BANKRUPT STATES

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How should the international community respond to sovereign defaults? This question has long troubled policymakers and writers. Current world economic conditions have subjected public finances to severe pressures and are likely to return the non-payment of public debt to the forefront of public policy. A convincing answer is far from obvious, and legal machinery to deal with unsustainable public debt has yet to emerge. This paper aims to enhance our understanding of how international and national law can help countries deal with serious financial difficulties.

The term sovereign default refers to non-payment of a country's financial obligations when due. Factually, sovereign defaults are a frequent empirical phenomenon. Since 1945, more than a hundred countries have defaulted on their external debt, on average almost two countries a year. Intuition suggests that a sovereign default does not necessarily coincide with sovereign bankruptcy – the inability of the state to pay debts as they fall due. This paper aims to clarify the distinction between sovereign default and sovereign bankruptcy, and to shed light on the question when a state may be considered to be bankrupt.[1] I will show why such an assessment is useful, though always probabilistic.

The orthodox view, prevalent among economists and financiers, is that countries never become bankrupt.[2] The usual argument goes like this. Countries are always able to pay back debt. If countries default, this is due to a lack of liquidity, rather than a lack of solvency. Over time, the government's taxation power puts the country in a position to meet all its financial obligations, no matter how large. The borrowing and default history of countries over the last several centuries speaks a different language, and challenges this orthodoxy. This article demonstrates why the orthodox position is flawed, on theoretical and practical grounds.

This paper conceptualizes the notion of sovereign bankruptcy by drawing on established principles of domestic bankruptcy law.[3] At present, neither international nor domestic law

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[1] Some writers lump sovereign defaults and state bankruptcy together, e.g. EDWIN BORCHARD AND WILLIAM WYNNE, STATE INSOLVENCY AND FOREIGN BONDHOLDERS (1951) and PHILIP R. WOOD, PROJECT FINANCE, SUBORDINATED DEBT AND STATE LOANS (1995). For analytical reasons, it is preferable to separate the two concepts.

[2] Cf. the famous remark by Walter Wriston, chairman of Citibank, one month after Mexico suspended payments on its external debts, an event that led to the widespread Latin American debt crisis in the 1980s, KARIN LISSAKERS, BANKS, BORROWERS AND THE ESTABLISHMENT. A REVISIONIST ACCOUNT OF THE INTERNATIONAL DEBT CRISIS (1991), 182.

[3] Early 20th century legal scholarship already drew attention to this similarity, largely forgotten since then. HERSCH LAUTERPACHT, PRIVATE LAW SOURCES AND ANALOGIES OF INTERNATIONAL LAW (1927), 151; JOHN FISCHER WILLIAMS, INTERNATIONAL LAW AND INTERNATIONAL FINANCIAL OBLIGATIONS ARISING FROM CONTRACT (1924), 52.

contains a bankruptcy mechanism for countries. Countries restructure their debts through *ad-hoc*, voluntary negotiations with creditors. But the differences between states, corporations and individuals in financial distress do not run as deep as is commonly supposed. Based on their factual similarities, courts have analogized sovereign to corporate or consumer bankruptcy. I argue that there are no inherent difficulties in applying general principles of bankruptcy law to countries.

Countries, like corporations or individuals, do in fact go bankrupt. The recent defaults of Argentina and Iceland are excellent empirical tests for the proposition that sovereign bankruptcy is more than just a colorful metaphor. At the height of the crisis and prior to its debt restructuring in 2005, Argentina's external public debt topped 160% of GDP. In the case of Iceland, an exceptionally deep banking crisis left the country in dire financial straits. Its banks had borrowed more than nine times of Iceland's GDP in foreign currency.

I. A SHORT HISTORY OF SOVEREIGN DEBT

Sovereign defaults have been a perennial feature of sovereign lending.[4] Their causes vary. The high frequency of sovereign defaults is particularly striking set against the small number of states before 1945. Sovereign defaults often cluster in time, due to economic linkages among countries and the dependence on world economic conditions, such as commodity prices and interest rates. A second reason is that major conflicts and their large financing needs often produce public financial turmoil. Sovereign defaults within a decade of major conflicts are common. A good early example is Rome after the First Punic War. Faced with high war debts, the Roman Republic debased its currency by 5/6 and thereby liberated itself of a heavy debt burden.

