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DOMESTIC AND EXTERNAL DEBT: THE DOOMED QUEST FOR EQUAL TREATMENT

ANNA GELPERN & BRAD SETSER*

I. INTRODUCTION

"Equality" has the ring of a basic value, an incontrovertible virtue. In international finance, equal treatment is enshrined in treaties and contracts.[1] Of all the equal treatment aspirations in finance, none seems more essential to a lawyer than equal treatment of creditors holding identical legal instruments: if one is to suffer a default, surely so should the others; restructuring options available to one must be open to all without regard to the creditor's identity.[2] Yet in the world of sovereign debt, local and foreign investors buying the same paper rarely achieve what anyone would recognize as equal treatment.

Until recently, governments borrowed from domestic residents and foreign investors using very different instruments. Residents bought "domestic debt"—paper denominated in local currency and governed by domestic law. Foreign investors preferred "external debt," which offered foreign currency and foreign law.

Because there was virtually no overlap between resident and nonresident holdings, it mattered little that lawyers and economists defined domestic and external debt differently: lawyers focused on features such as governing law and jurisdiction, economists on the holder's residence and currency of denomination. The legal and economic definitions of domestic and external debt were effectively bundled: "domestic debt" meant local-currency, local-law instruments held by local residents; "external debt" meant foreign-currency, foreign-law

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1. National Treatment/Most Favored Nation provisions in bilateral investment treaties and *pari passu* clauses in debt contracts are among the examples. *See, e.g.*, Bureau of Economic and Business Affairs, U.S. Department of State, *U.S. Bilateral Investment Treaty Program* (July 1, 2003), *available at* http://www.state.gov/e/eb/rls/fs/22422.htm; Lee C. Buchheit & Jeremiah Pam, *The* Pari Passu *Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869 (2004).

2. For example, under U.S. bankruptcy law, claims must be classified according to their legal character, not the identity of the holder. *See* 7 COLLIER ON BANKRUPTCY ¶ 1122.03[3] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004).

instruments held by foreign investors. In the end, lawyers and economists spoke of the same instruments.

This has changed since governments have loosened restrictions on international capital flows. In liberalized, global capital markets, foreigners now routinely invest in local-currency, domestic-law debt, and residents often dominate international sovereign bond issues.[3] With these changes, the legal and economic definitions of domestic and external debt have unbundled. Today, a lawyer's domestic bond—one that is governed by local law—may well look like external debt to an economist, because it is denominated in foreign currency and/or held by an offshore fund. Even more common, a lawyer's external bond —one that is governed by foreign law—looks like domestic debt to an economist, because it is held by a bank or other local financial institution.

This change in the pattern of sovereign borrowing demands a new way of framing the core issues that arise in a financial crisis. Most existing approaches focus disproportionately on one set of legal instruments: foreign-currency sovereign bonds governed by foreign law.[4] Our essay suggests that this focus is misplaced. It is the product of an analytic prism that no longer reflects reality well enough to offer a useful guide to crisis management. Expanding the inquiry beyond foreign-law bonds reveals debt structures whose composition and legal characteristics can change quickly under stress, largely at the discretion of the sovereign debtors. Sovereigns appear to have ample space to treat different creditor groups differently based on who they are, rather than the legal instruments that had defined the debtor-creditor relationship in good times. We argue that despite important concerns about inter-creditor equity, the ability to treat domestic and foreign creditors differently is a necessary policy option for governments in financial crisis. Recognizing this fact and the range of debt management tools available to governments in crisis should also help creditors evaluate

3. The case studies in this Essay illustrate the broader phenomenon: foreign investors were significant holders of Russia's domestic treasury bills, and local residents held nearly half of Argentina's bonded external debt.

4. *See* Anna Gelpern, *Beyond Balancing the Interests of Creditors and Developing States*, 97 AM. SOC'Y INT'L L. PROC. 221 (2003); Nouriel Roubini & Brad Setser, *Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions, and a Roadmap for Reform* 2 (2003), *at* http://www.iie.com/publications/papers/roubini-setser0303.pdf; Anna Gelpern, *For Richer, For Poorer: Sovereign Debt Contracts in Crisis*, J. INT'L BANKING REG. 23 & nn.4-8 (2000). In particular, domestic law debt has rarely merited international policy attention. *See, e.g.*, Int'l Monetary Fund, *Sovereign Debt Restructuring Mechanism—Further Considerations* 12-19 (Aug. 14, 2002) [hereinafter IMF, *Sovereign Debt*], *available at* http://www.imf.org/external/np/pdr/sdrm/2002/081402.htm.

and manage the risks of investing in sovereign debt.

We illustrate our argument with three case studies. We use the example of Russia's 1998 default to show that default on domestic-law, domestic-currency debt in a relatively small market can trigger global financial turmoil. We then examine the case of Argentina to show how countries in financial trouble transform their debt stocks to enable different treatment of domestic and foreign residents. In the last section, we recount Turkey's decision to forego involuntary debt restructuring in an effort to protect domestic banks, which had held most of its domestic-law and a substantial fraction of its external-law sovereign debt. In the conclusion, we touch on Uruguay's recent debt restructuring as a rare example of equal treatment, made possible by the relatively generous financial terms of the operation.

These examples hold two practical lessons. First, neither the legal nor the economic perspective on domestic and external debt alone is sufficient to explain or forecast government actions in crisis. All of our case studies suggest that when a government runs out of money, it often treats domestic and foreign creditors differently. Governments rarely allow the legal features of their instruments to drive core restructuring decisions. The desire to limit legal liability is one of many government concerns, and rarely the dominant one. The desire to curry favor with powerful political groups, to avoid a bank run, to stem the outflow of foreign exchange, or to preserve access to future financing may drive government policy.

