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The Role of the IMF in Debt Restructurings: Lending Into Arrears, Moral Hazard and Sustainability Concerns

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Division on Globalization and Development Strategies, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums.

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and contributions from the countries participating in the meetings of the G-24.

THE ROLE OF THE IMF IN DEBT RESTRUCTURINGS: LENDING INTO ARREARS, MORAL HAZARD AND SUSTAINABILITY CONCERNS

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Abstract

In recent years the IMF has made efforts to build an improved "crisis prevention and resolution framework" that minimizes the size and frequency of bailouts, largely out of a concern with the possible moral hazard consequences of its interventions. This framework, however, which includes an emphasis on greater private sector involvement, the encouragement of the use of collective action clauses and a more effective enforcement of access limits to IMF lending has not generated an observable change in practice. The institution may be trying to achieve an almost impossible objective: imposing more stringent criteria to constrain its intervention capacity without recognizing that such an approach is ultimately inconsistent with the IMF's intrinsically political nature. This is clearly evidenced in the cases of countries that have to restructure their debts. The failure of the SDRM project reflected, among other factors, the prevailing view in the United States administration that market forces should be relied on to find an "solution" in these situations almost on their own. But this has in practice meant that the IMF relinquishes its potential contribution to improving the result of sovereign debt restructurings. In fact, the IMF has frequently exerted pressure on the debtor and its views have often been biased in favour of the creditors' interests. In particular, its lending into arrears policy (LIA) has been used as a means to induce debtor governments to "accommodate" to these interests. But by providing financing to the debtor through its LIA policy the Fund could potentially play a positive role in reducing the gap between the creditors' "reservation price" and the country's repayment capacity while, at the same time, making sure that the debt burden becomes sustainable. In this way, both debtor countries and its creditors would be better off. However, the Fund should not support "market-friendly" sovereign debt restructurings that are incompatible with sustainable debt paths and may represent a greater risk for its resources than more "coercive" alternatives. Indeed, the paradox is that "investor friendly" debt restructurings represent quite the opposite of a market outcome: they require active and often massive IMF interventions and the level of the resulting haircut is sub-optimally low.

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THE ROLE OF THE IMF IN DEBT RESTRUCTURINGS: LENDING INTO ARREARS, MORAL HAZARD AND SUSTAINABILITY CONCERNS

Lucio Simpson*

Introduction

Negotiations between creditors and a sovereign debtor can become a long-drawn-out and costly process that delays the recovery of the debtor country without generating any "compensating" advantage for the holders of the defaulted claims. This suggests there is a potential constructive role that could be played by the IMF in both pre- and post-default situations, by pushing for an orderly restructuring process which attempts to strike a balance between the rights of creditors and debtor at the same time that it mitigates the collective action problem. The so-called statutory approach to debt restructurings, which was reflected in the development of the Sovereign Debt Restructuring Mechanism (SDRM), might have become one of the pillars of an improved "crisis resolution framework". However, this approach faced strong opposition and could not be put into effect, though the "threat" of its possible implementation has probably exerted pressure on market participants to adopt collective action clauses (CACs), in what has been labelled the "contractual" approach to debt restructurings.

Among the "interest groups" opposed to the SDRM was not only the investor community, whose opposition could reasonably be expected, but also the very middle-income countries that were supposed to eventually be able to benefit from it. Debtors' countries reluctance to support the SDRM should not be surprising since, in the IMF's view, the SDRM was an instrument that would make it possible to precipitate earlier defaults in those cases where the debt was deemed to be unsustainable, with the aim of reducing the frequency and scale of bailouts and attenuating moral hazard. This considerably decreased the incentives of debtor countries to support the IMF but, more fundamentally, reflected the adoption by the Fund of an approach that, under the guise of "market-friendly" rhetoric, is both suboptimal and inconsistently applied.

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This approach is reflected in the so-called "framework for crisis prevention and resolution", the name given by the IMF to the set of policies, instruments and criteria that establish the "rules of the game" in the cases of sovereign crises, and which includes an emphasis on greater private sector involvement (PSI), the encouragement of the use of CACs and a more stringent enforcement of access limits to IMF lending. As originally envisaged it would have obviously included the SDRM, if it had been put into effect. But, as we know, this did not happen. On the contrary, the IMF continued with its market-friendly approach and implemented changes in its lending into arrears (LIA) policy which will impose greater costs on both lenders and sovereign debtors.

If minimizing moral hazard is considered to be the preeminent objective, a "pure" market-based or laissez faire approach could indeed be preferable to other alternatives, and the Fund should adopt a strict hands-off stance. However, the empirical evidence shows that the relevance of moral hazard has been exaggerated but, regardless of this fact, the IMF has not been doing what it preaches. It has been inconsistent in its own terms by frequently intervening in the negotiations between creditors and the debtor country, often generating "outcomes" that are far from being the natural result of the free operation of market forces, and which may have a detrimental impact on the debtor's long-term economic prospects.

Its participation in post-default restructurings, in particular, has not been confined to fulfilling the role of expert, via the supply of information and analyses. On the contrary, through its role as "monitor", the IMF has frequently exerted pressure on the debtor and its views have generally been biased in favour of the creditors' interests. In particular, its lending into arrears policy (LIA) has been used as a means to induce debtor governments to "accommodate" to these interests. This is somewhat contradictory, in turn, with the academic consensus on the higher prevalence of creditor (as opposed to debtor) moral hazard in the current "international financial architecture".

In effect, an important issue is the extent to which "market-friendly" sovereign debt restructurings are compatible with sustainable debt paths. The approach used by the IMF to assess debt sustainability, despite some improvements in recent years, is not robust enough and may underestimate the risks faced by debtor countries, particularly when adverse shocks are positively correlated and persistent, as has often been the experience in developing countries. Moreover, the IMF has shown a systematic tendency to be overoptimistic in its debt sustainability assessments. If sustainability is not reasonably assured, there is a risk that market-friendly restructurings may not facilitate the country's access to international capital markets in the medium- and long-term, even if they are initially greeted with approval by the investor community.

There is indeed an inescapable trade-off between "investor-friendliness" and debt sustainability. But by providing financing to the debtor through its LIA policy the Fund could play a positive role in reducing the gap between the creditors' "reservation price" and the country's repayment capacity, thus generating a "Pareto improvement" that leaves both debtor and creditors better off. Instead, it seems to be placing too much emphasis on ancillary but largely useless criteria, such as the sovereign's compliance with the "good faith" criterion.

This paper will discuss the role that the IMF plays in sovereign debt restructurings and its views regarding the various components of the "framework for crisis prevention and resolution", with a special emphasis on LIA policy and the issue of debt sustainability. Because the SDRM was originally intended to be one of the pillars of such framework and because of the consequences of the debate it generated, the first section examines the reasons that explain the failure of the SDRM project to make progress. The second section comments on the recent widespread adoption of CACs, to a large extent as a result of the "threat" posed by the possible implementation of the SDRM. Sections three to six deal with LIA policy. They explain the objectives and implications of LIA policy as well as its evolution over time, discussing the suitability of the criteria that regulate its implementation, how the policy has been applied in practice and the relevance of the moral hazard problems that it might generate. In section seven, and against the background of the trade-off between investor-friendliness and debt sustainability, the potential positive role that the IMF could play in debt restructurings is discussed and is contrasted with the Fund's failed experience in Argentina and its bailout of Uruguay, which was clearly inconsistent with its own rules.[1]

I. The SDRM project nobody liked

The circumstances could not have been more propitious when the IMF started its work on the SDRM in late 2001. The idea of limiting bailouts and enforcing access limits had been gathering strength since Mexico's 1995 "rescue" package but this new policy orientation required that sovereign debtors do not postpone entering into restructuring negotiations until it was too late, in a desperate effort to "gamble for resurrection". The debtors' countries reluctance to restructure early was understandable, though, given that the growing diversity of the creditor base and the variety of the debt instruments involved seemed to pose a challenge to the objective of achieving a rapid agreement between the parties at a reasonable cost.[2] Official attempts to improve the "technology" used for restructuring sovereign debts had failed, beginning with the encouragement of the adoption of CACs by the "Rey Report" (Group of Ten, 1996), so there was some frustration about the lack of "spontaneous" progress of market-based solutions. At the same time, there was a growing consensus about the need for a mechanism that could deal effectively with the collective action and creditor coordination problems that the predominance of bonded debt exacerbated. In addition, the dismal failure of the IMF's policy in Argentina, and the country's imminent default, was an stimulus for work on the SDRM since, in the view of many, the complexity of the case called for precisely the sort of structured restructuring process that the envisaged SDRM could provide, instead of a more "chaotic" decentralized framework.

However, though the conditions were seemingly favourable for the birth of the SDRM, the initiative had to overcome deeply entrenched views against it, including the United States Government's traditional opposition to schemes which could limit creditors' rights in the international sphere.[3] The United States Treasury had never been in favour of an international bankruptcy court, mainly based on the argument that it would encourage default. So it is unlikely that the IMF would have embarked on the development of its SDRM proposal were it not for the brief "window of opportunity" provided by Paul O'Neill's period at the helm of the United States Treasury. In this regard, the abandonment of the SDRM project at the Spring 2003 meeting of the International Monetary and Financial Committee (IMFC) is not surprising, because the actual implementation of the scheme was from the start an event with a very low probability of occurrence. However, after O'Neill gave the initial impulse, the IMF's machinery was set in motion, and a proposal was drafted anyway, under the enthusiastic leadership of Anne Krueger.

