

DOMESTIC BONDS, CREDIT DERIVATIVES, AND THE NEXT TRANSFORMATION OF SOVEREIGN DEBT

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INTRODUCTION: BIG CHANGE

Not long ago, rich countries borrowed freely in their own currencies and under their own law. Most had deep and liquid financial markets where both local and foreign residents invested their savings. Unlike poor and middle-income countries, the rich rarely worried about losing access to credit. Conventional wisdom attributed this to some combination of credit-worthiness and institutional quality: stable currencies; sound fiscal and monetary policies; trustworthy legal systems; and deep, open, and well-regulated financial markets that encouraged innovation.¹

The emerging markets—poor and middle-income countries raising money internationally²—occupied an exotic corner of the financial uni-

* Rutgers University School of Law–Newark. The author is grateful to the organizers and participants in this symposium, the 2007 Annual Meeting of the Canadian Law and Economics Association, a workshop at the University of Pennsylvania Christopher H. Browne Center for International Politics, and to Robert Ahdieh, Femi Austin, Ed Bartholomew, Tom Callaghy, Philip G. Cerny, Guy-Laine Charles, Kevin Davis, Giselle Datz, Adam Feibelman, Mitu Gulati, Melissa Jacoby, Sky Julian, Chris Kushlis, Thomas Laryea, Michael Likosky, Mark Milford, Frank Partnoy, Matt Tubin, Brad Setser, David Skeel, and Mark Weidemaier for helpful comments and insights, and to the Dean’s Fund at Rutgers Law School for financial support.

1. See e.g., MORRIS GOLDSTEIN & PHILIP TURNER, CONTROLLING CURRENCY MISMATCHES IN EMERGING MARKETS 77–78 (2004); John Williamson, *From Reform Agenda to Damaged Brand Name: A Short History of the Washington Consensus and Suggestions for What to Do Next*, FIN. & DEV., Sept. 2003, at 10, available at <http://www.imf.org/external/pubs/ft/fandd/2003/09/pdf/williams.pdf>. For critical perspectives, see generally THE NEW LAW AND ECONOMIC DEVELOPMENT: A CRITICAL APPRAISAL (David M. Trubek & Alvaro Santos eds., 2006).

2. The Economist, Economics A–Z, <http://www.economist.com/research/Economics/alphabetic.cfm?LETTER=E> (follow “Emerging Markets” hyperlink; then follow “Developing Countries” hyperlink) (last visited Mar. 19, 2007); see Ashoka Mody, *What Is an Emerging Market?*, 35 GEO. J. INT’L L. 641, 641–43 (2004) (providing a sampling of popular definitions and proposing new defining criteria for the emerging markets); The World Bank, Country Classification, <http://www.worldbank.org/datastatistics> (follow “Country Classification” hyperlink) (last visited Sept. 4, 2007) (“Economies are divided according to 2006 GNI per capita The groups are: low income, \$905 or less; lower middle income, \$906–\$3,595; upper middle income, \$3,596–\$11,115; and high income, \$11,116 or more.”). Poor countries were often excluded from the term “emerging markets” for lack of market access. As these countries have begun to attract international portfolio capital, commentators have begun to distinguish between the more established, mostly middle-income “emerging” and recently arrived, mostly low-income “frontier” markets. For purposes of this essay, the salient distinction is between high-income countries like the United States and Japan, and all others to the extent they borrow internation-

verse. Barely two dozen had sustained access to foreign private capital.³ Those that could borrow abroad had to do so in foreign currency and under foreign law.⁴ Domestic credit markets were nonexistent or small, shallow, and closed to foreigners.⁵ Emerging economies suffered from frequent shocks and volatile asset prices, which rarely correlated with prices in New York or London. Conventional wisdom attributed this to some combination of low creditworthiness and poor institutional quality.⁶ Politics stood perennially in the way of emergence: the legacy of foreign financial exploitation cast a long shadow;⁷ domestic pressures drove dubious borrowing and default.⁸

Writing about emerging market debt meant writing about the Big Change: the shift in governments' foreign borrowing from bank loans in the 1970s to tradable bonds in the 1990s.⁹ Lawyers and economists ex-

ally. The term "emerging" here refers to "all others," recognizing that not all observations hold with equal strength for all countries.

3. See GLORIA M. KIM, J. P. MORGAN SECURITIES INC., EMERGING MARKETS BOND INDEX PLUS (EMBI+): RULES AND METHODOLOGY 1-2 (2004), available at http://200.32.4.58/~economia/moneda/EMBI_.pdf; GLORIA M. KIM, J.P. MORGAN SECURITIES INC., EMBI GLOBAL AND EMBI GLOBAL DIVERSIFIED: RULES AND METHODOLOGY 1-2 (2004) [hereinafter KIM, EMBI GLOBAL AND EMBI GLOBAL DIVERSIFIED] (on file with author); JOYCE CHANG ET AL., J.P. MORGAN SECURITIES LTD., EMERGING MARKETS EVOLVE AS AN ASSET CLASS 4 (2007) (on file with author).

4. Economic literature refers to countries' inability to borrow in their own currency as the Original Sin. See, e.g., Barry Eichengreen, Ricardo Hausmann & Ugo Panizza, *Currency Mismatches, Debt Intolerance and Original Sin: Why They Are Not the Same and Why It Matters* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 10036, 2003), available at <http://ksghome.harvard.edu/~rhausma/NBER/10036.pdf>. On governing law, see, for example, LEE C. BUCHHEIT, HOW TO NEGOTIATE EURO CURRENCY LOAN AGREEMENTS 132 (2000) ("Some sovereign borrowers are prohibited by their constitutions from signing a contract governed by the law of a foreign jurisdiction. These sovereigns are notable for their infrequent appearances in the Euromarkets.").

5. See Frank Packer, *Mind the Gap: Domestic Versus Foreign Currency Sovereign Ratings*, BIS Q. REV., Sept. 2003, at 55-56, available at http://www.bis.org/publ/qtrpdf/r_qt0309.htm; Philip D. Wooldridge et al., *Changing Links Between Mature and Emerging Financial Markets*, BIS Q. REV., Sept. 2003, at 45-47, available at http://www.bis.org/publ/qtrpdf/r_qt0309.htm.

6. See sources cited *supra* note 1.

7. See, for example, Louis A. Pérez, Jr. & Deborah M. Weissman, *Public Power and Private Purpose: Odious Debt and the Political Economy of Hegemony*, 32 N.C. J. INT'L L. & COM. REG. 699, 705-21 (2007), for a historical overview of politics driving private lending to Latin American sovereigns.

8. See Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default*, 6 CHI. J. INT'L L. 311, 316-26 (2005) (arguing that Argentina's default in 2001 was opportunistic); Brad Setser & Anna Gelpern, *Pathways Through Financial Crisis: Argentina*, 12 GLOBAL GOVERNANCE 465 (2006) (arguing that the depth of Argentina's last financial crisis was due in part to the political system's inability to pursue policies consistent with its currency regime or abandon the regime).

9. Many articles and conferences highlighted the shift. See, e.g., Lee C. Buchheit, *A Quarter Century of Sovereign Debt Management: An Overview*, 35 GEO. J. INT'L L. 637 (2004) (first in a series of essays in this issue that address the shift); *Conference on Sovereign Debt Restructuring: The View From the Legal Academy*, 53 EMORY L.J. 657 (2004); *Symposium on New Bankruptcy Arrangements for Sovereign Debt*, 1 BROOKINGS PAPERS ON ECON. ACTIVITY 229 (2002); *Symposium, The New Latin*

pected the shift to bring about collective action problems when countries hit financial distress. A cash-strapped sovereign with bonded debt might fail to persuade enough creditors to give it debt relief, leading to protracted economic decline. Such problems called for contractual or statutory analogues to domestic bankruptcy.¹⁰

Both the loans and the bonds at the center of this literature were denominated in foreign currency, governed by foreign (usually New York or English) law, and presumptively held by foreign residents. But the incident that jump-started the policy response to collective action problems, Mexico's "Tequila" crisis in 1994–95, centered on tesobonos—Mexican-law treasury instruments denominated in pesos and indexed to the U.S. dollar.¹¹ Some tesobonos were held by foreigners, but most were not. The fact that tesobonos were domestic bonds was completely overshadowed by the fact that they were bonds, and bonds were bad news.¹²

Domestic debt in poor and middle-income countries grew over the next decade; all the while the world debated how to amend New York- and

American Debt Regime, 16 NW. J. INT'L L. & BUS. 5 (1995); Symposium, *Sovereign Debt Restructuring*, 6 CHI. J. INT'L L. 177 (2005).

10. See, e.g., BARRY EICHENGREEN & RICHARD PORTES, *CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS* (1995) (an influential proposal for improving sovereign workouts, advocating contract reform); Kenneth Rogoff & Jeromin Zettelmeyer, *Early Ideas on Sovereign Bankruptcy Reorganization: A Survey* (Int'l Monetary Fund [IMF] Working Paper, Paper No. 02/57, 2002), available at <http://ssrn.com/abstract=879533> (providing an overview of academic proposals for a sovereign bankruptcy regime). Recently, the two alternatives were associated with their leading policy proponents, economists John Taylor and Anne Krueger. See John B. Taylor, Under Sec'y of Treasury for Int'l Affairs, *Sovereign Debt Restructuring: A U.S. Perspective*, Speech at the Conference on Sovereign Debt Workouts: Hopes and Hazards, Institute for International Economics (Apr. 2, 2002), available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=455> (on contracts); Anne O. Krueger, First Deputy Managing Dir. of the IMF, *New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking*, Speech at the Conference on Sovereign Debt Workouts: Hopes and Hazards, Institute for International Economics (Apr. 1, 2002), available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=454> (on bankruptcy). For background on the last round of initiatives, see Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627 (2006) (on contracts), and Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 GEO. J. INT'L L. 299 (2005) (on bankruptcy).

11. For a discussion of tesobonos in the context of Mexico's public debt management, see, for example, United Mex. States, Annual Report (Form 18-K), Exhibit D: Current United Mexican States Description, at D-79 to D-80 (Oct. 17, 2002), available at <http://www.sec.gov/Archives/edgar/data/101368/000095012302009762/y64564exv99wd.htm>; MEXICO 1994: ANATOMY OF AN EMERGING-MARKET CRASH (Sebastian Edwards & Moisés Naím eds., 1997) (a collection of essays on the causes and implications of the Tequila crisis), and GOLDSTEIN & TURNER, *supra* note 1, at 12–13, 14 tbl.2.2 (describing the role of tesobonos in the crisis). For a contemporary emerging market reaction, see, for example, Melike Altinkemer, *Problems with Issuing Foreign Currency and Foreign Indexed Bonds in the Light of Mexican Experience* (The Cent. Bank of the Republic of Turk., Discussion Paper No. 9617, 1996), available at <http://www.tcmb.gov.tr/research/discus/dpaper17.html>.

12. See generally EICHENGREEN & PORTES, *supra* note 10, at 28–30, 48 (citing Rory Macmillan, *Personal View: New Lease of Life for Bondholder Councils*, FIN. TIMES (London), Aug. 15, 1995, at 11) (in response to the Mexican crisis, stressing coordination problems in bonded debt and proposing to establish analogues to early twentieth-century foreign bondholder committees).