The second lesson is that risk assessment and crisis response must be based on a comprehensive and dynamic view of a country's debt stock. The legal composition of a sovereign's debt is increasingly fluid, as targeted debt exchanges can quickly transform the country's debt. In crisis, such exchanges can help the sovereign segment its creditors into different groups, making it easier to treat each group differently. *Ex-ante risk management* must reflect this new, dynamic, and flexible character of sovereign borrowing. For example, it would be a mistake to assume that all of a sovereign's foreign-law debt will be treated alike in distress. Moreover, the effective status of a single obligation relative to others could change several times in its lifetime as the sovereign dilutes, elevates, and subordinates instruments to suit. *Ex-post crisis management* strategies must also presume fundamental flexibility. It will be harder and harder to assume that domestic debt (however defined) can be ignored or treated wholly apart from other kinds of debt. The recent growth in the local-law, local-currency, and locally held debt of many emerging economies suggests that fewer and fewer countries will be able to overcome a financial crisis by focusing on foreign-law bonds

to the exclusion of all other paper. Preventing and managing financial crises against this background must involve the full spectrum of a country's liabilities. This approach is closer to firm bankruptcy than to a traditional sovereign restructuring.

Beyond these two lessons, we find little cause for alarm in the recent blurring of the line between domestic and external sovereign debt, or even in the continued discrimination between resident and non-resident creditors. Liberalization of international capital flows allows domestic and foreign residents to hold the same legal instruments and invest in the currencies of their choice, necessarily supplanting old bundled definitions of domestic and external debt. Yet liberalization has not transformed the international capital markets into a larger version of a domestic market. Most obviously, for as long as there are national governments, residents and non-residents will strike fundamentally different political and economic bargains with the borrowing country, even as their capital is relatively free to move about. In addition to debt repayment, residents look to their governments for physical and economic security, basic services, and political stability. The sovereign debt instruments they hold will be poor proxies for their stake in the country.[5]

There are two ways of dealing with this predicament in crisis. One is a sovereign bankruptcy regime that is capable of assessing and enforcing equal treatment among identical instruments.[6] But this is not necessarily desirable. Domestic firm or bank insolvency unfolds in the context of a social safety net—including, for example, unemployment and deposit insurance—to address the impact of economic failure on stakeholders whose interests in the failed enterprise are not adequately described by the instruments they hold.[7] The prospect of a sovereign bankruptcy regime complete with enforcement authority is distant at best;[8] no one has even mooted a matching social safety net. The alternative is the status quo—allowing national governments to address the impact of a financial crisis on different stakeholders ad hoc in ways

5. *See generally* Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J 1159, 1162-63 (2004). This is also true to some extent in domestic insolvency—for example, the case of employee shareholders, whose economic stake in the firm is different from those of other shareholders.

6. *See* Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763 (2004).

7. Firm bankruptcy in a modern economy is embedded in institutions that support stakeholders released by the bankrupt firm, including workers and depositors.

8. *See* Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, 4 J. INT'L ECON. L. 613, 633 (2001).

they see fit. Sometimes this involves discrimination among identical instruments; at other times, equal treatment of identical instruments followed by additional compensation to some holders (for example, bank recapitalization). The costs and benefits of each strategy to the country and the international financial system are highly case-specific.

II. HEDGE FUND AND SBERBANK: DOMESTIC DEBT DEFAULT BRINGS ON GLOBAL CALAMITY

Until recently, it was reasonable for the international community to regard *domestic debt*, understood to be locally held, denominated in local currency, and governed by local law, to be none of its business. It was difficult to imagine such debt having effects beyond the borrowing country's borders, let alone causing global instability. This impression rested on the understanding that sovereigns could freely expropriate their own citizens using state powers to print money and promulgate and enforce laws.[9] If a government ran short of funds to pay the domestic debt, it was expected to print enough currency to pay, or to restructure the debt unilaterally by law or fiat (assuming a docile domestic judiciary that would uphold the executive's restructuring decision). Regardless, most market participants, scholars, and policymakers acted as if governments could be counted upon to contain the domestic debt problem within their domain.[10]

The spectacular fallout from Russia's domestic debt default in 1998 showed the inadequacy of this assumption in today's capital markets.[11] In the mid-1990s, Russia began issuing short-term ruble-denominated treasury securities governed by Russian law, known by their Russian acronym as the GKOs. The government then embarked on one of the largest borrowing sprees in recent history to finance growing budget deficits.[12] Having overcome a bout of hyperinflation, Russia was no longer willing to print rubles and resorted instead to printing ruble-

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9. LEX REIFFEL, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 16 (2000).

10. *See* IMF, *Sovereign Debt*, *supra* note 4, at 13-14; LEE C. BUCHHEIT, HOW TO NEGOTIATE EUROCURRENCY LOAN AGREEMENTS 79 (2000); ANTHONY C. GOOCH & LINDA B. KLEIN, ANNOTATED SAMPLE REVOLVING CREDIT AGREEMENT 39 (Roberto G. MacLean & Jeswald W. Salacuse eds., 1994).

11. The Mexican crisis of 1994-1995 involved *tesobonos*—local-law, local-currency, dollar-indexed instruments held by domestic and foreign investors. However, thanks to the rescue package from the international community, led by the United States, Mexico did not default on its debt.

12. Int'l Monetary Fund, *Russian Federation: Recent Economic Developments*, IMF Staff Country Report No. 99/100, at 15, 18, 22 (Sept. 1999) [hereinafter IMF, *Russian Federation*], *available at* http://www.imf.org/external/pubs/ft/scr/1999/cr99100.pdf.

denominated promises to pay. The promises were sold first to domestic investors and later to foreign investors. By June 1998, the outstanding stock of GKOs and their longer-term counterparts, OFZs, was over $70 billion[13] with as much as 40% held by non-residents and the balance dominated by Russian banks.[14] The largest single portion was held by Sberbank, the mammoth Soviet-era institution that continued to take in the bulk of Russia's retail deposits.[15] Within a month, the stock dwindled to $49 billion as investors cashed out or exchanged GKOs and OFZs for Eurobonds in anticipation of default.[16] Foreign residents now held about 30% of this total.[17] In 1998, Russia also had outstanding over $10 billion dollars in longer-term dollar-denominated securities governed by Russian law, known as MinFins.[18] A large portion of the MinFins was held by foreigners. Foreign-law debt included $16 billion in medium-term Eurobonds, most of which were governed by English law, denominated in U.S. dollars, and held by foreigners; just under $30 billion in debts to foreign commercial banks (London Club), much of which had been securitized and sold to international investors; approximately $60 billion in obligations to foreign governments (Paris Club and others); $26 billion in multilateral credits; and several billion dollars in private supplier credits.[19]

The GKOs were an attractive investment for foreign creditors. With

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13. Bank for International Settlements, *Quarterly Review: International Banking and Financial Market Developments*, Nov. 1998, Statistical Annex at 77, tbl. 17, *available at* http://www.bis.org/publ/r_qa9811.pdf.