O'Neill did not represent Wall Street's interests and views, and this may explain why he saw the idea of an SDRM with less prejudice than other members in the administration. He was against bailouts and saw an orderly "bankruptcy procedure" as the obvious alternative to them.[4] But the institution he supposedly commanded would not work on the project. The United States Department of Treasury would never issue an official policy statement or an official document outlining a proposal for the SDRM and the Treasury's Undersecretary for International Affairs, John Taylor, publicly opposed the initiative. Instead, he favoured a "market-based" approach consisting in stimulating the widespread inclusion of collective action clauses in bond contracts, as an alternative to the "contractual" approach represented by the SDRM. The terminology is certainly misleading and looks like a marketing device, because the functioning of modern capital markets obviously depends on the legal infrastructure, which is a public good that increases overall economic efficiency. So the correct label should probably have been "investor-friendly", since the approach favoured by Taylor, who did not believe in radical reforms in the international financial architecture, was the one preferred by the financial community.

O'Neill would have acknowledged defeat if he had cancelled all work on the topic, so he put forward the so-called two-track approach, under which both alternatives would coexist for some time, and which was more palatable for the Government of the United States. According to O'Neill, the contractual approach would be the first to be implemented and the SDRM would become a complement to the former in the long term:

> ... The IMF will continue to develop a plan for the official sector approach, which will take some time because of the IMF rules. I will be encouraging them every step of the way. But we will also begin to implement the market-oriented, decentralized aspect of the plan right away, to capitalize on the consensus among the G-7 nations. Creditors and borrowers can

> begin immediately to incorporate contingent clauses into their sovereign debt contracts, such as a majority action clause, an engagement clause, and an initiation clause.[5]

But in essence, the SDRM project was already dead. What explains the lack of progress towards the implementation of the SDRM? Why was it not possible to garner enough support for it? After all, the SDRM's objective (Krueger, 2002) is to make possible an "orderly, predictable and rapid restructuring of unsustainable sovereign debt", something that can hardly be rejected by any of the parties affected by a sovereign debt crisis. If those objectives were achievable they would all be better off, since the SDRM would make it possible to get closer to an "optimal" balance between ex-ante and ex-post efficiency, by increasing the latter at the expense of a probably modest reduction in the former.

The United States position alone does not explain the stagnation of the SDRM project, which had the important support of the European countries' representatives in the IMF's Executive Board. It is true that O'Neill's lack of backing inside the United States Government, which was evident from the beginning, would deprive the SDRM of any serious chances of being implemented. However, the abandonment of the SDRM project was not only the result of opposition by the United States Government. Nearly all the "actors" whose interests would have been directly affected by the SDRM opposed its implementation, in some cases because they disliked specific elements of the proposal, but there was also more fundamental opposition to the very concept of an international bankruptcy court and the belief that there was no need for it.

Investors and underwriters of sovereign bonds, particularly in the United States, were the most vigorous opponents to the SDRM, arguing that it would encourage default, though they would not go as far as to acknowledge that their interests were much better served by IMF bailouts.[6] Borrowing countries, in particular the major Latin American nations with the exception of Argentina (for obvious reasons), worried that the SDRM would negatively affect their ability to issue debt in the international capital markets, because it would lead to an increase in the risk premia for emerging market issuers. Even more importantly, they feared that the implementation of the SDRM might be accompanied by a reduction in their access to IMF's "rescue" packages. In their view, the potential benefits of the SDRM, particularly its weak *legal* protection of debtors' rights,[7] could not make up for the loss of emergency access to multilateral financing. Finally, debtor countries were also reluctant to give up their sovereignty in matters like the legal treatment of debt issued under their domestic laws and the legal powers that the Dispute Resolution Forum (DRF) would have to impose a stay.[8]

So neither creditors nor debtors[9] wanted to lose the option of being bailed out[10] in exchange for a mechanism of doubtful efficacy, whose enforcement might not be feasible anyway. And from the perspective of creditor countries and the IMF, the main use of a well-functioning SDRM is precisely to limit bailouts,[11] by encouraging the debtor country to restructure its debt as soon as it becomes unsustainable. In effect, the IMF's staff view (Hagan, 2005) was that the SDRM would serve to limit bailouts in situations were the sovereign is involved, as opposed to a situation of illiquidity, where IMF financing may be the right option. But given the high costs of default, no country would follow this course unless it was clear that IMF financing would not be available. Thus, while no mandatory quantitative limits to IMF lending were included in the SDRM proposal, it was understood that compliance with the Exceptional Access Framework (EAF) would limit expectations of a bailout and, together with the SDRM, would enable the Fund to better resist political pressures to provide assistance.

This "political economy" dimension of the SDRM debate is interesting in its own right and has shown the significant difficulty of reaching a consensus at the international level, given the diversity, and most often conflicting, interests of the different parties. This difficulty was reflected in the evolving nature of the proposal, as its developers attempted to accommodate to the demands of opposing constituencies, among which was the IMF itself. In the end, the final version of the SDRM fell short of representing a substantial "revolution" in the international financial architecture, as some had expected. But, was it reasonable to expect such revolution in the first place? Could a technology transferred from the quite different corporate context be successfully applied in the sovereign context? Could the IMF play simultaneously the role of judge, umpire, legislator (it was the sole SDRM designer) and creditor? Did it not have obvious conflicts of interest? If the SDRM cannot satisfactorily replicate the features of corporate bankruptcy law, why would any party accept it in exchange for more tangible legal rights or de facto capacities?

Indeed, the "intellectual" battle between the opposing positions in the SDRM debate was fought along the lines marked by the unique characteristics of the sovereign context vis-à-vis the corporate context.

As is well known, the SDRM loosely resembles the "centralized" model in Chapter 11 of the United States Bankruptcy Code. The central aim of the SDRM is thus to resolve the problem of inter-creditor equity and the legal challenges posed by "holdouts" (which can disrupt negotiations) while moderating, at the same time, the negative impact that the mechanism may have on creditors' contractual rights. There are four crucial features that the SDRM "borrowed" from the bankruptcy code, though their scope, need, and the possibility of enforcing their application are not comparable in the sovereign context:[12]

- A stay on creditor litigation, which protects the debtor and addresses the collective action problem among creditors.
- A vote by a qualified majority on a restructuring plan that binds all creditors.
- The reorganization plan can give seniority to new financing (this is the so-called debtor-in-possession financing or DIP).
- The debtor is legally prevented from entering into transactions that would be harmful to creditors' interests.

The IMF largely concentrated on making the first of the above features effective in the SDRM, and sought for an adequate scheme that could increase the leverage of creditors as a group over individual creditors, so that the risk from holdouts would be minimized. IMF staff believed that the other features of an usual (domestic) bankruptcy framework were less relevant in the sovereign context.[13] But mimicking the majority voting mechanism that exists in the corporate context is difficult, and implied a trade-off between assuring that the coverage of debts was comprehensive and keeping the complexity of the SDRM within reasonable bounds. Besides, increasing the degree of coverage often implied restricting the debtor's sovereignty.

This was especially relevant regarding the treatment of domestic debt. The alternative of putting it within the scope of the SDRM, but as a separate class, was rejected partly out of concerns that it would have been considered too intrusive and would have generated strong opposition. No government or domestic legislature would be willing to adopt the SDRM if it could be used to restructure domestic debts. As Hagan (2005) has remarked:

> A number of countries could not accept the possibility that debt issued within their own territories and subject to their own laws could be restructured under a legal framework that would be administered by an international dispute resolution body. Even among mature market countries - who were very unlikely to avail themselves of the SDRM to restructure their debt - there was likely to be a concern that the domestic legislature would be unwilling to adopt the SDRM if there was even the remotest possibility that it could be used to restructure domestic debt.

The IMF eventually proposed that the sovereign debtor be required to identify those debts that would be restructured through the SDRM's single aggregated vote, separating them from those claims that would be restructured "outside" (debts to the Paris Club and part of the domestic debt) and those that would be totally excluded from the restructuring (trade-related debts, debts to the IFIs, etc.). Under this scheme, it is possible, even likely, that the amount of claims to be restructured "outside" the SDRM may exceed the amount to be restructured "inside". However, the proposed mechanism is a realistic option, taking into account the fact that, as the recent Argentine case shows, the sovereign debtor most often needs to establish its own de facto ranking of priorities in a crisis situation, and will decide which creditors will be paid and which will not so as to minimize domestic economic hardship.

Naturally, the investor community was galvanized and strongly opposed a scheme whereby it was forced to subordinate its claims beyond what, in their view, could be reasonably accepted. They believed the proposal narrowed the amount of "eligible" debt so much that the restructuring terms could only be harsh, since the non-privileged private creditors would bear all the costs associated with the needed reduction in the sovereign's unsustainable debt burden. And any financing provided by the IMF or other IFIs before a default would now have not just a de facto but a "legally sanctioned" seniority over private debts.

Another feature of corporate law that could not be satisfactorily included in the SDRM was the stay on creditor litigation, which was a conflictive issue that generated much of the initial resistance to the SDRM.

In effect, the first version of the mechanism (as presented by Krueger in November 2001) envisaged a restructuring process that would start with the debtor country formally requesting the IMF to activate the SDRM and impose the stay on the sovereign's outstanding debt obligations. If the request was accepted and endorsed by the Fund (which had to assess the sustainability of the country's debt) the stay on enforcement was to be "automatically" put into effect, in a way similar to the procedure in corporate bankruptcy law.

The fact that the IMF was empowered to decide whether a stay was necessary or not was one of the aspects of the proposal that faced stronger opposition in the investor community, which feared that it would create a strong incentive for debtors to default. Moreover, the financial private sector doubted the impartiality of the IMF and the extent to which its judgments would be based exclusively on economic criteria, fearing that political considerations might play an important role.

The IMF itself also became concerned that the "automatic" stay would shift too much legal leverage from creditors to the sovereign and wanted to minimize the risk of debtor moral hazard, so it gave in to investors' demands. In later versions of the SDRM, a stay or standstill on a specified action requires the approval of a qualified majority of creditors or it can be implemented if requested by the sovereign debtor and approved by both a creditors' committee and the SDRM decision maker (IMF, 2003a and 2003b).

