cases. Experience with measures for bailing in has been extremely limited up to now, so countries trying to bind in private debtors are facing high risks. Evidently, there is a trade-off between immediate cash-flow benefits and possibly reduced subsequent access to capital markets. The crucial issue is how it will affect future access to capital markets.

Not surprisingly, private investors in emerging markets warn that such a policy will increase the cost of borrowing for emerging market countries by widening the yield spreads. In a position paper on private burden-sharing, the Emerging Markets Traders Association (EMTA) argues that it would “put at risk a decade's progress in diversifying financial risk more widely throughout the financial system and restoring access of Emerging Markets countries to the benefits, as well as the disciplines, of international capital markets.”⁸ Folkerts-Landau and Garber from Deutsche Bank reject the idea with similar arguments.⁹ In the same vein, the Institute of International Finance, representing banks and institutional investors, is trying hard to lobby against “involuntary techniques involving the private sector”.

For obvious reasons, emerging market countries are also reluctant to introduce voluntarily measures which would raise their own costs of finance. To counter these arguments and to sweeten the idea of bailing in, proponents frequently claim that the yield

⁴ Cf. also Bank for International Settlements (BIS): International Banking and Financial Market Developments, BIS Quarterly Review, February 2000.

⁵ Barry Eichengreen: Toward a New International Financial Architecture: A Practical Post Asia Agenda, Institute for International Economics, Washington DC 1999.

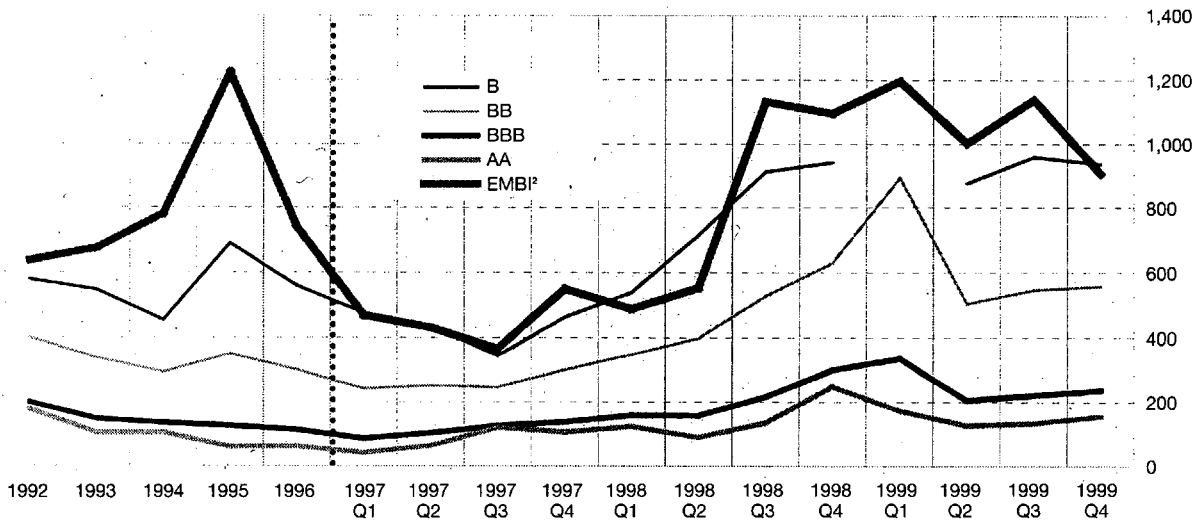
⁶ IMF: Involving the Private Sector in Forestalling and Resolving Financial Crises, Washington 1999.

⁷ Council on Foreign Relations: Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture, Institute for International Economics, Washington DC 1999.

⁸ Emerging Markets Traders Association (EMTA): Is Burden-Sharing Being Pushed Too Far?, Position Paper 1999.

⁹ David Folkerts-Landau, Peter Garber: The New Architecture in Official Doctrine, Deutsche Bank, Global Markets, April 1999, pp. 1-16.