14. William Tompson, *The Bank of Russia and the 1998 Rouble Crisis* 8-9, *in* ANATOMY OF THE 1998 RUSSIAN CRISIS (Vladimir Tikhomirov ed., 1999). On Russian bank participation, see for example Federico Sturzenegger, *Default Episodes in the 90s:* Factbook, Toolkit *and Preliminary Lessons* 23 (June 2003), *at* http://www.nber.org/~confer/2003/iases03/sturzenegger.pdf.

15. Catherine Belton, *Sberbank's Audit Delays Increase Concern*, ST. PETERSBURG TIMES (Russia), Oct. 15, 1999, *available at* http://www.sptimesrussia.com/archive/times/509/news/b_sberbank.htm.

16. NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS? RESPONDING TO FINANCIAL CRISES IN EMERGING ECONOMIES app. at 383-389 (2004) [hereinafter ROUBINI & SETSER, BAILOUTS].

17. According to the Russian finance ministry, foreign investors held 32% of the GKO/OFZ stock at August 17, 1998. RUSSIAN FEDERATION, OFFERING CIRCULAR 108 (July 18, 2000) (on file with authors). Foreign investors' GKO holdings had declined substantially and disproportionately between June and August because they were successfully targeted in the July 1998 exchange of GKOs for Eurobonds. *See* Tompson, *supra* note 14, at 8. Roubini and Setser offer an even lower estimate of foreign participation on the eve of the default. ROUBINI & SETSER, BAILOUTS, *supra* note 16, at 149-50, 385.

18. RUSSIAN FEDERATION, *supra* note 17, at 100.

19. *Id.*

average yields of 60% in May-June of 1998,[20] the GKOs promised a spectacular return so long as the ruble remained pegged to the dollar. However, such returns implied enormous risk and put a premium on getting out before the market crashed. With falling oil prices, rising deficits, political turmoil, and growing doubts about Russia's ability to adopt the policies needed to repay its debts in full, annual interest rates on the GKOs rose above 100%.[21] The market's increasing doubts about Russia's capacity to repay did not stop many from continuing to lend, possibly on the assumption that Russia's strategic importance guaranteed a rescue package from the International Monetary Fund (IMF) and major Western powers should something go wrong.

On August 17, 1998, the ride ended abruptly when Russia defaulted on the GKOs and the OFZs and let the ruble slide. The few billion dollars in foreign holdings of Russian Treasuries was a tiny drop in the global capital markets. Even if the GKO/OFZ default signaled a high probability of default on the MinFins, the Eurobonds, and the London Club debt (about $60 billion combined), the total amount of debt directly affected was modest relative to the multi-trillion dollar global markets.[22] Losses in Russia alone would be far too small to devastate any fully diversified global investor.

The Russian default nonetheless shook the markets for two reasons. First, many of the investors in Russia's debt were unregulated hedge funds that had borrowed vast sums of money to make their investments. Managing Russia's default for them involved unwinding an enormous web of financial arrangements often with far-flung counterparts. Second, the government's debt default and Russian banks' default on contracts designed to shield investors from ruble depreciation[23] exposed the downside of certain complex risk management strategies. These strategies failed because, despite fancy financial engineering, their performance ultimately hinged on the willingness and ability of local actors in crisis economies to make good on their promises.

Among the foreign investors stuck holding the bag was Long Term Capital Management (LTCM), a Connecticut-based hedge fund that had borrowed upwards of $120 billion on a capital base of under $5

20. *Id.* at 108; IMF, *Russian Federation*, *supra* note 12, at 22. GKO yields approached 200% in July and 300% in August. Yields on major industrialized country debt were in the single digits at the time. *Id.*

21. Tompson, *supra* note 14, at 8.

22. *See* RUSSIAN FEDERATION, *supra* note 17, at 100.

23. Sturzenegger, *supra* note 14, at 22.

billion.[24] It used the borrowed money to bet on market movements that turned out to be extremely risky. Including thousands of derivative contracts that had linked it with most major Wall Street institutions, LTCM had accumulated more than $1 trillion of exposure, most of it to the world's largest industrialized economies.[25] LTCM had only a small fraction of its portfolio in GKO trades, which were hedged with bets on the ruble. The bets fell through because LTCM's counterparties, Russian banks, had effectively shut down cross-border operations when the Russian government defaulted.

For LTCM and others, the effects of Russia's default went far beyond their GKO holdings, triggering a worldwide sell-off of risky securities and a mad scramble into the most liquid of U.S. Treasury bonds. Investors who had bought on margin—with money they did not have—had to sell good assets for cash to meet margin calls on assets such as the GKOs that had lost most of their value. As creditors called in loans, leveraged investors remained under pressure to sell in bad market conditions, compounding the market turmoil that was pushing them to the brink. All this activity led to enormous, unanticipated price movements in a vast range of emerging and mature financial markets, many of which seemed to have little in common.[26] Global financial markets went into a tailspin, threatening pervasive loss of liquidity and economic collapse.

