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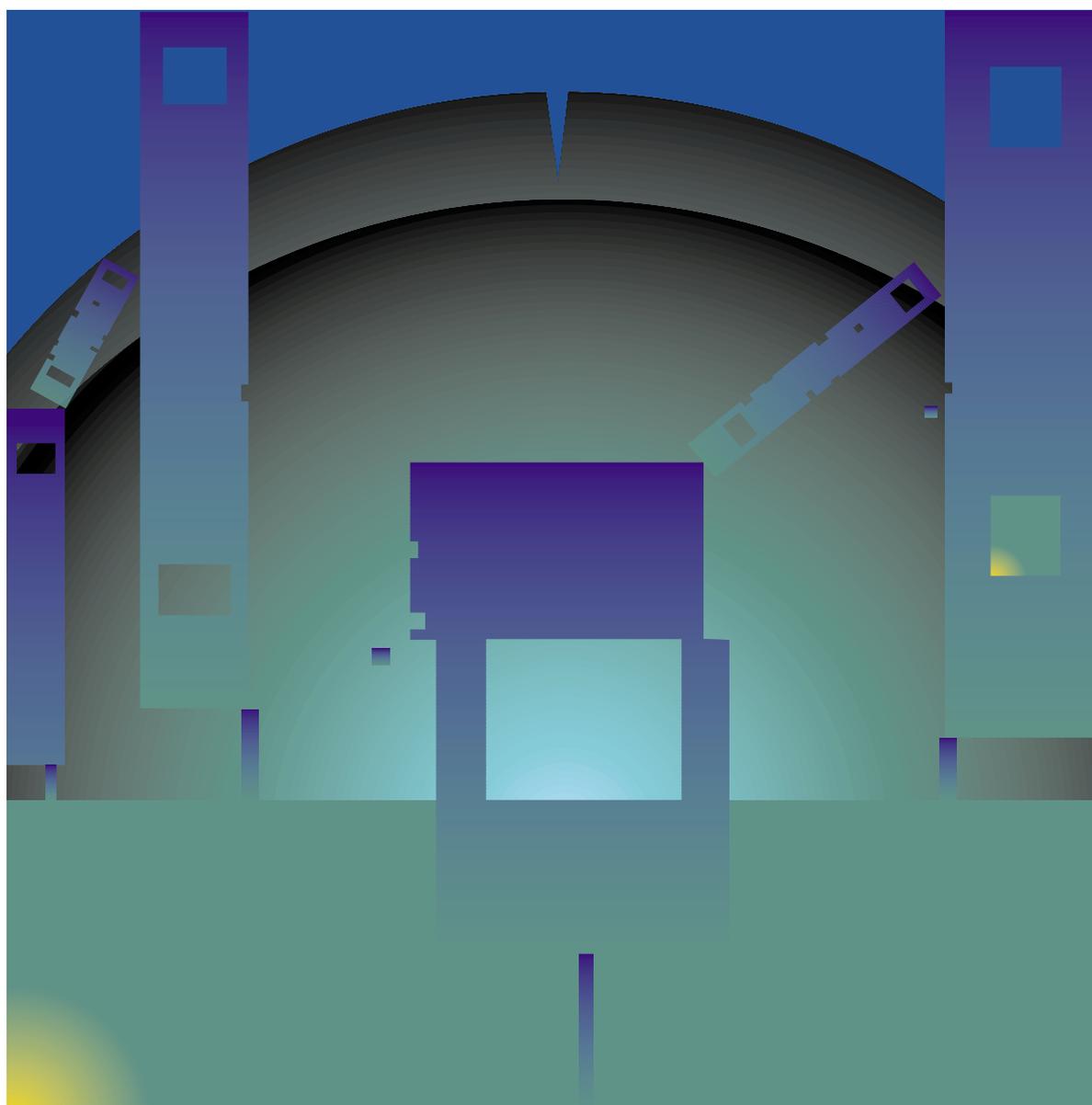
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CRISIS MANAGEMENT AND BURDEN SHARING

A. Introduction

There is a growing body of opinion that effective management of financial crises in emerging markets requires a judicious combination of action on three fronts: a domestic macroeconomic policy response, particularly through monetary and fiscal measures and exchange rate adjustment; timely and adequate provision of international liquidity with appropriate conditionality; and the involvement of the private sector, especially international creditors. With benefit of hindsight, it is now agreed that the international policy response to the Asian crisis was far from optimal, at least during the initial phase. An undue burden was placed on domestic policies; rather than restoring confidence and stabilizing markets, hikes in interest rates and fiscal austerity served to deepen the recession and aggravate the financial problems of private debtors. The international rescue packages were designed not so much to protect currencies against speculative attacks or finance imports as to meet the demands of creditors and maintain an open capital account. Rather than involving private creditors in the management and resolution of the crises, international intervention, coordinated by the IMF, in effect served to bail them out.¹

This form of intervention is increasingly considered objectionable on grounds of moral hazard and equity. It is seen as preventing market discipline and encouraging imprudent lending, since private creditors are paid off with official money and not made to bear the consequences of the risks they take. Even when the external debt is owed by the private sector, the burden ultimately falls on taxpayers in the debtor country, because governments are often obliged to serve as guarantors. At the same time, the funds required for such interventions have been getting ever larger and are now reaching the limits of political acceptability. Thus, a major objective of private sector involvement in crisis resolution is to redress the balance of burden sharing between official and private creditors as well as between debtors and creditors.

For these reasons, the issues of private sector involvement and provision of official assistance in crisis management and resolution have been high on the agenda in the debate on reform of the international financial architecture since the outbreak of the East Asian crisis. However, despite prolonged deliberations and a proliferation of meetings and forums, the international commu-

nity has not been able to reach agreement on how to involve the private sector and how best to design official lending in financial crises. As acknowledged by the IMF, “While some success has been achieved in securing concerted private sector involvement, it has become increasingly clear that the international community does not have at

its disposal the full range of tools that would be needed to assure a reasonably orderly – and timely – involvement of the private sector” (IMF, 2000f: 10). This chapter seeks to address this problem by defining the state of play, examining the issues that remain to be resolved and assessing various options proposed.

B. Private sector involvement and orderly debt workouts

Private sector involvement in financial crisis resolution refers to the continued or increased exposure of international creditors to a debtor country facing serious difficulties in meeting its external financial obligations, as well as to arrangements that alter the terms and conditions of such exposure, including maturity rollovers and debt write-offs.² In this context, it is useful to make a distinction between mechanisms designed to prevent panics and self-fulfilling debt runs, on the one hand, and those designed to share the burden of a crisis between debtors and creditors, on the other. To the extent that private sector involvement would help restrain asset grabbing, it would also reduce the burden to be shared. For instance, debt standstills and rollovers can prevent a liquidity crisis from translating into widespread insolvencies and defaults by helping to stabilize the currency and interest rates. In this sense, private sector involvement in financial crises is not always a zero sum game. It can also help resolve conflict of interest among creditors themselves by ensuring more equitable treatment.

Market protagonists often argue that foreign investors almost always pay their fair share of the

burden of financial crises in emerging markets. According to this view, international banks incur losses as a result of arrears and bankruptcies, while holders of international bonds suffer because the financial difficulties of the debtors affect the market value of bonds, and most private investors mark their positions to market (Buchheit, 1999: 6).

Losses incurred in domestic bond and equity markets are also cited as examples of burden sharing by private investors.³

In assessing creditor losses, it is important to bear in mind that, so long as the value of claims on the debtor remains unchanged, mark-to-market losses may involve only a redistribution among

investors. On the other hand, net losses by creditors are often compensated by risk spreads on lending to emerging markets. For instance, on the eve of the Asian crisis, the total bank debt of emerging markets was close to \$800 billion. Applying a modest 300 basis points as the average spread on these loans would yield a sum of more than \$20 billion per annum in risk premium, compared to the estimated total mark-to-market losses⁴ of foreign banks of some \$60 billion incurred in emerging-market crises since 1997.

A major objective of private sector involvement in crisis resolution is to redress the balance of burden sharing between official and private creditors as well as between debtors and creditors.

Foreign investors are directly involved in burden sharing when their claims are denominated in the currency of the debtor country and they rush to exit. This hurts them twice, by triggering sharp drops both in asset prices and in the value of the domestic currency. For this reason, countries that borrow in their own currencies (or adopt a reserve currency as their own) are expected to be less prone to currency and debt crises since potential losses would deter rapid exit and speculative attacks.