Figure 1
Spreads of Rated Bond Issues in Emerging Markets, by Credit Rating¹
 (in terms of US dollars, 10-years maturity, in basis points)



¹ Estimated credit spread on a 10-year rated bonds issued by emerging market economies over the benchmark industrial country government bond. No data available for B-rated issues in 1999 Q1. ² Emerging Markets Bond Index quarterly average.

Source: BIS: Quarterly Review: International Banking and Financial Market Developments, February 2000, p. 25.

spread might even be lowered by such measures.¹⁰ When a change in the legal structure of bond contracts makes debt renegotiation easier, coordination costs among atomised debtors in case of distress are reduced. So deadlocks and costly liquidation of illiquid assets will be avoided, making both debtor and creditor better off.

Below, a simple example illustrates how a redesign of contract can reduce coordination costs. But it would be completely wrong to conclude that mandatory bailing-in clauses might reduce spreads. Such a claim is either naive or preposterous. The main purpose of binding in the private sector is exactly to correct a market failure – the bias towards bond finance and short-term lending, resulting from moral hazard on the sides of both lenders and creditors. If these measures work, they should help to make a credible commitment for not bailing out private investors. By construction, properly designed, they should correct wrong price signals by raising the costs of short-term lending and so dampen short-term capital flows. If, instead, spreads went down,

price signals would go in the wrong direction, turning the whole exercise into a failure.

Bailing-in clauses work in a way comparable to imposing short-term capital controls. By throwing sand into the wheels of international capital flows, they are frequently said to deter investors from lending money and thus deprive emerging countries from the benefits of globalisation. It is no coincidence that the argument closely resembles those of the lobby groups against bailing in. Both measures intend to correct the alleged market failure of excessive market volatility. If there is a bias both towards bond financing and short-term bank loans, markets cannot perform efficiently unless a change in institutional design raises the price for these activities – either explicitly or implicitly.

The real issue is whether market failures can be corrected in a way encouraging long-term investment instead. A proper design should throw sand into the wheels of short-term capital flows and at the same time grease the engine of long-term financing. The theory of market failure tells us that market based incentive mechanisms are superior to rigid instruments. To borrow a phrase from environmental economics, a clever design should use taxes rather than quotas. Unilateral declarations of a standstill by a debtor country or the forced rescheduling of bonds

¹⁰ Cf. Barry Eichengreen, *op. cit.*, p. 68; Andy Haldane: Private Sector Involvement in Financial Crisis: Analytics and Public Policy Approaches, in: Bank of England: Financial Stability Review, 1999, pp.184-202, here p.196; and Stanley Fischer, *op. cit.*

in breach of original contracts belong to the latter category, just as do rigid capital controls.

In contrast, market based instruments would change the nature of bond contracts *ex ante* in a transparent and predictable way. They work as an explicit tax on bonds to correct for negative externalities and thus allow private agents to react smoothly to price incentives. Recently, a number of such market based instruments have been suggested. The main focus is on how to change the legal structure of bonds so as to ease restructuring: Collective action clauses in bond contracts play a prominent role. Other market based instruments include the arrangement of contingent credit lines from the private banking sector and the use of derivatives in debt instruments.¹¹

As pointed out, there is a lot of confusion in the debate about the impact of such measures. Partly, this may be due to the fact that different lobby groups try to push their own interest. But it is also due to the complexity of the issue: different kinds of market failure are involved, calling for a sophisticated second best analysis. In the following we try to disentangle the main issues.