English-law bonds held by foreigners. According to the Bank for International Settlements (BIS), the outstanding stock of domestic bonds in these countries went from one trillion dollars in 1995 to over four trillion dollars in 2006, with public sector borrowing close to three-quarters of the new total.¹³ In Mexico, domestic government debt went from just over twenty percent of total debt stock in 1995 to nearly eighty percent in 2007.¹⁴ This rise in domestic debt went hand in hand with innovations in risk management. In the emerging markets, credit derivatives—contracts to transfer credit risk among market participants—grew from zero in the mid-1990s to roughly three hundred billion dollars in 2005, surpassing the market capitalization of the leading bond index at the time, and projected to double annually.¹⁵

A shift from foreign to domestic borrowing and the rise of new risk transfer tools on such a vast scale portend fundamental change for many countries—reducing vulnerability to currency crises, multiplying debt management options for governments, developing domestic financial markets, and expanding access to credit.¹⁶ For those who see direct links between investor interest and institutional quality, the shift could signal new trust in emerging market institutions, from legal infrastructure to exchange rate regimes. The shift makes the emerging economies look more like “mature” rich ones, with their deep domestic markets and rapid financial innovation.

Yet since there is no single agreed upon definition of “domestic debt,” the scope and significance of the shift are unclear.¹⁷ Change is measured by

13. COMM. ON THE GLOBAL FIN. SYS., BANK FOR INT’L SETTLEMENTS, FINANCIAL STABILITY AND LOCAL CURRENCY BOND MARKETS 2, 3 fig.A1, 57 (2007), available at <http://www.bis.org/publ/cgfs28.pdf> [hereinafter CGFS ON LOCAL CURRENCY BOND MARKETS].

14. Secretaría de Hacienda y Crédito Público, United Mex. States, Outstanding Federal Government Debt, http://www.apartados.hacienda.gob.mx/clon_estadisticas/english/html/mensual.html (follow “Public Debt” hyperlink; toggle to “Advanced” radio button; select December 1995 or August 2007 under “Period,” then follow “Outstanding Federal Government Debt” hyperlink) (last visited Sept. 26, 2007).

15. The total refers to notional amounts outstanding. B. GERARD DAGES, DAMON PALMER & SHAD TURNEY, FED. RESERVE BANK OF N.Y., AN OVERVIEW OF THE EMERGING MARKET CREDIT DERIVATIVES MARKET 3 (2005), available at <http://www.bis.org/publ/cgfs22fedny4.pdf>. J.P. Morgan’s EMBI Global tracks dollar-denominated debt securities issued by emerging market governments under foreign law. KIM, EMBI GLOBAL AND EMBI GLOBAL DIVERSIFIED, *supra* note 3, at 1. Until recently, it was considered to be the benchmark for emerging market debt as an asset class.

16. See, e.g., Group of Eight, *G8 Action Plan for Developing Local Bond Markets in Emerging Market Economies and Developing Countries* (May 19, 2007), available at <http://www.g7.utoronto.ca/finance/g8finance-bond.pdf> [hereinafter *G8 Action Plan*].

17. This is partly due to the difficulty of gathering statistics in new and diverse institutional settings. Fin. Stability Forum, Working Group on Capital Flows, *Report of the Working Group on Capital Flows*, 43–48 (Apr. 5, 2000), available at http://www.fsforum.org/publications/Capital_flows00.pdf; CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 4, 89–90; *G8 Action Plan*, *supra* note 16, at 2.

proxy as growth in local-currency,¹⁸ locally-held,¹⁹ locally-issued,²⁰ or local-law²¹ debt. To be sure, all of the above grew, but not necessarily in tandem. And the tools designed to manage credit risk in the mainstream markets often cannot do the same in the emerging ones. Assessing change thus requires unpacking its different dimensions to reveal the legal and currency regimes, actors, instruments, and risk-shifting strategies that make up the new financial landscape in the emerging markets.

This symposium contribution examines four such dimensions—governing law, currency of denomination, identity of the creditors, and credit risk transfer—focusing on the implications for emerging market sovereign debt. Government debt is a sensible starting point for studying change because it still dwarfs private debt in poor and middle-income countries. Although domestic corporate issuance is substantial in some parts of the emerging world and rising fast in many more, to the extent there is a story of large-scale transformation, it is most apparent with sovereigns.

Parsing recent sovereign borrowing in this way reveals a partial convergence between emerging and mainstream markets. The two may share investors and use similar financial instruments, but this formal resemblance does not necessarily stand for substantive identity. Instead, investors use similar instruments differently in different markets, which, as some of the examples in the text suggest, can be a new source of risk. The image of “emergence” as a linear march to an ideal of market “maturity” (“development” rebranded) can obscure more than it reveals.

Law scholars played a central role in addressing the shift from bank loans to tradable bonds in the 1990s, but have yet to engage with the rise of domestic debt and credit derivatives in the emerging markets. The goal of this essay is not to offer the definitive analytical framework or policy prescription, but to map the ongoing transformation in a way that highlights gaps between formal and substantive convergence and indicates potential directions for future research.

18. See, e.g., RICHARD G. BENNETT, SHAKU PITHAVADIAN, GLORIA M. KIM & JENNIE BYUN, J.P. MORGAN SECURITIES INC., INTRODUCING THE JPMORGAN GOVERNMENT BOND INDEX-EMERGING MARKETS (GBI-EM) 1 (2006) (on file with author); Stijn Claessens, Daniela Klingebiel & Sergio L. Schmukler, *Government Bonds in Domestic and Foreign Currency: the Role of Institutional and Macroeconomic Factors*, 15 REV. INT'L ECON. 370, 372 (2007) (emphasizing currency of denomination over place of issuance).

19. See, e.g., IMF, BALANCE OF PAYMENTS MANUAL ¶¶ 13, 21, 57–64 (5th ed. 1993).

20. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 18, 112; Olivier Jeanne & Anastasia Guscina, *Government Debt in Emerging Market Countries: A New Data Set 6* (IMF Working Paper, Paper No. 06/98, 2006), available at <http://www.imf.org/external/pubs/ft/wp/2006/wp0698.pdf> (emphasizing place of issuance over residence of the holder).

21. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 18, 112.

The next section elaborates on the context for the transformation. Section II then examines four dimensions of change. Starting with governing law, it suggests that, contrary to popular perceptions, the rise of local-law debt may increase uncertainty about crisis resolution. Second, it notes that risk-sharing features often presumed to inhere in local-currency debt are easy to vary by contract, and that such variations were at the center of several recent crises. Third, it argues that the new diversity, mixing, and churning of creditors to emerging market governments may narrow the space for preemptive debt restructuring and may shrink the authorities' options in crisis. Credit risk transfer can exacerbate this effect. In addition, credit derivatives on emerging market sovereign debt have featured disproportionately in recent lawsuits and have helped shape the law governing the broader, multi-trillion dollar derivatives market. This essay concludes with implications for governance, risk management, and research.

I. ALMOST MAINSTREAM

In the emerging markets of the 1980s and 90s, creditors, borrowers, and instruments were segmented. Foreigners and local residents rarely held the same claims. Foreigners usually lent foreign currency under foreign-law contracts; locals lent local currency under local law.²² These divisions seemed especially stark since risk stayed with the creditors advancing the cash: the emerging markets lacked the risk transfer machinery that was reshaping mainstream finance.²³

Segmentation had two sets of pragmatic and analytical consequences. First, it made sense for academics and policymakers to treat emerging market financial vulnerabilities in a piecemeal fashion. For example, the sovereign bankruptcy proposal advanced by the International Monetary Fund (IMF) in 2001 addressed only sovereign bonds governed by foreign law.²⁴

22. Dollarized economies are an important but partial exception to the pattern of local residents holding local-currency claims. See Anne-Marie Gulde et al., *Dealing with Banking Crises in Dollarized Economies*, in INT'L MONETARY FUND, OCCASIONAL PAPER NO. 217, MANAGING FINANCIAL CRISES: RECENT EXPERIENCE AND LESSONS FOR LATIN AMERICA 54 (Charles Collyns & G. Russell Kincaid eds., 2003).

23. See Frank Packer & Chamaree Suthiphongchai, *Sovereign Credit Default Swaps*, BIS Q. REV., Dec. 2003, at 79, available at http://www.bis.org/publ/qtrpdf/r_qt0312g.pdf; DAGES ET AL., *supra* note 15. See generally FRANK PARTNOY, *INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS* (2003) (describing the emergence of complex risk transfer techniques in the mainstream markets).

24. See Hagan, *supra* note 10, at 350–52.

Governments were expected to sort out local debts on their own by changing the law, printing more currency, or squeezing local lenders.²⁵

Second, segmentation meant that those who worried about financial stability in the mainstream markets could safely ignore the emerging ones, except when mainstream institutions got mixed up there. The Latin American debt crisis in the 1980s threatened the health of large U.S. banks, which occasioned the Baker and Brady plans.²⁶ Russia's 1998 debt default brought down a Connecticut hedge fund, which threatened to bring down Wall Street, which in turn called for a Fed-orchestrated bailout.²⁷ Such exceptions aside, the emerging markets stood apart: actors, instruments, incentives, and the institutional rescue machinery (notably the IMF)²⁸ were distinct from, unlike, and essentially irrelevant to the mainstream. Emergence was at once a path to the mainstream and a way of denoting the distance between here and there.

The gap between emerging and mainstream financial markets began to narrow in the 1990s, but it took years for change to become visible. Financial liberalization early in the decade brought foreigners into the local markets (such as they were) and let locals invest abroad. A wave of crises halted the trend, but it resumed in the early 2000s. After the crises, governments in poor and middle-income countries focused on saving money. Their savings helped produce a surfeit of global capital,²⁹ which in turn supported the governments' efforts to cultivate domestic markets to guard against future shocks.

By 2005, investors faced a new world: money was cheap, lending to the mainstream paid little, and default looked remote even for the most marginal states. What little risk remained seemed easy to diffuse with financial technology, such as forward currency and credit derivative contracts. Emerging markets as an asset class shifted away from foreign law

25. *Id.*; IMF, SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS 12–19 (2002), available at <http://www.imf.org/external/np/pdr/sdrm/2002/081402.htm>.

26. See Ross P. Buckley, *The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993*, 21 *FORDHAM INT'L L.J.* 1802, 1802–15 (1998).

27. ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2000); PAUL BLUSTEIN, *THE CHASTENING* chs. 9, 11 (2001) (on the Russian Crisis and the Long-Term Capital Management rescue); THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT* 10–13 (1999), available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf>. Of course, Russia's crisis also raised security concerns apart from its effect on mainstream market institutions.

28. The last G7 country to borrow from the IMF was the United Kingdom, in 1977. JAMES M. BOUGHTON, *SILENT REVOLUTION: THE INTERNATIONAL MONETARY FUND 1979–1989*, at 180 (2001).

29. See, e.g., Governor Ben S. Bernanke, *The Global Saving Glut and the U.S. Current Account Deficit*, Remarks at the Sandridge Lecture, Virginia Association of Economics (Mar. 10, 2005), available at <http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm>.

and foreign currency to local law and local currency.³⁰ If the United States could sell dollar-denominated treasuries to foreigners,³¹ Brazil could now sell them bonds denominated in reals.³² Convergence was nigh.

II. DIMENSIONS OF CHANGE

The developments described in the preceding passage get credit for improving sovereign debt management flexibility and deepening local capital markets—both important milestones in emergence. Using one economist's metric, the shift to domestic borrowing looks like a shift from transactional (emerging) to institutional (mature) commitment strategies: investors no longer demand to be paid dollars in New York but rather seem to rely on the borrower's own institutions for managing its currency and enforcing its contracts.³³ To find out the extent to which the shift from transactional to institutional commitment has in fact taken place, and whether it translates into less risk for sovereigns, their lenders, and the system, this section unpacks different dimensions of change. It examines governing law, currency of denomination, creditor identity, and credit risk transfer, asking what has changed and why it matters.

