There aren't many institutions powerful enough to bring a sovereign nation to its knees. Most of those that are wield their power with great care; the rest are dangerous fundamentalists. Last week, the U.S. Supreme Court placed itself -- and the rest of the U.S. federal judicial system -- squarely in the latter camp when it refused to accept an appeal by Argentina against a lower-court decision. The consequences are certain to be dreadful for Argentina. More broadly, the ruling will make it more difficult for countries to free themselves from the burden of over-indebtedness. It will be very bad for international capital markets. Oh -- and it will also diminish national sovereignty.

The case involved Argentina and a group of so-called vulture funds, led by the deep-pocketed and highly litigious hedge fund Elliott Associates, which was demanding repayment in full on old Argentine debt. Elliott had first come to broad public attention in 2000, when it brought -- and won -- a similar case against Peru. That unprecedented victory against a sovereign government, although worth a mere $90 million, so deeply shocked the international financial community that it prompted the International Monetary Fund to undertake a messy and protracted attempt to create a brand-new sovereign bankruptcy court. The Argentina case is much, much bigger -- Argentina owes Elliott over a billion dollars. The total amount that it owes "holdout creditors," as the vulture funds are more formally known, is some $15 billion. Given that other holdout firms will immediately demand any terms awarded to Elliott, Argentina is not lying when it says that it simply can't afford to do what the U.S. courts are demanding of it -- which is to pay all the holdouts in full.

Nor, of course, would it ever want to. Argentina defaulted on all of its foreign bonds in 2002, at the end of a depression that saw its economy shrink by 28 percent, its currency devalue enormously, and millions of its citizens lose their jobs and go hungry. At the time, it was the largest debt default the world had ever seen. (Lehman Brothers would eventually break that record.) Argentina's foreign debt went unpaid until 2005, when the country offered its creditors a deal: Give us your old defaulted bonds and we'll give you new bonds in return, with a lower face value. You should do that, because we'll actually pay the money we owe on the new bonds. (This also hinted that it would remain in default on the old bonds.)

Argentina was true to its word, and, after a second bond swap was finished in 2010, some 93 percent of the holders of the original debt had swapped it out for what are known as "exchange bonds." The swap was coercive, to be sure: bondholders didn't have much say in the matter, beyond the choice of whether or not to participate. But that's the way of sovereign debt. If a sovereign defaults, there's not much creditors can do to force it to pay up. That's what "sovereign" means. Traditionally, then, most bondholders have simply accepted any exchange offer they're given. And, in turn, such exchanges have become an established means by which countries restructure their debts to avoid remaining in default indefinitely.

The case in New York -- the one that made it all the way to the Supreme Court -- was brought by bondholders that didn't participate in the exchange. They originally bought their debt at a deep discount, and they knew how to apply past-due compound interest

calculations to make the face value of the defaulted debt balloon into the billions. They knew that it wouldn't be easy to get paid in full, but if they managed it they would have scored one of the biggest home runs in hedge-fund history.

Thus did the cat-and-mouse game between Elliott and Argentina begin: Elliott would try to seize Argentine assets, and Argentina would try to keep them out of Elliott's reach. At one point, an Argentine naval sailing vessel, the Libertad, was confiscated by local authorities in Ghana, with the intention that it be handed over to Elliott. The ship was released only after a ruling from the International Tribunal for the Law of the Sea.

But behind all the legal shenanigans was a serious debate about sovereign bankruptcy, or, rather, about the fact that there's no such thing as sovereign bankruptcy. Countries do not default lightly: doing so nearly always results in the government falling, and in the country being unable to borrow money abroad for many years to come. Since most countries run deficits, being able to borrow money is extremely important.

If a country does default on debts, then it needs some way to cure that default, reenter the international financial system, and give itself and its companies the ability to fund themselves with debt. Because countries can't declare bankruptcy, exchange offers are the next best thing. But for those to work, a debtor country needs to be able to pay the exchange bondholders without paying the holdouts. Otherwise, no one would ever participate in an exchange, and no country could ever restructure its debts.

This, then, is why Brazil, France, Mexico, and the United States supported Argentina in the Elliott case. None of them had much sympathy for Argentina itself, or its government. But they did have a vested interest in maintaining a sovereign's right to pay one group of creditors without paying another. Indeed, it's something that anyone who found himself in a similar situation might do: he might choose to pay his rent even if that means falling behind on credit card payments, for instance. But this is where U.S. courts started getting creative.

For years, Judge Thomas Griesa had levied increasingly strict rulings against Argentina, which Argentina had ignored. After many years of fruitless litigation, Griesa turned to a nuclear option. He ginned up a new violation by Argentina, which was embedded in something called the pari passu clause. The pari passu clause is a piece of hoary financial boilerplate that means absolutely nothing in a sovereign context. The clause, which said that Argentina's bonds would "rank at least equally" with all its other indebtedness, makes sense only for debtors who can file for bankruptcy. Yet Griesa ruled that Argentina was in violation of pari passu. That ruling, in and of itself, was no big deal. Argentina was in violation of hundreds if not thousands of contractual obligations, and one more was hardly going to make much of a difference. But in this case, Griesa came up with a brand-new remedy to cure the newly discovered violation. And the remedy, much more than the violation itself, is what will end up transforming the world of sovereign debt.

Normally, when a borrower violates a contractual obligation, a judge will hand down a judgment against that borrower. In this case, however, Griesa went after the bondholders who had accepted 30 cents on the dollar for restructured Argentine debt. He told every other agent in the payments chain, up to and including the trustee for the exchange bondholders, that Argentina was not allowed to pay them until Elliott had been paid in full. If the trustee or anybody else helped Argentina pay its exchange bondholders, then Griesa would find them in contempt of court, assuming that Elliott had not been paid at that time.