Before the 18th century, the prevailing view was that the monarch, rather than the country, owed the debt. The debt was the ruler's personal obligation. As a result, the majority view maintained that the debt simply ceases to exist when an indebted monarch passed away. According to a minority view, the debt survived, but was automatically repudiated on the ruler's death.[5] Even though nominally it was the monarch's debt, citizens in effect repaid the debt for the monarch, often through forced loans and taxes. The subjects often had no choice but to hand over their savings to enable the repayment of the monarch's debts.

[4] ADAM SMITH, THE WEALTH OF NATIONS (1776), 563 ("Almost all states, however, ancient, as well as modern, when reduced to this necessity, have, upon some occasion, played this very juggling trick [of an undeclared national bankruptcy]); Borchard, *supra* note 1; MAX WINKLER, FOREIGN BONDS, AN AUTOPSY : A STUDY OF DEFAULTS AND REPUDIATIONS OF GOVERNMENT OBLIGATIONS (1933); Kenneth Rogoff and Carmen Reinhart, *This Time is Different: A Panoramic View of Eight Centuries of Financial Crises*, unpublished manuscript, Harvard University (2008, on file with author).
[5] Montesquieu, Mélanges inédits, II, 239 (questioning the king why he had not repudiated all debts contracted by Louis XIV).

Some countries are serial defaulters.[6] Spain defaulted fourteen times between 1557 and 1696. Between 1599 and 1788, France defaulted on its debt eleven times. The latest default in 1788 was one of the central triggers of the French revolution. In the early modern period, sovereign defaults by monarchs became so frequent that they became institutionalized. Debt maturity never exceeded forty years, the expected lifespan of the monarch and interest rates almost invariably reached double digits.

In the 1820s, sovereign bonds issuances by Latin American countries surged.[7] After just two years, a wave of sovereign default rattled financial markets, and over ninety percent of these Latin American bonds were in default. It took more than four decades to clean up the Latin American defaults in settlements. In North America, the picture was similar. Over the period 1837-43, half of all US state debt was in default, and 10 percent was repudiated outright.[8] Two further default waves in 1857 and 1870 further cemented the European view that US states were untrustworthy debtors.

From the 1870s onwards, a default wave gripped industrializing countries as the world economy became more integrated than ever before. Nicolas Politis called the second half of the 19th century "the period of financial debacle of government."[9] In the 20th century, the picture is similar. When the Soviets came to power in 1917, they repudiated Tsarist debt.[10] During World War I itself, sovereign defaults were comparatively uncommon. The one crucial exception was that many countries suspended interest payments and principal amortization to enemy nationals for the duration of the war.

In the Great Depression, all European countries with the exception of Finland defaulted on loans advanced by the United States to aid their war effort. Many debtor governments pleaded their inability to pay the full face value of their debts due to the devastating effects of the worldwide economic depression. The allies' capacity to repay the United States depended on receiving German war reparations, which were not forthcoming as promised. The financial quagmire illustrates the vicious circle of borrowing and inability to pay that sometimes befalls intergovernmental fiscal relations.

[6] Kenneth Rogoff and Carmen Reinhart, *Serial Default and the "Paradox" of Rich to Poor Capital Flows*, American Economic Review Papers and Proceedings, 53-58 (2004).
[7] The best overview of this episode is FRANK G. DAWSON, THE FIRST LATIN AMERICAN DEBT CRISIS: THE CITY OF LONDON AND THE 1822-25 LOAN BUBBLE (1990).
[8] REGINALD CHARLES MCGRANE, FOREIGN BONDHOLDERS AND AMERICAN STATE DEBTS (1933) has an in-depth account of US state defaults; William B. English, *When America Defaulted: American State Debt in the 1840's*, unpublished manuscript, University of Pennsylvania (1991, on file with author).
[9] NICOLAS POLITIS, LES EMPRUNTS D'ETAT EN DROIT INTERNATIONAL (1894), 1.
[10] In the Soviet Union's zone of influence repudiations were common.