A. *Governing Law*

The choice of foreign law to govern emerging market debt is usually specified in the debt contract, along with the parties' choice of dispute resolution forum.³⁴ Governing law provisions are less common in debt marketed domestically. It is often assumed that the issuer's own laws, as interpreted by its own courts, will govern such debt.³⁵ The growth in sovereign debt explicitly or presumptively governed by local law, and its new prominence in the portfolios of foreign investors, raises two kinds of questions: How would local-law debt contracts perform in crisis? And does the growth in local-law debt reflect newfound trust in emerging market legal

30. See CHANG ET AL., *supra* note 3; INTER-AM. DEV. BANK, *LIVING WITH DEBT: HOW TO LIMIT THE RISKS OF SOVEREIGN FINANCE* (2006).

31. U.S. Dep't of the Treasury & Fed. Reserve Bd., Major Foreign Holders of Treasury Securities, <http://www.treas.gov/tic/mfh.txt> (last visited Nov. 21, 2007). Central banks in the emerging markets are important buyers of U.S. Treasury securities.

32. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 24.

33. Mody, *supra* note 2, at 643.

34. BUCHHEIT, *supra* note 4, at 128, 135.

35. Reply Brief of Republic of Argentina and Banco Central de la Republica Argentina, Republic of Arg. v. Weltover, Inc., 504 U.S. 607 (1992) (No. 91-763), 1992 U.S. S. Ct. Briefs LEXIS 262, at **21-23 (arguing that Argentine legal references in the text of a domestic bond imply a choice of law and forum).

systems on the part of investors? This subsection focuses on the former question; in conclusion, it suggests directions for further study to elaborate on the latter.

The traditional view of crisis management takes governing law as proxy for the legal framework in which future financial distress would unfold. The sovereign borrower is then presumed capable of restructuring domestic-law obligations unilaterally, using legislative or executive measures to change the terms. Both these assumptions implicitly rely on a view of financial markets as segmented; both turn out to be problematic.

First, while most courts will respect contractual choice of law and forum made by sophisticated parties, if no explicit choice has been made—as is often the case in domestic debt—a foreign court may well take jurisdiction after finding a reasonable connection between the transaction and the forum.³⁶ Where the issue is straightforward payment default, a diligent investor may well find a sympathetic judge outside the borrowing country willing to call nonpayment a breach, even under the borrower's own laws.³⁷

A 1992 U.S. Supreme Court case at the center of the sovereign debt canon illustrates the point. The case involved bonods, Argentine-law instruments that had no clear provision for choice of forum or submission to jurisdiction.³⁸ The plaintiffs were not U.S. residents. Argentina vigorously protested the United States' assertion of jurisdiction. But the justices had no trouble letting New York courts hear the case based on the fact that bondholders had the option to be paid dollars in New York.³⁹ The case settled.

36. See, e.g., RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES pt. IV, ch. 2, introductory note (1987) (describing a trend away from territorial jurisdiction to recognizing a broader range of links); *id.* § 421 (Jurisdiction to Adjudicate).

37. Cf. *German High Court Rules Argentina Must Repay Bondholders*, MERCOPRESS (Uru.), July 7, 2007, <http://www.mercopress.com/vernoticia.do?id=10866&formato=pdf>; Karin Matussek, *Argentine Financial Crisis Doesn't Bar German Suits*, BLOOMBERG NEWS, July 5, 2007, <http://www.bloomberg.com/apps/news?pid=20601086&sid=aCEnnBN.i3x8&refer=news> (discussing a German court decision addressing the effect of Argentine economic emergency legislation under international law).

38. Reply Brief of Republic of Argentina and Banco Central de la Republica Argentina, *supra* note 35, at *21.

39. The case turned on the scope of the commercial activity exception under the Foreign Sovereign Immunities Act, 28 U.S.C. § 1605(a)(2) (2000). Under this provision, a sovereign is not immune and can be sued in a U.S. court based on "an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States." *Id.* The court ruled unanimously that borrowing money was a commercial activity, regardless of the purpose of the borrowing, and that a default on a bond that could be paid in New York had a sufficiently direct effect in the United States to support jurisdiction. *Republic of Arg. v. Weltover, Inc.*, 504 U.S. 607, 615–16, 618–19 (1992).

The legal regime most relevant for managing the next crisis may turn out to be *ex post* accidental. This is because judgments against sovereigns are almost impossible to enforce for lack of attachable assets outside the borrower's territory. Therefore, the most relevant court for a creditor seeking to recover may be in a country where she has found a pot of sovereign gold or, more likely, a payment stream susceptible to interception. This was the case in the late 1990s and early 2000s, when Belgium became the epicenter of sovereign debt litigation. Creditors targeted Belgium because it was the home of the main clearance and settlement system in the Euromarkets, processing trillions of dollars in payments and securities, including sovereign issues. In at least two cases against Latin American sovereigns, Belgian courts were willing to enjoin government payments to new creditors until debt judgment holders got a pro rata share of those payments.⁴⁰ Wall Street lawyers criticized this reading of New York-law contracts; mainstream market authorities ultimately preempted it with a Belgian law shielding Euroclear from injunctions.⁴¹ But jurisdiction doctrines continue to bring into play old-fashioned, mechanical attributes of sovereign debt issuance (location of the closing, payments, and clearance and settlement path), which may determine the legal universe in which disputes involving both foreign- and domestic-law debt will be resolved—often long after default.

Second, it is not apparent that governments defer to foreign or international tribunals any more than they do to their local courts. After its 2001 crisis, Argentina's government enacted emergency measures altering domestic financial contracts, including its own.⁴² It also defaulted on about one hundred billion dollars in foreign-law debt. It then faced hundreds of lawsuits worldwide and many more in Argentina. Six years later, many Argentines who lost out from the emergency measures and sued at home got partial compensation through direct and indirect channels.⁴³ Foreign

40. See *République du Nicaragua v. LNC Investments LLC*, No. 2003/KR/334 (Cour d'Appel de Bruxelles, Neuvième Chambre [Court of Appeals of Brussels, Ninth Chamber] Mar. 19, 2004) (unofficial translation on file with author); *LP Elliott Assocs.*, No. 2000/QR/92 (Cour d'Appel de Bruxelles, Huitième Chambre [Court of Appeals of Brussels, Eighth Chamber] Sept. 26, 2000) (unofficial translation on file with author); see also *Elliott Assocs., L.P. v. Banco de la Nacion*, 194 F.R.D. 116 (2000); Declaration of Professor Andreas F. Lowenfeld 11–12, *Elliott Assocs., L.P. v. Banco de la Nacion*, No. 96-7916, 2000 WL 1449862 (S.D.N.Y. Sept. 29, 2000).

41. See G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 *BUS. LAW.* 635 (2001); Vladimir Werning, *Argentina Debt Restructuring: Belgian Legal Reform Limits the Options of Hold Outs*, *EMERGING MARKETS TODAY*, Feb. 24, 2005 (on file with author).

42. Horacio Spector, *Constitutional Transplants and the Mutation Effect*, 83 *CHI.-KENT L. REV.* 129, 138–44 (2008).

43. The Republic of Arg., Prospectus (Registration No. 333-117111), at 112–14 (Dec. 27, 2004), available at <http://www.sec.gov/Archives/edgar/data/914021/000095012305000302/y04567e424b5.htm> #108. For example, banks paid the judgments and were later recapitalized by the government. See

creditors who refused to take part in Argentina's debt restructuring and sued abroad have yet to collect a penny.⁴⁴ The difference may have a lot to do with the identity of the creditors involved, discussed below. However, it is worth acknowledging that the choice of foreign law and resort to foreign fora have yet to bring higher (or any) litigation recovery. After Argentina, it also makes sense to ask whether and when a government may be willing to pay creditors to preserve the domestic legitimacy of its own legal system in financial and political crisis.⁴⁵ Scores of lawsuits in and outside Argentina are fertile ground for empirical analysis.

In sum, recent growth in domestic-law sovereign debt and foreign investment in it does not mean that governments in distress get to do as they please. Understanding change requires shifting focus from New York law and Second Circuit jurisprudence⁴⁶ to transnational dispute resolution. Doing so puts the past in a different light: even when New York- and English-law debt dominated, the greatest legal risk for sovereigns came from the likes of Belgian courts applying New York law,⁴⁷ New York courts applying Argentine law,⁴⁸ and German courts applying public international law.⁴⁹ This idiosyncratic path of law-making and payouts has benefited a few, but on balance may have increased uncertainty about enforcement and recovery.⁵⁰ Uncertainty—as distinct from sovereign impunity—may grow with domestic debt, as more combinations of borrowers, creditors, contract documentation practices, and national legal regimes come into play. This in turn may create demand for more standardization *ex ante* and may boost

FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, *DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES 185–86* (2006) (describing litigation and compensation awards in Argentina).

44. The judge presiding over much of the litigation against Argentina in the Southern District of New York famously observed, “[s]o the lawsuits, thus far, have not yielded, not only have they not yielded a hundred cents on the dollar, they have not yielded one cent on the dollar.” Transcript of Hearing at 18, *H.W. Urban GmbH v. Republic of Arg.*, No. 02-CV-5699, 2006 U.S. Dist. LEXIS 9668 (S.D.N.Y. Mar. 9, 2006). Judge Griesa’s observation still holds. *See also* Anna Gelpern & Brad Setser, *Domestic and External Debt: The Doomed Quest for Equal Treatment*, 35 *GEO. J. INT’L L.* 795, 804–10 (2004) (describing the treatment of domestic and foreign bondholders in Argentina’s last crisis).

45. Spector, *supra* note 42, at 138–44; STURZENEGGER & ZETTELMEYER, *supra* note 43, at 185–86.

46. *See, e.g.*, Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguard?: The Role of Litigation in Sovereign Debt Restructuring*, 53 *EMORY L.J.* 1043 (2004); Marcus Miller & Dania Thomas, *Sovereign Debt Restructuring: The Judge, the Vultures and Creditor Rights*, 30 *WORLD ECON.* 1491 (2007).

47. *Supra* note 40 and accompanying text.

48. *Republic of Arg. v. Weltover, Inc.*, 504 U.S. 607 (1992).

49. *See* sources cited *supra* note 37.

50. Eric Lindenbaum & Alicia Duran, *Debt Restructuring: Legal Considerations*, EMERGING MARKETS (Merrill Lynch & Co., New York, N.Y.), Oct. 30, 2000, at 4, available at http://www.emcreditors.com/pdf/n_merrill_debt%20restr.pdf (arguing that litigation against Peru in Belgium would make a Nigerian debt exchange more difficult); Gelpern & Gulati, *supra* note 10, at 63–64 (citing an emerging market fund manager blaming the Belgian litigation for uncertain recovery values in sovereign restructuring).

the appeal of statutory sovereign bankruptcy or international dispute resolution such as arbitration.⁵¹

Beyond crisis management, the rise of domestic-law debt in the emerging markets offers an opportunity to ask questions about the content and significance of legal regimes that underpin government borrowing. It is widely assumed that investors demanded contracts governed by New York or English law because, in the words of one sovereign debt veteran, “[o]nly legal systems that have a well-developed law relating to international financial transactions can supply . . . predictability” in contract enforcement.⁵² Does the fact that Mexico can now finance itself using local-law instruments much like the U.S. treasuries reflect investors’ judgment that its legal system can supply predictability, and that it did not in the past? To what extent is the new interest in Mexican-, Brazilian-, Ukrainian-, and Ghanaian-law debt a vote of confidence in emerging market legal systems rather than a reflection of their economic performance, the capital glut, and miscellaneous technical factors? How does the answer differ from country to country—at what point, if ever, does confidence in the legal regime help drive investment in local-law assets? This line of inquiry is more viable now that governing law has occasionally decoupled from other factors, such as currency of denomination and residence of the holder.⁵³

A distinct but related set of questions arises in connection with local-currency borrowing.