This change deprived debtor countries of protection from creditor litigation, so it clearly reduced the attractiveness of the SDRM from their viewpoint. However, the "rush to the courthouse" that justifies a stay in the corporate context is less of a concern in the sovereign context, where it lacks speed and faces uncertainty. In fact, creditors have argued that sovereigns in default have too much legal protection, not too little.

In this regard, recent experience in sovereign debt restructurings and the evolution of legal practice certainly put into question the relevance or (differential) practical impact of a formally declared stay, at least if the main concern is that of preventing holdouts from disrupting the restructuring process. In this regard, judge Griesa of the Southern District of New York, where lawsuits against Argentina are presented, has said:[14]

> ... the Republic ... made very broad waivers of sovereign immunity, agreed to jurisdiction in this Court, and presumably that was supposed to mean something ... What has been demonstrated by these lawsuits is how little it means ... The Republic has done everything possible to prevent the collection of these debts ... Can there be any recovery on the judgments? So far it looks as if it is virtually hopeless ... But what it illustrates is that these lawsuits may ultimately be illusory ...

Judge Griesa's words reflect that the ability of holdouts to disrupt a sovereign debt restructuring process is now perceived to be lower than it was some years ago. If the sovereign takes all the necessary precautions the feasibility of attaching any of its assets is almost nil, so the debtor can provide itself with a de facto stay. It is currently acknowledged that the famous Elliot vs. Peru case,[15] which seemed to imply that the threat of holdouts was considerable, was wrongly interpreted at the time by most analysts. In fact, had the Government of Peru waited for a few days it would have been able to pay through Euroclear without problems. In the end, in 2005 Belgium's parliament approved a law which would have made the Elliot strategy impossible. There remains the risk that the interpretation of the *pari passu* clause could be broadened. But the recent trend has rather been the opposite, towards a narrower interpretation of it.

Interestingly, some of the protection afforded to debtor countries, as in the mentioned case of Argentina, might be interpreted as originating in specific groups which belong to the private financial sector but whose interests are opposed to those of the creditors. This is, for example, the case with Euroclear. Belgium's Government has sought to protect its importance in the international payments system, and the associated fees, by preventing any weakening of its reliability. Similar considerations, preserving the market share and fees of the New York capital market "brand", may explain the *"amicus curiae"* (friend of the court) presented to judge Griesa in support of Argentina by the Association of Clearinghouses in the United States and by the Federal Reserve.[16]

In addition to the decreased disruptive capacity of holdout creditors, there are other reasons why a stay may not be as fundamental, which are a consequence of the specific characteristics that difference the sovereign from the corporate context. In the first case, it is difficult to enforce the general cessation of payments from the debtor to any creditors that is the counterpart to the stay on creditor enforcement, and any solution to this problem would undermine the principle of sovereignty. Given that in the SDRM the claims subject to restructuring would be identified by the sovereign, which may plan to continue to service certain debts left "outside" the SDRM, inter-creditor equity would require that the stay be implemented only after a vote by the creditors affected (Hagan, 2005).

But a creditor-approved stay would not be practical either, because the sovereign would not be protected from litigation until creditors have already voted on an aggregated basis, which may demand considerable time. These led the IMF to seek for an alternative that could generate some of the same incentives as a stay, and in the final version of the SDRM the so-called "hotchpotch" rule was included.[17] However, it is an imperfect substitute for a stay, since it does not preclude litigation by creditors, even if it does discourage them from choosing that option. Another alternative, consisting of imposing a "targeted", rather than a generalized stay, was considered by the IMF, but it required increasing the role of the DRF, which would determine if the risk from litigation justified the measure. Again, because it implied giving more power to a supranational entity this option was deemed unfeasible.

The other characteristic feature of corporate bankruptcy law, the possibility of providing financing to the debtor that is legally considered senior to the other claims cannot be satisfactorily replicated in the sovereign context either. It requires that creditors authorize through majority voting the exclusion of certain "DIP" financing from the SDRM, though unlike the case in the corporate context, they would not even then have the guarantee that their priority will be respected by the sovereign. Consequently, even if the SDRM was internationally adopted, the IMF, through its LIA policy, would in practice still be the only provider of financing for a country in default. As will be discussed later, this is an unavoidable characteristic of the international financial architecture that cannot be modified.

Leaving aside the lack of support for the SDRM, it is clear that the "final product" was much more limited in its scope than originally envisaged (Truman, 2005). The coverage of debts would be so narrow that, in practical terms, it would be restricted to the sovereign's bonded debt,[18] and the debtor would not be really protected from litigation, so its incentives to implement the SDRM will be modest. Not even the role of the IMF would change much, if at all, particularly with regard to its lender of last resort function before default and its LIA policy after a default.

Hence, it is natural to question whether the implementation of the SDRM (in its final version) (IMF, 2003b) would really improve the sovereign debt restructuring process as compared to the *status quo*, characterized by unilateral exchange offers.

II. The SDRM and the market's love for CACs

Does this mean that the SDRM project has only been a mere intellectual exercise that will be relegated to the dustbin of the history of economic ideas? Not necessarily, as there have been several positive consequences of the debate around the SDRM, not least the improvement in the understanding of the technical issues involved and the pressure it has put on the private sector to include collective action clauses in bond contracts.

Indeed, the SDRM may have made possible the recent expansion in the use of CACs in debt contracts. In a letter from the International Institute for Finance to Chancellor Gordon Brown as Chairman of the International Monetary and Financial Committee (IMFC), the private financial sector's position was stated as:

> ... continued official support for the "two track" approach involving both CACs and a sovereign debt restructuring mechanism (SDRM) runs the serious risk of undermining efforts to advance contractual changes.

The letter also said:

> We would encourage the official community to concentrate its energies on advancing with the private sector and issuer efforts already under way to put in place CACs, not to thwart or jeopardize those efforts.

Under strong opposition, particularly from the investor community, the SDRM project was thus cancelled, but the difficulties faced in trying to devise satisfactory solutions to some of its technical problems undoubtedly facilitated its demise. At its Spring 2003 meeting the IMFC concluded that it was not ("now") feasible to establish it. Consequently, the Fund abandoned the two-track approach and decided to focus exclusively on gradual reform measures along the lines of the "contractual" approach.

The hypothesis that the SDRM "menace" prompted the private sector to abandon its previous reluctance to adopt CACs is persuasive. In effect, already in May 1996, on presenting *The Resolution of Sovereign Liquidity Crises* or "Rey Report",[19] the G-10 had encouraged the widespread use of collective action clauses.[20] The report acknowledged that for the success of these efforts the inclusion of CACs should be a process driven by the market but stated that it would receive official support.

But the private sector remained uninterested in promoting the use of CACs and the clauses were not introduced, despite the official sector's encouragement of reform in market practices. What happened that made the private sector change its mind after seven years of neglecting the G-10's proposal?[21] It is difficult not to attribute this change to the pressure of the official sector which, in the end, had to be the driving force behind the adoption of CACs, to the point that it took the initiative of designing model clauses. The private sector realized that a staunch opposition would lead to the official sector promoting even harsher remedies, the SDRM, to deal with the problem of sovereign debt restructuring. It is, nevertheless far from certain that the threat of the SDRM becoming a reality was believable, but in the creditors' views what mattered was the fact that, some way or the other, the official sector would adopt a tougher line with respect to creditors' interests than before.

However, though the private sector eventually adopted collective action clauses in New York law bonds and claimed to support them, it fought a "rear-guard action" to limit their impact as much as possible. In effect, the private financial community came up with quite different proposals regarding collective action clauses than those that had been recommended by the Report of the G-10 Working Group on Contractual Clauses. Creditor groups tried to figure out how to include collective action clauses without actually reducing the capacity to hold out in a restructuring, with the obvious objective of making bonds even harder to restructure. This turns out not to be difficult and these groups came up with their own set of model clauses, which they recommended to be included as the standard.[22]

At a very general level, this set of model clauses is broadly similar to that of the G-10 Working Group on Contractual Clauses (Group of Ten, 2002; and BIS, 2003). But "the devil is in the details". The "Gang of Seven" proposals of model clauses differ from that of the G-10 in two important respects.[23] They essentially consist of increasing the majority needed to amend a bond's non-financial terms while, at the same time, tolerating the amendment of the bond's financial terms, but requiring a very significant majority to do so (90 per cent or higher). This actually makes it more difficult, not easier, to restructure bonded debt. First, by augmenting the necessary majority for amending the bond's non-financial terms it diminishes the feasibility of using the so-called "exit consents"[24] in a debt restructuring, which have often been used in exchange offers as a means of providing a de facto seniority to the new bonds over the original claims. Second, though the unanimous support of the bondholders is no longer required to amend the bond's financial terms, by establishing a very high minimum majority this "qualitative" change becomes worthless in practice, because it has a very low probability of ever being put into effect.

In short, and not surprisingly, what the private international financial community has in mind, when discussing ways of improving the process of restructuring sovereign debts, are mechanisms to strengthen their sector's bargaining power at the expense of the debtor country. In particular, in designing their proposals, creditors' efforts have been aimed at protecting the ability of individual creditors to undertake legal actions against the sovereign in detriment of the (collective) interests of the majority of creditors. The threatening presence of holdouts is conceived as a "disciplining device" that will force debtors to improve the terms of their restructuring offer as compared to what they would be in their absence. There is an implicit hypothesis that the sovereign debtor has (at least) a considerable degree of "unwillingness to pay". Otherwise, if this were not the case, it may be argued that creditors should not always strive to obtain the most "generous" terms in a debt restructuring, if those terms are incompatible with debt sustainability, because that can only generate further "workout" costs and a lower recovery of value in the long term.

III. Lending into arrears policy: its pro-creditor bias and inconsistent implementation

The IMF's policy of lending into arrears enables the Fund to provide balance of payments support to a sovereign debtor that has fallen into arrears to its private creditors and is one of the main elements of the so-called "framework for crisis prevention and resolution.[25] It is probably the main "instrument" with which the Fund can influence the outcome of the debt restructuring process of a sovereign that is already in default as well as its future economic performance. In effect, by lending into arrears, and through the conditionality associated to it, the Fund contributes to determining the precise balance between financing and adjustment.