Countries in other parts of the world joined the list of defaulters. Most Latin American countries defaulted on their external debt. In Australia, New South Wales imposed a moratorium and reduced foreign claims by legislation. The United States de facto defaulted de facto by abrogating gold clauses, mirroring a widespread movement to abolish gold clauses – a commitment device to maintain a stable unit of account during the Great Depression. A constitutional challenge to this abrogation failed in large part.[11] Countries thereby effectively changed the unit of account and the unit of payment of international debt, depriving creditors of a part of their promised consideration.[12]

The immediate post World War II period stands out for an unusually high degree of international cooperation to deal with the debt overhang left by the two world wars and the interwar period. Among the major achievements figure the British-American Financial Agreement of 1946 and the London Conference on German External Debt of 1953, a substantial simplification and curtailment of Germany's financial obligations. Countries took the lessons from the failure of the war reparations regime under the Versailles Treaty. The terms of the German Debt Agreement were highly concessionary – Germany received much debt relief. The Agreement marked a watershed in international finance for its emphasis on how much Germany could pay, in contrast to how she was legally obliged to pay.[13]

Since 1945, more than a hundred countries have defaulted on their debt.[14] Latin America experienced another wave of sovereign debt defaults in the 1980s. East Asia had a deep financial crisis in the 1990s.[15] In 1998, Russia was the first nuclear power to openly default. Argentina, the first major sovereign default in the 21st century, was thus only one chapter in the long history of sovereign overindebtedness. The last two decades were unusual in that sovereign bankruptcy was a phenomenon confined to the periphery of the world economy.

When is a country bankrupt? The next section provides economic priors on sovereign bankruptcy. I argue that countries have, in fact, limited payment capacity. There is a limit to how much debt any given country is able to repay at a given point in time.

[11] *Perry v. United States,* 294 U.S. 330 (1935) (abrogation of gold clauses invalid for federal debt, but valid for private, municipal and state obligations).
[12] ARTHUR NUSSBAUM, MONEY IN THE LAW (1950, 2nd edition), 280-283, has a list of countries that abrogated gold clauses. Germany converted foreign currency liabilities into Deutschmark in the 1930s.
[13] GEORGES DELAUME, LEGAL ASPECTS OF INTERNATIONAL LENDING AND ECONOMIC DEVELOPMENT FINANCING (1967), 53.
[14] Rogoff and Reinhart, *supra* note 6.
[15] PAUL BLUSTEIN, THE CHASTENING : INSIDE THE CRISIS THAT ROCKED THE GLOBAL FINANCIAL SYSTEM AND HUMBLED THE IMF (2001) paints a riveting account of the politics behind the IMF's attempt to rescue East Asia from the financial abyss.

II. CONCEPTUALIZING SOVEREIGN BANKRUPTCY

The notion of sovereign bankruptcy eludes easy characterization. There is no definition in treaty law, or indeed in domestic laws, to provide guidance. The absence of a definition is perhaps understandable as no legal consequences flow from a determination that a country is bankrupt. Moreover, no independent decision-maker has explicit competence to render such a verdict. Still, it is puzzling that economists and other social scientists have not developed an analytical definition of the term.

At the outset, sovereign defaults need to be distinguished from state bankruptcy – the *inability* of the state to pay debts as they fall due. They two are distinct, even if a sovereign default often goes hand in hand with a sovereign bankruptcy. Sovereign bankruptcy also differs from the repudiation of sovereign debt. Repudiations occur when a country that is able to pay its debts refuses to meet its pecuniary obligations.

Sovereign debt instruments typically define specific events of defaults. A prescribed percentage of creditors, typically 25% are given the power to collectively decide whether to treat the situation as a formal default and to accelerate the debt instrument. As a result, the contract's acceleration provisions come into effect. The debt becomes immediately due and payable, even for debt instruments with long maturities. Typically, acceleration also triggers cross-defaults clauses in other debt instruments. The result is that most or all of the sovereign's external indebtedness becomes due immediately.