B. Currency

In 2006, J. P. Morgan’s family of emerging market government debt indices got a new sibling: GBI-EM tracks liquid local-currency government debt of poor and middle-income countries.⁵⁴ Market capitalization for the new index at the start of 2007 was \$693 billion, more than twice that of the older flagship index for foreign-currency debt of the same countries.⁵⁵

51. Karen Halverson Cross, *Arbitration as a Means of Resolving Sovereign Debt Disputes*, 17 AM. REV. INT’L ARB. (forthcoming 2008), available at <http://ssrn.com/abstract=1014833>. For a perspective on the transnational litigation research agenda, see Samuel P. Baumgartner, *Transnational Litigation in the United States: The Emergence of a New Field of Law*, 55 AM. J. COMP. L. (forthcoming 2007).

52. BUCHHEIT, *supra* note 4, at 130.

53. *But see, e.g.*, Kevin E. Davis, *What Can the Rule of Law Variable Tell Us About Rule of Law Reforms?*, 26 MICH. J. INT’L L. 141 (2004) (pointing out problems with recent attempts to establish empirically the relationship between law and economic development); Tamara Lothian & Katharina Pistor, *Local Institutions, Foreign Investment and Alternative Strategies of Development: Some Views From Practice*, 42 COLUM. J. TRANSNAT’L L. 101 (2003).

54. BENNETT ET AL., *supra* note 18, at 1. The report launching the index observed that “JPMorgan created the GBI-EM as local instruments enter the mainstream of investors’ decisions.” *Id.*

55. CHANG ET AL., *supra* note 3, at 4 (citing GBI-EM Broad market capitalization at \$693 billion, compared to EMBI Global at \$299 billion). Narrower indices show a similar relationship: GBI-EM

GBI-EM is also part of J. P. Morgan's Government Bond Index (GBI) family, which follows mainstream market government bonds. The two families were joined at last.

This subsection examines the extent to which new local-currency instruments reflect assumption of emerging market currency risk by the creditors. Where they do not, it asks whether the resulting arrangements for sharing currency risk create new vulnerabilities. Put differently, are emerging market borrowers reaping the benefits traditionally associated with issuing local-currency debt? And are investors and policymakers addressing the risks embedded in the new instruments?

The shift from foreign- to local-currency borrowing has attracted more policy attention than any other dimension of change. It is easy to see why currency matters. Local-currency debt is usually nominal to the sovereign issuer⁵⁶—its value changes with inflation and can be altered by the debtor without changing contract terms. Printing money reduces the local-currency debt burden. It may also raise prices, depress the value of the currency, and increase the burden of servicing foreign-currency debt. Similarly, an external shock that brings down a currency takes the local-currency debt burden down with it; the burden of paying foreign-currency debt goes up. Recent growth in medium- and long-term local-currency debt and foreign interest in it seems to imply that investors trust emerging market governments to keep their currencies reasonably stable and valuable.⁵⁷

This apparent link between local-currency debt and faith in government policies requires elaboration. For example, just because an instrument

Global at \$468 billion, compared to EMBI+ at \$222 billion. *Id.*; see also DRAUSIO GIACOMELLI, CLAUDIO PIRON, WILLIAM OSWALD & GRAHAM STOCK, J.P. MORGAN SECURITIES INC., LOCAL MARKETS GUIDE—LATIN AMERICA 4–5 (2007) (citing similar numbers and observing that growth in domestic government debt is evidence of “enter[ing] mainstream” and “convergence”).

56. Economies where financial assets and liabilities are indexed to inflation are an exception: the real burden of local-currency debt indexed to prices does not go down as a result of inflation. For an example of the effects of indexation on local- and foreign-currency debt management, see Luis Óscar Herrera & Rodrigo O. Valdés, *Dedollarization, Indexation and Nominalization: The Chilean Experience* (Cent. Bank of Chile, Working Paper No. 261, 2004), available at <http://www.bcentral.cl/estudios/documentos-trabajo/pdf/dtbc261.pdf>.

57. See Jeanne & Guscina, *supra* note 20, at 10, 24–26 fig.10 (suggesting that recent history of hyperinflation constrains governments' abilities to issue long-term domestic debt). For governments, promoting stable and valuable currencies includes refraining from printing money and reducing currency mismatches in the economy. The crises of the 1990s brought home the danger of such mismatches. Banks, companies, and governments borrowed dollars because they could not borrow local currency long-term in the local markets. But their assets and revenues were in local currency. Crisis hit, assets lost value, debts ballooned, and economies went bankrupt. See generally GOLDSTEIN & TURNER, *supra* note 1 (explaining currency mismatches and their implications); Mark Allen, Christoph Rosenberg, Christian Keller, Brad Setser & Nouriel Roubini, *A Balance Sheet Approach to Financial Crisis* (IMF Working Paper, Paper No. 02/210, 2002), available at <http://www.imf.org/external/pubs/ft/wp/2002/wp02210.pdf>.

is denominated in a particular currency does not mean it is paid in it. At one end of the spectrum, Mexico's tesobonos were payable in Mexican pesos but indexed to the U.S. dollar.⁵⁸ This created a vulnerability not normally associated with local-currency debt: printing more pesos would reduce their value and raise the amount of pesos owed to the creditors. At the other end of the spectrum, Brazil and Colombia recently launched global bonds denominated in local currency and payable in U.S. dollars.⁵⁹ For both tesobonos and local-currency global bonds, exchange rate risk is separated from payment risk. In Mexico in 1994, investors shifted exchange rate risk back to the government. In Brazil in 2006, investors took the exchange rate risk, but not the risk of currency controls, since Brazil promised to pay abroad in foreign currency.⁶⁰ Under the terms of the global bond, if the real's value drops relative to the dollar, creditors get fewer dollars. Payment risk could still materialize under extreme conditions where no one is willing to sell dollars for reais at any price. The choice of New York law added to investor comfort.⁶¹

Even with instruments denominated and paid in local currency, the degree to which investors are in fact taking on local risk is uncertain. For example, in the run-up to Russia's financial crisis in 1998, foreigners bought local-currency treasury bills (GKOs) but sought to hedge themselves using forward currency contracts with Russian banks. The banks promised to deliver dollars in exchange for roubles at a set rate in the future, taking the risk that the rouble would lose value. Market participants widely assumed that the banks had implicit government backing; the strategy was to shift rouble risk from the foreign investors back to the Russian government via the Russian banks.⁶² The move backfired: in crisis, the government imposed currency controls that caused banks to breach their forward contracts.⁶³ The experience made foreign investors more wary of

58. See United Mex. States, Annual Report, *supra* note 11, at D-79 (referencing dollar indexation of the tesobonos).

59. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 24. This is not a new phenomenon. Debtor-currency bonds payable in creditors' currencies or gold were common in the nineteenth and early twentieth centuries. See 1 EDWIN BORCHARD, STATE INSOLVENCY AND FOREIGN BONDHOLDERS 26-36 (1951).

60. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 23-24.

61. Following a Belgian court decision against Peru, an investment bank report cited legal experts suggesting that the "time, currency, and most importantly place, of payment established in the fiscal agency agreement are 'of the essence.'" Lindenbaum & Duran, *supra* note 50, at 3.

62. NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS?: RESPONDING TO FINANCIAL CRISES IN EMERGING ECONOMIES 59-61 (2004).

63. *Id.* at 60; STURZENEGGER & ZETTELMAYER, *supra* note 43, at 100; Gelpert & Setser, *supra* note 44, at 801 (describing the capital controls and Russian bank defaults on currency contracts).

local counterparties whose willingness to take local risks came with embedded exposure to local institutions.

Investors can increasingly unload currency risk without implicating local partners by using offshore non-deliverable forward contracts (NDFs). Like deliverable forwards, NDFs shift exchange rate risk between contract parties; however, NDFs do not require the actual exchange of one currency for another. The party that placed the losing bet must deliver only the difference in value, not the full contract amount, to the other side at maturity. Most NDF trading in emerging market currencies takes place offshore and is settled in foreign currencies; most of the participants are foreign.⁶⁴ Today's NDF markets began with trading in Latin American currencies in the early 1990s; recently, market and policy attention has shifted to Asia.⁶⁵

NDF markets embody the dilemma of partial convergence between emerging and mainstream markets. A typical rationale for their existence involves restrictions on the ability of foreign and/or local residents to exchange local currency and the often-related dearth of currency hedging opportunities onshore.⁶⁶ A floating exchange rate and unrestricted onshore forward markets should (and did in Australia) obviate the need for offshore NDF trading. Where onshore and offshore markets exist in parallel—usually where governments fix or heavily manage the exchange rate—the relationship between the two can turn contentious.⁶⁷ Offshore NDF trading creates hedging options to support demand for local-currency debt, but can also put pressure on the local currency. Insured domestic institutions trading in NDF markets can compound a government's liability. Most recently, NDF trading was blamed for putting pressure on the Thai baht, prompting the government to ban local banks from participating.⁶⁸ On the other hand,

64. Most trading is also over-the-counter, subject to minimal regulation. See LAURA LIPSCOMB, FED. RESERVE BANK OF N.Y., AN OVERVIEW OF NON-DELIVERABLE FOREIGN EXCHANGE FORWARD MARKETS (2005), available at <http://www.bis.org/publ/cgfs22fedny5.pdf>; Guy Debelle, Jacob Gyntelberg & Michael Plumb, *Forward Currency Markets in Asia: Lessons from the Australian Experience*, BIS Q. REV., Sept. 2006, at 53, available at http://www.bis.org/publ/qtrpdf/r_qt0609g.pdf. In theory, NDF settlement can be onshore or offshore, in local or foreign currency. Australia had an active onshore NDF market in the 1970s and 1980s that disappeared soon after it removed currency controls. Debelle et al., *supra*.

65. Andy Mukherjee, Viewpoint, *Asian Policy Makers*, INT'L HERALD TRIB., Sep. 14, 2006, at 19, available at <http://www.iht.com/articles/2006/09/14/bloomberg/sxmuk.php>; Postings of Various Commentors to Brad Setzer's Blog, <http://www.rgemonitor.com/blog/setzer/94845> (Aug. 10, 2005).

66. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 56.

67. See sources cited *supra* note 65; Debelle et al., *supra* note 64.

68. See Press Release, Bank of Thailand, Revision of Measures to Prevent Thai Baht Speculation and Options on Unremunerated Reserve Requirement (Mar. 1, 2007), available at <http://www.bot.or.th/BOTHomepage/General/PressReleasesAndSpeeches/PressReleases/news2550/Eng/n1350e.htm>; Press Release, Bank of Thailand, Measures to Curb Short-term Capital Inflows (Dec. 4, 2006), available at <http://www.bot.or.th/BOTHomepage/General/PressReleasesAndSpeeches/PressReleases/News2549/Eng/n4849e.htm>.

onshore regulation can still impact the offshore market: unexpected bank holidays in Argentina in 2001 and Venezuela in 2003 disrupted NDF trading in their currencies.⁶⁹

In sum, local-currency bonds in the emerging markets may look much like their mainstream-market counterparts, but they often come with transactional features that limit the benefits of local-currency borrowing for the sovereign. The progression from Mexico's dollar-indexed tesobonos to Brazil's local-currency global bonds suggests that eventually investors may buy local-currency bonds issued by emerging market governments without simultaneously attempting to offload the currency risk or pass it back to the borrower. In the interim, Mexican and Russian crises show that contractual devices to opt out of emerging market currency regimes can obscure the location of currency risk and create a false sense of security on both sides of the transaction.