However, the denomination of external debt in the currency of the debtor country does not eliminate the so-called collective action problem which underlines self-fulfilling debt runs and provides the principal rationale for debt standstills; even though creditors as a group are better off if they maintain their exposure, individual investors have an incentive to exit quickly for fear of others doing so before them. The consequent declines in domestic asset prices and in the value of the currency not only hurt creditors, but also have serious repercussions for the debtor economy. In some cases, there could be a run for the strong foreign-owned domestic banks as well, placing a particular burden on locally-owned and smaller banks and other financial institutions. It is for these reasons that governments of debtor countries are often compelled to take action to prevent a rapid exit of foreign investors from domestic capital markets. Such actions may go beyond monetary tightening. In Mexico, for instance, market pressures in 1994 forced the Government to shift from peso-denominated *cepes* to dollar-indexed *tesebonos* in the hope that removing the currency risks would persuade foreign creditors to stay. However, this did not prevent the eventual rush to exit, the collapse of the peso and hikes in interest rates. Thus, even when external debt is denominated in domestic currency, arrangements to involve private creditors through standstills and rollovers can play an important role in efforts to achieve greater financial stability.

As discussed in detail in *TDR 1998*, the rationale and key principles for an orderly debt

workout can be found in domestic bankruptcy procedures. Although chapter 11 of the United States Bankruptcy Code is the most cited reference, other major industrial countries apply similar principles. These principles combine three key elements:

- (i) provisions for an automatic standstill on debt servicing that prevents a “grab race” for assets among the creditors; (ii) maintaining the debtor’s access to the working capital required for the continuation of its operations (i.e. lending into arrears); and (iii) an arrangement for the reorganization of the debtor’s assets and liabilities, including debt rollover, extension of existing loans, and debt write-off or conversion. The way these elements are combined depends on the particularities of each case, but the aim is to share the adjustment burden between debtor and creditors and to assure an equitable distribution of the costs among creditors.

Under these procedures, standstills give the debtor the “breathing space” required to formulate a debt reorganization plan. While, in principle, agreement is sought from creditors for restructuring debt, the procedures also make provisions to discourage holdouts by allowing for majority – rather than unanimous – approval of the creditors for the reorganization plan. The bankruptcy court acts as a neutral umpire and facilitator, and when necessary has the authority to impose a binding settlement on the competing claims of the creditors and debtor under so-called “cramdown” provisions.

Naturally, the application of national bankruptcy procedures to cross-border debt involves a number of complex issues. However, fully-fledged international bankruptcy procedures would not be needed to ensure an orderly workout of international debt. The key element is internationally sanctioned mandatory standstills. Under certain circumstances, it might be possible to reach agreement on voluntary standstills with creditors but, as recognized by the IMF, “... in the face of a broad-based outflow of capital, it may be difficult to reach agreement with the relevant resident

While debtor countries have the option to impose unilateral payment suspension, without a statutory basis such action can create considerable uncertainties, thereby reducing the likelihood of orderly debt workouts.

and nonresident investors ...” (IMF, 2000f: 10). On the other hand, while debtor countries have the option to impose unilateral payment suspension, without a statutory basis such action can create considerable uncertainties, thereby reducing the likelihood of orderly debt workouts. Furthermore, debtors could be deterred from applying temporary payment standstills for fear of litigation and asset seizure by creditors, as well as of lasting adverse effects on their reputation.

Standstills on sovereign debt involve suspension of payments by governments themselves, while on private external debt they require an imposition of temporary exchange controls which restrict payments abroad on specified transactions, including interest payments. Further restrictions may also be needed on capital transactions of residents and non-residents (such as acquisition of assets abroad or repatriation of foreign capital). Clearly, the extent to which standstills would need to be combined with such measures depends on the degree of restrictiveness of the capital account regime already in place.

Since standstills and exchange controls need to be imposed and implemented rapidly, the decision should rest with the country concerned, subject to a subsequent review by an international body. According to one proposal, the decision would need to be sanctioned by the IMF. Clearly, for the debtor to enjoy insolvency protection, it would be necessary for such a ruling to be legally enforceable in national courts. This would require a broad interpretation of Article VIII(2)(b) of the Articles of Agreement of the IMF, which could be provided either by the IMF Executive Board or through an amendment of these Articles so as to cover debt standstills. In this context, Canada has proposed an Emergency Standstill Clause to be mandated by IMF members (Department of Finance, Canada, 1998).

However, as argued in *TDR 1998*, the IMF Board is not a neutral body and cannot, therefore,

be expected to act as an independent arbiter, because countries affected by its decisions are also among its shareholders. Moreover, since the Fund itself is a creditor, and acts as the authority for imposing conditionality on the borrowing countries, there can be conflicts of interest vis-à-vis both debtors and other creditors. An appropriate procedure would thus be to establish an independent panel for sanctioning such decisions. Such a procedure would, in important respects, be similar to GATT/WTO safeguard provisions that allow developing countries to take emergency actions when faced with balance-of-payments difficulties (see box 6.1).

For private borrowers the restructuring of debts should, in principle, be left to national bankruptcy procedures. However, these remain highly inadequate in most developing countries (see chapter IV, subsection B.6). Promoting an orderly workout of private debt, therefore, crucially depends on establishing and developing appropriate procedures. Ordinary procedures for handling individual bankruptcies may be inappropriate and difficult to apply under a more widespread crisis, and there may be a need to provide general protection to debtors when bankruptcies are of a systemic nature. One proposal that has

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been put forward is “... to provide quasi automatic protection to debtors from debt increases due to a devaluation beyond a margin ...” (Miller and Stiglitz, 1999: 4). Clearly, the need for such protection will depend on the extent to which standstills and exchange controls succeed in preventing sharp declines in currencies. For sovereign debtors, it is difficult to envisage formal bankruptcy procedures at the international level, but they too could be given a certain degree of protection against debt increases brought about by currency collapses. Beyond that, negotiations between debtors and creditors appear to be the only feasible solution. As discussed below, these may be facilitated by the inclusion of various provisions in debt contracts, as well as by appropriate intervention of multilateral financial institutions.

GATT AND GATS BALANCE-OF-PAYMENTS PROVISIONS AND EXCHANGE RESTRICTIONS

The balance-of-payments provisions of Articles XII and XVIII B of GATT 1994 allow a Member to suspend its obligations under the Agreement, and to impose import restrictions in order to forestall a serious decline in, or otherwise protect the level of, its foreign exchange reserves, or to ensure a level of reserves adequate for implementation of its programme of economic development.¹ The provisions of Article XVIII B (part of Article XVIII dealing with governmental assistance to economic development) are directed particularly at payments difficulties arising mainly from a country's efforts to expand its internal market or from instability in its terms of trade. Permissible actions include quantitative restrictions as well as price-based measures. In applying such restrictions, the Member may select particular products or product groups. The decision is taken unilaterally, with notification to the WTO Secretariat and subsequent consultations with other Members in the Committee on Balance-of-Payments Restrictions. Restrictions are imposed on a temporary basis, and are expected to be lifted as conditions improve. However, the Member cannot be required to remove restrictions by altering its development policy.

Similar provisions are to be found in Article XII of the General Agreement on Trade in Services (GATS), which stipulates that, in the event of serious difficulties in the balance of payments and in external finance, or a threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. Again, such restrictions are allowed to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for implementation of the Member's programme of economic development or economic transition. The conditions and modalities related to the application of such restrictions are similar to those in the GATT 1994 balance-of-payments provisions.

Clearly, these provisions are designed to avoid conditions in which countries are forced to sacrifice economic growth and development as a result of temporary difficulties originating in the current account of the balance of payments, particularly trade deficits. Even though they may not be invoked directly for the restriction of foreign exchange transactions and the imposition of temporary standstills on debt payments at times of severe payments difficulties arising from the rapid exit of capital – and a consequent capital-account crisis – resort to such action in those circumstances would be entirely in harmony with the provisions' underlying rationale.

¹ For more detailed discussion, see Jackson (1997, chap. 7); and Das (1999, chap. III.3).

C. Recent debate within the IMF

Despite its potential benefits to both debtors and creditors, private sector involvement in crisis resolution has proved to be one of the most contentious issues in the debate on reform of the international financial architecture. While the international community has increasingly come to recognize that market discipline will only work if creditors bear the consequences of the risks they take, it has been unable to reach agreement on how to bring this about. According to one view, a voluntary and case-by-case approach would constitute the most effective way of involving the private sector in crisis resolution. Another view is that, for greater financial stability and equitable burden sharing, a rules-based mandatory approach is preferable. This divergence of views is not simply between debtor and creditor countries, but also among the major creditor countries.