From this discussion, it is already evident that a sovereign default, as defined by any standard debt instrument, is an insufficient condition for a sovereign bankruptcy. Several reasons could explain a default under the debt instrument. First, such a default could be the result of a purely administrative error, such as a delay in transferring a monthly interest payment. Second, the sovereign could have decided to repudiate or contest the validity of some of its debt obligations. Third, the state may lack the willingness to pay and defaults opportunistically. Finally, it may be that the default was caused by the state's inability pay, a notion to which I now turn.

A. SOVEREIGN BANKRUPTCY CAPACITY

After World I, two leading economists shared the belief that many European states would be unable to repay their debts.

John Maynard Keynes equated Europe's dire state of financial affairs to sovereign bankruptcy. He wrote: "Europe was in complete dependency on the food supplies of the United States; and financially she was even more absolutely at their mercy. Europe not only already owed the

United States more than she could pay; but only a large measure of further assistance could save her from starvation and bankruptcy."[16]

Edwin Seligman, a leading exponent of the historical and institutional approach to public finance, was equally forceful about the missing creditworthiness of the continent ruined by the war: "The truth is that our [European] debtors are bankrupt. They cannot pay now, and will not be able to pay in any assignable time. I have found no prominent business man or banker here or abroad who believes that there is any possibility of paying the debts. You cannot extract water from stone."[17]

My argument in this section is that states can, and in fact, do, become bankrupt. States are the ultimate bearers of risk. They often take over liabilities contracted by the private sector. The recent defaults by Argentina and Iceland provide excellent empirical tests for the proposition that sovereign bankruptcy is more than just a colorful metaphor. After its crisis in 2001, Argentina's external public debt topped 160% of GDP. In the case of Iceland, an exceptionally deep banking crisis left the country in dire financial straits at the end of 2008. Icelandic public debt went from less than 5% to more than 120% in the space of a few months.

The mainstream view in modern macroeconomics is that a country's capacity to pay is unlimited, at least for all practical purposes. This view runs like is a thread through the large modern economics literature on sovereign debt.[18] According to this burgeoning literature, sovereign bankruptcy is merely a theoretical possibility, with very few if any actual cases in the history of sovereign finance to match. The assumption is that countries never lack the ability to pay back their debts. To speak of a bankrupt state is said to be a red herring and at best a metaphor for a complex phenomenon. Countries do not go bankrupt. If states default, this is because they are unwilling to pay.

Adam Smith already noted, however, that sovereign debt beyond a certain threshold inevitably leads to national bankruptcy: "When national debts have once been accumulated by a certain degree, there is scare, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy: sometimes by an avowed one, though frequently by a pretended

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[16] JOHN MAYNARD KEYNES, THE ECONOMIC CONSEQUENCES OF THE PEACE (1919), 84 (appalled by the vindictive reparation payments exacted from Germany, Keynes expressed his grave concerns about the Versailles Peace Treaty).
[17] Edwin Seligman, *Is Allied Debt a Just Debt? Dr. Seligman Answers Hoover, Recent Speech Analyzed*, New York Times 5 November. 1922, published in Edwin R. A. Seligman, The Allied debts (1922). With a bankrupt Germany this would be impossible: "There is no surplus of social income, and is not apt to be for a long time."
[18] Jonathan Eaton and Racquel Fernandez, Sovereign Debt, in HANDBOOK OF INTERNATIONAL ECONOMICS (Gene Grossman and Kenneth Rogoff, eds., 1995) provide a comprehensive survey of this literature.

payment."[19] Before showing why Smith was right, I set out the main arguments for the view that states incapable to go bankrupt. I address methods of defining the threshold in the next section.

Four principal arguments are often cited in defense of the orthodox proposition that countries lack the capacity to become bankrupt.