C. Creditors

More than a dozen emerging economies recently lifted restrictions on foreign participation in their domestic government bond markets. Meanwhile, emerging market institutions previously limited to holding domestic securities are buying bonds marketed to foreigners.⁷⁰ As a result, different investors have come to hold identical debt instruments. In addition, domestic debt traditionally held to maturity by local institutions is beginning to trade. This subsection explores the implications of these two developments for crisis management.

Creditor identity can trump both governing law and currency of denomination in determining government approaches to debt management. Governments want to know who their creditors are partly to predict how they would behave and to have a sense at least of the initial allocation of losses in the event of a debt crisis. Creditors have different risk tolerance, regulatory constraints, claims on the national treasury, and political connections. For their part, governments' capacity to influence their own citizens and foreigners, individuals and institutions, and regulated and unregulated lenders varies widely.

It is useful to elaborate on aspects of creditor identity that have played a role in crisis management. Balance of payments statistics turn on creditor

69. Without onshore trading, it was difficult or impossible to value NDF contracts at maturity. LIPSCOMB, *supra* note 64, at 5.

70. BENNETT ET AL., *supra* note 18, at 1–2 (on foreign participation in local markets); GOLDSTEIN & TURNER, *supra* note 1, at 96 (on local institutions buying foreign debt).

residence.⁷¹ It is the traditional way of delimiting the national economy—and the corresponding polity⁷²—from the rest of the world. Capital inflows are defined as transfers from nonresidents to residents; transfers to nonresidents are outflows. Governments' decisions to default or restructure are influenced by the politics of who wins and who loses. Where local residents vote or otherwise influence the government and resident institutions have a direct claim on the country's fiscal resources, the residence of the holder may reflect these concerns.⁷³

Recent restructuring experience confirms this intuition. For example, Argentine banks and pension funds continued to buy government debt under government pressure long after non-resident institutions had stopped. In crisis, they accepted local-law instruments rejected by foreigners.⁷⁴ This allowed the Argentine government to separate domestic and foreign creditors into different instruments, so that default on foreign-currency, foreign-law bonds was in the first instance a default on the foreigners.⁷⁵ Other governments have variously refrained from defaulting on debt held by local banks and have compensated local residents after default while leaving foreigners in the lurch. Administrative mandates, regulatory capital treatment, side payments, and good old-fashioned arm-twisting are examples of debt management tools that governments use more freely and successfully with local residents.

Using creditor residence as a proxy for creditor preferences and treatment in crisis raises two sets of concerns. First, residence may be either

71. IMF, *supra* note 19.

72. Allan Drazen, *Towards a Political-Economic Theory of Domestic Debt*, in *THE DEBT BURDEN AND ITS CONSEQUENCES FOR MONETARY POLICY* 159 (Guillermo Calvo & Mervyn King eds., 1998). Note that although balance of payments statistics *imply* a polity by defining a relevant space where economic agents move under government authority, in theory, an economy with residents need not correspond to any recognized political unit or depend on the recognition of other states. IMF, *supra* note 19, ¶¶ 21, 57–64.

73. Drazen, *supra* note 72 (focusing on interest groups and the domestic/external divide); Alexander Guembel & Oren Sussman, *Sovereign Debt Without Default Penalties* (Nov. 13, 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=885434> (arguing that debt default and restructuring are driven by the preferences of a median domestic voter).

74. The Republic of Arg., *supra* note 43, at 126, 165–66; STURZENEGGER & ZETTELMEYER, *supra* note 43, at 177–78 (describing Phase I/Phase II debt exchange plans); Gelpern & Setser, *supra* note 44, at 805–06.

75. See Giselle Datz, *Global-National Interactions and Sovereign Debt Restructuring Outcomes*, in *DECIPHERING THE GLOBAL: ITS SCALES, SPACES AND SUBJECTS* 323, 334, 336–37 (Saskia Sassen ed., 2007) (on the treatment and behavior of Argentine pension funds in the 2001 crisis). In November 2001, the pension funds along with other Argentine holders agreed to exchange their foreign-law bonds for Argentine-law, dollar-denominated loans. The government defaulted on the foreign bonds, but not on the local loans. It then unilaterally redenominated the loans into pesos. The pension funds balked. In response, the government reinstated the funds' holdings of foreign-law bonds, which by then were in default.

unknowable or misleading.⁷⁶ Even ignoring the impact of credit derivatives (discussed in the next subsection), active trading means that a bond may change hands many times in one day. No reporting system can keep up in real time. In addition, securities are commonly held through layers of intermediaries for reasons ranging from administrative convenience to tax evasion. It is often impossible to determine whether a creditor holds a bond on another's behalf.⁷⁷ The simplest example of this is the case of Russia, with the largest reported foreign resident exposure to local-currency instruments by dollar value (\$44.5 billion in September 2006).⁷⁸ Anecdotal evidence collected by regulators suggests that most of this debt is held by offshore Russian investors.⁷⁹ It is far from clear whether their behavior in crisis would resemble that of onshore Russians, bona fide foreigners, or neither.

Second, even if a creditor's residence were ascertainable, using it alone may obscure other proxies for creditor behavior. Did Argentine banks and pension funds, discussed earlier, act the way they did because they were Argentine, because they were regulated, or because the maturity structure of their assets differed from that of their liabilities? The answer must be some combination of the above. Among domestic investors, the rich may have more influence over their government⁸⁰ or may be politically easier to expropriate via domestic debt default.⁸¹ Wealthy individuals may have access to private information and more ways to move capital offshore in bad times. Local banks may have less leeway in crisis for fear of a run on deposits; in contrast, pension funds that make no payouts for years may be more flexible but also more politically expendable in the short run.⁸² Both banks and pension funds may succumb to pressure from the borrowing government whose priorities shift from prudential regulation to macro-economic crisis management. On the other hand, deposit insurance and governments' reluctance to stiff voting depositors or alienate bank owners

76. This is related to the more general concern, shared by students of the mainstream markets and discussed below, that the identity of the beneficial owner of an instrument and therefore creditor behavior may be difficult to ascertain at any given time due to active trading, layers of intermediaries, and credit risk transfer.

77. See *Fidelity Partners, Inc. v. First Trust Co. of N.Y.*, 58 F. Supp. 2d 52 (S.D.N.Y. 1997) (highlighting the importance of intermediaries and the difficulty of ascertaining beneficial ownership).

78. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 78.

79. *Id.*

80. Cf. Guembel & Sussman, *supra* note 73, at 3–4.

81. Michael Kremer & Paras Mehta, James Madison, George Soros, and Feldstein-Horioka: Disfavored Creditor Groups and Government Debt 31–32 (May 15, 2007) (unpublished manuscript), available at http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/miller/esrcproffellows/summer2007/programme2/kremer_-_globalizationand_publicfinance_07.09.07_notrack.pdf.

82. See Datz, *supra* note 75, at 334, 336.

may give banks bargaining leverage that other investors lack. Any of these factors may become salient in any given crisis; the ways in which they affect the crisis path and the policy response vary with the context.

Preferences also differ among foreign investors. Again, Argentina is a rich and pertinent example. Many of the creditors who rejected its debt restructuring offer (some twenty billion dollars in outstanding principal) likely were European individuals.⁸³ In contrast, most institutions agreed to restructure. There were also anecdotal reports of large-scale transfers from people to hedge funds on the eve of the debt exchange, which may have made the restructuring possible.⁸⁴ Among institutions, those that commit to holding emerging market debt, as well as regulated crossover investors (such as mainstream pension funds), may seek to avoid volatility. Surveys suggest that some crossover investors avoid instruments popular with hedge funds.⁸⁵

Finally, for many emerging markets there is still the sizable presence of foreign public (official) creditors. The old official creditors—wealthy G7 countries and international financial institutions such as the IMF and the World Bank—are receding in importance, thanks to prepayments by middle-income countries and debt relief for the poorest.⁸⁶ A different breed is replacing them: emerging market governments seeking some mix of policy influence and higher return on their enormous savings.⁸⁷ China and oil-exporting economies in the Middle East have attracted the most attention worldwide. In Latin America, the spotlight is on Venezuela, which has sought to use its oil wealth to expand its economic and political clout in the region. It stepped into the shoes of the IMF and foreign private creditors to buy Argentine bonds and has offered financing to Bolivia, Ecuador, and

83. Anna Gelpern, *After Argentina* 3, 7 (Peterson Inst. for Int'l Econ., Policy Brief No. 05-2, 2005), <http://petersoninstitute.org/publications/pb/pb05-2.pdf>.

84. Bottom-fishers are only happy to buy a bond from an Italian retiree for \$0.17 and sell it for double a week later, even where double may be a fraction of full face value. Active traders, such as hedge funds, can profit from price volatility. *Id.* at 7 box 2.

85. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 88. *See also* IMF, GLOBAL FINANCIAL STABILITY REPORT: MARKET DEVELOPMENTS AND ISSUES 74–84 (Apr. 2007), *available at* <http://www.imf.org/External/Pubs/FT/GFSR/2007/01/index.htm>.

86. *See, e.g.*, Murilo Portugal, Deputy Managing Dir., IMF, Remarks at a Debt Managers Conference (Feb. 8, 2007), *available at* <http://www.imf.org/external/np/speeches/2007/020807.htm> (citing examples of governments that have prepaid their debt to the IMF under favorable capital markets conditions); IMF, FactSheet—The Multilateral Debt Relief Initiative (MDRI), <http://www.imf.org/external/np/exr/facts/mdri.htm> (last visited Dec. 3, 2007); The Paris Club, Terms of Treatment, <http://www.clubdeparis.org/sections/termes-de-traitement> (last visited Sept. 13, 2007); The World Bank, Economic Policy and Debt—(HIPIC) The Enhanced Heavily Indebted Poor Countries Initiative, <http://www.worldbank.org/hipic> (last visited Sept. 13, 2007).

87. IMF, *supra* note 85, at 63, 85; Edwin M. Truman, *Sovereign Wealth Funds: The Need for Greater Transparency and Accountability* (Peterson Inst. for Int'l Econ., Policy Brief No. 07-6, 2007), *available at* <http://www.petersoninstitute.org/publications/pb/pb07-6.pdf>.

others. The question with the new batch of public creditors, as with the old, goes to the political exchange embedded in the debt relationship. If China or Venezuela is lending to extract cooperation, it may forbear or restructure more easily in crisis, but, just as the G7 before it, may use financial distress to secure policy commitments.

The discussion so far suggests that knowing creditor preferences and the incentives to which they respond is all-important for debtors, creditors, and international policy makers. Creditor residence has been the traditional proxy for political voice, as well as the size, strength, and likelihood of a creditor's claim on the borrowing government's resources. However, residence may be unknowable or misleading (as in the case of Russia). While policymakers increasingly recognize that other aspects of creditor identity (such as their status as regulated institutions, government agencies, or political pariahs) may turn out to be more important, these are no more ascertainable owing to active trading, layers of intermediaries, and risk transfer.