Its effectiveness resides in that it creates an incentive structure that may lead to negotiations between the debtor and its creditors, where the former, despite its financial vulnerability, is not as hard pressed to rapidly reach an agreement at any cost as it would be the case if arrears were not tolerated. Because of this, LIA policy can have a major impact on the balance of power between the debtor and its creditors and was, in fact, originally designed to curb the latter's power.

How does the IMF use its lending into arrears policy? The Fund has an effective "carrot" to impose some conditions on the debtor since, together with the other IFIs, it is the only actor that may be willing to lend to a sovereign in default. This gives it the capacity to induce the sovereign debtor to adopt the adjustment policies required to comply with conditionality under an IMF programme. In exchange, the Fund continues to provide support if the sovereign's negotiations with its creditors stagnate because they are demanding restructuring terms that are not consistent with the programme. Progress with the elimination of arrears is monitored by the IMF's Board through financing assurances reviews, which are maintained as long as the country has outstanding arrears to external private creditors. Creditors are also supposed to benefit from LIA policy, to the extent that the implementation of an IMF programme presumably indicates that the financing that the sovereign debtor is seeking from them is consistent with the mix of adjustment and financing assumed in the programme. On the other hand, by signalling that it is willing to support the debtor country the Fund may also force the creditors to accept less favourable terms in the debt restructuring than what they otherwise might have obtained.

In essence, the IMF is providing what, in the corporate context, is called debtor-in-possession financing.[26] The function of this "DIP" financing in the sovereign context is to compensate for the lack of an international legal framework that can guarantee enforceability over the sovereign debtor. As was discussed in previous sections, there are considerable difficulties in creating a legal seniority whereby private creditors accept to subordinate their claims to the providers of new money. Thus, the IMF and the other IFIs have no viable substitute in the sovereign debt context, because they are the only actors with de facto seniority or preferred creditor status. This is what enables them to provide DIP financing in the first place.

From 1989, when LIA policy was first codified,[27] until the early 2000s, the IMF adapted the policy to the changing circumstances and developments in international financial markets, basically relaxing the conditions needed to put the policy into effect. But in recent years the IMF has reversed the stance it had maintained since 1989 and has made the conditions required for having access to IMF financing under its LIA policy more stringent. Though the practical application of the policy has been quite inconsistent lately, and less strict than what the "codified version" would suggest, it seems that, probably as a result of the Argentine experience, LIA policy is increasingly seen by the IMF as a means to induce debtor governments to "accommodate" to creditors interests.

This view of what "optimal" LIA policy should be like is rather contradictory with the prevailing consensus that creditor moral hazard is much more relevant than debtor moral hazard in the current "international financial architecture". What is then the IMF's motivation? As will be discussed below, a plausible answer is that the Fund is giving in to the pressure of the international financial community. But regardless of political economy considerations, there is a danger that this change in policy, if it consolidates, may complicate debt restructurings and harm debtor countries' interests.

The "new view" on the role of LIA policy cannot be justified on reasonable public policy foundations. Through its LIA policy and by choosing the amount of resources that it is prepared to make available, the IMF can have a large influence over whether and when a sovereign seeks to restructure its private sector debt and also over the terms that the country will seek in the debt exchange, including the size of the haircut. Thus, its participation, "distorting" what would otherwise be a market outcome, can only be justified if it induces, at least, a "paretian improvement", but not if it undermines the interests of the debtor country by pushing it again into an unsustainable debt path. This would be in clear contradiction to the original motivation for implementing the LIA policy and could render it useless or, at least, greatly diminish its possible contribution to a constructive restructuring process. Why has the IMF been reversing the historical orientation of its LIA policy? To find an answer to this question it is useful to review the evolution of this policy over time.

IV. The evolution of LIA policy over time

The circumstances that motivated the birth of LIA policy are worth mentioning, because they illustrate the nature of the problems the lending into arrears policy was originally intended to address, and serve as a reminder that the effective implementation of the LIA policy, because of the way the IMF may apply it in practice, can eventually turn its original logic on its head.

The policy was put into effect at a relatively recent stage in the IMF's history and was a consequence of the 1980s debt crisis. In fact, until 1989, the IMF's access policy prohibited the Fund from extending new lending to a country that had fallen into arrears on payments to other creditors. This non lending into arrears principle, which dates back to 1970, is still, in reality, the prevailing general rule and the LIA policy must be understood as an exception to it, rather than as a substitute.[28] Originally this general policy applied to arrears arising from the imposition of exchange restrictions but in 1980 its coverage was extended to payment arrears originating in sovereign defaults. Interestingly, the 1980 review of the policy recognized that the objective of elimination of arrears during the relevant programme period – normally 12 months – was not always achievable for members with large debt service problems (Boughton, 2001).

The traditional IMF's rationale for not lending into arrears on external payments was that a sovereign incurring in arrears was acting against two fundamental IMF principles and the assumption was that such stance was against its own interests as well. First, by not paying its external creditors, the sovereign was significantly reducing its chances of having access to voluntary foreign financing, which would have the effect of exacerbating its balance of payment problems in the long term and putting into doubt its medium-term sustainability. Moreover, and from an international public policy perspective, the incurrence of arrears was against the IMF's objective of promoting international monetary cooperation, and could have adverse effects on trade and capital flows. Thus, Fund programmes required the elimination of existing arrears and the non-accumulation of new arrears to official and private external creditors during the programme period.

Second, the non lending into arrears policy was to a large extent a consequence of the objective of "safeguarding the Fund's resources". When foreign private creditors are trying to limit their exposure, the Fund cannot assume that they will be willing to contribute in the financing of Fund-supported programmes. Accordingly, the elimination of arrears was a necessary precondition for a member's re-access to capital markets, which, in turn, was viewed as necessary to enable the member to repay the Fund.

However, by the late 1980s the principle of non-toleration of arrears was effectively blocking progress towards a solution of the debt crisis. Moreover, creditor banks, which until then had been persuaded to (partially) finance debtor countries, were increasingly reluctant to maintain that *modus operandi*.

In effect, once the balance sheets of creditor banks had been "cleaned", through the full provisioning of their sovereign loans, the bargaining position of these creditors strengthened and they adopted a tougher stance in the negotiations with sovereign debtors. This factor, coupled with the growing consensus in the debtor countries that the "laissez faire" approach to debt restructuring had failed to effectively moderate the debt overhang, led to a wider divergence of positions between creditors and debtor countries regarding the terms of those debt restructurings. In brief, there had been too much adjustment and too little debt relief, but now banks were in no hurry to "conceal" any losses. On the contrary, they faced a profitable "upside", and the larger it was the better.

Consequently, the problem was that, even when the debtor countries were willing to undertake adjustment programmes so that their debts could be serviced, creditors would demand payment terms that typically imposed an exaggerated burden on sovereign debtors. In this context, the IMF's policy of not lending into arrears precluded the Fund from providing financial assistance to a debtor that was in arrears to its private creditors, even when the member country was making every effort to restructure its debts and improve its repayment capacity.

This had the undesirable consequence of effectively giving private creditors the power to exercise a veto over IMF lending, since they knew that the debtor country would not have access to IMF support unless it could reach an agreement with them first. As a consequence there was a risk that the adjustment process in the debtor country could be undermined and end up being more costly and disorderly.

In response to concerns that this "approach" was unnecessarily restrictive, the IMF finally introduced, in 1989, a lending into arrears policy that allowed the provision of financial assistance in the presence of arrears. In addition to the LIA policy, the Fund established a policy that made resources available to help finance the up-front cost of Brady debt and debt-service reduction operations. This antecedent is relevant nowadays and the possibility of including similar initiatives under the LIA policy should be considered.

Not by chance, the birth of the new policy coincided with the dawn of a new era (at least considering the period after WWII) where bond financing and the securitization of loan portfolios was replacing the dominance of bank financing as the preferred means of lending to sovereign governments.[29] In fact, the possibility of selling sovereign loans in the increasingly liquid secondary markets was one of the main factors that had helped to strengthen the bargaining position of banks. The migration from bank to bond financing would only strengthen the rationale of the LIA policy, by increasing coordination problems among creditors in the process of restructuring sovereign debt.

Nevertheless, in its first 1989 version, the LIA policy was restricted to bank debts, and allowed for the approval of an arrangement before banks had provided assurances of their willingness to provide "support" in line with the assumptions of the IMF programme (support which typically consisted of a combination of a restructuring of arrears and principal maturing during the period and new money that helped debtor countries meet interest payments). Lending into arrears was to be approved when the following conditions were met:

- prompt Fund support was considered essential for the successful implementation of the member's adjustment programme;
- negotiations between the member and its commercial bank creditors on a restructuring had begun;
- it was expected that a financial package consistent with external viability would be agreed within a reasonable period.

In practice, these were neither necessary nor sufficient conditions to justify providing financing to a sovereign debtor in arrears, and the policy was (and is) to be applied on a case-by-case basis. This constitutes a sort of "escape clause" which gives the Executive Board more flexibility.

In 1998 the LIA policy was broadened to cover debt to non bank private creditors, which, in practice, meant largely debt in the form of international sovereign bonds. This implied changes in the wording in two of the above-mentioned conditions, resulting in the following:

- prompt Fund support was considered essential for the successful implementation of the member's adjustment programme;
- negotiations between the member and its *private creditors* had begun;
- there were firm indications that the sovereign borrower and its private creditors would negotiate in good faith on a debt restructuring plan.

The changed wording of the last condition reflected concerns over the possibility that negotiations with bondholders could become complex and protracted (as opposed to the relatively "easy" negotiations with international banks[30]). Moreover, the revised 1998 version brought *non sovereign* arrears to private creditors arising from the imposition of exchange controls within the scope of the lending into arrears policy under fairly similar criteria.