First, under the assumption that states exist forever, the net present value of their power to tax is infinite. Put differently, over their lifespan, states benefit from an inexhaustible source of revenue. With their coercive power to tax, countries will be able to pay back their debt, no matter how large, given a suitably long period of time. Accordingly, sovereign financial distress of countries cannot be permanent. Moreover, economic growth, technological improvements and the discovery of natural resources will tend to increase the size of the country's productive, taxable assets over time.

Second, states, under eminent domain or another constitutional basis, retain the power to confiscate substantially all assets of their citizens. Financial markets are said to enforce a hard budget constraint ensuring that governments cannot borrow indefinitely. Governmental borrowing merely changes the country's intertemporal consumption path: it borrows to consume more now; by implication, the country as a whole must reduce its future consumption by the aggregate borrowing plus debt service costs. In models of this kind, no allowance is made for a possible sovereign default and partial or full non-payment of debt.

Third, modern governments are said to have plenty of scope to cut back their expenditures to achieve sufficient primary surpluses – the budgetary surplus before servicing their debt to reduce or at least stabilize their debt stock. With a moderate rate of economic growth and spending restraint, it is thus assumed that most government will be able to grow out their debt. Francois Gianviti, the IMF's General Counsel in the 1990s, belongs to that classical school when he maintains that a lack of foreign currency is simply that: "a shortage of liquid means of payment which can be remedied by appropriate policies."[20]

Fourth, as monetary sovereigns, countries are said to enjoy control over the money supply. As such, they should be able to simply inflate their debt away through an expansion of the monetary base – the amount of money circulating in the economy. The traditional view thus holds that a state's inability to pay relates to foreign currency obligations only. As a result of complete control over its own currency, a state can never be bankrupt by reasons of liabilities denominated in such currency.

[19] Smith, *supra* note 4, 563.
[20] Francois Gianviti, *The International Monetary Fund and External Debt*, 215 Recueil des Cours 205-286 (1989), 241.

When the central bank increases the amount of money beyond the rate of economic growth (a rough proxy for demand for money), the typical result is inflation, easing the country's debt burden in real terms. While there may be constitutional limitations or limitations in central bank statutes to guard against a strategy of deliberately inflating away debt[21], the historical experience suggests that countries monetize debts once their fiscal problems are sufficiently deep. It would be imprudent to put too much faith in institutions such as central bank independence to prevent a repetition of inflationary policies.

Thus, for the four reasons outlined above, sovereign bankruptcy is said to remain a theoretical possibility, at least as long as the total assets owned by the country's citizens, the country's own assets and the country's future income stream exceed the country's liabilities, including debt servicing cost.[22]

Let us now contrast these four arguments in support of the orthodox view to the actual experience with sovereign defaults over the last decades.

First, the argument that taxation is an unlimited source of revenue does not withstand closer scrutiny. Even if the government manages to suppress any existing legal limits on tax – in ordinary or constitutional law – there are economic limits to the amount of revenue a given tax yields. As the marginal tax rates increase, tax yield declines at some point.[23] This is in part because some taxpayers will move to other jurisdictions and in part because the propensity to evade taxes increases in the marginal tax rate. Even assuming a stable tax base and constant propensity for tax evasion, the relevant time horizon for repayment of the debt is finite.

There is also a political constraint. Governments will often encounter strong opposition when they propose sudden, substantial hikes in taxes. In addition, they cannot repay unsustainable debt burdens without some regard to their ability to provide essential public services. In exchange for paying taxes, taxpayers expect to receive public services. Taxpayers are likely to revolt if too large a share of current tax revenue, rather than being devoted to public service provision in their lifetime (or in the lifetime of their offspring), is devoted to the repayment of debt.

Second, the confiscation of assets is a policy tool of limited effectiveness. A large-scale confiscation of assets owned by households or corporations would rarely be regarded as just.

[21] E.g. Protocol on the Statute of the European System of Central Banks and of the ECB, Official Journal C 191, 29.7.1992, 68 (Article 2 "…the primary objective of the ESCB shall be to maintain price stability").