Preoccupation with creditor identity is not unique to the emerging markets. The political salience of Asian government holdings of U.S. treasuries is just one example of the same phenomenon in the rich world.⁸⁸ But borrowers such as the United States have adjusted to uncertainty from trading. They use surveys, reporting requirements, and other techniques to get a better sense of who their creditors are—and do not base their debt management on knowing for sure. Unlike the G7, whose domestic debt is freely traded, emerging market governments traditionally placed much of theirs with local banks for recapitalization or other domestic policy purposes.⁸⁹ Such debt was often non-tradable and low-yielding; it was uniquely valuable to the banks because their regulators treated it favorably. The sovereign borrower enjoyed the side benefit of knowing and regulating the bulk of its creditors. The presence of non-tradable debt in regulated institutions, described as a sign of market immaturity,⁹⁰ gave governments more scope for selective default and disparate treatment of its creditors in distress.⁹¹

As regulatory barriers and other transaction costs go down, this pattern of segmentation is receding:⁹² liquidity is the new goal, with fewer bespoke obligations tailored to specific creditor groups, and fewer options for a

88. *See, e.g.*, William Jefferson Clinton, Speech at the Democratic National Convention (July 26, 2004).

89. CGFS ON LOCAL CURRENCY BOND MARKETS, *supra* note 13, at 67–72. This is in large part a legacy of past crises, which required multiple rounds of bank recapitalization with low-interest, non-tradable, local-currency, local-law government bonds.

90. *Id.*

91. Gelpern & Setser, *supra* note 44, at 805–06.

92. *See supra* Section I.

government seeking to discriminate among them. Where segmentation persists, creditors that expect to be disfavored in distress (for example, foreigners) may seek out obligations held by those with more influence (for example, local banks or the median voter).⁹³ But this strategy is self-limiting: the presence of disfavored creditors dilutes the very influence that would protect them. Economists argue that with a rising probability of default thanks to the presence of disfavored creditors, borrowing costs could go up, offsetting or surpassing the savings from greater liquidity.⁹⁴

The diversity of sovereign debt holders, their intermingling, and the difficulty of ascertaining their identity evoke two kinds of responses among policy makers: calls for transparency and administrative restrictions.

Transparency is presumptively good. Governments should gather and disclose more information on their creditors, as well as their own lending.⁹⁵ However, calling for investment in transparency demands an acknowledgment of its costs and its limits. Some governments lack resources to ramp up statistical operations. A G8 “Action Plan” released in May 2007 promised support to develop statistical capacity for local bond markets in the emerging economies.⁹⁶ But even as traditionally domestic statistics gain international significance, wealthy government institutions do not always agree on what constitutes “domestic” debt, and, therefore, on what information should be gathered about it and why. Coordination among authorities is critical to achieve consensus on this point before launching new survey systems.

Moreover, as discussed earlier, no disclosure regime can operate in real time. Better, wider, and deeper surveys will reveal trends—which can better inform regulation, debt management, and political debate—but not who holds the bonds on the eve of default. Precision may have to wait until the morning after losses fall where they may.

Substantive rules and administrative restrictions, such as making some instruments off-limits to some investors (foreign governments, ordinary people, or institutions that hold their savings), are one way to address the limits of transparency. But governments face competing policy goals when devising rules of this sort. For example, to protect banks holding people’s deposits, it makes sense to restrict their investment options and cap their holdings of risky government debt. On the other hand, if the goal is to

93. See Guembel & Sussman, *supra* note 733.

94. Kremer and Mehta argue that the result of having favored and disfavored creditors mingled in the same instruments is a higher probability of default and higher borrowing costs. Kremer & Mehta, *supra* note 81, at 5–6.

95. Cf. Truman, *supra* note 87.

96. See G8 Action Plan, *supra* note 16.

maximize sovereign debt management flexibility, local banks make attractive creditors because they are susceptible to regulatory pressure. In practice, time consistency problems abound: governments cap local institutions' holdings of their bonds in good times, only to bribe or pressure them into breaching the caps in crisis.⁹⁷ And absent iron-clad capital controls and perfect international coordination, some evasion is inevitable.

In sum, the growing diversity of investors in government debt and more active trading in local bonds make the emerging markets look more mainstream. But to this day, "domestic government debt" in many countries evokes non-market instruments parked in local banks by some combination of mandate and special accommodation. The ongoing shift away from this model should prompt governments to rethink the use of creditor identity as a debt management tool. This is a sign of progress; it also makes for tough choices in countries that remain vulnerable to financial crises. Two implications follow. First, governments may be forced to rely less on their ability to discriminate among creditors and more on making the legal and financial terms of the debt instrument more flexible.⁹⁸ Second, with fewer options to manage creditor composition in advance, restructuring operations after the onset of financial distress may serve an increasingly important diagnostic function. At the extreme, a government may have no choice but to default on all creditors and compensate favored groups after their losses are ascertained.

D. Credit Risk

In the mainstream markets, concerns over creditor identity reappear as concerns over the location of risk in the financial system. Policymakers who worry about systemic risk have focused on the impact of credit derivatives.⁹⁹ Without shifting ownership of a debt instrument, a credit derivative

97. Argentina is one example. Pension funds were subject to caps on the order of 50%, which were flouted in 2001 with the government's blessing. Thomas V. Ciampi, *Help on the Way: Argentina's Pension Funds Get Incentives to Buy Bonds*, PENSIONS & INVESTMENTS, May 28, 2001, at 14.

98. See, e.g., INTER-AM. DEV. BANK, *supra* note 30, at 270-74.

99. See, e.g., Timothy F. Geithner, President and Chief Executive Officer, Fed. Reserve Bank of N.Y., Remarks at the Global Association of Risk Professionals (GARP) 7th Annual Risk Management Convention and Exhibition in New York City: Risk Management Challenges in the U.S. Financial System (Feb. 28, 2006), available at <http://www.ny.frb.org/newsevents/speeches/2006/gei060228.html>; Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks to the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure: Risk Transfer and Financial Stability (May 5, 2005), available at <http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050505/default.htm>. For the most comprehensive legal treatment to date, see Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007). The link between concern with creditor identity and the impact of credit derivatives is most explicit in the bankruptcy context. See, e.g., Stephen J. Lubben, *Essay: Credit Derivatives & the Future of Chapter 11* (Seton Hall Pub. Law Re-

contract can create a parallel set of obligations that effectively reconstitute a portion of the risk embedded in the debt contract. For example, in a credit default swap (CDS) one party (“protection seller”) agrees to pay the other (“protection buyer”) the full face value of a bond (“reference obligation”) if one or more bad things (“credit events,” such as payment default) happen to the bond or its issuer. The buyer pays a fee and, if it makes a claim, usually delivers the bond.¹⁰⁰ Investors use contracts like this, and many more complex variations,¹⁰¹ to offload credit risk embedded in the instruments they hold or to take stand-alone market positions without ever holding the underlying debt.

Credit risk is not a fixed, shared concept but rather a contingent one, defined by the terms of the transfer contract itself. For example, one CDS contract may use debt restructuring to trigger the seller’s payment obligation, while another may require bankruptcy or payment default.¹⁰² The two constitute and move different parcels of risk.

Parsing and shifting credit risk can alter creditor incentives. On a large scale, it can exacerbate the uncertainty about creditor identity and behavior in distress, and narrow the scope for preemptive measures further along the lines discussed in the preceding subsection. In this respect, which has received considerable policy and academic attention, the impact of credit derivatives on mainstream and emerging markets is essentially similar. This subsection focuses instead on the differences in the way these contracts function in mainstream and emerging markets and asks whether these differences pose new risks.

Contracts that reference emerging market debt are less than ten percent of the thirty trillion dollar global market in credit derivatives,¹⁰³ but

search Paper No. 906613, 2007), available at <http://ssrn.com/abstract=906613> (arguing that credit derivatives may undermine the current premise of the U.S. corporate reorganization regime that creditors have economic ownership of their claims against the debtor). For a similar argument in the emerging market sovereign context, see Pierre-Hugues Verdier, *Credit Derivatives and the Sovereign Debt Restructuring Process* 64–69 (Apr. 27, 2004) (unpublished LL.M. paper, Harvard Law School), available at http://www.law.harvard.edu/programs/pifs/pdfs/pierre_verdier.pdf.

100. Physical settlement—delivery of the reference obligation or permitted equivalent—is still common in the emerging markets; however, cash settlement is on the rise.

101. See e.g., Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 DUKE J. COMP. & INT’L L. 541 (2002) (discussing more complex structures for credit transfer); see also Claire A. Hill, Comment, *The Future of Synthetic Securitization: A Comment on Bell & Dawson*, 12 DUKE J. COMP. & INT’L L. 563 (2002); Partnoy & Skeel, *supra* note 99; Lubben, *supra* note 99 (discussing the implications of complex structures).

102. See, e.g., Elisabeth Bertalanffy, *Restructuring Debate Reaches Fed*, INT’L FINANCING REV., Dec. 2, 2006, at 97 (describing the implications of different credit event definitions for corporate credit derivatives markets in the United States and Europe).

103. Roger Merritt & James Batterman, *Fitch Ratings, Credit Derivatives Update* (Mar. 6, 2007), slides available at <http://www.fitchratings.com/dtp/pdf1-07/vcre0306.pdf> (citing notional outstanding

they account for two out of four reported U.S. cases on credit derivatives.¹⁰⁴ Emerging market contracts differ from mainstream market contracts in three ways. First, the bulk of emerging market credit derivatives are basic CDSs. Mainstream markets use more complex structured vehicles that are still rare in the emerging world.¹⁰⁵ Second, the underlying credit is overwhelmingly sovereign. Most mainstream contracts key off corporate credit.¹⁰⁶ Third, credit derivatives in the emerging markets transfer different risks and often serve very different functions than their mainstream counterparts. The remainder of this section elaborates on the second and third distinctions, which were at the heart of recent litigation.

1. Sovereign Misfits

Citibank chairman Walter Wriston's famous aphorism to the effect that states do not go bankrupt¹⁰⁷ may have been wrong as a matter of credit assessment, but remains an astute summary of the sovereign borrowing predicament. States routinely run short of funds and the political capacity to pay their creditors. But for states, unlike most borrowers, the moment of reckoning is inherently political and often self-judging.¹⁰⁸ The absence of a formal bankruptcy framework does not mean that sovereign default is discretionary; it does mean that apart from failure to pay, there is no natural (insolvency) or formal (bankruptcy) threshold that can serve as a proxy for extreme credit deterioration.¹⁰⁹ This is a problem for contracts that rely on hard triggers, such as the CDS.

The problem surfaced in a case that turned on the interplay between domestic and external sovereign debt. In 2001, a New York-based hedge

between twenty-five and thirty trillion dollars in June 2006, with sovereign credits at 4.2 percent of the total, based on data from the British Bankers Association, BIS and ISDA).

104. For disputes involving emerging market sovereign CDSs, see *Aon Fin. Prods., Inc. v. Société Générale*, 476 F.3d 90 (2d Cir. 2007); *Eternity Global Master Fund Ltd. v. Morgan Guaranty Trust Co. of N.Y.*, 375 F.3d 168 (2d Cir. 2004); and *Ursa Minor Ltd. v. Aon Fin. Prods., Inc.*, No. 00 Civ. 2474, 2000 U.S. Dist. LEXIS 10166 (S.D.N.Y. July 21, 2000). For disputes involving mainstream corporate CDSs, see *Deutsche Bank AG v. AMBAC Credit Prods., LLC*, 04 Civ. 5594, 2006 U.S. Dist. LEXIS 45322 (S.D.N.Y. July 6, 2006); *In re Enron Corp.*, 328 B.R. 58 (Bankr. S.D.N.Y. 2005); and *In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

105. IMF, GLOBAL FINANCIAL STABILITY REPORT: MARKET DEVELOPMENTS AND ISSUES 53 (Apr. 2006), available at <http://www.imf.org/External/Pubs/FT/GFSR/2006/01/index.htm>.