In 1999 the LIA policy was modified again (IMF, 1999), with the problems posed by bond financing as the paramount motivation behind the changes. There were concerns that coordination and other difficulties provoked by the large number and potentially disparate interests of bondholders could lead creditors to delay negotiations following a default and to be less disposed toward a settlement, a situation aggravated by the fact that most bondholders did not have a long-term business relationship with the debtor country to protect, unlike many banks in the 1980s debt crisis. As a consequence, there was a risk that the Fund could be prevented from lending even if the sovereign debtor was undertaking appropriate policies ("appropriate" in the view of the IMF, of course) and the IMF's support was essential to the adjustment effort, given that the two last criteria above would not be met. Those two criteria were thus replaced by a somewhat "softened" language while the first criterion remained unchanged, leading to the following formulation:

- prompt Fund support is considered essential for the successful implementation of the member's adjustment programme;

- the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors.

The main change in comparison with the 1998 formulation is the fact that the implementation of the LIA policy no longer required that the sovereign debtor actually engage in negotiations prior to its requesting financial assistance from the Fund. Instead, it should have been making "good faith" efforts, a clause that, in principle, may improve the "incentive structure" depending on the way in which it is interpreted. This was a modification of no minor importance and an improvement over the previous requirement that the debtor had actually begun negotiations by the time it applied for IMF lending. However, it must be taken into account that, whereas in the 1989 and 1998 formulations both the debtor and its creditors were implicitly required to "prove" that they had embarked on negotiations with the other party, the 1999 changes imply that only the debtor has to make a "good faith" effort.

As could be anticipated, the 1999 modification of LIA policy was not well received in the international financial community, where some investors emphasized their concern that the prospect of IMF's assistance would encourage debtor moral hazard.[31] The critics' view was that IMF policy had gone too far and it was necessary to give back to creditors some of the bargaining power they had lost. The IMF has since then tried to attenuate the presumed bias of its lending into arrears policy in favour of debtors' interests, taking heed of private sector demands that the "playing field" be rebalanced.

In effect, the 1999 modification was the last "softening" in the conditions required for lending into arrears. These would be "tightened" in September 2002, when the latest formal changes to LIA policy were codified. On that occasion the Fund established a set of general principles and procedures to guide creditor-debtor dialogue (IMF, 2002a), in an attempt to clarify the meaning of the "good faith" criterion.

Indeed, because of its nature, the "good faith" criterion is inherently subjective and somewhat vague, so it soon became evident that, to make it operational, it would need some "refining". This was consistent with the Fund's policy of recent years, which has proclaimed its preference for the enforcement of rules along the "rules versus discretion continuum", a preference that has been based on concerns about moral hazard. However, actual policy implementation has often turned out to be less constrained than what the formal procedures would suggest. This is not bad in and of itself, on the contrary, it is probably realistic and better than mechanically following rules, but it is certainly at odds with what the IMF claims to be doing and. Still worse, the IMF can use the degree of discretion it has in a way that may harm debtor countries' interests, as happened in the case of Argentina, instead of contributing to their economic recovery.

The stated aim of the principles for creditor-debtor dialogue is to deal with the inter-creditor equity problem (as a complement to the SDRM[32] and the positive effects of CACs) and, at a more general level, to contribute to the efficient operation of capital markets. Because the "good faith criterion" has become so central to the LIA policy, it is worth examining them in detail. They are the following:

- When a member has reached a judgment that a restructuring of its debt is necessary, it should engage in an early dialogue with its creditors, which should continue until the restructuring is complete;
- The member should share relevant, non confidential information with all creditors on a timely basis, which would normally include:
  - an explanation of the economic problems and financial circumstances that justify a debt restructuring;
  - a briefing on the broad outlines of a viable economic programme to address the underlying problems and its implications on the broad financial parameters shaping the envelope of resources available for restructured claims;
  - the provision of a comprehensive picture of the proposed treatment of all claims on the sovereign, including those of official bilateral creditors, and the elaboration of the basis on which the debt restructuring would restore medium-term sustainability, bearing in mind that not all categories of claims may need to be restructured.
- The member should provide creditors with an early opportunity to give input on the design of restructuring strategies and the design of individual instruments.

The Fund made it clear that it was up to the sovereign debtor to choose the specific modality for conducting the dialogue with its creditors so that it could be "tailored to the specific features of individual cases". This seems to provide with enough flexibility to accommodate particular circumstances. However, it still places the burden on the debtor to prove that it was making every effort to maintain adequate consultations with its creditors. Because of its implications, how the debtor engages its creditors is a crucial issue, on which the impact of the whole LIA policy in its practical application can rest.

The key issue here is the degree of "formality" that is required of the engagement with the creditors to qualify as satisfactory for compliance with the "good faith" criterion. Is it advisable to require the debtor to engage creditors within a very formal negotiating framework or it would suffice with a less structured kind of dialogue? IMF staff discussed three possible approaches for "refining" the LIA policy as regards this criterion and giving it procedural clarity (IMF, 2002a). Under the first approach, or *status quo* approach, the policy would have remained unchanged and sovereign debtors would have maintained considerable discretion regarding the mechanics of engagement with its creditors. This approach was rejected because, in the view of the Fund, it implied giving too much leeway to debtors. The stated reasons for rejecting it were its inconsistency with the promotion of transparency and its ambiguity, which would create uncertainty about the restructuring process that could have negative spillover effects on the access of other countries to international capital markets.

Under the second approach, the debtor would have been required to negotiate with its creditors within an organized framework. This option was rejected because it was obviously too impractical, since it lacked the minimum degree of flexibility necessary to adapt to the varying circumstances of sovereign debt restructurings and because it did not take into account the fact that constituting a representative committee in a short period may prove unfeasible.

The third approach, which in theory is currently being implemented, is a sort of compromise between the first and second approaches, under which the debtor "would be expected to engage in an early and continuous dialogue with its creditors" in accordance with the above-mentioned principles for creditor-debtor dialogue. Importantly, under this approach the debtor is "expected" to enter into negotiations with a "sufficiently representative" committee when this exists.

For this approach to be operational, the Fund is supposed to consider a set of factors that influence the extent to which a more or less formal kind of engagement between debtor and creditors can be judged to be adequate. The first of these factors is the complexity of the restructuring, which depends on the number and heterogeneity of creditors, the variety of debt instruments and claims, with its consequent impact on inter-creditor equity issues, and the likely size of the haircut required to reestablish debt sustainability.

The second factor for judging whether a formal negotiating framework is necessary or not is the representativeness of the creditor committee. The Fund claims that this can be inferred from the proportion of principal held by creditors that have signalled their support for the committee and by the extent to which the main types of creditors are represented in it, though it falls short of recommending the establishment of a numerical threshold.

The third factor considered is whether a "reasonable period has elapsed to allow for the formation of a representative committee", where the judgment has to take into account the characteristics of the investor base (if it is spread over many countries or not) and the debtor's behaviour either facilitating or trying to block the formation of the committee. However, once a committee that is deemed to be "representative" by the IMF has been established, even if it is not representative at all in the view of the debtor, the sovereign is required to make good faith efforts to negotiate with it.

Moreover, the debtor is expected to negotiate the terms of the restructuring with the committee on the basis of the following set of principles of "best practice", which were drafted by the private sector:[33]

- A collective framework could be established for the sovereign debtor to negotiate a restructuring of its debt with a steering committee representative of all private creditors. In complex restructurings, there may be a number of subcommittees that channel into the steering committee;
- The debtor would share information with the steering committee, including – where necessary – confidential information, to enable creditors to make informed decisions regarding the terms of a restructuring. Committee members would need to commit to take appropriate steps to preserve confidentiality;
- Creditors represented on the committee would agree to a standstill on litigation during the negotiating process;
- The steering committee would retain financial and legal advisors and the reasonable costs of these advisors would be borne by the debtor. To expedite complex restructurings, the committee and the debtor may choose to appoint a mediator to facilitate the negotiating process;
- The steering committee would not be able to take decisions that would be binding on creditors. At the same time, the debtor would not be required to secure unanimous support of the committee for restructuring proposals.

The only counterbalance to this clearly procreditor bias is that, when negotiations stagnate because the demands of creditors are inconsistent with the parameters that may have previously been established in a Fund-supported programme, the Fund can continue to support the country despite the lack of progress in negotiations.

In effect, in theory the LIA policy is designed to operate against the background of a Fund arrangement that provides for an appropriate[34] balance between financing and adjustment, a balance that should aim at both preventing the debtor country from suffering extreme economic hardship and encouraging it to undertake measures to recover external viability. At the same time, this contributes to supporting the value of creditor assets or, at least, to preventing an excessive loss of value.

This implies that the Fund can have a significant influence on the expectations that both creditors and the debtor will have about the possible terms of the restructuring, because it is clear that the mentioned parameters define the limits or possible range of the restructuring terms. This, in turn, underlines the centrality of the IMF's debt sustainability assessments (DSA) for the application of LIA policy, given that it is the technical element on the basis of which the multilateral institution can judge whether creditors' demands are consistent or not with the parameters of the Fund programme.

The criteria and principles that have just been reviewed reflect the IMF's attempts to be seen as an impartial arbiter in debt restructurings, after all the criticisms the institution had received from representatives of the (private) international financial community. However, the IMF is still not an impartial arbiter, but has rather drifted in favour of creditor interests. It would have been more commendable, and would have fit more comfortably with the role the IMF should play as a multilateral institution, if a more balanced set of principles had been proposed.

Certainly, there is an obvious asymmetry between the incentives that the sovereign debtor and its creditors have to implement the principles: while the possibility of receiving Fund financing represents a strong incentive for the debtor, so that it may feel compelled to comply with the guidelines, there is no similar incentive for the creditor to agree (or to maintain) a standstill on litigation during the negotiating process. This imbalance is not unintended, but is the result of a deliberate attempt to strengthen the creditors' position in sovereign debt restructurings. Moreover, the implications are currently more profound than when the principles were proposed (2002), since when the SDRM project was still a possibility, the issue of the standstill had some chance of being stipulated in a more balanced form.