The main argument in favour of a rules-based system is that a case-by-case approach could lead to asymmetric treatment – not only between debtors and creditors, but also among different creditors. It would also leave considerable discretion to some major industrial powers, which have significant leverage in international financial institutions, to decide on the kind of intervention to be made in emerging-market crises. Private market actors, as well as some major industrial countries, are generally opposed to involuntary mechanisms on the grounds that they create moral

hazard for debtors, that they alter the balance of negotiating strength in favour of the latter, that they delay the restoration of market access, and that they can be used to postpone the adjustments needed.⁵

The recent debate within the IMF on private sector involvement in crisis resolution appears to have focused on three mechanisms. First, it is agreed that the Fund should try, where appropriate, to act as a catalyst for lending by other creditors to a country facing payments difficulties. If this is inappropriate, or if it fails to bring in the private sector, the debtor country should seek to reach an agreement with its creditors on a voluntary standstill. Finally, it is recognized that, as a last resort, the debtor country may find it necessary to impose a unilateral standstill when voluntary agreement is not feasible.

All these measures should also be accompanied by appropriate monetary and fiscal tightening and exchange rate adjustment. A report of the meeting of the IMF Executive Board concerning the involvement of the private sector in the resolution of financial crises stated:

Directors agreed that, under the suggested framework for involving the private sector, the Fund's approach would need to be a flexible one, and the complex issues involved would require the exercise of considerable judgement. ... In cases where the member's financing needs are relatively small or where,

Current practices leave too much discretion to the Fund and its major shareholders in decisions regarding the timing and extent of the official financing it should provide, and under what conditions.

despite large financing needs, the member has good prospects of gaining market access in the near future, the combination of strong adjustment policies and Fund support should be expected to catalyze private sector involvement. In other cases, however, when an early restoration of market access on terms consistent with medium-term external sustainability is judged to be unrealistic, or where the debt burden is unsustainable, more concerted support from private creditors may be necessary, possibly including debt restructuring ...

Directors noted that the term “standstill” covers a range of techniques for reducing net payment of debt service or net outflows of capital after a country has lost spontaneous access to international capital markets. These range from voluntary arrangements with creditors limiting net outflows of capital, to various concerted means of achieving this objective.

Directors underscored that the approach to crisis resolution must not undermine the obligation of countries to meet their debt in full and on time. Nevertheless, they noted that, in extreme circumstances, if it is not feasible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally. Directors noted that ... there could be a risk that this action would trigger capital outflows. They recognized that if a tightening of financial policies and appropriate exchange rate flexibility were not successful in stanching such outflows, a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls. (IMF, 2000h)⁶

Clearly, there still remains the possibility of large-scale bailout operations. Some countries apparently attempted to exclude this possibility, but could not secure consensus:

A number of Directors favoured linking a strong presumption of a requirement for concerted private sector involvement to the level of the member’s access to Fund resources. These Directors noted that a rules-based approach would give more

predictability to the suggested framework for private sector involvement, while limiting the risk that large-scale financing could be used to allow the private sector to exit. Many other Directors, however, stressed that the introduction of a threshold level of access to Fund resources, above which concerted private sector involvement would be automatically required, could in some cases hinder the resumption of market access for a member with good prospects for the successful use of the catalytic approach to securing private sector involvement.

Nor has there been agreement over empowering the IMF to impose stay on creditor litigation in order to provide statutory protection to debtors that impose temporary standstills:

Most Directors considered that the appropriate mechanism for signalling the Fund’s acceptance of a standstill imposed by a member was through a decision for the Fund to lend into arrears to private creditors ... Some Directors favored an amendment to Article VIII, section 2(b), that would allow the Fund to provide a member with some protection against the risk of litigation through a temporary stay on creditor litigation. Other Directors did not favor such an approach, and noted that in recent cases members’ ability to reach cooperative agreements with private creditors had not been hampered by litigation.

Considerable flexibility is undoubtedly needed in handling financial crises since their form and severity can vary from country to country. However, current practices leave too much discretion to the Fund and its major shareholders in decisions regarding the timing and extent of the official financing it should provide, and under what conditions; how much private sector involvement it should require; and under what circumstances it should give support to unilateral payment standstills and capital controls. The suggested framework generally fails to meet the main concerns of debtor countries regarding burden sharing in crisis resolution and the modalities of IMF support and conditionality. Nor does it provide clear guidelines to influence the expectations and behaviours of debtors and creditors with the aim of securing greater stability.

D. Official assistance, moral hazard and burden sharing

The above discussion suggests that there is now a greater emphasis on private sector involvement when designing official assistance to countries facing financial difficulties. The elements of this strategy include the use of official money as a catalyst for private financing, lending into arrears to precipitate agreement between debtors and creditors, and making official assistance conditional on prior private sector participation. Some of these policies were, in fact, used for the resolution of the debt crisis in the 1980s, although their objectives were not always fully met. For instance, under the so-called Baker Plan, official lending to highly-indebted developing countries sought to play a catalytic role, but faced stiff opposition from commercial banks, which refused to lend to these countries. The practice of IMF lending to debtors that are in arrears on payments owed to private creditors dates back to the Brady Plan of 1989, when commercial banks were no longer willing to cooperate in restructuring third world debt as they had made sufficient provisions and reduced their exposure to developing country borrowers. A decision by the IMF Board in September 1998 formally acknowledged lending into arrears as part of the Fund's lending policy and extended this practice to bonds and non-bank credits in the expectation that it would help countries with Fund-approved adjustment programmes to restructure their private debt.⁷

The current emphasis on official assistance being made conditional on private sector participation includes a commitment not to lend or grant official debt relief unless private markets similarly roll over their maturing claims, lend new money or restructure their claims. This strategy, which

has come to be known as "comparability of treatment", aims not only at preventing moral hazard as it pertains to private creditors, but also at ensuring an acceptable form of burden sharing between the private and official creditors. Its underlying principle is that public assistance should not be made available unless debtors get some relief from private creditors, and no class of private creditors should be exempt from burden sharing.⁸ In 1999, Paris Club creditors specifically advised Pakistan to seek comparable treatment from its private bondholders by rescheduling its eurobond obligations. However, this policy does not seem to have been implemented in the case of recent official assistance to Ecuador, when the IMF did not insist that the country reach an agreement on restructuring with the holders of its Brady bonds as a precondition for official assistance (see box 6.2; and Eichengreen and Ruhl, 2000: 19).

Certainly, the emphasis on burden sharing and comparable treatment between private and official creditors constitutes a major advance over the debt strategies adopted in the 1980s and in the more recent emerging-market crises. During these episodes, official intervention was designed primarily to keep sovereign debtors current on debt servicing to private creditors and the seniority accorded to multilateral debt went unchallenged. However, the emphasis on burden sharing among creditors does not necessarily lead to improved outcomes regarding the more important question of burden sharing between debtors and creditors.

In this respect, a key issue is whether a strategy that makes official assistance conditional on private sector participation could succeed in pro-

RECENT BOND RESTRUCTURING AGREEMENTS

A number of recent sovereign bond restructuring agreements have been widely hailed by the international community for their success "... in puncturing unsustainable expectations of some investors that international sovereign bonds were, in effect, immune from restructuring ..." (IMF, 2000f: 10). However, they also show that, under current institutional arrangements, there are no established mechanisms for an orderly restructuring of sovereign bonds, and that the process can be complex and tedious.¹ Success in bringing bondholders to the negotiating table does not depend on the presence of CACs in bond documents alone. A credible threat of default could be just as effective. However, even then, the debtors are not guaranteed to receive significant debt relief, particularly on a mark-to-market basis.

Pakistan restructured its international bonds at the end of 1999 without invoking the CACs present in its bonds, preferring a voluntary offer to exchange its outstanding eurobonds for a new six-year instrument, which was accepted by a majority of the bondholders. Communication problems were not serious because the bonds were held by only a few Pakistani investors. It is believed that the presence of CACs and a trustee, as well as the request of the Paris Club to extend "comparability of treatment" to eurobonds, along with a credible threat of default, played an important role in discouraging holdouts.² However, the terms of restructuring were quite favourable to bondholders compared to the prevailing market price, and the new bonds offered were more liquid. According to the IMF, there was a "haircut" for the creditors compared to the relative listing price but not to the relative market value, and although the initial impact of the restructuring on the debt profile of the country was somewhat positive, "by 2001 market estimates suggest that debt-service payments will be back to levels before restructuring and will be higher for the remaining life of the exchange bond" (IMF, 2000g: 137 and table 5.2).

By contrast, **Ukraine** made use of the CACs present in four of its outstanding bonds in a restructuring concluded in April 2000. Unlike Pakistan, the bonds were spread widely among retail holders, particularly in Germany, but the country managed to obtain the agreement of more than 95 per cent of the holders on the outstanding value of debt. As in Pakistan, however, this involved only the extension of principal maturities rather than relief, since reorganization was undertaken on a mark-to-market basis. Indeed, there was a net gain for creditors relative to market value (IMF, 2000g, table 5.2).