106. *Id.*; DAGES ET AL., *supra* note 15, at 1–2.

107. Walter B. Wriston, *Banking Against Disaster*, N.Y. TIMES, Sept. 14, 1982, at A27.

108. On the political character of sovereign debt and its implications, see generally Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J. 1159 (2004), and Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, 4 J. INT'L ECON. L. 613 (2001).

109. The concept of debt sustainability is an analogue to solvency; however, the thresholds are policy driven (as in official debt relief) and highly contested. See sources cited *supra* note 86 for World Bank, IMF, and Paris Club views on debt sustainability in the context of debt relief.

fund, Eternity Global, bought three CDS contracts on Argentine sovereign debt from a J. P. Morgan affiliate.¹¹⁰ As Argentina's credit plummeted, but before it missed its first debt payment, the government offered to swap foreign-law, foreign-currency bonds for Argentine-law, dollar-denominated loans with longer maturity and a much lower interest rate.¹¹¹ The offer was technically voluntary, designed to appeal to domestic institutions so as to segregate them from foreigners and set the stage for more restructuring operations.¹¹² Eternity was among the few foreign institutions to participate. It then turned to Morgan, claiming that Argentina's offer was a "mandatory transfer" of the old bonds in exchange for new ones with less favorable terms, which would trigger a credit event under the CDS contracts. Morgan refused to pay. Eternity sued. The district court in New York dismissed Eternity's complaint relying on Argentina's own (admittedly self-serving) characterization of the debt exchange as voluntary. The Second Circuit reversed, noting that the contractual definition of restructuring, including "mandatory transfer," was ambiguous enough for the case to go forward.¹¹³

The impact of the decision went far beyond Eternity's dispute with Morgan because CDS contracts are highly standardized. Standardization underpins the speed and informality that define this vast transnational market: multimillion dollar deals can consummate in minutes over the telephone.¹¹⁴ The International Swaps and Derivatives Association (ISDA) oversees the production of standard terms for most—including credit—derivative contracts. A court's interpretation of a standard term can unsettle market expectations. As the unofficial guardian of this market,¹¹⁵ ISDA steps in to avert disruption.

110. *Eternity Global Master Fund Ltd. v. Morgan Guaranty Trust Co. of N.Y.*, 375 F.3d 168, 174 (2d Cir. 2004). On the legal features and economic context of the bonds-for-loans exchange, see STURZENEGGER & ZETTELMAYER, *supra* note 43, at 177–78; Gelpern & Setser, *supra* note 44, at 804–10; and Setser & Gelpern, *supra* note 8, at 469.

111. STURZENEGGER & ZETTELMAYER, *supra* note 43, at 177–78; Gelpern & Setser, *supra* note 44, at 805. This exchange was also mentioned in the last subsection. See *supra* notes 74–75 and accompanying text.

112. It is quite plausible that domestic, though not foreign, institutions were pressured into participating. Local institutions also had strong regulatory incentives to participate. STURZENEGGER & ZETTELMAYER, *supra* note 43, at 177–78.

113. *Eternity Global Master Fund Ltd.*, 375 F.3d at 180–82.

114. See, e.g., Gillian Tett, *Bankers Get Lucky with Clean-Up of Credit Derivatives Trades*, FIN. TIMES (London), July 28, 2006, at 36 (the speed of trading in credit derivatives has raised concerns about industry documentation practices among U.S. and U.K. regulators).

115. Beyond producing boilerplate, ISDA works to harmonize national legal regimes for derivatives trading to reflect the interests of its membership and has successfully blocked attempts to regulate over-the-counter swap markets. For ISDA's role in boilerplate production, see Stephen J. Choi & G. Mitu Gulati, *Contract as Statute*, 104 MICH. L. REV. 1129, 1139–42 (2006), and Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate*, 104 MICH. L. REV. 1075, 1081 (2006). For critical

During the *Eternity* litigation, ISDA convened an expert group to fix the credit event definitions in standard CDS contracts. The fix replaced “mandatory transfer” with restructuring “bind[ing] on all” holders of the reference obligation.¹¹⁶ On its face, the new language replaced a substantive test with a formal one. It eliminated the problem of finding coercion in a distressed but formally voluntary debt exchange by eliminating coverage for such exchanges. This was significant because “quasi-voluntary” exchange offers had emerged in the 1990s as the predominant way of managing sovereign debt crises.

Eternity reflects the awkward fit between mainstream market instruments and the emerging market context, and its capacity to make bad law. The case also sheds light on ISDA’s institutional role in mediating global financial integration. A quintessentially emerging-market operation—an exchange designed to separate domestic and foreign holders of distressed sovereign debt—could not match the mainstream CDS template. The deal was informal and political: distressed but not bankrupt, and effectively mandatory for some creditors (local banks) but not others (foreign hedge funds). As the courts grappled for ways to reflect this complexity in contract interpretation, ISDA’s quasi-legislative response ended the awkwardness by ending coverage for similar deals going forward.

To the extent market participants continue to buy protection for restructuring¹¹⁷ and as the 2003 post-*Eternity* definitions gain ground,¹¹⁸ they may change sovereign restructuring practice. Absent sovereign bankruptcy, creditors facing default will have two basic ways of collecting under a sovereign CDS: getting bound or not getting paid.¹¹⁹ A sovereign that seeks to

analysis of ISDA’s role, see PARTNOY, *supra* note 23, at 46–47; ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASON IN THE GLOBAL FINANCIAL MARKETS, ch. 2 (forthcoming 2008) (manuscript on file with author); Frank Partnoy, *Second-Order Benefits from Standards*, 48 B.C. L. REV. 169, 171, 185–88 (2007).

116. Compare INT’L SWAPS & DERIVATIVES ASS’N, 1999 ISDA CREDIT DERIVATIVES DEFINITIONS §§ 4.7(a), 4.9 (1999), with INT’L SWAPS & DERIVATIVES ASS’N, 2003 ISDA CREDIT DERIVATIVES DEFINITIONS § 4.7(a) (2003). See Choi & Gulati, *supra* note 115 (describing ISDA’s intervention and making the analogy to legislation).

117. Cf. Bertalanffy, *supra* note 102. Large segments of the credit derivatives market have dispensed with restructuring as a credit event altogether. This is partly due to the often-ambiguous relationship between credit risk and restructuring out of bankruptcy, but also to the difference in the composition of market participants in the United States and Europe, and the differences in bank regulatory treatment of credit derivatives between the United States and Europe, which in turn comes from different approaches to implementing Basel II capital adequacy standards in the two jurisdictions.

118. In late 2003, almost all sovereign CDSs used the 1999 definitions of “restructuring”; by then, close to half of bank and corporate CDSs had adopted substantially modified restructuring clauses. Packer & Suthiphongchai, *supra* note 23, at 83–84.

119. *Eternity* illustrates how credit derivatives can change incentives. Having bought protection, *Eternity* may have been moved to act “out of character”—more like local banks than like foreign funds—joining in the domestic exchange because it thought it had little to lose. In addition, the CDS

restructure against the background of a large stock of CDSs may come under pressure to declare a moratorium, stop paying, use local law to impose new terms on its creditors, or use contract provisions that allow a creditor majority to impose new terms on a dissenting minority. Default can trigger massive economic disruption.¹²⁰ As noted earlier,¹²¹ restructuring by fiat can undermine confidence in the legal system—though recent research suggests that the risk may be worth taking.¹²² The 2003 definitions may give fresh impetus to the remaining option, using majority rule to cram down new terms.

2. Country Risk and Basis Risk

The Second Circuit's lucid discussion of how credit derivatives work made *Eternity* an instant textbook classic in mainstream corporate and international finance.¹²³ One aspect of the incident has received little attention: *Eternity* appears to have bought CDSs on foreign-law, foreign-currency Argentine sovereign bonds to hedge *country* risk on a portfolio of local corporate and sovereign debt.¹²⁴ If so, it engaged in a common practice.

Unlike insurance, credit derivatives can be used either to hedge or to take stand-alone market positions with no other exposure to the reference credit. But in the emerging markets, they often play an in-between role. This is because the available hedging instruments—straight CDS contracts on foreign-currency, foreign-law sovereign debt—lag behind the proliferating investment opportunities in local-currency, local-law sovereign and corporate debt. An investor holding a General Motors (GM) bond may buy a CDS on a GM bond; an investor in a bond issued by GM's joint venture partner AvtoVAZ¹²⁵ must usually settle for a CDS on Russian sovereign

mechanism potentially introduces new players with an interest in the restructuring outcome: protection buyers who are not also creditors of the government, for whom a credit event brings pure gain. Since a sovereign debtor generally does not know who holds protection and on what terms, the authorities could find it harder yet to design a pre-default restructuring to accommodate new creditor behavior.

120. ROUBINI & SETSER, *supra* note 62, at 305–07 (emphasizing domestic constraints in governments' decisions to default).

121. *Supra* Section II A.

122. Charles Calomiris, *Devaluation with Contract Redenomination in Argentina* (Nat'l Bureau of Econ. Research, Working Paper No. 12644, 2006) (demonstrating significant domestic investment benefits from Argentina's unilateral modification of local-law contracts).

123. See, e.g., WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 30–39 (5th ed. Supp. 2005); PAUL B. STEPHAN, JULIE A. ROIN & DON WALLACE, JR., INTERNATIONAL BUSINESS AND ECONOMICS: LAW AND POLICY 85–106 (3d ed. Supp. 2007).

124. *Eternity Global Master Fund Ltd. v. Morgan Guaranty Trust Co. of N.Y.*, 375 F.3d 168, 171 (2d Cir. 2004).

125. Cf. WILL OSWALD & SAHZAD HASAN, J.P. MORGAN SEC. INC., RELATIVE VALUE COMMENTARY: RUSSIA CDS UNDERPERFORMANCE: EM CORPORATE RISK BEING HEDGED VIA

Eurobonds. A recent investment bank report observed that market participants routinely “hedge” exposure to Russian corporate credit with sovereign CDS contracts.¹²⁶ To the extent hedging implies a view that Russian corporate and sovereign risks move in tandem, one need only recall the demise of Yukos Oil to worry.¹²⁷ Similar concerns arise when contracts on foreign-currency sovereign debt are used to hedge against default on local-currency sovereign debt,¹²⁸ although the gap between offsetting elements in the hedging strategy (“basis risk”) may be smaller.

The nature and magnitude of basis risk in the emerging markets has two sets of implications: one for economists, another for lawyers. First, while economists look to mainstream CDS prices as proxies for the market view of the underlying credit risk, emerging market CDS prices may not convey the same information if a large portion of them is used for country risk insurance (and very partial insurance at that).¹²⁹ Second, basis risk can make bad law when mainstream market instruments and norms combine with emerging market facts. Another Second Circuit case illustrates.