Financial Fragility and International Capital Markets

At first sight, the rapid substitution of bank lending by bond financing during the last decade appears to be a healthy process. It might simply indicate that emerging markets are beginning to participate in the benefits of modern financial engineering. With sophisticated technologies reducing transaction costs, these markets become less dependent on information intensive bank-intermediation. When securitisation goes global, private capital can flow much more efficiently to those countries with the highest expected return. If this view were correct, interventions in the legal framework aiming to discourage bond financing would be detrimental. As Folkerts-Landau and Garber argue, "Their ultimate result, if implemented, would be primarily to shift the global financial system back one generation to a relationship mode of banking."¹²

Indeed, relative to what the theory of perfect capital markets suggests, international diversification of financial trade is still extremely limited. Nevertheless, reducing the extent of bond finance may paradoxically contribute to more efficient sharing of risks. At present, it is mainly the creditors who benefit from securitisation. By making use of secondary markets, they can diversify risk according to individual needs. In contrast, emerging market countries as debtors are

hardly able to diversify, even though they have an enormous need for global risk sharing: under traditional debt contracts, obligations are fixed as long as no default is declared. Creditors do not provide any explicit contractual insurance, adjusting the payment load when countries are hit by negative shocks.

Modern instruments such as indexed bonds or catastrophe-linked derivatives could provide this kind of insurance: these sophisticated means of finance – more like equity than debt. – would automatically reduce the amount of debt service in case of bad shocks. Emerging market bonds, however, are usually of the non-indexed type, so the benefits of modern globalisation are more a myth than reality.

Obviously, there are good reasons why sophisticated bonds are so rare for emerging markets. Moral hazard and adverse selection problems reduce the scope for trading risks. Under perfect insurance, there would always be strong incentives to claim bad luck or even declare strategic default.¹³ So bonds can be indexed safely only to events which are truly exogenous (such as worldwide shocks). Incentive problems are aggravated among sovereign countries: in the absence of international bankruptcy courts, contracts are difficult to enforce. The incompleteness of markets is an endogenous response to incentive problems. Taking this into account, it no longer seems surprising that international trade is far behind the first best outcome under perfect financial markets.

The lack of explicit market insurance is the main reason for the increased fragility of financial markets during the last 20 years. Under debt contracts, severe shocks lead to default. Leverage effects amplify the impact of negative shocks, creating excessive volatility. Feedback mechanisms may cause contagion to other markets. Worldwide safety nets have been installed to cope with the fragility of financial markets. Explicit market insurance is substituted by an implicit reliance on international bail-out.

Thus, investors are encouraged to extend bond finance beyond the efficient level, relying on the international community to come to the rescue when default is looming. The combination of debt contracts and implicit bail-out introduces a bias towards

¹¹ For an extensive study see IMF, *op.cit.*

¹² Cf. David Folkerts-Landau, Peter Garber, *op. cit.*, p. 11.

¹³ Gerhard Illing: Nominal Bonds and Budgetary Discipline in a Currency Union, in: *Kredit und Kapital* 1999, pp. 1-23.

¹⁴ Kenneth Rogoff: International Institutions for Reducing Global Financial Instability, in: *Journal of Economic Perspectives*, Volume 13 (1999), No. 4, pp. 21-42.

excessive bond financing relative to the second best outcome. The larger the extent of bond finance, the more likely financial crises and the heavier their impact. Evidently, this bias is a main factor contributing to the increased frequency of financial crises.

Because of the high costs of financial crises and contagion, a threat not to bail out is hardly credible. An obvious solution is to let creditors participate in risk sharing. How can changes in the legal structure of debt contracts help to correct the market failure? The answer requires a careful understanding of the underlying incentive problems. At least three different moral hazard problems are involved, working in opposite directions:

- the creditor's incentive to liquidate assets in order to secure a large slice for himself,
- the debtor's incentive to declare strategic default, and
- both the creditor's and the debtor's incentive to free ride on the international community.

American vs. British-style Bonds

Most outstanding emerging market bonds are issued according to American law. This gives bondholders a very strong bargaining position. There are no contractual provisions allowing qualified majorities to modify the terms of a bond and to impose these modifications on minority holders. In the event of default, there are hardly any limitations for individual bondholders to initiate and benefit from legal action on their claims. So renegotiation is extremely costly. Acceleration clauses aggravate the problem: if bondholders representing more than 25 per cent of the principal vote for acceleration, the issuing country is forced to accelerate (immediate) repayment of all principal and interest due in the event of default.