From mid-1999 **Ecuador** started having serious difficulties in making interest payments on its Brady bonds, ending up in a default in the second half of the year. As rolling over maturities would not have provided a solution, the country sought a large amount of debt reduction by offering an exchange for global bonds issued at market rates, but with a 20-year maturity period. This was rejected by the bondholders, who furthermore, voted for acceleration. After a number of failed attempts, Ecuador invited eight of the larger institutional holders of its bonds to join a Consultative Group, with the aim of providing a formal mechanism of communication with bondholders rather than negotiating terms for an exchange offer. In mid-August, bondholders accepted Ecuador's offer to exchange defaulted Brady bonds for 30-year global bonds at a 40 per cent reduction in principal, while the market discount was over 60 per cent. This resulted in a net gain for the creditors relative to market value.³

¹ On these restructuring exercises, see De la Cruz (2000); Eichengreen and Ruhl (2000); Buchheit (1999); and IMF (2000g, box 5.3).

² For a different view on the impact of the Paris Club's request, see Eichengreen and Ruhl (2000: 26–28).

³ For an assessment of the Ecuadorian restructuring, see Acosta (2000).

moting orderly debt workouts with private creditors. The rationale for this strategy is that, if the Fund were to stand aside and refuse to lend to a country under financial stress unless the markets rolled over their claims first, private creditors would be confronted with the prospect of default, which would encourage them to negotiate and reach agreement with the debtor. The main weakness of this strategy is that, if the default is not very costly, creditors will have little incentive for restructuring their claims. On the other hand, if it is costly, the IMF will not be able to stand by and let it happen, since the threat to international financial stability, as well as to the country concerned, would be serious.

The insistence on IMF non-intervention would be no more credible than an announcement by a government that it will not intervene to save citizens who have built houses in a flood plain.⁹ This dilemma provides a strong case for explicit rules prohibiting the building of houses in flood plains or a “grab race” for assets.¹⁰

Thus it appears that a credible strategy for involving the private sector in crisis resolution should combine temporary standstills with strict limits on access to Fund resources. Indeed, such a strategy has received increased support in recent years.¹¹ According to one view, access could be limited by charging penalty rates. However, since such price-based measures are unlikely to succeed in checking distress borrowing under crisis conditions, quantitative limits will be needed. A recent report by the United States Council on Foreign Relations (CFR) on reform of the international financial architecture argued that the IMF should adhere consistently to normal access limits of 100 per cent of quota annually and 300 per cent on a cumulative basis, and that countries should be able to resort to unilateral standstills when such financing proves inadequate to stabilize markets and their balance of payments. The amounts committed in recent interventions in emerging-market crises, beginning with the one in Mexico in 1995, far exceeded these limits, being in the range of 500 per cent to 1,900 per cent of quota.

A credible strategy for involving the private sector in crisis resolution should combine temporary standstills with strict limits on access to Fund resources.

However, in setting such access limits, it should be recognized that IMF quotas have lagged behind growth of global output, trade and financial flows, and their current levels may not provide appropriate yardsticks to evaluate the size of IMF packages. According to one estimate, adjust-

ing quotas for the growth in world output and trade since 1945 would require them to be raised by three and nine times, respectively (Fischer, 1999). In an earlier proposal – made in an IMF paper on the eve of the Mexican crisis – to create a short-term financing facility for intervention in financial crises, 300 per cent of quota was considered a possible upper limit (see *TDR 1998*, chap. IV, sect. B.4). Such amounts ap-

pear to be more realistic than current normal access limits.

Fund resources are not the only source of rescue packages, and in many cases bailouts rely even more on the money provided by some major creditor countries. This practice has often increased the scope for these countries to pursue their own national interests in the design of rescue packages, including the conditionalities attached to lending. It is highly probable that major creditor countries will continue to act in this manner whenever and wherever they see their interests involved, and some debtor countries may even prefer to strike bilateral deals with them rather than going through multilateral channels. However, limits on access to Fund resources should be observed independently of bilateral lending under crisis. Furthermore, it is desirable to keep such ad hoc bilateral arrangements separate from multilateral lending in order to reduce the scope for undue influence over Fund policies by some of its major shareholders.

A key question is whether such access limits should be exceeded under certain circumstances. For instance, while arguing for strict limits, the CFR report suggested, “In the unusual case in which there appears to be a systemic crisis (that is, a multicountry crisis where failure to intervene threatens the performance of the world economy and where there is widespread failure in the abil-

Box 6.3

RECENT INITIATIVES IN IMF CRISIS LENDING

The IMF has recently taken steps to strengthen its capacity to provide financing in crises, though this capacity still falls short of that of a genuine international lender of last resort.¹ The Supplemental Reserve Facility (SRF), approved by the IMF's Executive Board in response to the deepening of the East Asian crisis in December 1997, was designed to provide financing without limits to countries experiencing exceptional payments difficulties, but under a highly conditional stand-by or Extended Arrangement (IMF, 1998b: 7). However, the SRF depends on the existing resources of the Fund which, recent experience suggests, are likely to be inadequate on their own to meet the costs of large interventions.

The Contingency Credit Line (CCL), created in Spring 1999, is intended to provide a precautionary line of defence in the form of short-term financing, which would be available to meet balance-of-payments problems arising from international financial contagion (IMF, 1999). Thus, unlike the SRF, which is available to countries in crisis, the CCL is a preventive measure. Countries can pre-qualify for the CCL if they comply with conditions related to macroeconomic and external financial indicators and with international standards in areas such as transparency, banking supervision and the quality of banks' relations and financing arrangements with the private sector. The pressures on the capital account and international reserves of a qualifying country must result from a sudden loss of confidence amongst investors triggered largely by external factors. Moreover, although no limits on the scale of available funds are specified, like the SRF, the CCL depends on the existing resources of the Fund. Originally, it was expected that the precautionary nature of the CCL would restrict the level of actual drawings. However, in the event, no country has applied for this facility. It is suggested that, under the initial terms, countries had no incentive to pre-qualification because fees and interest charges on the CCL were the same as under the SRF. In addition, access was not automatic, but subject to the Board's assessment of policies and risks of contagion effects. The IMF Board took steps in September 2000 to lower charges as well as to allow some automatic access with a view to enhancing the potential use of the CCL (IMF, 2000j), but there appear to be more serious design problems. In particular, countries seem to avoid recourse to it for fear that it will have the effect of a tocsin in international financial markets, thus stifling access to credit.²

¹ For a discussion of these facilities, see IMF (2000i). For a discussion of the issues involved in establishing an international lender of last resort, see *TDR 1998* (chap. IV, sect. B.4), and Akyüz and Cornford (1999).

² For an earlier assessment along these lines, see Akyüz and Cornford (1999: 36). For a more recent assessment, see Goldstein (2000: 12–13).

ity of private capital markets to distinguish creditworthy from less creditworthy borrowers), the IMF would return to its 'systemic' backup facilities ..." (CFRTE, 1999: 63). It proposed the creation of a facility to help prevent contagion, to be funded by a one-off allocation of special drawing rights (SDRs),¹² which would replace the existing IMF facilities for crisis lending (see box 6.3).

While the concerns underlying different lending policies for systemic and non-systemic crises may be justified, in practice exceptions to normal lending limits could leave considerable room for large-scale bailout operations and excessive IMF discretion. One possible implication is that countries not considered systemically important could face strict limits in access to Fund resources, but

would have the option of imposing unilateral standstills. However, for larger emerging markets bailouts would still be preferred to standstills. Recent events involving defaults by Pakistan and Ecuador (see box 6.2), but rescue operations for Argentina and Turkey (see chapter II) bear this

out. In the latter cases, difficulties experienced were largely due to the currency regimes pursued rather than to financial contagion from abroad. However, there is wide concern that if these crises had been allowed to deepen, they could have spread to other emerging markets.

E. Voluntary and contractual arrangements

As noted above, considerable emphasis is now being placed on voluntary mechanisms for the involvement of the private sector in crisis management and resolution. However, certain features of the external debt of developing countries render it extremely difficult to rely on such mechanisms, particularly for securing rapid debt standstills and rollovers. These include a wider dispersion of creditors and debtors and the existence of a larger variety of debt contracts associated with the growing spread and integration of international capital markets, as well as innovations in sourcing foreign capital. As a result, the scope of some of the voluntary mechanisms used in the past has greatly diminished.