However, as has been stressed before, all this does not necessarily mean that the actual implementation of LIA policy will be tough on the debtors in each and every case, but it does imply that the IMF will have more formal excuses for adopting a less supportive position in some instances, as has been the case in Argentina since 2002.

Certainly, despite paying lip service to the presumed freedom that debtors would have in managing creditor-debtor relations, the principles are not far from prescribing definitive rules as to how the debt negotiations should be conducted. This is very clearly evidenced in the requirement that once creditors have organized a representative committee on a timely basis the sovereign must conduct negotiations with that committee. The risk is that this may be giving back to creditors precisely the lost leverage that LIA policy was created to take away from them in the first place. It also entails limiting the flexibility that was being sought when LIA policy was established as an exception to the general rule of not lending into arrears.

In any event, the Fund should avoid the temptation to "micromanage" the debt restructuring process. This would clearly be a mistake, given the complexity and diversity of the circumstances which may characterize that process, as determined by the types of bonds held by creditors, the investor base, the scale of the restructuring, whether the debtor country is or not in default, etc. In some aspects, the principles establish details that are almost ridiculous for the IMF to endorse. For example, the fees of legal and financial advisors should be borne entirely by the debtor country. Is it a matter of principle that there cannot be any burden sharing of these costs?

The principles are also based on assumptions that may not be justifiable. Again, the preference for negotiations undertaken with creditor committees is a case in point. Even though an "organized framework"[35] may be advantageous for the sovereign debtor in some circumstances this is not always so. After all, it is sensible to assume that no party other than the sovereign debtor is in a better position to evaluate the relative costs and benefits of this framework vis-à-vis a more informal mechanism. In fact, there may be situations where because of "strategic" considerations the debtor may consider that the risks and costs of negotiating with a formal creditor committee clearly outweigh the benefits. This may happen if, for example, the sovereign is concerned about the possibility that a collective framework might provide a platform for dissident creditors to rally support, a development that may end up further complicating the restructuring process instead of accelerating it. If creditor heterogeneity is prevalent in the most complex cases of sovereign default, then this concern cannot be lightly dismissed. Besides, it is a fact that trading in secondary markets can rapidly change the identity of "final" creditors, making the effective functioning of a creditor committee more complicated by altering the relative weights of the different creditor "interest groups".[36] Even if, in principle, a more formal collective negotiating framework becomes more desirable the more complex the restructuring is bound to be, this very complexity makes it highly unlikely that a committee can be established on a timely basis. Another drawback is the time-consuming nature and resource intensiveness of an organized framework for negotiations between the debtor and its creditors.

This preference for a creditor committee can also backfire from the perspective of the Fund itself. If the sovereign debtor engages in a very "structured" dialogue with creditors prior to the approval of a Fund supported programme, creditors will probably seek to influence the parameters that define the envelope of resources. At the same time, the Fund would be "negotiating" the same parameters with the debtor. Consequently, there would be two negotiating tables operating simultaneously, which would inevitably be interrelated, with each side trying to exploit the linkages between them to its advantage. The Fund is supposed to "strike a balance" and determine the exact amount of burden sharing that each side will bear. But there is a risk that it could fall captive to one of the parties and that it might thus lose legitimacy. A more informal negotiating environment would diminish (though it would not eliminate altogether) this risk. Besides, in the context just mentioned, it would be crucial for the debtor to preserve confidentiality. It is doubtful that there is a strong case for sharing confidential information with a representative committee on a regular basis. This should be left to the debtor's discretion and not be a part of a "best practices guide". Given the high stakes involved in a sovereign debt restructuring, it is unlikely that the debtor will be willing to test the strength of "Chinese walls" or the honesty of supposedly impartial advisors.

There is a more fundamental criticism of the attempt to establish these "LIA-compatible" guidelines for negotiations between the sovereign debtor and its creditors. Are these procedural issues the most important factors that may retard an agreement or even make it impossible? This is unlikely to be the case. Creditors seem to be (and actually should be) more concerned with substantial issues, such as the definition of debt-service envelopes, problems of inter-creditor equity, questions related to the design of the new debt instruments to be offered in exchange for the defaulted ones, etc.

But despite the effort devoted by the IMF to clarifying the meaning of the "good faith" criterion and the "recommended" modalities of engagement of the debtor with its creditors, what matters in the end is how the LIA policy is actually applied and the extent to which it contributes to achieving a fair debt restructuring.

V. LIA policy in practice

There is a currently a consensus regarding LIA policy: it has been inconsistently applied across countries and it has failed in terms of its objectives. The IMF itself considers its LIA policy to be the main element in need of improvement in its "framework" for crisis resolution in emerging markets (IMF, 2005a). But it is seeking to improve it though changes in the formal criteria regulating the application of the policy. This may not have a significant impact on the way the policy is implemented if enough flexibility has to be preserved.

Indeed, the effective implementation of LIA policy has been criticized on several grounds. It has been argued that LIA policy lacks predictability (an usual criticism regarding IMF lending in general[37]), and that there are still significant uncertainties for all actors involved regarding the precise role that the IMF may play in post-default restructuring negotiations. In particular, there is an ongoing debate about how to give a more operational content to the "good faith" criterion. There are also more basic questions that have been posed with regard to this criterion: is it just possible to establish clear guidelines for something that is inherently quite vague? Is the criterion useful, either in its current formulation or with any other alternative language? Is further "clarification" the way to improve LIA policy?

Probably not. Because of the nature of the problem it is designed to address, LIA policy will always be necessarily ambiguous and cannot be suitably "parameterized". Even more, greater precision could be counterproductive, and the IMF's Executive Board seems to be well aware of this. That might be the reason why the efforts to achieve more "clarity" have not made progress. The IMF does not want to tie its own hands. That may be a good thing.

After all, a certain degree of discretion or even "arbitrariness" might be sometimes called for if it is for the sake of improving outcomes from what they otherwise would have been under a very neatly specified formal framework which does not leave any "margin for manoeuvre". This is just another manifestation of the time-inconsistency problem. Of course, it implies that the incentive structure faced by debtors and creditors will be suboptimal, but it is very hard to envisage an "optimal" LIA policy that adequately balances ex ante and ex post efficiency considerations and gets rid of moral hazard completely. It is simply not possible to foresee all the contingencies that may have to be dealt with in a complex post-default context when a country needs to restructure its debt.

Leaving the question of the specific wording of the criteria aside, it is important to evaluate if the Fund's recent interventions by means of its LIA policy have contributed to moderating the costs of crises for debtor countries and have played a constructive role in debt negotiations. In short, have they been welfare improving? Have they really struck a balance between the objective of improving the functioning of capital markets and the objective of providing timely and (let's add) "adequate" assistance to countries undergoing an extreme economic crisis?[38]

Focusing on middle-income countries, the set of nations where LIA policy has been applied in recent years is relatively small, because there were exchange offers of sovereign debt which took place before there were any formal arrears to private creditors (these were the cases of Ukraine and Uruguay) and the remaining holdouts did not represent a significant amount of the original debt and were paid in full. LIA policy has been applied in the cases of Argentina, Ecuador and the Russian Federation.[39] In the case of Ecuador, after restructuring its debt with the participation of 98 per cent of bondholders, the remaining arrears had been cleared by December 2000, so LIA policy ceased to apply after that date. In the case of the Russian Federation, lending under the stand-by arrangement approved in July 1999 applied LIA policy, given the existence of arrears to private bondholders.

But it is surely the Argentine experience after its default, that provides the best case study of the difficulties involved in the application of LIA policy. Paradoxically, it was precisely the Argentine crisis and its paradigmatic status as the greatest sovereign default in history what had given impetus to the IMF to refine such policy. Thus, the revised LIA policy (2002) failed its first test.

The most contentious issue has been (and still is) the interpretation of the “good faith” criterion. In particular, with regard to the expectation that, when a “representative” committee has been established on a “timely” basis the country should go beyond constructive dialogue and enter into good faith negotiations with it. The application of this criterion is supposed to be based on the “unique characteristics” of each case[40] and the crucial aspects are the complexity of the situation – which may warrant a less structured mechanism for dialogue –, the representativeness of the committee and the timeliness of its constitution.

In the case of Argentina, a committee called GCAB (Global Committee of Argentina Bondholders) was established on a timely basis but Argentine authorities disputed its representativeness and argued that, because of the complexity of the envisaged debt exchange a structured framework for negotiations would be counterproductive. In particular, they argued that the GCAB did not have the power to bind in creditors and there was not enough evidence of support from the bondholders it claimed to represent. Moreover, Argentine authorities remarked that important constituencies of bondholders (principally those located in Argentina) were not represented in GCAB.

The IMF maintained that creditor committees have an advisory role and are not supposed to be able to take decisions that would be binding and insisted on the representativeness of the GCAB. Related to this issue were also questions about conflicts of interest[41] of some of the entities forming GCAB. The head of GCAB, Nicholas Stock, threatened to use the IMF as an instrument to put pressure on Argentina to negotiate with GCAB. In fact, this pressure was not even necessary, since both the United States Treasury and the G-7 were also requiring the IMF to push for a “negotiated” solution (Helleiner, 2005). Argentina did not bow to the pressure and the issue was a source of continuous frictions between the debtor and the IMF.