[22] This leaves aside one important qualification: Citizens, especially those with many assets, may choose to emigrate rather than pay punitive taxes. One would need to take citizen's propensity to emigrate with respect to higher taxes into account.

[23] The so-called Laffer curve, the inverted u-shaped relationship between the tax rate and tax yield. There exists a tax rate t* which maximes tax revenue – beyond that higher taxes result in lower revenue for the government.

Moreover, it will often be problematic under constitutional and international law. Such takings would typically trigger an obligation to compensate, which risks undoing the original aim of augmenting the public resources. An exception is asset recovery in cases where individuals or corporations committed fraud or other economic crimes. In general then asset confiscation thus does not seem to be a viable strategy.

Third, states need to provide essential public services even in financial distress. There is hence a limit as to how far governmental expenditure may be cut, for two primary reasons. First, reducing government expenditure – one component of GDP – can feed a vicious circle. Expenditure cuts further depress the level of economic activity in the wider economy, lowering tax revenues and so forth. Second, to enable the government to continue carrying out its core tasks, an absolute limit to the enforcement of creditor claims is essential.[24]

Undoubtedly, any debt incurred today implies that the population's real income needs to be lower in the future while the debt is being repaid than it would otherwise be. Creditors may rightly expect that the debtor will accept sacrifices and substantially cut public services to pay interest and principal. During periods of economic growth, the fruits of rising prosperity may be enough to repay creditors. When a country is an economic crisis, however, a reduction in the population's living standards is inevitable. And the larger the debt burden, the larger the necessary decline in the population's real income.

There are limits to this proposition however. The amount a country is able to transfer abroad each year is limited. It would be nonsensical to maintain that as long as yearly debt service does not exceed the country's annual GDP, the country is solvent. No government could transfer all of the country's current income abroad to satisfy creditor claims (the so-called transfer problem). The great difficulty is for the country to reach an agreement with an often large and diffuse array of creditors in the absence of a formal restructuring framework that incentivizes the parties to reach agreement. The central question is how much of the burden the country should bear relative to creditors. The need to share the pain is reminiscent of corporate and consumer bankruptcy. Iceland offers a striking example of the long delays that result from the parties' inability to agree to a formula for burden-sharing.

Fourth, debt monetization is rarely a workable strategy. Theoretically, countries with debt denominated exclusively or largely in domestic currency could inflate their way out of high indebtedness. There are precedents for such an approach, especially to deal with huge debt burdens to finance major wars. A good example is Germany in the 1920s. A strategy of deliberate

[24] Up to the 1960s, sovereign immunity was an absolute and highly effective bar.

inflation can be a sovereign bankruptcy in disguise.[25] That said, international financial markets often accept reductions in creditor claims via inflation more readily than "open and avowed" sovereign defaults. These reductions in the value of claims seem to be regarded as a fact of life. In contrast, financial markets take a much more skeptical view of any debt restructuring measures that call upon creditors to reduce their claims or impose a reduction in their claims.

Similar to economic and political limits on taxation, there are also practical limits to the monetization of debts. High inflation often inflicts a terrible price on the real and financial economy, and may rapidly become uncontrollable. Inflation redistributes wealth in major, arbitrary and unpredictable ways, the most important direction of redistribution being from creditors to debtors.[26] In light of the disastrous economic effects of high inflation, in recent years a number of states chose to defaulted on domestic currency obligations, rather than inflating such debt away. This group includes countries as diverse as Turkey in the 1970s, Nigeria in the 1980s and Russia in the 1990s.

Moreover, for a growing number of countries recourse to inflation as a means of coping with high levels of sovereign debt is impossible. Countries that have dollarized their economies, such as Ecuador, or member countries of European Monetary Union, are no longer even in a theoretical position to inflate their debt away. Bankruptcy through monetizing debt is excluded for this growing group of countries. If a country does not possess an autonomous monetary policy and its own currency, inflation as a means of coping with high debt is no option.