Perhaps the most important development, often cited in this context, is the shift from syndicated bank loans to bonds in sovereign borrowing, since, for reasons examined below, bond restructuring is inherently more difficult. Sovereign bond issues were a common practice in the interwar years when emerging markets had relatively easy access to bond markets. During the global financial turmoil of the late 1920s and early 1930s, many of these bond issues ended up in defaults. There was little recourse to bond financing by emerging-market governments prior to the 1990s. The share of bonds in the public and publicly guaranteed long-term debt of developing countries

stood at some 6.5 per cent in 1980, but rose rapidly over the past two decades, reaching about 21 per cent in 1990 and almost 50 per cent in 1999 (World Bank, 2000). This ratio is lower for private, non-guaranteed debt, but the increase in the share of bonds in private external debt is equally impressive – from about 1 per cent in 1990 to some 24 per cent in 1999. According to the Institute of International Finance (IIF), from 1992 to 1998, of a total of about \$1,400 billion net capital flows to 29 major emerging markets, 23 per cent came from commercial banks and 27 per cent from other private creditors, mainly through bonds (IIF, 1999, table 1).

A second important development is that international lending to emerging markets has been increasingly to private sector borrowers. The share of public and publicly guaranteed debt in the total long-term debt of developing countries exceeded 75 per cent in the 1980s, but stood at less than 60 per cent in 1999. The increased importance of private sector borrowing has meant a rapid increase in the dispersion of debtors. While an important part of private borrowing consists of interbank loans, direct lending to corporations is also important in some emerging markets. In Indonesia, for example, such borrowing accounted for more than three quarters of the total private debt. Furthermore, in developing countries, an

increasing proportion of the private sector's external bank debt is in the form of bilateral rather than syndicated lending, implying also a greater dispersion of creditors. The creditor base is further broadened as a result of repackaging arrangements and credit derivatives, whereby economic interest in the original loan is passed on to third parties (Yianni, 1999: 81–84).

Various developments regarding emerging-market debt have also increased the scope for rapid exit and creditor runs, thereby reducing the room for cooperative solutions. Perhaps the most important of these is the shift in bank lending towards more short-term loans. In the mid-1980s, bank loans with a maturity of less than one year accounted for around 43 per cent of total bank loans, but they increased to almost 60 per cent on the eve of the Asian crisis, and dropped to about 50 per cent thereafter. Similarly, the widespread use of acceleration and cross-default clauses and put options in credit contracts has increased the scope for dissident holdouts, making it difficult for debtors and creditors to reach rapid agreement on voluntary standstills and workouts.¹³

A number of proposals have been made for designing mechanisms to facilitate voluntary involvement of the private sector in crisis resolution. In discussing these mechanisms, it is useful to make a distinction between bond covenants and other contractual and cooperative arrangements designed to “bind in” and “bail in” the private sector.

1. Bond restructuring and collective action clauses

As already noted, the notion that sovereign bonds as well as bank loans may need to be restructured has only recently been accepted by the international community (though not necessarily by all segments of financial markets). The emerging-market sovereign debtors that had issued bonds in the 1970s and 1980s generally remained current on such obligations during the debt crisis of the 1980s while rescheduling and restructuring their commercial bank debt – a factor that appears to have played an important role in the rapid ex-

pansion of bond financing in the 1990s relative to bank lending. As a result of this rapid increase, together with the increased frequency of virulent financial crises, bond restructuring has gained in importance, particularly for sovereign borrowers.

However, there are serious difficulties in bond restructuring compared to rescheduling and restructuring of syndicated credits. First of all, there are collective representation and collective action problems, which are more acute with bonds than with loan contracts. These arise from communication difficulties between the bond issuer and holders; in general bondholders are anonymous and more diverse and include a variety of investors, both individual and institutional. The communication problem is further aggravated by trading in secondary markets. Moreover, there are legal impediments to the establishment of communication mechanisms between issuers and holders, as well as to dealing with non-participating holders, that vary according to the legislation governing bonds. Again, as legislation for bond contracts varies, it becomes difficult to apply uniform procedures in restructuring. Current arrangements also encourage holdouts and litigation by bondholders since, unlike the practice during the interwar years, sovereign issuers are often required to include a waiver of sovereign immunity. Thus, sovereign debtors do not enjoy the protection accorded to private debtors under domestic bankruptcy and insolvency procedures that often overrule holdouts and eliminate free riders.

Quite independently of the contractual and legal provisions governing a bond, a sovereign issuer facing serious financial difficulties always has the option of making an offer to exchange its existing bonds with new instruments containing new terms of payment. However, the problems of communication and holdouts render such exchange offers difficult to implement effectively. Thus, since the Mexican crisis, emerging-market borrowers have been increasingly urged to include so-called collective action clauses (CACs) in bond contracts in order to improve communication with bondholders and facilitate bond restructuring.¹⁴ Such clauses appear to be particularly desirable for sovereign borrowers, who do not benefit from national bankruptcy codes. There are basically three types of CACs:

- *collective representation clauses*, designed to establish a representative forum (e.g. a trustee) for coordinating negotiations between the issuer and bondholders;
- *majority action clauses*, designed to empower a qualified majority (often 75 per cent) of bondholders to agree to a change in payment terms in a manner which is binding on all bondholders, thereby preventing holdouts; and
- *sharing clauses*, designed to ensure that all payments by the debtor are shared among bondholders on a pro-rated basis, and to prevent maverick litigation.

It should be noted that the inclusion of CACs in bond contracts, where allowed by law, is optional – not mandatory – and often depends on market convention. Issuers generally adopt the documentation practices prevailing in the jurisdiction of the governing law. In general, collective representation clauses are not contained in bonds governed either by English law or New York law. Majority action clauses are routinely included in bond contracts governed by English law, but not in those issued under New York law, even though the latter does not preclude them from sovereign issues. Similarly, bonds governed by German and Japanese laws do not generally contain majority action clauses. In these cases, any change to the terms of payment requires a unanimous decision by the bondholders. This is also true for Brady bonds, even when governed by English law. It appears that the inclusion of a unanimity rule was a major reason for the Brady process to be implemented through loan-for-bond exchanges rather than through amendments to the existing loan contracts (Buchheit, 1999: 9).

Sharing clauses are routinely included in syndicated bank loans, but are uncommon in publicly issued bonds since they are often viewed by markets as a threat to the legal right of creditors to enforce their claims.¹⁵ The absence of sharing

clauses, together with the waiver of sovereign immunity, leaves considerable room for bondholders to hold out against restructuring and to enter into a “grab race” for assets through litigation.

According to available data, about one third of total bonds issued by emerging markets during the 1990s were governed by English law; the share of bonds issued under New York law was lower, but still exceeded a quarter, followed by those issued under German law (just under one fifth) and Japanese law (around 13 per cent). It appears that Asian, and particularly Latin American, emerging markets have made greater use of New York law than English law in their issues. Japanese law is seldom used in Latin American issues but governs about a quarter of Asian issues, while the opposite is true concerning the use of German law. Between 1995 and 2000, there was an increase in the proportion of bonds governed by New York law, but it is not clear if this is linked to the increased frequency of financial crises in emerging markets (Dixon and Wall, 2000: 145–146; Eichengreen and Mody, 2000a, table 1).

It is estimated that about half of all outstanding international bond issues – including those issued by industrial countries – do not include

CACs, and this proportion is even greater for emerging-market bonds. A major concern of emerging markets is that the inclusion of CACs would curtail their access to markets and raise the cost of borrowing because it would signal a greater likelihood of default. They thus insist that such clauses be introduced first in sovereign bonds of industrial countries. Some industrial countries, such as Canada and the United Kingdom, have recently decided to include or extend CACs in their international bond and note issues in order to encour-

age a wider use of such clauses, particularly by emerging markets. International private sector groups find majority voting acceptable, subject to a threshold in the order of 90–95 per cent, but they prefer voluntary exchange offers, and are opposed

A major concern of emerging markets is that the inclusion of collective action clauses would curtail their access to markets and raise the cost of borrowing because it would signal a greater likelihood of default, but the empirical evidence on the impact of such clauses on the cost of international bond financing is inconclusive.

to making CACs mandatory in bond contracts (IMF, 2000g: table 5.2; Dixon and Wall, 2000: table 2).

The empirical evidence on the impact of CACs on the cost of international bond financing is inconclusive (BIS, 1999; Eichengreen and Mody, 2000b; Dixon and Wall, 2000). Indeed, CACs can have two opposite effects. On the one hand, their inclusion can raise the default probability in the eyes of investors since they may create moral hazard for the debtor, leading to a higher risk premium. On the other hand, in the event of a default, such clauses help recover the claims of investors by facilitating bond restructuring. The net effect depends on how CACs affect the perceived default probability and the expected recovery rate. For countries with high credit ratings, the latter effect could dominate, so that the inclusion of CACs may, in fact, lower the cost of bond financing. For lower-rated bonds, however, such clauses may well lead to sharp increases in the perceived risk of default, thereby raising the spread on new issues.

