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United States Court of Appeals

FOR THE SECOND CIRCUIT

NML CAPITAL, LTD., AURELIUS CAPITAL MASTER, LTD., ACP MASTER, LTD., BLUE ANGEL CAPITAL I LLC, AURELIUS OPPORTUNITIES FUND II, LLC, PABLO ALBERTO VARELA, LILA INES BURGUENO, MIRTA SUSANA DIEGUEZ, MARIA EVANGELINA CARBALLO, LEANDRO DANIEL POMILIO, SUSANA AQUERRETA, MARIA ELENA CORRAL, TERESA MUNOZ DE CORRAL, NORMA ELSA LAVORATO, CARMEN IRMA LAVORATO, CESAR RUBEN VAZQUEZ, NORMA HAYDEE GINES, MARTA AZUCENA VAZQUEZ, OLIFANT FUND, LTD.,

Plaintiffs-Appellees,

(*caption continued on inside cover*)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

**BRIEF FOR *AMICUS CURIAE* PROFESSOR ANNE KRUEGER
IN SUPPORT OF THE REPUBLIC OF ARGENTINA AND REVERSAL**

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—v.—

THE REPUBLIC OF ARGENTINA,

Defendant-Appellant,

THE BANK OF NEW YORK MELLON, as Indenture Trustee,
EXCHANGE BONDHOLDER GROUP, FINTECH ADVISORY INC.,

Non-Party Appellants,

EURO BONDHOLDERS, ICE CANYON LLC,

Intervenors.

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Rules:

With the Court's leave, Professor Anne Krueger submits this brief as *amicus curiae* supporting reversal of the decisions of the district court that are on appeal to the extent they require the Republic of Argentina to pay holdouts from past sovereign debt restructurings ratably with restructured debt holders.[1]

INTEREST OF *AMICUS CURIAE*

Anne Krueger is Senior Research Professor of International Economics at the Johns Hopkins University, School of Advanced International Studies (SAIS). She has written and taught extensively about international economics and sovereign debt restructuring. She is past President and Distinguished Fellow of the American Economic Association and a member of the National Academy of Sciences.

Professor Krueger served as First Deputy Managing Director of the International Monetary Fund (IMF) from 2001-2006, and as Acting Managing Director for three months during 2005. While serving in these capacities, she was closely involved in the IMF's efforts to preserve stability of the international financial system, prevent economic crises, and, when such crises did occur, help resolve them.

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[1] This brief is filed contemporaneously with a motion seeking leave to file pursuant to Federal Rule of Appellate Procedure 29(b). Pursuant to Local Rule 29.1, no party's counsel authored this brief in whole or in part; and no person, other than amicus or her counsel, contributed money that was intended to fund preparing or submitting this brief.

Before serving at the IMF, Professor Krueger was the Herald L. and Caroline L. Ritch Professor of Humanities and Sciences in the Department of Economics at Stanford University, and the founding Director of Stanford's Center for International Development. She was chief economist of the World Bank from 1982 through 1986.

Professor Krueger's interest in a proper understanding of sovereign debt restructuring is deep and longstanding. While at the IMF, she was instrumental in developing the IMF's proposal for a sovereign debt restructuring mechanism, *see* A New Approach to Sovereign Debt Restructuring (International Monetary Fund, Washington 2002), and co-authored "Sovereign Workouts: An IMF Perspective," Chicago Journal of International Law, Vol. 6, No.1 (2005).[2]

As an economist who has studied and written extensively about sovereign debt restructuring, Professor Krueger provides a valuable perspective about the consequences that would flow from requiring holdouts from past debt restructurings to be paid ratably with restructured debt holders. These consequences would be felt by debtor nations, creditors, the United States, and the international economy as a whole. Her discussion will assist the Court in addressing the important issues presented by this appeal.

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[2] Professor Krueger's *curriculum vitae* and a full list of her publications can be found at http://legacy2.sais-jhu.edu/faculty/krueger.

ARGUMENT

NEGATIVE CONSEQUENCES WILL RESULT FROM REQUIRING RATABLE PAYMENTS TO HOLDOUTS FROM PAST DEBT RESTRUCTURINGS

This brief is written by an economist, and can only speak to the economics of sovereign debt and the sovereign debt market.