The idea of these provisions was initially to protect individual bondholders against the risk that big institutional investors cut a deal with the debtor at the expense of diversified minority holders. The consequence, however, is that any restructuring is bound to fail under diffuse ownership. It can lead to litigation, loss of value, and perhaps even loss of access for other borrowers. This will be exacerbated if "vulture funds" – investors that are skilled in extracting payments from troubled borrowers – were to increase their presence in emerging markets.

There have been several proposals to lower the costs of renegotiation. They follow the legal terms of "British-style" bonds. These bonds contain "collective action clauses" that allow for:

Collective representation – clauses that provide procedures for bondholders to organise and designate a representative to negotiate on their behalf with the debtor. Under British law, a trustee is appointed acting on behalf of bondholders – a bondholders analogue to the Paris or London Club. In the Paris Club, official representatives arrange terms for rescheduling officially held public debt, whereas the London Club deals with the restructuring of bank loans. Bank advisory committees handle these negotiations from the creditor side.

Qualified majority voting – clauses that enable changes to be made in the terms of a bond contract without the unanimous consent of bondholders, and thus prevent a small number of dissident bondholders from blocking an agreement beneficial to the majority. Under British law, rather than insisting on unanimity, typically a 75% majority is required to change terms. At a bondholders' meeting, there is a 25% quorum for attendance, so the 75% rule may translate to as little as just above 18.75%.

Sharing clauses among bondholders – clauses requiring bondholders to share the proceeds of litigation against a debtor with all other creditors, thus reducing the incentive for individual creditors to take independent legal action against the debtor. Sharing clauses change the threat point significantly in favour of the debtor: when bondholders have to share their winnings with other investors, the incentive to pursue debtors is drastically reduced.

The Coordination Game

In a simple example, we illustrate how the legal structure crucially affects the outcome of the renegotiation process. The rules of the game determine the threat point. American-style bonds give bondholders a strong bargaining position. They have de facto senior status. This creates, however, serious coordination problems among diversified creditors. Consider a bond with nominal value 100 and just 2 creditors, each holding half of the asset. With some probability p , the issuing country is hit by a negative shock. If the shock triggers default, the country runs into a severe insolvency crisis. Costly liquidation of illiquid assets reduces the liquidation value of the bonds to just 40. If instead, the country is given time for restructuring, partial recovery increases the present value of the bond to 70.

Under American law, each individual bond holder has a strong incentive to opt for litigation, thus

appropriating as much as possible from the liquidation value for himself. Since all creditors do the same, they face a prisoners dilemma (Figure 2a). All would benefit from coordinated action, but it is a dominant strategy to block restructuring. Free-riding results in inefficient liquidation, making both creditors and debtor worse off. Obviously the problem gets worse with an increasing number of creditors. Acceleration clauses aggravate the dilemma.

Sharing clauses change the nature of the game dramatically. Since benefits of legal action now have to be shared equally, restructuring is the dominant strategy equilibrium (see Figure 2b).

As the example shows, once in a crisis, all would benefit from legal arrangements making renegotiation easier. When default probability p is fixed, such clauses could reduce spreads on emerging market bonds significantly. As an illustration, assume the safe interest rate is 10%, and creditors are risk-neutral. The ex ante interest rate of American-style bonds is determined by the arbitrage equation $p \cdot 0.4 + (1-p)(1+r) = 1.1$. For British-style bonds we instead get $p \cdot 0.7 + (1-p)(1+r) = 1.1$. Take $p = 0.2$. American bonds would have to charge an interest rate $r = 27.5\%$, whereas interest on bonds with sharing clauses would reduce to $r = 20\%$.