Even more importantly, the common assumption that countries have supreme authority over their debt is incorrect. However, for all but a handful of states, factually, such control does not in fact exist. It is crucial to keep in mind that the monetization of debt works only for debt denominated in domestic currency. For the vast majority of sovereign borrowers, all or a significant part of their debt is denominated in foreign currency. The economics literature has labeled this structural feature of sovereign borrowing original sin. Original sin refers to the country's inability to borrow in domestic currency. This inability is widely believed to be one of the central causes of sovereign debt crises.[27]. Their choice is often between borrowing in foreign currency and not borrowing at all.

III. A FRESH START FOR NATIONS

[25] Cf. GERALD D. FELDMAN, THE GREAT DISORDER: POLITICS, ECONOMICS, AND SOCIETY IN THE GERMAN INFLATION, 1914-1924 (1993).
[26] Smith, *supra* note 19, 563: Sovereign bankruptcy "occasions a general and most pernicious subversion of the fortuntes of private people; enriching, in most cases, the idle and profuse debtor at the expense of the industrious and frugal creditor.)"
[27] E.g. Olivier Jeanne, "O*riginal sin", balance sheet crises, and the roles of international lending*, IMF working paper WP/02/234 (2002).

In contrast to corporate or consumer bankruptcies under domestic law, the answer is less straightforward. Countries cannot file for bankruptcy. There is no formal, comprehensive machinery for enabling countries to restructure their sovereign debt and emerge from that process with a sustainable balance sheet. In current international and national law, the process is fragmented. The outcome depends to a large extent on ad hoc negotiations between the country and its creditors, the scope and terms of IMF involvement and the positions assumed by major creditor governments. In the following I explain why the current state of affairs suffers from a number of shortcomings.

A. A WORLD WITHOUT (FORMAL) BANKRUPTCY

Various fragmented rules in national and international law affect the relationship between creditor and sovereign debtor. Countries restructure their debt obligations in ad-hoc ways, using debt restructuring techniques similar to those employed by private companies. Current attempts to restructure sovereign debt are often characterized by protracted negotiations without the beneficial shadow of bankruptcy law to shape and constrain the bargaining positions of the parties. The outcome is sometimes neither in the best interest of the debtor nor the creditor. Sustainable economic recovery is unnecessarily postponed. The people suffer greater cuts in public services than otherwise necessary. Creditors are discriminated against. And the fate of debtor countries hinges on political considerations.

A frequent method is a bond exchange, where the debtor country offers creditors new bonds in exchange for old debt instruments, with a different maturity profile or a net reduction in the value of their claims. The government hires financial and legal advisors who prepare an offer to creditors to exchange the old for new debt instruments, with different payment terms. The aim is to convince enough creditors to give up their old obligations voluntarily, and thereby reduce the country's overall debt burden.

Generally, sovereign debt restructurings do not render debt obligations worthless. In some cases, restructurings merely change the time profile of repayments (lengthening of maturities).[28] Still, they often go together with a considerable loss in principal. This is the so-called haircut.[29] The size of haircuts varies, but typically ranges from 0% to 70%. In its 2005 restructuring, Argentina imposed a haircut of about 65% on its creditors.

[28] Sturzenegger and Zettelmeyer, *supra* note 4, 3, define restructurings as "changes in the originally envisaged debt service payments".

[29] This term of art refers to realized investor losses in sovereign debt restructurings. See Federico Sturzenegger & Jeromin Zettelmeyer, *Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings, 1998-2005*, IMF Working Paper No. 05/137 (Washington: International Monetary Fund) (2005).

In conventional sovereign debt management, it is deemed sufficient if the debtor government obtains the consent to exchange debt securities of 90% of creditors or more.[30] Creditors who chose to remain outside of the debt exchange are often left with the defaulted debt instruments whose value has collapsed. While such creditors – often called holdouts – do at times succeed in obtaining judgments against the recalcitrant sovereign debtor, their attempts to enforce their judgments are in many cases in vain.