From an economist's point of view, there are three interrelated, preliminary, issues that are important, and need addressing, in order to assess the likely effects of requiring ratable payments to holdouts from past debt restructurings. The first concerns the question of the circumstances in which sovereigns may be unable to service their debt. The second is the importance of the sovereign debt market for all countries, but especially for emerging markets. The third is the need for addressing unsustainable sovereign debt, and the ways in which it can most productively be handled.

Those three matters are considered first. Then, attention turns to the likely effects on the sovereign debt market and emerging market countries of a move to require ratability of outstanding holdout debt when a country, whose debt has been restructured, can again access private capital markets. Those effects include the likely higher cost of sovereign borrowing even for countries that are deemed creditworthy, the effects on sovereigns encountering debt-servicing difficulties, and the problems such a requirement would pose for the International Monetary Fund (IMF).

A. Debt Sustainability

It is important to recognize that borrowing to finance productive investments can enhance growth and growth prospects in countries whose macroeconomic policies (and other economic policies) are reasonably sound. Although sovereigns can and do access official creditors for some of their financing, official credit is extended primarily to low-income countries, while emerging market sovereigns rely much more on private lenders.

Just as there are times in commercial life when firms cannot service their debt, there are circumstances in which sovereigns have unsustainable debt burdens. Moreover, just as with firms encountering difficulties, sovereigns can face major difficulties while still able to access international markets, albeit at higher interest rates and reduced maturities.

The reasons are much the same as with commercial bankruptcies. When a country's sovereign debt is mounting (as a percentage of GDP), holders of sovereign debt become increasingly reluctant to roll it over as the risk that the sovereign may not be willing or able to pay rises.

In many cases, difficulties arise as several phenomena, including a global economic slowdown, a sharp fall in the price of a major export, or an increase in the price of a key import such as oil or food grains) occur within the same time period. In the early 1980s, for example, interest rates rose sharply at the same time as the world economy went into recession so that exports earnings of some heavily indebted countries fell while debt service obligations on floating-rate debt rose. Some currencies were devalued which led to an increasing domestic burden of the debt (including principal repayments due) at the same time as interest rates rose, further increasing debt-service ratios. Moreover, some of these countries' governments incurred rising fiscal deficits because tax revenues were down (due to domestic recession or other reasons), and fiscal expenditures increased to offset the effects of recession.[3]

As fiscal deficits (or other factors) result in an increasing debt ratio, the market assessment of likely future difficulties increases. In countries where corrective action is not taken, the interest rate on their debt rises and the maturities of rolled over and new debt shorten. If the authorities still fail to react, a point can be reached at which even the principal coming due cannot be rolled over (and the fiscal deficit cannot be financed without printing money).

[3] In some instances, of course, excessively expansionary fiscal policies can themselves result in a rapidly rising fiscal deficit and hence sovereign debt. A case in point was Mexico in the early 1980s, where government expenditures increased even more rapidly than the large revenues accruing from greatly increased oil exports, and the government borrowed rather than raising taxes.

In reality, markets do not wait until debt is truly unsustainable. A truly unsustainable debt would arise when there was no set of policies the authorities could undertake to restore macroeconomic balance and service their debts. (If the authorities did undertake a set of credible policies to enable debt-servicing to resume, markets would likely respond by increasing willingness to lend). But when it becomes obvious that sufficient actions to restore sustainability cannot or will not be taken, creditors refuse to finance new issues or even to rollover debt, and a sovereign debt crisis occurs.

B. Importance of International Capital Market for Emerging Markets

Since domestic investment cannot exceed the sum of domestic savings plus the net foreign capital inflow (by definition), foreign capital inflows can enable increased investment (with the flows of know-how and technology that some of these can bring) and higher growth rates when macroeconomic policies (and incentives for investment) are sound.

It should be noted that the same sorts of forces are at work for sovereigns as would be at work with a domestic firm prospectively facing bankruptcy were there no legal resolution mechanism: creditors would refuse new credit and attempt to offload existing debt. As they did so, the firm’s survival prospects would evaporate even sooner than with a commercial bankruptcy where, if the value of the firm as an entity is greater than the valuation of its individual assets, a write-down can occur so that the going concern can survive. The incentives for creditors holding sovereign debt to sell their holdings (and fail to buy up issues when rollovers are needed) are strong.