To stop the panic, the Federal Reserve cut interest rates, and on October 3 the Federal Reserve Bank of New York facilitated a rescue of LTCM by its creditors. By the time the New York Fed stepped in, the fund's capital had shrunk to a mere $500 million, not enough to support its trillion-dollar portfolio. A further loss of half a percentage point on the firm's total assets—to be expected in turbulent markets—would wipe out LTCM's remaining capital.

A month later, in November 1998, Russia offered cash and new longer-term instruments in exchange for the GKOs and OFZs. In theory, the same offer was open to all investors with a few minor exceptions.[27] But unlike domestic residents, foreigners had to deposit all proceeds in restricted accounts, which could be used to buy small

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24. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 12 (Apr. 1999) [hereinafter HEDGE FUND WORKING GROUP REPORT].

25. ROGER LOWENSTEIN, WHEN GENIUS FAILED, at xix (2000); *see* HEDGE FUND WORKING GROUP REPORT, *supra* note 24, at 11-12.

26. *See* HEDGE FUND WORKING GROUP REPORT, *supra* note 24, at 12.

27. *See infra* note 32 and accompanying text.

amounts of dollars at special auctions. In effect, the Russian government prevented non-residents from converting the meager exchange proceeds into foreign currency and taking them abroad.[28] In addition to default and restructuring, government restrictions on capital flows prevented Russian banks from performing on their hedge contracts with foreign investors.[29] As noted earlier, foreigners had entered these contracts as a form of insurance against default. Their collapse contributed to the undoing of some hedge funds and big losses by global financial institutions.

Despite the government's professions of equal treatment for all investors, Russian banks that had dominated the local market and Russian depositors that had invested in the defaulted securities indirectly through the banking system fared much better than the foreigners. Sberbank reported unloading a large portion of its GKOs and OFZs in exchange for dollar-denominated bonds by early 1999.[30] In a secret side deal, several Russian commercial banks exchanged their worthless GKOs and OFZs for new liquid Central Bank paper (the KBOs).[31] Some Russian institutional investors got more cash in the exchange, while socially important holders such as individuals, media, and insurance funds escaped restructuring altogether.[32] Many deposits were transferred from shaky commercial banks to Sberbank and were paid in full.[33] Finally, some domestic investors were able to get rubles for their GKOs and then use the rubles to buy dollars.

At the time of the default, Russia considered several choices that might have been more favorable to foreigners. For example, some in the government had argued for a drastic devaluation without default. However, the authorities concluded that printing enough money to service the GKOs would result in hyperinflation, devastating the domestic population that had seen hyperinflation eat up its savings only a few years before.[34] Another possible alternative was scrupulous formal equality in restructuring and no special treatment for Sberbank or

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28. *See* RUSSIAN FEDERATION, *supra* note 17, at 108-09.

29. Sturzenegger, *supra* note 14, at 23. Note that the banks would have likely defaulted on the hedges even without government interference, because they would have gone bankrupt as a result of the GKO default and economic collapse.

30. Belton, *supra* note 15.

31. Tompson, *supra* note 14, at 12-13; Sturzenegger, *supra* note 14, at 23.

32. RUSSIAN FEDERATION, *supra* note 17, at 109.

33. *See* Tompson, *supra* note 14, at 8; Sturzenegger, *supra* note 14, at 24; IMF, *Russian Federation*, *supra* note 12, at 86.

34. Interview with Hon. Sergei Dubinin, former Governor, Central Bank of Russia, in Oxford, Eng. (Apr. 30, 2004); CHRYSTIA FREELAND, SALE OF THE CENTURY 317-18 (2004).

other domestic holders. Again, the decision tilted in favor of protecting the well-connected as well as the average Russian. Many Russians kept their money in dollars and under the mattress, a result of Russia's spotty banking history.[35] Those that had put savings in banks overwhelmingly chose Sberbank, an established, state-owned institution with a nationwide network of retail outlets. Wiping out the people's savings along with the hedge funds' investments was not politically viable. The government might have achieved the same economic effect with more legal integrity, by restructuring all GKOs and OFZs on the same terms while injecting public capital in Sberbank to cover the resulting losses and back deposits. Domestic depositors would have taken smaller aggregate losses as a result of a bank bailout.[36] One can only guess that the exigencies of the crisis made the two-step approach impractical.

Few could have predicted that Russia's economy (barely the size of the Netherlands') and its tiny ruble debt market (a speck relative to the multi-trillion dollar U.S. Treasury market and a fraction of Brazil's local market) would trigger a global crisis. Yet six years later, the dramatic and wide-ranging consequences of foreign access to what was conventionally called emerging markets domestic debt are indisputable, while any expectation that foreign and domestic investors in domestic-law debt would get equal treatment in crisis looks increasingly naive. Several years later, Argentina's example would show that even foreign law offers limited assurance of equal treatment to foreign and domestic holders of the same instruments.

III. BORN-AGAIN BODEN: FINANCIAL CRISIS TRANSFORMS A DEBT STOCK

The Russian crisis showed the world that domestic debt can have global significance and that a government in trouble does not shrink from treating domestic and foreign creditors differently with little regard for the instruments they hold. Argentina went a step further by demonstrating the wide discretion and creativity governments may deploy in unilaterally refashioning their debt stocks to accommodate their political and financing needs. And again, the legal features of the government's debt instruments did not appear to constrain its crisis management strategy.

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35. IMF, *Russian Federation*, *supra* note 12, at 88.

36. Of course, unless the government was willing to stick its taxpayers with the bailout bill, the need for funds to recapitalize the banks would have made the debt restructuring terms marginally worse, ultimately penalizing the foreign investors. The key point is that handouts for domestic constituencies would have been dispensed outside, not through, the debt exchange.