The whole issue of negotiations is probably beside the point and is a rather “ancillary” element that should not distract from the fundamental problems. Indeed, the importance of establishing “formal” negotiations with a “representative” creditor committee must be questioned, since it may imply putting too much emphasis on the debtor’s “good manners” (and not on the creditors’!!), which have nothing to do with the issues of substance. After all Argentina did what has become the standard in sovereign debt restructurings: a take-it-or-leave-it unilateral exchange offer. It clearly did not innovate on this, given that negotiations in the IMF solemn meaning of the word did not take place in any of the previous debt restructurings, largely because there was no need for them. Moreover, the “technique” of unilateral exchange offers does not imply that there are no consultations with creditors or that creditors do not have the opportunity to provide any inputs to the restructuring proposal. It simply implies that this task is undertaken by the investment banks hired to design the details of the debt exchange, which do the market soundings to, precisely, check its degree of acceptability among the creditors.

A clarifying perspective to consider this issue is by imagining what negotiations would mean in the world of corporate debt restructurings if there was no bankruptcy law and no possibility of easily attaching assets. In that context, negotiations could not even take place “in the shadow of the law”, as often happens in practice. They would probably resemble the offers we see in sovereign restructurings. But sovereign restructurings have an obvious additional dimension that cannot be overlooked, because it is an essential part of the problem: governments will never accept to seriously discuss their economic programmes with private creditors and will not want to be "seen" by their constituents as doing so. Their political survival would be at stake. This is perhaps less stark in a pre-default context, where the population might be willing to support draconian measures. However, there have been no negotiations in the IMF meaning of the word in pre-default situations either.

Another difficulty with LIA policy raised by the Argentine case is, precisely, that it does not establish any difference between the pre- and post-restructuring scenarios. The policy is applied under the same conditions as long as there are arrears with external creditors. However, this poses a problem. If the "haircut" required to restore debt sustainability is very high, as it was in the Argentine case, the participation rate of bondholders may be relatively low, at least as compared to other exchange offers where debt sustainability is more easily achievable. As a consequence, arrears on private external debt will remain high, but not as a result of a lack of will to seek a collaborative dialogue by the debtor but because the "reservation price" of the (marginal) creditors is inconsistent with sustainability. Paying holdout creditors in full, as has often been done in other debt exchanges, would not be feasible when the amounts involved have macroeconomic significance, but this implies that arrears may persist for a long time. Thus, LIA policy would seem to require more flexibility when applied in a post-restructuring context, though this does not imply that there should necessarily be specific "written" conditions for such cases.

The Argentine case had another complicating facet. Given that Argentina represented a dramatic example of a failed bail out, IMF's exposure before the default was already at high levels, so financial assistance to Argentina had to be framed within the Exceptional Access Framework[42] and the "formal" barriers to further financing were consequently considerable, if for no other reason than the wish to show that the EAF was effectively enforced.

Thus, Argentina, despite the depth of the crisis after the devaluation and default, was the only major Fund debtor that did not receive any financing in net terms as from late 2001. Is this justified? It can be argued that it is not.

The situation was so catastrophic that it is sensible to demand that the IMF, being a multilateral institution whose role is, in theory, to help its members moderate the costs of balance of payments crisis, should have intervened by providing some net financing. At the very least, it should have accepted to maintain, if not to increase, its exposure until the worst phase of the crisis had passed. Instead, the IMF sought to systematically reduce its exposure as rapidly as it could.[43] What was the rationale for this behaviour?

It was obviously, in part, the concern that maintaining its exposure to Argentina, not to speak of increasing it, would have been in contradiction with the proper safeguarding of Fund resources required by LIA policy. In the IMF's view Argentina entailed risks that were too high. This view, although it has turned out to be wrong,[44] was not at all absurd initially,[45] even if the risks were overestimated.[46] The problem is not the fact that the Fund sought to safeguard its resources, which is understandable, but rather that it has not been consistent across countries in its efforts to do so. Moreover, it seems clear that there was an intention of "punishing" Argentina, probably as a means of generating a demonstration effect on other potential defaulters.

If Argentina was an unacceptable risk, so was Uruguay in 2003, when the Fund endorsed a debt restructuring that was probably too "investor friendly", implying the need for the IMF to maintain or even increase exposure during a long period.[47] Besides, even if the Fund had provided net lending to Argentina in 2002, the country's exposure would have still been below several other cases of exceptional access.[48] (in per cent of quota). It is also legitimate to ask whether LIA policy should be different in the cases of "catastrophes" as opposed to "grave but not extreme" economic crises. If there is a need for a LIA policy tailored for low-income countries, there might be a need for a LIA policy tailored to middle-income countries under extreme circumstances. The latter, in contrast to the former, have access to the international capital markets, which adds and additional layer of complexity, unlike in the case of low-income countries, where most debt is owed to the IFIs themselves. In the end, questions such as this reinforce the perception that LIA policy cannot and should not be "parameterized" beyond some easily agreed-on principles. It is by essence highly judgmental. Not least because those that have to implement it are human beings, after all, and this may play a role.[49]

For example, in the case of Argentina, in mid-November 2002 the government decided that it would not make payments due to the IMF and the World Bank. The reason was that Argentina only had around 300 million dollars in reserves over and above the maturing amounts owed to the IFIs, and would be in a very vulnerable situation when, in May 2003, the presidential elections were going to be held. Consequently, the Argentine Government requested for an extension of the repurchase schedule, but the IMF (Koehler) was not willing to accept such a request (even though it was only a rollover, strictly speaking). In the end, it was pressured to do so by the United States Treasury and the G-7, and an IMF "transitional" programme was approved in January 2003,[50] that took into account the upcoming presidential elections. Would the IMF have lent to Argentina if it had been a technocratic institution with full independence and isolated from political pressures? Probably not, and this fact is very much related to the uselessness of trying to establish in too precise terms the conditions of access to IMF financing. It is simply contradictory with the inevitable political character of the Fund as an institution.

The conflictive relationship between Argentina and the Fund has continued to this day, and the implementation of LIA policy has been increasingly at the centre of the disputes in one way or the other, relegating other issues to the sidelines. The IMF used the LIA criteria to do the opposite of what LIA policy was originally intended to do: it was used as a way of extorting the debtor to offer more money to its creditors.

In September 2003 a three-year programme was launched and IMF pressures based on its interpretation of the good faith criterion intensified. At the same time, however, the Fund did something different than what had been its usual procedure in the previous episodes in which LIA policy had been applied: the fiscal targets of the programme beyond 2004 were specifically left undefined above a 3 per cent floor (for the primary surplus), with the aim of giving Argentina and its creditors the room to negotiate over the terms of the restructuring.[51] This was the United States Treasury's laissez faire approach to the Argentine debt restructuring in action. The country and its creditors had to agree on a debt restructuring with not input from the IMF, which abandoned its role as a natural mediator but kept insisting on compliance with the formal, and debatable, requirements of LIA policy, instead of taking advantage of its (potential) capacity to play a constructive role.

This paper has argued that the implementation of LIA policy was biased in favour of creditors' interests in the Argentine case. But, of course, the Fund did not go as far as to relinquish its de facto preferred creditor status[52] and it was not willing to put issues of principle before its interest in sharply reducing exposure. Thus, when Argentina, facing a real possibility that the Fund would not authorize an effective "rollover" of its debts coming due,[53] "threatened" not to pay in March 2004,[54] at a time when the second review of the IMF programme was underway, the IMF eventually gave in and the review was approved.

However, executive directors representing more than a third of votes abstained (which actually means they opposed the approval), a situation with virtually no precedents in IMF history. Moreover, the G-7 decided to put pressure on Argentina to improve its offer to creditors and the IMF was instructed to operate in the same way through its LIA policy. Finally, when the third review was underway, Argentina decided to stop it on its tracks. The country would keep paying its debts to the IMF as they came due but was not willing to accept the stringent conditionality that was put forward as a precondition for approving the review. There was one overriding issue among those conditions. Indeed, it was probably the only issue on which the approval depended on, the others being mere formalities: Argentina had to improve its offer to creditors. So the end of this story was that the country "bought" the IMF's "silence", and could then deal with its creditors alone, without IMF's interference on their behalf. Was this the result of a deliberate, if convoluted, attempt to bail in creditors forcefully by the IMF? It is unlikely, but this story poses some questions of general interest about the role of the IMF in debt restructurings.

What other (general) considerations might have influenced the decision not to help Argentina financially?[55] One often mentioned concern is that a LIA policy that is too liberal might encourage moral hazard on the part of both debtors and creditors. How relevant is this argument in practice?

VI. LIA policy and moral hazard

From a theoretical perspective, moral hazard is an inevitable consequence of any form of "insurance" that weakens the agents' perception of risk and the disciplining power of capital markets. So, to the extent that, by providing financing to a country in arrears both the debtor and the creditor are better off as compared to a situation without any assistance, there is a potential for moral hazard, in which both sides count on being "rescued" by the IMF. But its relevance may be questioned in practice and the case of debtor vis-à-vis creditor moral hazard should be distinguished.

First of all, *a priori*, the case for the existence of moral hazard in LIA policy is weaker than in pre-default situations, where every effort is made to avoid default, and the amount of resources committed in bailouts is much larger than in any conceivable application of LIA policy. Second, in the same way that debtor moral hazard has been found to be weak or non-existent in pre-default situations (see Kamin, 2002; Lane and Phillips, 2000; and Zhang, 1999), given that incumbent governments are held responsible for the crisis by their constituents and do not reap any "profits" from their presumed misdeeds, debtor moral hazard cannot be a relevant concern in the implementation of LIA policy.

Of course, it may be argued that if the financing provided is too generous the country will have less incentives to pursue appropriate, but unpopular, policies. Moreover, the financing provided by the IMF will reduce the pressure on the sovereign's foreign exchange reserves and fiscal situation, with the possible effect of diminishing the debtor government's incentives to reach a restructuring agreement rapidly. This is a clearly a moral hazard side-effect, but its relevance should not be overestimated. A moderate amount of net financing cannot change the incentives faced by a country with a pronounced balance of payments deficit[56] and an enormous debt that is already in default.