In a crisis, American-style bonds cause high efficiency losses. To conclude that this type of bond is a sure sign of market failure would, however, be premature. The cost of renegotiation is bound to affect default probability. The lower these costs, the higher the debtor's incentive to declare strategic default. By claiming a crisis, better conditions may be obtained in renegotiations. Of course, as long as default pro-

bability does not rise too much, the spread can still be lower under British-style bonds (in the example above, even for $p = 0.3$ sharing clauses would have a lower r).

But incentives for strategic default are rather high in the case of sovereign debt. The reasons for debtor countries to make repayments are not well understood. As Rogoff argues,¹⁴ reputational effects may not provide sufficient incentives. The threat by foreign creditors to legally harass them when they try to borrow and trade abroad after a default can be a much more effective enforcement mechanism. So the threat of a costly negotiation period may be the main deterrence against moral hazard. Dooley presents a model in which costly negotiation is necessary to support any level of positive international debt.¹⁵ The dead weight loss during a real crisis is the price that has to be paid to make international financial trade sustainable.¹⁶

Free-riding in the coordination game suggests that renegotiation costs should be lowered so as to ease restructuring. On the other hand, raising renegotiation costs can reduce the risk of a crisis happening. It depends on the specific case which effect dominates. When creditors and debtor rely on a bail-out, incentive problems become even more intricate. Renegotiations prevent a solvency crisis under British-style bonds. In contrast, under American-style bonds, repayment of interest and principal to investors must be guaranteed. A crisis is triggered unless international funds come to the rescue. In the example above, an amount of $100(1+r) - 70$ of public funds is needed to prevent a run. With an implicit bail-out guarantee, ex ante spreads for American-style bonds would be lower than those with collective action clauses. The higher the expectation of a bailout, the lower the spread relative to riskless bonds.

Figure 2a

Collective Action Problem: Coordination Dilemma

	Restructure	opt for litigation
Restructure	35.35	0.40
opt for litigation	40.00	20.20

Figure 2b

Equal Sharing Rule; Nonacceleration

	Restructure	opt for litigation
Restructure	35.35	20.20
opt for litigation	20.00	20.20

Empirical Evidence on Spreads

Before the Asian crisis in 1997, spreads of rated bond issues in emerging markets narrowed down considerably (see Figure 1), in line with the bail-out

¹⁵ Michael P. Dooley: The IMF and Bailing in the Private Sector, Working Paper, University of California, Santa Cruz 1999.

¹⁶ Erik Bergloff, Gerard Roland and Elu von Thadden: An Incomplete Contracts Approach to Corporate Bankruptcy, Working Paper 2000, show that, in an incomplete contract framework, having multiple creditors increases the debt capacity of a firm. In their model, incentives to default strategically are increased as well. They show that bankruptcy rules can prevent a run on the assets. For sovereign debt, however, there is no international bankruptcy court.

Test Cases for Bailing In

Countries trying to bind in private debtors face high risks. Experience with measures for bailing in has been extremely limited up to now. There is uncertainty how it will affect future access to capital markets. For that reason, countries in financial trouble initially resisted pressures to involve bondholders in restructuring. In the first half of 1999, the IMF tried to force Pakistan and then Romania to restructure their bonds. But both countries ducked out at the last minute and instead preferred to pay back the debt.

Then Ukraine came under pressure to demand "comparable" concessions from private creditors when it tried to reschedule official debt.¹ In June 1999, Ukraine unsuccessfully tried to restructure maturing debt as its hands were tied by the stringent conditions of an aid package with the IMF. But as creditors threatened to declare the country into default if they were not repaid in full, Ukraine scrambled to find alternative sources of financing² to repay the debt at the beginning of August.

Ecuador was chosen as the next test case. At the end of August, the IMF indicated that it would grant new loans only under condition of structural reforms and the bailing in of private creditors. But the effort to restructure outstanding bonds failed in October 1999. Ecuador, being effectively bankrupt and unable to service its debt, could not reach an agreement with its debtors. Investors, led by the New York hedge fund Gramercy Advisors, rejected its offer to swap part of its debt. They assembled 35 per cent of bondholders to vote for acceleration. Ecuador was the first country to declare default both on Brady bonds and Eurobonds.