In the 1990s, Argentina had become a model of financial openness and innovation. The invention was born of necessity: Argentina desperately needed foreign capital to finance chronic budget deficits and pay for imports that far outpaced its exports, owing to an overvalued currency.[37] To meet the demand for financing, the government raised money in multiple countries and currencies, selling bonds to U.S. banks, Italian retirees, and Japanese households. Through the 1990s, the government placed more and more foreign-law, foreign-currency bonds with domestic financial institutions.[38] After Brazil—Argentina's biggest trading partner and competitor—devalued its currency in 1998, Argentina sank into deeper recession. Foreigners began to balk at lending to Argentina. As a result, after 1999, the government grew even more dependent on domestic institutions.[39] As Argentina slipped into a deeper crisis during 2000, close to half of the government's debt was in the hands of local banks and pension funds, many of which were owned by large U.S. and European institutions.[40]

In November 2001, after a failed attempt to reprofile its debt in an external bond exchange the previous summer, Argentina launched a more innovative operation. The government asked domestic financial institutions to tender their foreign-law, foreign-currency bonds in exchange for slightly longer-term Argentine-law, dollar-denominated loans notionally backed by revenue streams from the government's new financial transactions tax. In return for this enhancement (and in practice to avoid default), the coupon on the new instrument was effectively reduced by 30%, to 7%.[41] The exchange was uniquely attractive to domestic institutions. Argentine banks and pension funds

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37. *See* MICHAEL MUSSA, INST. FOR INT'L ECON., POLICY ANALYSES IN INT'L ECON. NO. 67, ARGENTINA AND THE FUND 9-17 (2002); Brad Setser & Anna Gelpern, Pathways Through Financial Crisis: Argentina 14-15 (June 11, 2004) (unpublished manuscript on file with authors, prepared for the Global Economic Governance Programme, University College, Oxford).

38. *See* MUSSA, *supra* note 37, at 16; INT'L MONETARY FUND, LESSONS FROM THE CRISIS IN ARGENTINA 26 (Oct. 8, 2003) [hereinafter IMF, LESSONS], http://www.imf.org/external/np/pdr/lessons/100803.pdf.

39. Guillermo Perry and Luis Servén, *The Anatomy of a Multiple Crisis: Why Was Argentina Special and What Can We Learn from It* 47 (Apr. 2003), *at* http://www.worldbank.org/research/bios/lserven/Argentina%20041703.pdf.

40. Daniel Marx, *Sovereign Debt Restructuring: The Upcoming Case of Argentina* 14 (Mar. 2003), *available at* http://www.rbwf.org/2003/Madrid/Marx.pdf; Setser & Gelpern, *supra* note 37, at 9.

41. IMF, LESSONS, *supra* note 38, at 61; Domingo Cavallo, Argentinean Tragedy, Address Before the National Bureau of Economic Research, Harvard University (July 17, 2002), *at* http://www.nber.org/~confer/2002/argentina02/cavallodinner001.pdf; Tim Loughran, *Argentina's Debt Swap Snags on Provincial Loans*, DOW JONES NEWSWIRES, Nov. 27, 2001.

could value the new instrument at par, not at its market price. On the other hand, foreign investors, mindful of the lessons Russia taught, did not want an instrument governed by domestic law, particularly an instrument structured as a loan rather than a bond. Nearly all of the foreign-currency, foreign-law bonds held by Argentine financial institutions (though not all the bonds that were held by individual Argentines) were tendered in the exchange.[42] Just over a month later, in December 2001, the government defaulted on the remainder of its external bonds, which were now held overwhelmingly by foreign residents. At the same time, the Argentine peso, which had been pegged to the U.S. dollar at the rate of 1:1, was allowed to float and lost nearly three quarters of its value within a few months.[43]

Far from ending the transformation of Argentina's debt stock, the default sped it up. In the early months of 2002, the government issued decrees that redenominated Argentine-law contracts into pesos at subsidized rates.[44] In the process, the dollar-denominated domestic-law loans that emerged from the November swap were converted into pesos and lost the collateral feature.[45] Argentine pension funds, with the exception of the fund managed by state-owned Banco Nación, challenged the move. More than a year later, the private pension funds that refused to go along with the peso conversion were punished: the government canceled their guaranteed loans and reinstated their holdings of defaulted bonds.[46] The state-owned pension fund and certain Argentine banks continued to hold tens of billions of dollars in peso-denominated loans. These instruments lost value in the peso conversion, but continued to be serviced in local currency.

After segregating certain domestic bondholders into restructured

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42. *See* IMF, LESSONS, *supra* note 38, at 61.

43. *See, e.g.*, Fernando J. Losada, *Argentina: The Economy and the Elections*, EMERGING MARKETS FORT. (ABN AMRO, Neth.), Feb. 19, 2003, at 21, 25. For background, see MUSSA, *supra* note 37, at 49-55.

44. M. & M. Bomchil Abogados, *Public Emergency and Foreign Exchange System Reform Act*, LEGAL UPDATES FROM ARGENTINA, Jan. 2002, *available at* http://www.bomchil.com.ar/cas/novedades/Public%20emergency%20and%20foreing%20exchange%20system%20reform%20act.htm; M. & M. Bomchil Abogados, *Financial System Restructuring*, LEGAL UPDATES FROM ARGENTINA, Feb. 2002, *available at* http://www.bomchil.com.ar/cas/novedades/Financial%20system%20restructuring.htm.

45. *See* Rafael Rofman, *The Pension System and the Crisis in Argentina: Learning the Lessons* 12-14, World Bank (2002), *available at* http://www.brandeis.edu/global/rosenberg_papers/rofman_paper.pdf. At the time of the writing, Rofman was an officer of the state-owned Nación pension fund.