That order was stayed pending appeal, but it is now in full effect. Make no mistake: the innocent are being punished. The exchange bondholders have done nothing wrong, and there is no way that they're going to get their payment in full and on time, as Argentina would like. But the ruling goes well beyond punishing the innocent. It also turns the natural order of debt on its head. It used to be that having a bond was good but that having a judgment was much better. Now, however, it's the other way around: judgments will get you nowhere, while bonds, if they have a pari passu clause, can make you all-powerful.

There's also no logic to how this new system of jurisprudence should be enforced. The remedy seems to be available, more or less randomly, only to bondholders with a certain clause in their contracts. Worse, it actually discourages countries from making any payments at all, even if they're both willing and able to do so, unless they can make all the payments they're obliged to make.

Griesa's ruling was the act of an exasperated judge at the end of his tether. And, in truth, he deserves a certain amount of sympathy: he has had the gruesome and thankless task, over the past decade, of overseeing dozens of lawsuits against Argentina. But once he had ruled, it became the job of the appeals courts -- first the Second Circuit, and then the Supreme Court -- to grapple with what he had done and to think hard about the implications.

But both of them ducked those questions. Griesa, they said, was within his rights to rule as he had done -- true enough. And Argentina should be required, under New York law, to pay its debts -- that's true, too. But that leaves open the questions of sovereign immunity, the future of sovereign debt restructuring, and the future of New York as a financial center.

This is where the Supreme Court's ruling comes in. On June 16, it handed down a 16-page decision in a parallel and much less important case, also finding against Argentina. In that ruling, Justice Antonin Scalia explained that, once upon a time, the Supreme Court would defer to the executive branch whenever the time came to make decisions involving judicial power over sovereign states. And invariably the executive branch would seek to hold foreign sovereigns immune from U.S. judicial proceedings. The result, says Scalia, was "bedlam," which was "abated" only by the passage of the Foreign Sovereign Immunities Act in 1976. For the past 38 years, such questions have no longer been up to the U.S. State Department, or even the president; they've been entirely under the purview

of the courts. “Any sort of immunity defense made by a foreign sovereign in an American court must stand on the Act’s text,” he writes. “Or it must fall.”

What Scalia is saying is that it’s not his job to worry about the fate of international bond markets, or the sanctity of concepts such as sovereign immunity. He can look only within the four corners of a legal document, and see what he finds there. Nothing else matters. Which is basically what the Second Circuit said, even though it couldn’t entirely duck the sovereign immunity question -- it said that “further guidance from the Supreme Court” could settle that question more decisively. Yet, so far, the Supreme Court has remained silent. The result is, to use Scalia’s term, bedlam. Argentina wants to pay the exchange bondholders, but it can’t. Argentina doesn’t want to pay Elliott, but it has to. It is stuck on the horns of a dilemma, where every possible course of action is a bad one.

So what should Argentina do? It has said that it will negotiate with Elliott, but given how stubborn both sides are, it would be astonishing were the negotiations to bear fruit. Argentina has also said that it will not default on the exchange bondholders -- although there’s a case to be made that simply tendering payment to the Bank of New York, even if that payment is refused, is technically enough to avoid default. (Which of course would come as cold comfort to the unpaid bondholders.)

There has also been talk of trying to do some kind of new bond swap, where exchange bondholders could swap their paper again for new bonds issued in Argentina, away from the reach of U.S. courts. That seems extremely unlikely to happen, though, since only the trustee can reliably identify who the bondholders are, and the trustee would never cooperate with such a plan without Griesa’s permission.

There is one other possibility. It’s not a pleasant one -- not for exchange bondholders, not for Argentina, not for Griesa, and certainly not for Elliott. But it might just be the least unpleasant option.

In the world of public corporations, it has become popular to buy back stock instead of issuing a dividend: shareholders often have tax reasons for preferring buybacks to dividends, and companies are following their preferences. Bond issuers don’t have that option: they’re contractually obliged to make coupon payments. But once a bond has defaulted, it is possible to get a bit more imaginative. And if Argentina wanted to continue to funnel money toward the exchange bondholders, one way of effectively doing so would be to simply buy up those bonds on the secondary market. Argentina could simply take the money that it would otherwise have spent on coupons and spend it instead of buying newly defaulted exchange bonds.

Or it could go further, and attempt some kind of full-fledged de facto bond exchange. Argentina will certainly continue to issue local debt, including local bonds pegged to the dollar, just as it has done for many years. So maybe it could step up that local debt issuance, and start using the proceeds to buy back its defaulted exchange bonds. The country’s total indebtedness would not go up; if anything, thanks to the defaulted bonds trading at a discount, it might well go down. But the longer Argentina conducts that trade

-- the more local debt it issued, and the more exchange bonds it bought back on the secondary market -- the closer it would come to much the same outcome as if it had simply swapped the exchange bonds for local bonds in a big formal exchange offer.

There would be serious costs to such a strategy. For one thing, Argentina would be cementing its status as a financial-markets untouchable: it would be going backward rather than forward. But at least it wouldn't have to make the politically disastrous decision to pay Elliott -- and the other holdout creditors -- billions of dollars it can't afford.

And if anybody started criticizing the country for being in default on the exchange bonds, Argentina could always say, quite honestly, that it has both the ability and the willingness to pay -- and that the only reason its bondholders aren't getting paid is that the U.S. courts won't let them be paid. Both the Second Circuit and the Supreme Court had every opportunity to avert this disaster, and instead they punted. They are the ones who should be held responsible for the fallout.