If the intention was to make bondholders in general aware of the risk of being bailed in, it did not succeed. On the contrary, after Ecuador's default, the yield spread on J. P. Morgan's Emerging Markets Bond Index (EMBI+) narrowed.³ Obviously, Ecuador was seen as a special case by investors. Market participants expressed doubt that the same principle would be applied to large countries, such as Russia and Brazil.

Pakistan's effort to restructure had more success when it got into trouble again in December 1999. More than 90 per cent of holders accepted the offer to exchange Eurobond issues with a total face value of \$610m for new six-year Eurobonds, paying a fixed interest rate of 10%. Two factors helped restructuring: Pakistan's bonds are issued under British law and have trustees. In addition, most of the debt was owned by institutional investors.

The latest guinea pig being pushed into debt restructuring has been, again, Ukraine. The country is suffering from a highly bunched debt service profile. With reserves of only \$1.2bn, it faces debt repayments of more than \$3.2bn this year. In February 2000, Ukraine offered to swap \$2.6 billions' worth of new international bonds with seven years maturity (paying a fixed interest rate of 10-11%). All bonds will be exchanged at par and repaid on a semi-annual basis. The offer represented a premium of about 30 per cent to the trading price on the secondary market. The offer expired on March 15th. Most of the Eurobonds were issued in Luxembourg under British-style law, requiring consent of a qualified majority of 75%. The DM bond, however, was issued under German law which follows the American style.⁴

About half of the bonds is held by private investors. Between 3,000 and 5,000 retail investors held bonds, mainly in Germany, Switzerland, Italy and Belgium. These diffuse investors were approached via internet, e-mail and a press campaign, advertising the offer in several newspapers. According to ING Barings, the lead manager of the exchange, there was broad acceptance among institutional investors, while private bond holders were waiting until the last minute to hand in their tender. But finally, far more than 85% of total bondholders are said to have agreed. Nevertheless, the offer was extended for several weeks. The success of the deal is an important boost to the IMF's attempt for burden sharing between taxpayers and private investors.

¹ Investors in Russia and Ukraine are considered by many observers to be the main culprits. The Council on Foreign Relations, *op. cit.*, argues, "If one wants to see what happens when moral hazard effects become large, one need look no further than recent private capital flows to Russia and the Ukraine - widely known on Wall Street as 'the moral hazard play'. Here, despite serious underlying weaknesses in the economic fundamentals, investors were prepared to purchase large amounts of high-yielding government securities - presumably in large part under the expectation that if conditions worsened, geopolitical and security concerns would prompt G-7 governments and the IMF to bail them out. In the first half of 1998, Russia placed four issues of eurobonds that doubled the outstanding stock."

² Not surprisingly, these funds were raised by adding an additional tranche with a face value of DM 531 million to an - American-style - DM bond issued initially in 1998, maturing in 2001.

³ According to the Bank for International Settlements, *op. cit.*, this may partly be due to special factors, reversing the preceding rise in anticipation of an eventual default. Several governments (Mexico, Brazil and the Philippines) used the low prices before October to buy back or swap Brady obligations in order to reduce interest payments or free up collateral. These transactions pushed Brady bond prices up, which have a heavy weight in the EMBI.

⁴ There has been controversy whether collective action clauses would, in principle, be allowed for foreign sovereign bond issues under German law. Recently, the federal ministry of finance issued a statement that the general principle of freedom of contract applies equally to private and sovereign foreign bonds.

view. The real question, however, is whether spreads of different types of bonds diverge. The empirical evidence is rather mixed up to now. Some studies find no systematic effect. In a recent study, however, Eichengreen and Mody¹⁷ claim to find significant differences between the two types when the credit rating of issuers is taken into account. They compare launch spreads of bonds issued under British and American law in emerging markets between 1991 and 1998. For creditworthy issuers, British-style bonds seem to reduce the cost of borrowing. With high reputation, strategic default may be of no concern, and so benefits from an orderly restructuring process dominate. In contrast, less creditworthy issuers appear to pay higher spreads. For those bonds, strategic default effect seems to be the decisive factor.