46. *See* Hewitt Associates, *Impact of Argentina's Economic Crisis on Private Pension Plans* (Sept. 2003), *at* http://was4.hewitt.com/hewitt/resource/legislative_updates/latin_america/argentina_0903.htm.

guaranteed loans and defaulting on external bondholders and domestic pension funds, Argentina needed to find still more ways to meet the financial demands arising from its crisis. Foremost among these was the imperative to inject capital into the domestic banking system, which otherwise faced insolvency. The federal government also needed funds to buy back scrip issued by provincial governments during the crisis. In response, the government issued over $20 billion in new *Boden* bonds. Most *Boden* were denominated in pesos, though a small portion were in U.S. dollars.[47] The government also assumed billions of dollars in provincial debt as part of a general reform of its revenue-sharing arrangements with the provinces (co-participation). All this new debt is performing, and the government has pledged to exempt it from any restructuring, effectively subordinating most foreign bondholders and ensuring that holders of the new bonds and the guaranteed loans have the first claim on the government's budget surplus.[48]

The result of Argentina's swap gymnastics was, in the first instance, to transform a debt stock that was overwhelmingly foreign-law into a bifurcated debt stock, with most of the politically protected domestic constituencies holding local-law debt. The secondary market values of the bonds still held by external creditors and private pension funds at this writing hover around thirty cents on the dollar.[49] The domestic holders of these bonds who first swapped into the guaranteed loans and then accepted the peso conversion came to hold instruments worth closer to sixty cents on the dollar, although valuations are not very reliable because the trading in some of the instruments is thin.[50]

Next came one of the more ironic twists of the Argentine debt saga. The very foreign bondholders that had suffered the injury of default and the insult of ex-post subordination began vying for the small number of *Boden* trading in the secondary market. They—and Argentines looking for high-yielding investments—bid up the Boden price to nearly seventy cents on the dollar, compared to thirty cents for the

47. Lacey Gallagher, Carola Sandy & Filippo Nencioni, *Debt Restructuring: Past or Future?*, CreditSuisseFirstBoston, Emerging Markets Economics: Argentina, Aug. 20, 2003, at 13; Martin Anidjar, *Argentina: Persisting Economic and Political Uncertainty Does Not Justify Current Debt Prices*, JPMorgan Emerging Markets Research Strategy Report, Dec. 19, 2002, at 19-21.

48. *See, e.g.*, Martin Anidjar & Anna Titarchuk, *Argentina: International and Domestic Tailwinds Require an Update to Debt Restructuring Analyses*, JPMorgan Emerging Markets Research Strategy Report, July 18, 2003, at 10.

49. Deutsche Bank, Global Relative Value Research, Sovereign Debt Instruments—Prices at Close, Aug. 18, 2004.

50. ROUBINI & SETSER, BAILOUTS, *supra* note 16, at 272.

defaulted foreign-law bonds of the same issuer.[51] By most accounts, only a few billion of the total has traded, because the principal holders of the *Boden*, Argentine banks, are allowed to hold the debt on their books at full face value and have no incentive to sell it at a discount. Despite the fact that their own experience might lead them to doubt the Argentine government's promise to repay, foreign investors believe the government will stay current on the *Boden* because they are a key asset of the domestic banking system. Unless the current holding pattern for the bonds changes dramatically, investors are betting against default[52] because it would threaten another bank run, antagonize Argentine depositors (who vote), and likely give rise to new fiscal liabilities for another round of bank recapitalization. The strategy is self-limiting: the calculus would reverse if foreign residents became the predominant holders of the debt.

Finally, as Argentina is poised to restructure over $80 billion in defaulted foreign-law, foreign-currency bonds, the holdings of private domestic (but mostly foreign-owned) pension funds have emerged as a key factor in the government's strategy. As the previous government was running out of funding sources in the late 1990s, it pressured the pension funds to buy more and more of its debt, with the result that these institutions account for a significant share of the total debt in default.[53] As noted earlier, the pension funds had initially swapped out of their foreign-law bonds into Argentine-law loans, but were reinstated in their holdings of defaulted bonds after refusing to accept peso conversion for their loans. Pension funds are also in an awkward political position: on the one hand, in the aftermath of pension privatization in the mid-1990s, they hold some of the savings for ordinary voting Argentines. On the other hand, the pension funds' existing liabilities are largely long-term, and do not seem to have the immediate and visceral political significance of bank deposits.

The current government is no friend of the private pension funds, a project of the previous government that has been blamed by some for helping get Argentina into its crisis. At the same time, the continued inflows into the pension system are among the few potential sources of financing available to the government. The government's financing plan suggests that it intends to tap this resource to make payments on the *Boden* and other effectively senior debt. It remains to be seen

51. Deutsche Bank, *supra* note 49.

52. Anidjar & Titarchuk, *supra* note 48.

53. Marx, *supra* note 40, at 6; *see* MUSSA, *supra*, note 37, at 26; Perry & Servén, *supra* note 39, at 47.

whether the pension funds will use their holdings to band with foreign bondholders, reach a regulatory side deal with the authorities to secure a favorable accounting treatment of the exit instruments, or simply succumb to government suasion and take whatever terms they are offered.

In sum, the lessons of Argentina are threefold. First, the identity of the creditor holding an instrument, be it an Argentine-law *Boden* or a foreign-law bond, is important in assessing the risk of default and restructuring. Domestic holders may do their government favors on occasion and provide financing when others will not, but their cooperation comes at a price. Leaders who care about their popularity can ill afford to stiff domestic creditors systematically: these creditors vote, hold the savings of voters, and often have other means of influencing the government that foreigners do not. Moreover, from the economic balance of payments perspective, concessions to resident creditors merely redistribute resources within the country—they do not produce inflows or outflows. Concessions to non-residents produce outflows.

Second, both the Russian and Argentine crises show that governments are uniquely reluctant to impose punitive terms on debt held by banks for fear of wiping out popular savings and shutting off credit to the economy. Governments that do restructure such debt on a large scale tend to recapitalize the banks to protect the financial system. In this case, a dollar taken from Argentine bank capital would simply become a liability of the government. Foreign investors appear to appreciate the recapitalization imperative and recognize that formally equal treatment in restructuring would bring them little economic benefit: subsequent compensation to the banks would simply reduce the resources available to pay foreign creditors.