In the case of commercial domestic bankruptcies, the resolution of a crisis comes about as the courts assess the reorganization plan; if the stricken firm has a reasonable prospect of returning more value as a going concern than it would have with the breakup and sale of the assets, the resolution process returns more value to shareholders and preserves value.

Unlike commercial bankruptcy, however, there is currently no international bankruptcy court for sovereigns. Moreover, a sovereign cannot be forced to sell off assets.[4] When the sovereign accepts that voluntary debt servicing is infeasible, a collective action problem arises. It is in the interests of all that debt be restructured expeditiously, in order for the domestic economy to resume functioning (and therefore be capable of larger debt-service payments). Longer crisis periods harm the sovereign's domestic economy and international creditors.

C. Need for Short-Term External Funding

This leads immediately to the third preliminary issue: what needs to be done when it is clear that sovereign debt is unsustainable without some sort of

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[4] In many instances, however, policy packages designed to restore creditworthiness and growth to sovereigns do entail the privatization of government owned enterprises.

outside interaction. As stated earlier, the usual situation is one in which the fiscal deficit has led to rising sovereign debt for some time, and the debt ratio is high and rising, while the spreads demanded by creditors are becoming steeper and maturities at which they will lend at all shorter. Usually, too, economic growth has slowed, if not stalled, and real GDP may even be falling.

In those circumstances, several things need to occur: (1) something has to be done to enable debt servicing to continue or there must be a restructuring of debt; (2) macroeconomic policy changes must be made to generate a greater primary surplus (or smaller primary deficit)[5] and this necessarily entails measures to raise revenues and/or reduce expenditures; and (3) a way must be found to enable prospects for economic activity and economic growth to improve over time.

Debt service can be continued in these circumstances only with external support; the alternative is restructuring of the debt, or default. External support (usually from official agencies, led by the IMF) can enable a country to maintain its debt service.[6] But without changing the expected future path of the

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[5] The primary surplus is defined as government expenditures minus all government revenues except interest payments on debt. Thus, the primary surplus is the amount that can be allocated to debt servicing.

[6] In many instances, external support is also needed in order to enable resumption of normal commercial relations. This is especially true if the authorities have tried to maintain a fixed exchange rate (or let it depreciate too slowly relative to domestic inflation) and export earnings have weakened.

primary surplus, it can be, at best, a very temporary palliative.[7] That is why changes in macroeconomic policy are essential – not only to lower the fiscal deficit but to insure that, going forward, a sufficient primary surplus will be forthcoming to enable the country once again to finance its debt servicing obligations. When it is feasible for a country to be able to resume its debt servicing obligations after a period of reform, that course is almost always chosen by the country's authorities.[8]

When a country's debt is truly unsustainable, short of really unforeseen positive changes (such as discovery of oil) debt must be restructured with a reduction in the net present value of creditors' holdings. Even with policy reforms, the country's capacity to service its debt would be insufficient to enable it fully to do so.

Greece provides a case in point. Even with a shift from primary deficit to primary surplus and macroeconomic and structural reforms, it was inconceivable that Greece could grow sufficiently fast, and obtain a sufficient

[7] The IMF cannot lend until there is a program in place to assure that the sovereign can resume voluntary debt-servicing within a reasonable period of time. The decision to undertake restructuring is the sovereign's, but the alternatives are usually bleak enough that the sovereign seeks IMF support and undertakes economic policy changes.

[8] For example, after the crisis in 1997, the Korean authorities undertook economic reforms supported by an IMF program. The Koreans maintained voluntary debt service but could not have done so without external assistance in the short run.

primary surplus. Without restructuring, the debt ratio would have soared well over 200 percent of GDP under optimistic assumptions; there was no way that economic growth could be fast enough, or the primary surplus increased quickly enough, to enable Greece voluntarily to continue servicing its debt. The debt ratio was clearly unsustainable.

But the third requisite is equally important: without both policy changes and financial support, a country with unsustainable sovereign debt has very poor prospects. Sovereigns certainly cannot access private capital markets in the midst of a debt crisis; yet without some financing, maintaining even the existing level of economic activity is infeasible. But economic activity must prospectively increase or the debt ratio will rise as GDP falls.

To date, the IMF has taken the lead role in sovereign debt crises. When invited, it has worked with country authorities to develop macroeconomic plans that will be consistent with a resumption of growth and the country's ability within a few years to return to normal debt servicing and to access to private international capital markets. Often, it is the technical competence and experience of the IMF staff that contributes significantly to the development of a program of macroeconomic and other necessary policy changes that would enable a return to growth and solvency.