The Asian Financial Crisis reached its destructive peak in 1998.¹³⁰ As cranes froze across the region, a Philippine company procured a one-year nine-million-dollar loan to build a condo tower.¹³¹ The lender, an affiliate of U.S. investment bank Bear Stearns, got a ten-million-dollar surety bond from the state-owned Philippine Government Service Insurance System (GSIS).¹³² Bear Stearns also bought a CDS contract on the surety bond from Aon, a U.S. investment fund that helped arrange the underlying loan for the Philippine developer. Aon would pay Bear Stearns ten million dol-

SOVEREIGN CDS 7 (2007) (on file with author) (observing the dearth of liquid Russian corporate CDSs and its implications). For information on the GM-AvtoVAZ joint venture, see General Motors, GM-AvtoVAZ, http://www.gm-avtovaz.ru/new_en/inside.php?page=contents/company&model=it7 (last visited Sept. 11, 2007). For AvtoVAZ bond issuance, see ABTOBA3 [AvtoVAZ], Aktsioneram i investoram: Tsennye Bumagi [To Shareholders and Investors: Securities], <http://www.lada-auto.ru/floater.xml> (last visited Sept. 11, 2007).

126. OSWALD & HASAN, *supra* note 125, at 7.

127. The Russian government effectively expropriated Yukos Oil and jailed its owner while the Russian economy was enjoying record fiscal and external surpluses and prepaying its debts. *See In re Yukos Oil Co.*, 321 B.R. 396, 401–03 (Bankr. S.D. Tex. 2005).

128. *See, e.g.*, PAUL FAGE, CREDIT SUISSE, EMERGING MARKETS FIXED INCOME STRATEGY: EM: DOES IT MAKE SENSE TO HEDGE LOCAL CURRENCY POSITIONS WITH CDS? (2007) (on file with author).

129. *Cf.* Claire A. Hill, *Latin American Securitization: The Case of the Disappearing Political Risk*, 38 VA. J. INT'L L. 293 (1998) (analyzing the use of asset securitization to reduce political risk, using examples from cross-border project finance).

130. *See, e.g.*, BLUSTEIN, *supra* note 27, at 207–10.

131. *Ursa Minor Ltd. v. Aon Fin. Prods., Inc.*, No. 00 Civ. 2474, 2000 U.S. Dist. LEXIS 10166, at **3–4 (S.D.N.Y. July 21, 2000). The transaction was conceived in 1998 and consummated in early 1999.

132. *Id.*

lars if GSIS did not.¹³³ As far as Bear Stearns were concerned, they had offloaded the Philippine developer's credit risk onto GSIS or, at worst, onto Aon.

Aon sought to protect itself with a CDS on Philippine government debt, which it bought from Société Générale (SocGen), a French bank.¹³⁴ It is unclear whether Aon thought it had passed GSIS's credit risk on to SocGen, or simply bet that the parastatal would not default so long as the Philippine Republic was servicing its foreign bonds. Aon charged Bear Stearns almost \$100,000 more for bespoke protection against default by GSIS than it paid SocGen for a generic sovereign CDS.¹³⁵ Aon remained exposed to the gap between Philippine sovereign credit risk and that of GSIS.

The developer soon defaulted and GSIS disowned the surety bond. Bear Stearns turned to Aon. Aon first tried to get out of paying Bear Stearns, but lost.¹³⁶ Aon then went to SocGen. SocGen refused to pay on the grounds that GSIS was not its problem and Philippine sovereign debt was doing just fine. Aon sued and won—at first. The district court ruled that its transactions with Bear Stearns and SocGen should be treated as a single financing package.¹³⁷ It also suggested that default by GSIS was tantamount to Philippine sovereign default, even though Aon did not ask the government for money until after its contract with SocGen had expired.¹³⁸

The court appeared to read the SocGen CDS as an instance of mainstream market hedging practice and took basis risk out of the deal. Put differently, it perceived an industry norm (back-to-back CDS contracts function as credit insurance) and assumed that contracting parties had intended to give effect to the norm.¹³⁹ If the court had recognized that the case was about the gap between credit and country risk in the emerging markets, it may have deduced a different norm and ruled differently.

133. *Id.* at **6–8.

134. *Aon Fin. Prods., Inc. v. Société Générale*, 476 F.3d 90, 93–94 (2d Cir. 2007).

135. *Id.*

136. *Ursa Minor Ltd.*, 2000 U.S. Dist. LEXIS 10166, at **18–29.

137. *See Aon Fin. Prods. v. Société Générale*, No. 00 Civ. 5863, 2005 U.S. Dist. LEXIS 2719, at *10 (S.D.N.Y. Feb. 18, 2005), *rev'd*, 476 F.3d 90 (2d Cir. 2007).

138. *Id.* at **15–21.

139. *Cf.* Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001) [hereinafter Bernstein, *Private Commercial Law*]; Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710 (1999) (arguing that judicial reliance on industry custom is usually misplaced and would undermine the informal order, which relies on judicial enforcement of contracts as written).

In the event, ISDA submitted its first-ever amicus brief on credit derivatives in support of SocGen's appeal.¹⁴⁰ It argued for a narrow interpretation of CDS terms and asked that Aon be punished among other things for failing to follow contractual settlement formalities.¹⁴¹ Aon lost badly in the second round. The Second Circuit's reversal went to great lengths to address each of ISDA's concerns. The effect of the ruling was to endorse the view that the heavily norm-based credit derivatives market depended for its survival on strict judicial enforcement of its contracts as written.¹⁴²

In an ironic twist, ISDA's role in the Aon saga evokes the role of the U.S. government in sovereign debt litigation since the 1980s. For example, the United States intervened midway in a famous trilogy of cases involving the government of Costa Rica, arguing for a narrow interpretation of the debt contract after a court sought to imply cooperative sovereign debt restructuring norms from U.S. efforts to manage the crisis.¹⁴³ Several years later, the United States intervened again, this time on the side of Brazil, deploying a similarly formalist argument against a creditor.¹⁴⁴ Like ISDA, the U.S. government has repeatedly argued for a strict separation between judicial contract enforcement and policy-driven, norm-based crisis resolution. In the 1980s and 1990s, the U.S. government spoke as an institutional guarantor of the nascent market in emerging market sovereign debt; in 2006, ISDA played a similar quasi-public role in the global market for credit derivatives. By advocating judicial formalism, both guarantors preserved their own respective dominance in the norms realm.

In sum, much like the changes discussed earlier, the rapid growth of credit derivatives could make resolving the next emerging market financial

140. Brief of Amicus Curiae International Swaps and Derivatives Association, Inc. in Support of the Brief of Defendant-Appellant at 6, *Aon Fin. Prods. v. Société Générale*, 476 F.3d 90 (2d Cir. 2007) (No. 06-1080-CV).

141. *Id.* at 11–20; cf. Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981) (classic argument for judicial formalism in interpreting relational contracts).

142. See *Aon Fin. Prods., Inc. v. Société Générale*, 476 F.3d 90 (2d Cir. 2007). This is not necessarily a contradiction. In Lisa Bernstein's terms, this is an argument that "relationship-preserving norms" in an industry where participants routinely compromise to avoid litigation depend on strict enforcement of formal "end-game" norms that come into play in litigation. See Bernstein, *Private Commercial Law*, *supra* note 139, at 1780, 1780 n.217. Cf. Goetz & Scott, *supra* note 141; *Deutsche Bank AG v. AMBAC Credit Prods., LLC*, 04 Civ. 5594, 2006 U.S. Dist. LEXIS 45322, at **38–41 (S.D.N.Y. July 6, 2006) (enforcing strict compliance with deadlines specified in the CDS contract after describing the plaintiff's failed attempts to invoke relationship-preserving norms to settle the dispute).

143. Brief for the United States as Amicus Curiae at 4, 6–7, *Allied Bank Int'l v. Banco Credito Agrícola de Cartago*, 757 F.2d 516 (2d Cir.1985) (No. 83-7714). For excellent historical analysis, see Pérez & Weissman, *supra* note 7, at 738–45. See also James Thuo Gathii, *The Sanctity of Sovereign Loan Contracts and its Origins in Enforcement Litigation*, 38 GEO. WASH. INT'L L. REV. 251 (2006).

144. Statement of Interest of the United States of America in Opposition to the First Amended Complaint at 9, *CIBC Bank & Trust Co. (Cayman) Ltd. v. Banco Central do Brasil*, 886 F. Supp. 1105 (S.D.N.Y. 1995) (94 Civ. 4733).

crisis more complicated. Creditors will act differently where the goal is to get paid in full under a sovereign CDS, rather than to collect in part from Argentina. Governments may not know for sure who their creditors are until after the protection buyers have collected and have handed over the sovereign IOUs to the protection sellers. Without a bankruptcy backstop, this process could be long, traumatic, and politically contentious. In this respect, the difference between the impact of credit derivatives on emerging and mainstream markets would be one of degree. But quite apart from adding to complexity and uncertainty, credit derivatives—like domestic debt—often serve different functions in emerging and mainstream markets. And where contracts purporting to move credit risk are used to hedge country risk, they are more likely to break down. Since many emerging market sovereign CDSs are standard-form New York-law contracts between rich country institutions, a court might easily miss the difference, with consequences for the broader markets.

CONCLUSION: THE CHALLENGE OF CONVERGENCE

At this writing, mainstream financial markets are reeling from failures that have a distinctly emerging market feel: overborrowing, a lack of transparency, vanishing trust in institutions, and regulatory incapacity to keep up with market sophistication. Emerging market economies, with their abundant surpluses and reserves, are today's "safe havens."¹⁴⁵ "Convergence" and market "maturity" look like increasingly elusive ideals. Global financial integration has gone from clichéd prophecy to messy reality.

This symposium contribution has attempted to map a piece of this reality, the changed world of emerging market sovereign debt. Recent growth in local-currency, local-law instruments and risk transfer machinery from NDFs to CDSs all seem to suggest that middle-income and poor countries are becoming more like the rich. However, a closer look reveals that the picture of steady progress to a fixed goal of market maturity is flawed. This essay has focused on instances of incomplete convergence, where formally similar instruments are used differently in different markets.

Examples in the text suggest that the appearance of convergence carries its own risks. Local-currency debt where creditors shed all or part of the currency risk, bonds designed for local banks that move into the hands of foreign funds, and credit derivatives that function as country risk insurance can upset the expectations of policymakers and market participants,

145. Jerome Booth, *Emerging Market Debt is the New Safe Haven*, FIN. TIMES (U.S.), Aug. 29, 2007, at 22.

and cause or exacerbate the effects of default. In cases like *Eternity* and *AON*, the gap between emerging market facts and mainstream market instruments can drive lawmaking on financial innovation.

For the emerging markets, there are risks in shrinking the space to manage sovereign distress before default. Where creditor identity, location of currency risk, and the relevant legal regime for debt collection are not knowable in advance, pre-emptive restructurings are hard to design. There are risks for everyone in the proliferation of legal and currency regimes relevant to financial stability. These may prompt demands for centralized solutions, or at least for greater standardization.

One lesson from recent events is the need to define “domestic debt” more precisely. Policymakers and market participants using the term often talk past one another. Statistics gathering is inconsistent across countries and institutions. This essay suggests that each dimension of change—governing law, currency, and creditor identity, to name a few—implicates different actors, different risks, and a different line of policy inquiry. This does not mean that the authorities should abandon surveys based on any one of the dimensions. It does mean that the consequences of using law over residence, or residence as a proxy for currency, should be recognized and made explicit.

In addition, the decoupling of governing law, currency, and creditor identity in emerging market sovereign debt offers an opportunity to ask new questions about the relevance of legal regimes for attracting capital, and about the viability of existing governance structures for exchange rates and currency markets. Local-law debt may or may not stand for trust in emerging market legal systems, just as local-currency debt need not stand for broad-based sharing in local-currency risks.

The emerging markets are neither marginal nor mainstream—and the mainstream itself is no longer fixed or insulated from the periphery. Locating, managing, and exploiting the gaps and failures of convergence are key challenges for students and practitioners of global governance. The task is technically complex, politically fraught, and unavoidable.