It is not clear if the introduction of CACs in bond contracts could make a major impact on debt restructuring, since experience in this respect is highly limited.¹⁶ In any case, even if such clauses were rapidly introduced by emerging-market borrowers in their new bond issues, the initial impact would be limited because of the existence of a large stock of outstanding bonds without CACs. On the other hand, CACs have been rarely used by emerging markets for bond restructuring even when they are present in bond contracts, partly because of the fear that bondholders' meetings could be used to mobilize opposition against attempts to restructure bonds and to take a decision for acceleration (which typically requires the consent of 25 per cent of bondholders). Clearly, such risks can be serious, since the ultimate decision on restructuring lies with bondholders, and the sovereign debtor does not have the means of obtaining court approval for its restructuring plan, as provided, for instance, under the "cramdown" provisions of the United States Bankruptcy Code for corporate borrowers.

The existing practice regarding bond issues leaves little scope for securing a rapid standstill on a voluntary basis.

In assessing the potential role of CACs in involving the private sector in crisis resolution, it is important to distinguish between standstills and financial restructuring. The existing practice regarding bond issues leaves little scope for securing a rapid standstill on a voluntary basis.¹⁷ Such a standstill requires representational bodies, such as trustees or bondholder committees, as well as prohibition of litigation by individual bondholders and/or sharing clauses. As already noted, there is strong resistance by private investors to the inclusion of such clauses across almost all jurisdictions, and they are not likely to be introduced on a voluntary basis. Majority action clauses alone cannot secure rapid voluntary standstill and "cramdown" on dissident bondholders, because invoking such clauses is a tedious process and leaves ample time and opportunities for rogue bondholders to impose a financial stranglehold over the debtor.

Private investors often point out that the major financial crises in emerging markets were not precipitated by a rapid exit of holders of sovereign bonds through litigation and a "grab race" for assets, but by short-term hot money (Buchheit, 1999: 7). This is certainly true for East Asia, where sovereign bond debt was generally negligible. However, with the rapid growth of the bond market, granting bondholders unmitigated power of litigation and asset attachment is potentially a serious source of instability. As already discussed, the current emphasis in official lending on private sector participation is unlikely to generate adequate incentives for voluntary standstill and rollover of private debt at times of crisis.

The consequences of unilateral suspension of payments on bonds could be more serious than defaults on bank debt because the effect would be immediately transmitted to secondary markets. A sharp increase in the risk premium and a decline in bond prices would then create considerable opportunities for profit-making by litigious investors (the so called "vultures"), who could acquire distressed debt at substantial discounts and pursue a "grab race" for assets.¹⁸ On the other hand, as some recent bond restructuring exercises show,

even when unilateral defaults lead to an agreement on restructuring, the process tends to be disorderly and does not always guarantee significant relief for the debtor (see box 6.2).

Thus a possible solution would be to combine internationally sanctioned mandatory standstills with majority action clauses in order to prevent a “grab race” for assets and facilitate voluntary restructuring. One proposal (Buiters and Silbert, 1999) favours a contractually-based approach to standstill, which would require all international loan agreements to include an automatic universal debt rollover option with a penalty (UDROP). However, such a clause is unlikely to be introduced voluntarily and would need an international mandate. Another proposal is to empower the Fund to impose or sanction standstills on bondholders at the outbreak of a crisis (see, for example, Miller and Zhang, 1998). This could be combined with IMF lending into arrears, when needed, in order to alleviate the liquidity squeeze on the debtor country and encourage a rapid restructuring. Debt restructuring should be left to a voluntary agreement between the bondholders and the issuer, subject to provisions in the bond contracts. It is neither feasible nor desirable to empower the IMF or any other international authority to impose restructuring of sovereign debt, such as the one practised under the “cram-down” provisions of chapter 11 of the United States Bankruptcy Code. Nevertheless, the Fund could still exert considerable influence on the process through its policy of conditionality on lending.

It has been argued that proposals such as CACs and standing committees “... are appropriate if it is one’s judgement that most countries that experience crises have problems with fundamentals that require debts to be restructured in the absence of a bailout. ... UDROPs and internationally sanctioned standstills are appropriate if one instead believes that most crises are caused by creditor panic, and that all that is required to restore order to financial markets is a cooling-off period” (Eichengreen and Ruhl, 2000: 4, footnote 4). However, the consid-

erations above suggest that both instruments are needed in the arsenal of measures since resolution of most crises requires both a cooling-off period and debt-restructuring. Even when the underlying fundamentals are responsible for a crisis, debtors need breathing space, as markets have a tendency to overreact, and this leads to overshooting of asset prices and exchange rates, thereby aggravating the financial difficulties of the debtors. Under such circumstances, standstills would allow time to design and implement cooperative solutions to debt crises.

2. Restructuring bank loans

For the reasons already discussed, it is generally believed that debt workouts are easier for international bank loans than for sovereign bonds, as they allow greater scope for voluntary and concerted mechanisms. Furthermore, the experience in the 1980s with restructuring of syndicated credits, and the more recent negotiations and rollover of bank loans in the Republic of Korea and Brazil, are often cited as successful examples of debt workouts with banks.¹⁹ However, a closer look at these experiences shows that there are considerable weaknesses in the procedures followed, and the outcomes reached appear to bail out – rather than bail in – the private sector.

A main factor, which facilitated negotiations with commercial banks in the 1980s, was the existence of advisory or steering committees consisting of representatives of banks selected mainly on the basis of their exposure to the debtor country concerned. Clearly, this helped solve the representation problem by providing a forum for negotiations. Furthermore, the presence of sharing clauses in syndicated loan contracts, together with sovereign immunity, deterred litigation against debtor countries. However, agreement required the unanimous consent of committee members, who were also expected to strike a deal that would be

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acceptable to non-participating banks. This, in effect, allowed considerable room for holdouts by individual banks, in much the same way as bond contracts without majority action clauses. Such holdouts resulted in protracted negotiations, leading to frictions not only between debtors and creditors but also among creditors themselves. As noted by an observer of sovereign debt reschedulings in the 1980s: “From the borrower’s perspective, the unanimous consent method translated into always being negotiated down to the minimum common denominator, one acceptable to all members of the committee based on consultation with their respective constituencies. Namely, one bank had the ability to prevent an entire package from being adopted if it disagreed with any one of its features” (De la Cruz, 2000: 12).

The primary strategy of these negotiations was to avoid default and to ensure that the debtor had enough liquidity to stay current (i.e. to continue servicing its debt). The money needed was provided by the creditor banks as part of the rescheduling process as well as through official lending. In this way banks could keep these assets in their balance sheets without violating regulatory norms regarding credit performance. Maturities were rolled over as they became due, but concessional interest rates and debt cancellation were not among the guiding principles of commercial debt workouts.

Thus, as described in *TDR 1988*, the process involved “concerted lending”, whereby each bank rescheduled its loans and contributed new money in proportion to its existing exposure, the aggregate amount being the minimum considered necessary to avoid arrears. The IMF also made its provision of resources to debtor countries – to keep them current on interest payments to commercial banks – contingent upon the banks’ making the contributions required of them. Thus, official intervention amounted to using public money to pay creditor banks even though it was designed to bind the banks in. Developing countries saw their debt growing, not only to commercial banks, but also to the official creditors, as they borrowed to remain current on their interest payments (*TDR 1988*, Part One, chap. V).

The negotiated settlements also resulted in the socialization of private debt in developing

countries when governments were forced to assume loan losses, thereby, in effect shifting the burden to the tax payers. For example, in the case of Chile, it was noted that “private debts have been included in debt rescheduling being negotiated between the Chilean State and the foreign bank advisory committee for Chile. Apparently the Chilean Government caved in under pressure from the bank advisory committee ... To make their viewpoint absolutely clear, foreign banks apparently tightened up their granting of very short-term commercial credits to Chile during the first quarter of 1983, a technique reportedly used with some success 10 years earlier vis-à-vis the same country. The International Monetary Fund, also active in the debt rescheduling exercise, has not publicly objected to this threat” (Díaz Alejandro, 1985: 12). For Latin America as a whole, before the outbreak of the crisis in 1982, around two thirds of the lending by United States banks was to private sector borrowers. In 1983, the first year of debt restructuring, the share of publicly guaranteed debt rose to two thirds, and eventually reached 85 per cent in 1985 (UNCTC, 1991).