These findings qualify the argument that collective action clauses would not be introduced voluntarily – as argued in Eichengreen¹⁸ or by the Council on Foreign Relations.¹⁹ 1160 bonds were subject to UK law, and only 840 to US law. One might conclude that markets take into account reputation for strategic default when pricing bonds and so cope efficiently with the first two types of moral hazard by a self-selection of issuers. Most market participants, however, concede that default on sovereign debt has not been a serious concern until recently. Evidently, they have hardly been aware of the difference between legal structures.²⁰ Certainly, this was the case for some official representatives calling for mandatory clauses.²¹

So the results of Eichengreen and Mody have to be treated with caution. If there was a significant difference in spreads in the past, it is hard to see why less creditworthy issuers should have issued British-style bonds in the first place. It seems more likely that the law under which bonds have been issued in the

past is history-dependent rather than the result of deliberate choice. Bonds of commonwealth countries are more likely to be UK based. It may be no coincidence that Asian borrowers tended to issue more frequently under British law than borrowers from other regions. Obviously, more evidence is needed. In particular, it would be worthwhile to compare spreads of bonds issued by the same country under different laws.

In any case, the results in Eichengreen and Mody leave no doubt that mandatory collective action clauses will indeed raise borrowing costs for issuers with low reputations in the future. As was shown above, introducing such mandatory clauses would increase efficiency. It would help to correct the third moral hazard problem – the bias towards bond financing. It will not be easy, however, to implement such a change. Evidently, there is a conflict between two principles: the honouring of existing bond contracts and the comparability of treatment.

The first principle suggests that only new bonds issued from now on should be subject to these changes. Such a process would, however, take a very long time, so it offers no solution for the current problems of countries in distress. The present IMF policy is trying both to honour existing contracts and at the same time to enforce bailing in on a voluntary, market-based approach. This way, only bonds issued under British law have a realistic chance of being bailed in right now (as is the case for Pakistan). But bailing out American-style bonds obviously contradicts the second principle. Such a policy would violate equal treatment of bondholders if the type of bond has been history-dependent in the past. It would even contradict the whole idea of bailing in, if this type of bond has been chosen on purpose to make restructuring costly.

The only way to honour both principles is a default on American style bonds, as in the case of Ecuador. Such an outcome might be avoided by raising the implicit costs of litigation against those sovereign countries who try to restructure under IMF support. Incentives to litigate may be reduced when there is enough evidence for a lack of international support for enforcing such legal claims. Of course, a crucial condition for broad acceptance of these measures is that the principle of comparability of treatment will be applied to all creditors – both public and private. Neither bilateral or multilateral official creditors, nor vulture funds should be treated better than bank loans, dispersed bondholders and institutional investors.

¹⁷ Barry Eichengreen and Ashoka Mody: Would Collective Action Clauses raise Borrowing Costs?, NBER Working Paper No. 7458, 2000.

¹⁸ Barry Eichengreen, *op. cit.*

¹⁹ Council on Foreign Relations, *op. cit.* In their study, they argue: "The difficulty is that if only emerging-market bonds include these clauses, it might be taken by the markets as a signal of their need to restructure; they will therefore not do it alone. No signal would be forthcoming if the bonds of the most creditworthy borrowers also included such clauses."

²⁰ IMF: The International Capital Markets Report, *op. cit.*, p.89.

²¹ Stanley Fischer, *op. cit.*, states, "It was only subsequently that many discovered that such bonds already exist, in the form of British-style Trust-deed bonds."