The IMF has a double function (although the two are highly interrelated). On one hand, the IMF supports the country's authorities in devising a credible economic program, usually for two or three years. That, in turn, increases the credibility of the sovereign to the country's creditors. On the other hand, the IMF lends to the sovereign to enable the financing of the program during its first two or three years as the policy changes take effect. Without financial support, the retrenchment in fiscal policy would be so sharp that economic activity would likely plummet, thereby reducing government revenues and thus harming any prospects for recovery. Without policy change, the financial support could not, in the longer term, offer the promise of improved economic performance and creditors would refuse to resume lending.

D. Likely Negative Effects of Court Decision on Sovereign Debt Markets

If sovereigns were required, as a condition to making payments on restructured debt,[9] to repay holdout creditors on a preferential basis once their level of economic activity and creditworthiness was reestablished, there would be

[9] In the period prior to resolution of the issues involved in paying ratable debt, the markets in sovereign debt would also be affected by uncertainty and delays in repayments on debt which the sovereign would otherwise have serviced. Once the new ruling was in force, of course, that possibility would be priced into the spreads on sovereign debt.

several negative effects.[10] These would include: (l) the increased reluctance of creditors to share in any restructuring and hence an increase in the likelihood and number of holdouts; (2) higher interest costs for all sovereign borrowers; (3) a reduction in capital inflows even for countries with sound macroeconomic policies; (4) increased delays by sovereigns before accepting the need for restructuring and thus higher costs to borrower and creditors alike; and (5) issues for the International Monetary Fund in supporting countries where policy reform could lead to a return to debt sustainability and voluntary debt-servicing if debt were restructured.

These interrelated effects would feed cumulatively on each other but are discussed separately. The first effect is the increased reluctance of creditors to share in any restructuring. If existing creditors believed that the sovereign in question would be required to make ratable payments to them once the economy and creditworthiness had recovered, they would surely be more reluctant to agree voluntarily to a restructuring. The reason is self-evident: the expectation of

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[10] The premise of this sentence is virtually self-contradictory. Should holdout creditors be expected to be paid on a ratable basis with new borrowing by the sovereign, the reluctance to lend would increase greatly (and the incentive to hold out would increase). In these circumstances, it is unlikely that the sovereign could regain creditworthiness, and certainly the path to restored creditworthiness would be far more painful and time-consuming.

receiving greater payments at a later date would lead to a higher threshold for accepting a restructuring offer.

Collective Action Clauses (CACs) were introduced into some sovereigns' bond issues. Although some have argued that CACs reduce the likelihood of holdouts, that is by no means certain. CACs have been included in bond issues only in the past decade and there is insufficient experience with them to date to have empirical evidence with respect to their effects. No country with CACs in its bonds has been close to restructuring, so it is certainly not possible to reach a firm conclusion that CACs would prevent holdouts. But even with CACs, holders of particular issues could vote against restructuring (indeed, holdouts could buy just more than the percentage of the issue required to restructure).

To address this concern, some CACs (five countries so far) have two parts: each bond issue contains provisions that (1) a specified percentage of holders of that issue voting in favor of restructuring binds all holders of that issue to an agreed-upon restructuring (as above); and (2) a different aggregate percentage of all bondholders is specified to bind holders across issues.

Thus, if 75 percent of creditors' approval was required to compel all holders of a particular issue to accept restructuring, a creditor or group of creditors holding 26 percent of the issue would be sufficient to block acceptance, unless, if there were aggregation, a different percentage were met to restructure across all issues. So while CACs may preclude holdouts in some cases, it is not clear that they would do so in all. Moreover, CACs are not binding on other creditors (such as debt to commercial banks). As the likelihood of other holdouts increases, and the possibility of preferential treatment for holdouts later increases, the attractiveness of accepting a restructuring offer would diminish for bond holders.

That there would be higher interest costs for all sovereign borrowers is also self-evident. Even countries with sound macroeconomic policies can run into difficulties because of factors possibly outside their control. As already seen, a sharp drop in the price of oil for an exporter, an abrupt shift in the terms of trade, and other factors can lead to difficulties. Would-be creditors, knowing this, can judge few sovereign bonds to be totally absent of any risk of the need for restructuring. If the likelihood of holdouts rises, and the difficulty and costs of restructuring increases, that would penalize all sovereigns attempting to access the international financial markets.