The third lesson of Argentina's crisis is that sovereign debt stocks are dynamic and flexible to the extent not understood before. Even where a government is unwilling to resort to outright discrimination among identical instruments based on who holds them (as Russia did in restructuring the GKOs), the government can deploy voluntary and involuntary debt exchanges to alter the holding pattern, governing law, and even the currency of denomination of its debt. By shifting domestic residents into a new instrument, the government can more easily offer different restructuring terms to two sets of investors that once held the same instrument.

Argentina's experience suggests that governments in emerging market economies know enough about the preferences of different creditor groups to take advantage of these differences. In crisis, they may use regulatory and political suasion to change the legal composition of

their debts to achieve the desired result. Foreign investors that express surprise at these maneuvers may put more emphasis on formal legal protections and pay less attention to the sovereign's overall economic and political interests.

IV. A RESTRUCTURING THAT WASN'T: DOMESTIC BANK HOLDINGS SPARE ALL[54]

On February 20, 2001, the Turkish government held an auction for local-currency local-law Treasury bonds. It needed to refinance some $6 billion in Treasury bonds coming due the next day and was willing to offer bonds maturing a month later at an annual interest rate of 144%. There were hardly any takers. In the next few days, overnight interest rates shot up above 2,000%, and the government was forced to abandon the lira-dollar peg after losing $5 billion in reserves in three chaotic days. This was Turkey's second financial crisis in less than six months. Both crises had roots in the combination of a too-rigid exchange rate and a government strapped for revenues that depended on an overextended banking system for financing. In November 2000, foreign banks began to pull short-term interbank deposits from their Turkish counterparts, but the incipient run paused on the back of an augmented IMF program. The reprieve proved short-lived. A public spat between the president and the prime minister against the background of continued concerns with the banking sector triggered a run on the currency that led to the collapse of the exchange rate regime.[55]

The end of the peg resulted in large losses for the Turkish commercial banking sector, which had bet big on the lira.[56] These losses came on top of pre-existing losses in the state banks that had been obscured with creative accounting.[57] In response, foreign banks started pulling their remaining credit lines, putting further pressure on the Turkish banks and on the government debt market.[58]

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54. We are grateful to Eva Sanchez-Ampudia and Yarkin Cebeci of JPMorgan for generously sharing with us their data on Turkish debt.

55. Int'l Monetary Fund, *Turkey: Sixth and Seventh Reviews Under the Stand-By Arrangement* 2-4, 7, 10, 12, 25, IMF Country Report No. 01/89 (June 2001) [hereinafter IMF, *Turkey*], http://www.imf.org/external/pubs/ft/scr/2001/cr0189.pdf.

56. Banks financed their investments in Turkish government lira Treasury bills with domestic dollar deposits and cross-border interbank lines. ROUBINI & SETSER, BAILOUTS, *supra* note 16, at 65-66.

57. See IMF, *Turkey*, *supra* note 55, *Staff Supplement: Foreign Exchange Exposures in the Banking Sector* 6.

58. IMF, *Turkey*, *supra* note 55, at 7.

The government's liabilities then comprised mostly lira-denominated domestic-law debt totaling $55 billion, $35 billion of which was held by the local banking system (including their off-balance sheet holdings).[59] Turkey also owed $23 billion in dollar- and euro-denominated foreign-law bonds held by a mix of foreign investors, expatriate Turks, and domestic banks. Since the government extended a broad deposit guarantee in late 2000 and had long backed the state banking system, the government was also sure to face additional bank recapitalization costs that would add tens of billions of dollars to the government's debt burden by the end of 2001. In fact, the dollar value of Turkey's domestic-law, local-currency debt securities increased by $30 billion, to $84.7, billion during the course of the year as high interest rates and bank recapitalization costs added to the budget deficit.[60]

After the collapse of the exchange rate peg, Turkey's leaders turned to a new economic team led by Kemal Dervis, a veteran World Bank official, for a new economic strategy. The new team faced a choice: they could restructure some or all of the debt in an involuntary exchange, print enough currency to meet the lira obligations (leading to an inflation spiral), or shrink imports, boost revenues, and effectively ration foreign exchange.

Like Russia and Argentina, Turkey sought to contain inflation. The short-term structure of Turkey's lira debt made inflating away the debt a difficult proposition. Meaningful debt relief would have likely required something close to hyperinflation, or dramatically extending the maturities of domestically held debt. Moreover, printing money would have eroded the real value of domestic Turkish savings (denominated in lira) while protecting the real value of foreign investors' Eurobonds.

According to Dervis, the team had considered and rejected a coercive debt restructuring that would have lowered the real return on Turkey's lira debt.[61] The fact that domestic banks, and through them domestic depositors, held more than 50% of the domestic debt (and

59. *Id.* at 44-45, 77-78; *see also* Eva Sanchez-Ampudia & Yarkin Cebeci, *Turkey: Inward Focus May Puncture Virtuous Circle*, EMERGING MARKETS TODAY (JPMorgan, New York, N.Y., June 4, 2004); Sanchez-Ampudia & Yarkin Cebeci, JPMorgan Turkish Debt Data (2004) [hereinafter JPMorgan Turkish Debt Data] (unpublished data, on file with authors).

60. *Id.*

61. Interview with Hon. Kemal Dervis, former Economy Minister of Turkey, in Oxford, Eng., (Apr. 30, 2004).

probably as much as a quarter of Turkey's Eurobonds)[62] was the dominant factor in the decision. If the bulk of the debt had been held by foreign investors or even expatriate Turks, the government may well have opted for a coercive restructuring.