This process of protracted negotiations between banks and debtors, with the intermediation of international financial institutions (a strategy widely described at the time as “muddling through”), continued for several years without making a dent in resolving the problem and removing the debt overhang. Highly-indebted developing countries increasingly questioned the rationale of engaging in such Ponzi financing – whereby they had to keep on borrowing in order to service their debt – which eventually pushed some of them into default on interest payments and led to legal battles with the banks. On the other hand, creditors too became highly sceptical of the merits of “putting good money after bad”, and started to dispose of such debt in secondary markets as they accumulated adequate provisions. Through the Brady Plan, the resolution of the crisis eventually involved the private sector, but only after costing the debtors a lost development decade.

In more recent episodes of financial crisis in emerging markets, creditor banks were again able to organize themselves into groups to conduct negotiations with the debtors – with the Republic of Korea in January 1998, and with Brazil in March 1999. Again, in both cases negotiations and

agreements came only after the deepening of the crisis. In the case of Brazil, banks were unwilling to roll over debt in late 1998 and agreement was reached only after the collapse of the currency. The Government of the Republic of Korea had already suspended payments at the end of December 1997 and, as recognized by the IMF, "... the agreement to stabilize interbank exposure to Korea was struck ... when it was generally recognized that reserves were almost exhausted and that, absent an agreement, a default was inevitable" (IMF, 2000f: footnote 26). A number of banks had already left, which contributed to the turmoil in the foreign exchange market.

While the rescheduling of debt provided some breathing space in both cases, the impact was far less than what could have been achieved with timely standstills. As the Government of the Republic of Korea noted in its subsequent report to the G-20, "Many of those who have analysed Korea's 1997–1998 crisis contend that Korea could have solved its liquidity problems sooner had a standstill mechanism been in place at the time it requested IMF assistance" (Ministry of Finance and Economy, Republic of Korea, 1999: 13), that is, at the end of November 1997.²⁰ In Indonesia, restructuring came even later than in the Republic of Korea (eight months after the first IMF programme) and made very little impact on stabilizing the economy.²¹

More significantly, such debt restructuring exercises can hardly be portrayed as examples of the private sector bearing the consequences of the risks it had taken. In the restructuring in the Republic of Korea, private debts were effectively nationalized via a government guarantee. This was also the case for subsequent reschedulings by Thailand and Indonesia. Moreover, creditors ended up better after the rescheduling; there was no debt write-off but simply a maturity extension, with new loans carrying higher spreads than the original loans. Although the maturity extension spreads were considered to be relatively low, particularly compared to the IMF's Supplemental

Reserve Facility (SRF), such a comparison overlooks the fact that the original bank loans already carried a risk premium.²²

Problematic as they are, it is found that such restructuring exercises cannot be replicated in many other countries. According to the IMF, "the success of the Korean operation reflected two specific features, which are unlikely to apply to other cases. First, Korea maintained a restrictive capital account regime that forced a high proportion of imported foreign saving to be channelled through domestic banks ... Second, at the onset of the crisis, the sovereign external debt burden was very low. As a result, the extension of a sovereign guarantee ... did not place excessive burden on the sovereign" (IMF, 1999: 41–42). It is thus recognized that debt restructuring with foreign banks can run into serious difficulties when debtors are widely dispersed and the capital account is wide open.

The latter feature could indeed discourage creditor banks from entering into restructuring since it would allow other investors to exit at their expense. It is also recognized that a concerted rescheduling of international private bank debt in emerging markets would require sovereign guarantees –

a practice inherited, as noted above, from the 1980s – though this is not consistent with the established principles of orderly workouts of private debt.

A further difficulty with such concerted rescheduling operations is that they require the exertion of moral suasion by the supervisory authorities of creditor banks. This gives considerable discretionary power to major industrial countries, that may not apply it in a predictable and equitable manner to different episodes of crisis. As recognized by the IMF, "supervisory authorities are likely to be reluctant to exert moral suasion over the commercial decisions of the banks under their supervision except in the most extreme circumstances, especially in the context of debtors that do not pose a systemic threat to the national or international banking system" (IMF, 1999: 41–42). Again, this means that "non-systemic

"Many of those who have analysed Korea's 1997–1998 crisis contend that Korea could have solved its liquidity problems sooner had a standstill mechanism been in place at the time it requested IMF assistance."

countries” would have no option but to impose unilateral standstills.

Thus it appears that, for international bank loans, too, there are serious difficulties in reaching orderly and timely workouts on a voluntary and concerted basis in order to stem self-fulfilling debt runs and ensure that the creditors bear the consequences of the risks they take. As in the case of bonds, certain *ex ante* contractual arrangements can help facilitate orderly workouts. One

possibility would be to introduce call options in interbank credits lines that would provide an automatic rollover under certain conditions, such as a request for IMF assistance by the debtor country. However, unless all debt contracts incorporate such automatic standstill clauses, including them in interbank lines alone can be counterproductive as it can trigger capital flight as soon as a debtor country runs into financial difficulties and enters into negotiations with the IMF. But such clauses are unlikely to be introduced voluntarily.

F. Conclusions

It thus appears that an effective and viable strategy for private sector involvement in financial crises in emerging markets would be to combine voluntary mechanisms designed to facilitate debt restructuring with internationally sanctioned temporary standstills to be used when needed. These arrangements need to be accompanied by the provision of international liquidity aimed primarily at helping debtor countries to maintain imports and economic activity, rather than to maintain open capital accounts and allow private creditors and investors to escape the crisis without losses. In general, normal access to IMF facilities, appropriately adjusted to allow for the expansion of world output and trade, should meet such needs. While in some cases additional financing may be required, it should also be recognized that, once exceptions are allowed on grounds of preventing global spillovers and systemic instability, they could easily become the rule, thereby aggravating the moral hazard problem. In this respect, the minimum strategy should be to require private participation, once official financing is raised above the normal lending limits – or a threshold level – as suggested by some of the Directors at the IMF Board.

Much has been written on the pros and cons of officially sanctioned payment standstills in the resolution of financial crises in emerging markets. There is strong resistance by some major creditor countries as well as private investors to a mandatory temporary stay on creditor litigation on the grounds that it would give rise to debtor moral hazard and weaken market discipline. That this need not be the case has been argued forcefully by the Deputy Governor of the Bank of England:

Some have argued that articulating a clearer role for standstill may perversely alter debtor incentives, by weakening the presumption that debtors should pay their debts in full and on time. But an orderly standstill process should support, not supplant, market forces and market disciplines. Corporate bankruptcy law grew up as it became clear that market forces delivered losers as well as winners and that some orderly means was needed of dealing with the losers. In this way, bankruptcy law supports the market mechanism.

The situation is no different in a sovereign context. A well-articulated framework for dealing with sovereign liquidity problems

should reduce the inefficiencies and inequities of the current unstructured approach to standstills. It would support the international capital market mechanism. It would be no more likely to induce debtors to default than bankruptcy law is to induce corporate debtors to default. (Clementi, 2000)

Another concern is that the threat of a standstill could accelerate capital outflows, thereby aggravating the crisis. Indeed, that is why standstills and exchange controls need to be imposed rapidly, and why the decision to do so should rest with the country concerned. Furthermore, as noted above, the threat of suspension of payments could provide an incentive for creditors to engage in voluntary solutions, particularly for sovereign debt, thereby avoiding the need to impose standstills.

The threat of suspension of payments could provide an incentive for creditors to engage in voluntary solutions, particularly for sovereign debt, thereby avoiding the need to impose standstills.

It is also argued that standstills could make it difficult for the debtor country to regain rapid access to international financial markets, forcing it to make painful trade adjustments or to continue to rely on official financing. But that is precisely why such decisions can be expected to be taken with prudence. After all, countries that may need to impose temporary standstills are likely to be those that are closely integrated with international financial markets and would stand to lose if the decision was not exercised with care and prudence. In this respect, the recent Malaysian experience holds some useful lessons. The measures adopted by Malaysia included temporary and selective payments standstills, which sought to prevent the deepening of the currency crisis and widespread insolvencies. There was no significant outflow of capital when the controls were lifted in September 1999, and the country enjoyed an upgrading of its foreign currency credit in December of the same year

The measures advocated here will almost certainly somewhat reduce aggregate financial flows to emerging markets by deterring short-term, speculative capital. However, this outcome would have a beneficial side.

as well as the normalization of relations with international capital markets.²³

There is concern among policy makers in some emerging-market countries that the inclusion of internationally sanctioned standstills among the arsenal of measures for managing and resolving financial crises and the tying of the provision of large-scale emergency financing to greater involvement of the private sector would limit their access to international capital markets and would also reduce private capital flows to their economies. Such concerns are particularly widespread in middle-income countries with low saving and investment rates and uneven growth performance, and with only limited success in attracting greenfield FDI in tradeable sectors and achieving a stronger export base. Such countries are heavily dependent on financial inflows to meet current-account deficits that tend to increase rapidly as soon as domestic demand picks up.