With consensual, purely contract-based sovereign debt restructurings, outcomes often depend on political and foreign policy considerations. Responses to sovereign defaults and bankruptcies are very much ad hoc. This creates uncertainty in the sovereign debt market and may lead to unequal treatment across creditor groups and even more importantly, across countries. A country that is a close ally of several major creditor nations has much better chances of achieving a favorable restructuring than a country that has few friends.[31]

B. AN ANALOGY TO DOMESTIC BANKRUPTCY LAW

Over the past decades, bankruptcy laws diffused across countries and became a virtually universal institution. Bankruptcy laws today put more emphasis on forgiveness and less on punishment. There are bankruptcy laws for corporations, for consumers and for subnational entities – with one important exception: countries. When a country defaults, there is little predictability for creditors and the debtor alike.

Bankruptcy law is an essential feature of a functioning market economy on the national scale. By the same token, past and recent experience suggests that international financial markets are in many cases unable to handle country-level financial distress in an efficient and reasonable manner without a sound legal framework. The numerous coordination problems and lawsuits that have characterized the resolution of Argentina's and Iceland's financial crises underscore the need for a more structured mechanism to deal with unsustainable levels of debt.

Is domestic bankruptcy law a suitable object for analogy? Given the peculiarities of the international legal order, solutions developed in *foro domestico* cannot be transposed one-for-one to States. In similar fact situations analogies to municipal law may nonetheless validly be drawn. Judges, in applying such analogies, perform in part a law-creating function in the international legal order.

[30] In Argentina's bond restructuring, participation was unusually law (77%).
[31] Such unequal outcomes in terms of debt relief are apparent, for instance, when comparing Iraq's highly concessionary debt restructuring in 2006 and Zimbabwe's inability to restructure its debts.

A country's incapacity to pay gives rise to an irreducible tension with the legal obligation to pay. This conflict between the legal obligation to pay on the one hand and limited payment capacity on the other hand is permanent, absent voluntary agreement between debtor and all creditors. In a world without formal sovereign bankruptcy mechanism, the only escape route is an agreement between the country and every single creditor. Contrast this with bankruptcy law, where supersedes the old payment obligation. It cures the payment default by a new legal act.

The institution of bankruptcy has a number of policy rationales. Bankruptcy law disciplines debtors and creditors, structures negotiations and encourages collective action, between the debtor and creditors and among creditors inter se. Moreover, bankruptcy helps restore fiscal sustainability to guarantee delivery of public goods; serves creditors as group by maximizing the amount available for repayment and strengthens creditor rights underpinning international lending. The resulting clarity on remedies available to creditors in a sovereign default will tend to improve sovereign creditworthiness. As creditor remedies increase, the costs of borrowing for responsible sovereign borrowers could fall.

Support for a fresh start is also found in international treaty-making. The Dawes Plan of 1924 is a good example. In the early renegotiations of German World War I reparations, the attitude of complete payment prevailed among the Allies. The Dawes Plan, however, endorsed the principle that the "total of Germany's annual payments must depend upon her capacity to make the payments without the disintegration of her economic and financial system."[32] Under the Dawes Plan, an independent international authority, the Transfer Committee, was charged with ensuring that any transfers abroad did not endanger Germany's financial stability.[33] The Committee, in other words, ensured that payments were in line with German capacity to pay.

Few countries enjoy the privilege of borrowing only in domestic currency. Many are less fortunate, especially in the developing world. The global financial crisis has already had a severe impact on governmental balance sheets. Thus far, total fiscal support by governments worldwide exceeds 8 trillion €. The economic dislocations of the late 19th century and early 20th century produced a rich literature on sovereign bankruptcy. That literature remains highly relevant as the ghosts of sovereign bankruptcy return to the developed world.

[32] HARALD MOULTON, GERMANY'S CAPACITY TO PAY (1923), 342.
[33] REPARATIONS COMMISSION, THE EXPERT'S PLAN FOR REPARATION PAYMENTS (1926), 19 and 31; Fischer Williams, 342; Borchard, *supra* note 1, 131, n. 21; LUDWIG KASTL AND ROBERT LIEFMANN, DAS TRANSFER-PROBLEM (1926), 9ff.