Rather than launch a coercive restructuring, Turkey undertook massive fiscal adjustment (moving from a primary budget deficit of 2% in 1999 to a surplus of 5.5% in 2001) and paid enormous real interest rates (estimated at close to 50% in early 2001) to attract domestic financing to roll over its short-term debt and finance the budget. Turkey then saw its debt levels approach 100% of its GDP.[63] But even the astronomical interest rates were not enough to attract all the financing the government needed. To avert default, Turkey also received unprecedented levels of financing from the IMF relative to the size of its economy.[64]

Turkey's experience reaffirms the critical place of creditor identity in policymakers' decisions on crisis management. Having determined that it was unwilling to restructure the bulk of its debt, the government chose not to restructure any. Most of its local-currency, Turkish-law debt was held by residents. Some of Turkey's foreign-currency foreign-law debt was also in local hands. Therefore, a restructuring of foreign-currency, foreign-law debt on punitive terms would have reduced domestic confidence and might have made it difficult to refinance local-currency, local-law debt. The fact that Turkey's harsh budget measures were being used to pay domestic creditors no doubt also made it more palatable politically.

V. CONCLUSIONS

Domestic debt is clearly much too important for countries' overall financial position to remain outside the scope of policy action in crisis management. Whether defined by currency, law, or residence of the holder, domestic debt can be central to how a crisis proceeds inside the country and its effects on the international financial system.[65]

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62. JPMorgan Turkish Debt Data, *supra* note 59; Dervis interview, *supra* note 61.

63. WORLD BANK, Rep. No. 26301-TU, 2 TURKEY: COUNTRY ECONOMIC MEMORANDUM: TOWARDS MACROECONOMIC STABILITY AND SUSTAINED GROWTH 2-4 (2003), *available at* http://www-wds.worldbank.org/servlet/WDS_IBank_Servlet?pcont=details&eid=000160016_20030820162436.

64. IMF, *Turkey*, *supra* note 55, app. at 46.

65. For example, Brazil's domestic debt is nearly $300 billion and nearly seven times the size of its external liabilities. *International Banking and Financial Market Developments: Statistical Annex*, BIS Q. REV. at A85, A92, tbl. 12D, 16A (Mar. 2004), *available at* http://www.bis.org/publ/r_qa0403.pdf.

It is not uncommon for countries to have legislation specifying that domestic residents holding claims on an insolvent private debtor get priority against non-residents during the distribution of the debtor's assets.[66] For a sovereign, giving priority to domestic payments makes economic sense. So long as residents do not take their foreign currency out of the country, such payments merely redistribute resources within the economy, from the government to the residents. Payments to non-residents, however, create an outflow from the economy that can ill-afford it in crisis. Favorable treatment for residents in debt restructuring makes even more sense if one considers the fact that domestic residents suffer the brunt of economic contraction and currency devaluation.[67]

Recent experience strongly suggests that countries may consider the residence and identity of the creditor and currency of denomination ahead of other factors when deciding how or even whether to default or restructure. Even where the legal risks to the government are low, as in domestic-law and domestic-currency obligations,[68] governments often choose to spare domestic holders, especially domestic banks. On the other hand, investors should be cautious when trying to generalize from one case to another: after all, Russia has successfully kept its Eurobonds out of any restructuring.

Where local and foreign investors are both significant participants in the issuer's foreign- law instruments (as in the case of Argentina's Euro- and Global Bonds), the country may segregate different holders into different debt instruments to gain crisis management flexibility. Argentina induced domestic residents to swap out of its Global Bonds and created new privileged domestic-law debts, while seeking major concessions from its Global Bond holders. The legal documentation alone was hardly determinative.

Turkey avoided restructuring altogether in part because domestic banks dominated its debt stock. This meant that a restructuring would have merely shifted a government liability from one category (debt service) to another (bank recapitalization and more debt service), all at an enormous political cost of alienating depositors and other voters.

The cases of both Turkey and Argentina suggest the advantage to foreign investors of being minor players in a field effectively dominated

66. Buchheit & Pam, *supra* note 1, at 905, citing Emilio J. Cardenas, *International Lending: Subordination of Foreign Claims Under Argentine Bankruptcy Law, in* DEFAULT AND RESCHEDULING 63 (David Suratgar ed., 1984).

67. ROUBINI & SETSER, BAILOUTS, *supra* note 16, at 265.

68. IMF, *Sovereign Debt*, *supra* note 4, at 15-16.

by domestic banks investing the funds of politically vital domestic depositors. On the other hand, governments that pack their financial systems with their own debt may pose a higher risk of default. Moreover, the Russian case should caution against excessive reliance on holding the same instrument as domestic banks: when truly pressed, governments are quite capable of discriminating among holders even without the intervening nicety of separating them into different instruments.

All this is not to say that equal treatment is impossible, merely that it is increasingly rare. Mexico paid off all its creditors after receiving a $40 billion rescue package from the United States and the IMF in 1995.[69] When Uruguay restructured its external bonds, it launched a simultaneous domestic exchange that was widely perceived as highly comparable to the international operation. It is significant that Uruguay's exchange did not result in principal losses for participants, but merely pushed out maturities across the board.[70] Few countries are able to offer such terms in deep crisis.

These examples illustrate that approaches to sovereign debt restructuring that address only external-law bonds risk leaving open some of the most crucial questions that arise in a crisis. On the other hand, restricting sovereign authority over local-law, local-currency, or locally held debt would eliminate important tools countries use to limit the domestic economic dislocation associated with extreme financial crises. Developing more effective approaches to crisis resolution will require looking seriously at the full gamut of debt instruments issued by sovereigns, and searching for ways to balance a sovereign's legitimate desire to limit domestic dislocation with the international markets' desire for greater predictability.

Perhaps most importantly, recent experiences with domestic and external debt offer an important lesson about the limits of financial globalization. With the advent of globalization, domestic and foreign investors can and do buy the same debt instruments. But this does not mean that their political and economic interests have converged, or that they have the same political and economic leverage with the government. It should come as no surprise then that the two groups rarely get equal treatment at the hands of a government that has run out of money.

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69. ROUBINI & SETSER, BAILOUTS, *supra* note 16, at 8.

70. República Oriental del Uruguay, *Registration Statement Under Schedule B of the Securities Act of 1933*, as filed with the U.S. Securities and Exchange Commission on April 10, 2003, *available at* http://www.sec.gov/Archives/edgar/data/102385/000095012303004071/y84311a1svbza.htm.