The measures advocated here will almost certainly somewhat reduce aggregate financial flows to emerging markets by deterring short-term, speculative capital. However, this outcome would have a beneficial side, since such capital flows add little to the financing of development, while provoking significant instability and leading to a stop-go pattern of growth (see *TDR 1999*, chap. V, and *TDR 2000*, chap. IV). In this sense, arguments in favour of such measures have a rationale similar to those in favour of regulation and control of short-term, speculative capital inflows. There is often a temptation for countries to rely on surges in financial inflows, while paying insufficient attention to their longer-term consequences. However, it is difficult to attain rapid and sustained growth without undertaking the reforms needed to address

structural and institutional impediments to capital accumulation and productivity growth – reforms which will reduce dependence on financial inflows.

As noted above, the risk of spillovers and contagion to other emerging markets seems to be the main reason for the reluctance of international financial institutions to encourage standstills in countries that are considered important for the stability of the system as a whole. Various channels of contagion have been mentioned in this context, including cutting exposure to other countries, liquidating assets held in other markets in order to meet margin payments, or a general withdrawal of funds from emerging markets (IMF, 2000f: 22). However, the introduction and use of standstills as part of standard tools in crisis intervention would influence investor and creditor behaviour and portfolio decisions, which could result in reducing such potentially destabilizing interdependences. More importantly, as noted above, such orderly debt workout mechanisms are quite different from messy unilateral defaults in their impact on the functioning of international financial markets.

Perhaps one of the most important potential benefits of binding in and bailing in the private sector is the possible impact on policy-making in the major creditor countries. Interest rate and exchange rate policies in these countries exert a significant influence on the competitiveness, balance of payments and capital flows of debtor developing countries, which cannot always be countered with domestic policy adjustment. Indeed, most major financial crises in emerging markets have

been associated with sharp swings in exchange rates, interest rates and market liquidity in the major industrial countries. The latter have not always paid attention to the global repercussions of their policies, mainly because adverse spillovers to their financial markets from emerging-market crises have been contained, thanks largely to bailout operations. Nor has the IMF been able to deal with unidirectional impulses resulting from changes in the monetary and exchange rate policies of the United States and other major OECD countries, in large part because of shortcomings in the existing modalities of multilateral surveillance (Akyüz and Cornford, 1999: 31–33). Burden sharing by creditors in emerging-market crises can thus be expected to compel policy makers in the major industrial countries to pay greater attention to the possible impact of their policies on emerging markets. Indeed, it appears

Effective mechanisms designed to involve the private sector in the resolution of emerging-market crises could bring a greater global discipline to policy-making in the major industrial countries – something that multilateral surveillance has so far failed to achieve.

that the potential for adverse spillovers from the crisis in the Russian Federation played a crucial role in the decision of the United States Federal Reserve to lower interest rates in late 1998, even though, on the eve of the Russian default, the Fed was widely expected to move in the opposite direction. As is well known, the default caused considerable losses to Western investors and creditors, and threatened to set a precedent regarding compliance of emerging markets with their external obligations. Thus, it can be expected that effective mechanisms designed to involve the private sector in the resolution of emerging-market crises could bring a greater global discipline to policy-making in the major industrial countries – something that multilateral surveillance has so far failed to achieve. ■

Notes

- 1 For an analysis of the policy response to the Asian crisis, see *TDR 1998* (chap. III), and *TDR 2000* (chap. IV).
- 2 A wider use of the concept includes greater transparency in standards of policy-making and improved data dissemination, as these measures are seen to be essential for markets to appropriately assess and price risks (IMF, 2000g, chap. V).
- 3 According to the Institute of International Finance, losses incurred by private investors since 1997 in emerging-market crises have amounted to \$240 billion for equity investors, \$60 billion for international banks and \$50 billion for other private creditors on a mark-to-market basis (Haldane, 1999: 190). Losses incurred by foreign banks in the Asian crisis are estimated at some \$20 billion (Zonis and Wilkin, 2000: 96).
- 4 Losses resulting from daily adjustments to reflect current market value, as opposed to historic accounting (or book) value.
- 5 On the private sector position, see IIF (1999), and IMF (2000g).
- 6 Unless stated otherwise, all quotations that follow in this section are from the same source (i.e. IMF, 2000h). For a more detailed discussion, see IMF (2000f). Temporary suspension was proposed in an earlier Working Party report to the Group of Ten: "... in certain exceptional cases, the suspension of debt payments may be a necessary part of the crisis resolution process" (Group of Ten, 1996: 3). Subsequently, it was supported by the Council on Foreign Relations Task Force (CFRTF); see CFRTF (1999).
- 7 This was also first proposed by the G-10 Working Party: "Such lending can both signal confidence in the debtor country's policies and longer-term prospects and indicate to unpaid creditors that their interest would best be served by quickly reaching an agreement with the debtor" (Group of Ten, 1996: 3).
- 8 On the "comparability of treatment" principle and its recent application, see Buchheit (1999); De la Cruz (2000); and IMF (2000g).
- 9 For this so-called problem of "the inconsistency of optimal plans", see Kydland and Prescott (1977).
- 10 See Miller and Zhang (1998). The same arguments about the ineffectiveness of official assistance policy in securing private sector involvement in crisis resolution were used in favour of the introduction of collective action clauses in bond contracts in order to facilitate restructuring (see Eichengreen and Ruhl, 2000).
- 11 A notable exception to calls for smaller IMF packages is the so-called "*Meltzer Report*" (see International Financial Institutions Advisory Commission, 2000). For a discussion of the debate on IMF crisis-lending, see Goldstein (2000).
- 12 In creating this facility all Fund members would agree to donate their share of the allocation to the facility and there would also be agreement that only developing countries would be entitled to draw on the facility. This clearly differs from another proposal, which is to allow the Fund to issue reversible SDRs to itself for use in lender-of-last-resort operations - that is to say, the allocated SDRs would be repurchased when the crisis was over. See Ezekiel (1998); United Nations (1999); and Ahluwalia (1999).
- 13 *Acceleration clauses* allow creditors to demand immediate repayment of unpaid principal following a default. Under *cross-default (or cross-acceleration) clauses*, creditors are entitled to bring forward their claims if the debtor has defaulted on other debts. *Put options* allow creditors to demand repayment ahead of the scheduled contract date, under certain conditions.
- 14 See, for example, Group of Ten (1996). This recommendation has been reiterated following the Asian crisis (see Group of Twenty-Two, 1998). For a discussion of problems in bond restructuring and CACs, see Eichengreen and Portes (1995); Dixon and Wall (2000); and Buchheit (1999).
- 15 In the case of English-law bonds issued under a trust deed, the trustee represents the interest of all bondholders and shares any proceeds recovered on a pro

- rata basis. However, trustees rarely exist for sovereign issues (Yianni, 1999: 79–81; Dixon and Wall, 2000, box 1).
- 16 For some recent experiences of bond restructuring by emerging markets, see box 6.2.
- 17 This is also recognized by the IMF (2000f: 16).
- 18 The Bulgarian case of 1996–1997 is cited as an example of such market breaks leading to litigations (Miller and Zhang, 1998: 16).
- 19 See, for example, IMF (1999: 41–42; and 2000b, chap. V); and Eichengreen and Ruhl (2000: 5, footnote 7).
- 20 For support of this position based on a study of the Malaysian capital controls, see Kaplan and Rodrik (2000, particularly pp. 27–28).
- 21 For a description of the East Asian restructuring see Radelet (1999: 66–67).
- 22 The deal included a total debt of \$21,740 million owed to 13 banks, and the maturities were extended from one to three years, involving spreads between 225 and 275 basis points. The spread on SRF was 300 basis points – lower than the maximum spread on maturity extension mentioned in the previous note (Ministry of Finance and Economy, Republic of Korea, 1999: 14).
- 23 See *TDR 2000*, box 4.1. This situation was also recognized by the IMF: “They [Malaysia’s controls] do not appear to have had any significant long-term effect on investor behavior” (IMF, 2000f, footnote 28). While it is suggested that “capital controls may have contributed to a decline in FDI” compared to the Republic of Korea and Thailand (*ibid.*: 24), it is quite likely that an important aspect of the stronger recovery of FDI in those two countries in 1999 was the spate of fire-sale investments and takeovers associated with the collapse of asset prices and exchange rates.