This in turn, would result in the third negative consequence: even countries that were following sound economic policies would experience smaller capital inflows. The very fact that interest rates were higher would induce a reduction in net capital inflows. But, in addition, the penalties for reaching unsustainable debt would increase substantially as creditors' knowledge that, if there were difficulties, access to international capital markets would be precluded for a longer period of time than is currently probable. As already noted, there is always risk of adverse developments. At present, debt ratios of about 40 percent are deemed "safe" for most emerging markets. That ratio would almost certainly drop if preferential treatment of unrestructured debt were later required in cases of debt restructuring.

It may also be noted that increasing the penalty for restructuring would surely make the authorities in countries with incipient debt-servicing difficulties even more reluctant to recognize their plight, and hence raise the costs to borrowers and creditors alike when restructuring finally did occur. That would likely delay the decision to attempt restructuring, thus raising the costs of the sovereign's difficulties to creditor and debtor alike.

The ratability requirement would also render the IMF's role more problematic. As noted earlier, the IMF lends to countries with debt difficulties *if* the loan *and* policy reforms can be expected to result in an increased primary surplus sufficient for the country to be able to service its debts within a time frame of 3-5 years. But if there were holdouts, the time period in which the country could return to the international capital markets would be longer both because the costs of servicing new debt would increase (because of outstanding unrestructured ratable debt *and* higher interest costs to all borrowers). That, in turn, would reduce the likelihood that economic growth would resume, and the likely growth rate, even after reforms, would still be lower (if positive at all). That, at a minimum, would make the needed policy reforms even more stringent, and would more likely result in a long period without IMF support and a return to creditworthiness.[11]

E. Conclusions

There are debt levels that are unsustainable. In those cases, restructuring of the debt on a timely basis with necessary policy reforms, and short-term financial support, is the best policy solution for a country and the world.

Without an international regime for sovereign restructurings, creditors and the debtor have negotiated with each other, with the IMF playing a key role in advising on policy reforms, providing credibility to the sovereign, and extending the needed financing in the period during which the reforms take hold and creditworthiness will be reestablished.

The problem of holdouts in voluntary debt restructurings has long been an issue. CACs were introduced in the hope that they would prevent the holdout problem. It is by no means certain that they are sufficient to enable restructurings, and the likelihood of problems would increase were holdouts

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[11] While a breakup of the firm is the ultimate resort in cases of private bankruptcies, the limit with unsustainable sovereign debt is political stability. When reforms are painful and the prospective benefits long delays, the political resistance to reforms and the likelihood of political instability increases.

assured (or be given reason to believe they would receive) preferential treatment later.

Holdout creditors are therefore still a possible issue in circumstances where a country's difficulties with debt-servicing difficulties are mounting. Ratability requirements would increase the attractiveness of holding-out, thus reducing the likelihood of achieving the needed threshold. Even if restructuring did occur, ratability requirements would certainly delay the point at which the country could reaccess the private international capital market, because the costs of any new borrowing would include payments under ratability to holdouts. That, in turn, would increase the stringency of the policy reforms needed in order for the IMF to support a reform program and restructuring.

For sovereign debtors following sound macroeconomic policies, the costs of borrowing would rise and hence the rate of growth they could attain would be reduced. For countries where debt servicing difficulties were increasing, fear of the consequences of restructuring would be heightened, thus delaying the day when the necessary restructuring was undertaken and prolonging a period of low growth.

All of these consequences would reduce prospects for growth in developing countries, increase the costs to creditors and debtors of debt resolution, harm the international sovereign debt market, and reduce the ability of the private international capital market to enhance the growth of developing countries.

CONCLUSION

For the reasons stated above, the decisions of the district court on appeal should be reversed insofar as they impose a ratability requirement.

Dated: New York, New York
January 4, 2013

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

Pursuant to Rule 32(a)(7)(C) of the Federal Rules of Appellate Procedure, the undersigned counsel for Amicus Curiae hereby certifies that this brief complies with the type-volume limitation of Rule 32(a)(7)(B). As measured by the word processing system used to prepare the brief, there are 4110 words in this brief.

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CERTIFICATE OF SERVICE & CM/ECF FILING

12-105-cv(L)

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