After all, and as has been explained before, the reason for allowing the IMF to lend into arrears in the first place was because the Fund would often be held hostage by private creditors striving for better restructuring terms. To be a cause of debtor moral hazard, LIA should be on a scale that it is not intended to have and should have a very weak conditionality, which is not the case.[57]

Could the IMF have feared that if it had provided financing in net terms to Argentina it would have created a precedent which could have induced debtor moral hazard in other countries? Not really, only a "giveaway" would have generated that result and we would be entering the realm of fantasy. However, creditor moral hazard is much more likely to be stimulated if LIA policy is too lax, or even more so if a debt restructuring to avert default (which is outside the scope of LIA policy) implies a massive rescue of creditors. This last kind of moral hazard is probably the only one that may be relevant in practice, even though the evidence is also scant.

VII. The Fund's role in debt restructurings in two recent cases

In this regard, the Fund's policy in Argentina and Uruguay could not have been more contrasting. In drawing lessons from the Argentine case, given that at the "climatic point of the battle" the Fund abandoned creditors to suffer their fate, the outcome will, if anything, strongly discourage the notion of creditor moral hazard in a post-default context. From the IMF's perspective, this may have been the only positive "fruit" of the Fund's laissez faire policy "experiment" in Argentina. There was a considerable degree of private sector "involvement". But overall, the IMF's "strategy" was a total failure, in which it pursued its own self-interest instead of contributing to making both debtor and creditors better off.

In the case of Uruguay, in contrast, the IMF did not apply a hands-off policy but embarked on a large-scale bailout;[58] it was actively involved but the private creditors were not, at least not to the extent that the situation required. The restructuring terms implied only a very modest haircut in net present value,[59] and almost no reduction in the face value of the debt. Debt "relief" consisted largely in a re-profiling of the debt's maturities.[60] The IMF intervention improved the situation of creditors but only provided short-term relief to the debtor, because it did not clearly solve Uruguay's debt sustainability problem in the long term. The debt burden may have remained too high.[61]

Besides, holdout creditors are being paid in full. Does this not generate "perverse" incentives, by encouraging the adoption of the holdout strategy in future debt restructurings? However, whereas the Argentine debt restructuring was not considered entirely satisfactory by the IMF,[62] despite some formal compliments, Uruguay's debt exchange was hailed as a model of the "market-friendly" approach to crisis resolution and as an example of the inclusion of innovative "aggregation" clauses in bond contracts.

There is something odd here, probably due to the confusing terminology being used. It may be argued that, while Uruguay's exchange offer was indeed "friendly" with investors it was not an example of a market outcome. It was not based on what the market can deliver when operating without public intervention. Conversely, Argentina's exchange offer was harsh but it was much closer to have been a "pure" market outcome. This is the result of a fundamental problem: given the lack of an international bankruptcy court,[63] market friendly debt restructurings require a high degree of intervention or even, in some cases, coercion. They will never be a "natural" result of the interaction of debtor and creditors.[64]

This puts the IMF in an impossible position. On the one hand, it is supposed to strictly control the use of its resources, avoid large rescue packages and focus on PSI. On the other hand, it promotes marked-friendly debt restructurings which are impossible to achieve without it becoming (very) involved, even more so because they imply very little PSI, so the sovereign's debt sustainability is far from being assured, implying that IMF resources have to be committed for a very long period. This square is impossible to circle.

Of course, the cases of Argentina and Uruguay have a fundamental difference in the initial conditions: Argentina had defaulted whereas Uruguay was trying to avoid default. Debt restructurings cannot be too coercive before default and they should not be too market friendly after a default. What could be a constructive role for the IMF in these two different contexts?

In both cases, the IMF's overriding concern should be to make sure that the haircut is high enough so that the probability of the debt following an unsustainable path becomes almost negligible if the sovereign debtor adopts and maintains adequate policies. Consequently, undertaking an in-depth and broad debt sustainability assessment (DSA) is crucial for determining the necessary degree of PSI. The IMF has been making efforts in recent years to improve its DSA technology (see IMF, 2002b, 2003c; and Hostland and Karam, 2006). However, it is still not robust enough (see Ferrucci and Penalver, 2003; Garcia and Rigobon, 2004; Mendoza and Oviedo, 2004; and Gapen et al., 2004). At present, it does not even take into account the fact that emerging market economies are often hit by a set of simultaneous (correlated) negative shocks,[65] and the persistence of these shocks is also not adequately reflected in the IMF's DSAs.

Of course, building a truly robust DSA methodology is no easy task. Perhaps, it will never be possible, because of the complexity of the issue and the multiple factors that may affect the sustainability of a country's debt.[66] Thus, there will always be an element of judgment, and the error levels in the projections of future debt dynamics may be considerable.

But if this is so, the Fund should choose to err on the side of caution. This means that the results of its DSAs, which determine the so-called "envelope" of resources available for servicing the sovereigns' debt, should only be taken as an indication of the debtor country's maximum (as opposed to average) repayment capacity.[67] In addition, in cases where the sovereign is in default, the Fund could contribute, by means of its LIA policy, to reducing the gap between the debtor's offer and the creditors' "reservation price", by providing financing for "sweeteners" or guarantees in the style of the Brady Plan. The amount of resources involved need not be great because the situation would be characterized by very low prices of the sovereign's debt. It is precisely in this contexts when the IMF should not passively observe what the "market's outcome" will be. The Fund should also encourage the use of "equity-like" instruments, like GDP warrants, which reduce the debtor's financial vulnerability at the same time that it may provide creditors with significant returns if the country's economic performance is good enough.[68]

In pre-default situations, and to be consistent with its stated preference for market solutions (and to show its confidence in the robustness of its DSAs) it should not accept debt restructurings that do not assure sustainability within a reasonable, but low enough, margin of error. This would make it possible to achieve an acceptable degree of PSI, limit moral hazard and, at the same time, safeguard IMF's resources. Otherwise, the Fund's rhetoric will be far from its real actions.

Conclusions

The IMF is currently at a crucial juncture in its history. Its relevance and usefulness are being questioned from different perspectives and the institution is in search of an appropriate role in a world that is very different from what it was when the IMF was created. The IMF's intervention as a key actor in the cases of middle-income countries facing external debt (financing) crises was not originally envisaged as one of its tasks but, in practice, it has become one of its main activities. One aspect of this intervention is the position adopted by the Fund when there is a need to restructure a sovereign's debt. Recent experience suggests that the institution rarely plays a constructive role that balances the interests of the sovereign debtors with those of the creditors. It is unlikely that the IMF will ever be able to contribute to improving the outcomes of debt restructurings undertaken under its "supervision" if it does not acknowledge the existence of an unavoidable tension between its preference for investor-friendly arrangements and long-term debt sustainability.

In effect, the IMF's rhetoric emphasizes its preference for market-based solutions to the problems of the "international financial architecture" and the efforts in recent years to improve the so-called "framework for crisis prevention and resolution" point in that direction. In this context the SDRM, which was to be one of the pillars of that framework, was doomed to failure from the start, since the United States Government wanted the framework to drift in the opposite direction, towards a more hands-off approach with less involvement by the IMF. This view reflects an overriding concern with the problem of moral hazard, which seems exaggerated in the light of the weak empirical evidence about its significance. However, the changes in LIA policy and the more stringent criteria for exceptional access show that this concern has had an impact on the way policies are being shaped.

As a consequence, the IMF has made its policies formally "tougher" but it has put itself in an uncomfortable position, because adherence to strict rules is inconsistent with the inherent political character of the Fund and often becomes impossible in practice, in addition to being significantly inefficient, from an ex post perspective. Inevitably, there has been a significant gap between the formal criteria regulating IMF "interventions" and actual practice. However, these more stringent formal criteria are not totally harmless because they can provide the "excuse" for adopting a hands-off stance or even favouring the creditors, which is not the proper role for the IMF.

The institution should instead focus on making a positive contribution to the reduction in the costs of crises for both debtor countries and their creditors, by trying to support a "Pareto improving" arrangement that leaves both sides better off. The Fund can have a significant influence on the outcome of sovereign debt restructurings, mainly through its LIA policy, but financing through this mechanism should be provided on a larger scale and recognizing the difference between pre- and post-restructuring situations.

In this effort, the IMF's primary consideration should be to guarantee that the debt burden is reduced to the point where a future default is a low probability event for the debtor country. Since debt sustainability analysis is not robust enough, debt service capacity should be estimated taking into account that the margin of error may be large, so that the "resource envelope" can be properly "adjusted".

Paradoxically, it is the IMF's attempt to encourage market-friendly debt restructurings which may represent a real danger to the safeguarding of IMF's resources, because they may be often associated with massive Fund support. In contrast, countries that implement deeper haircuts will be more likely to be able to repay the Fund.

Notes

1 This does not imply that the IMF was wrong in supporting Uruguay, whose economy has registered significant improvement since 2003. We believe that supporting Uruguay was the right thing to do, even if we disagree with the kind of debt restructuring that the IMF backed. It simply means that the IMF did not do what it preaches. It was inconsistent with it own proclaimed principles for dealing with crises such as that in Uruguay in 2003.

2 This refers to the "deadweight" costs of a restructuring process.

3 The enactment of the Foreign Sovereign Immunities Act in 1976 with a restrictive interpretation of sovereign immunity is an example of this position.

4 However, his stated concerns about the costs borne by American taxpayers because of the rescue packages are unfounded. Middle-income countries have always honoured their debts to the IMF.

5 25 January 2002. PO-3042. Treasury Secretary Paul H. O'Neill Remarks to the Bond Market Association New York City.

6 Lawyers, in particular, might benefit from the additional "complexity" generated by the absence of a smoothly functioning restructuring mechanism, which may be associated with higher fee income.

7 In contrast to the de facto protection that they may have, as is discussed below.

8 Decisions by the DRF would not be subject to challenge in domestic courts.

9 Debtor countries saw the possible advantages of the SDRM, but their official position was against both the SDRM and the widespread use of CACs, for fear of losing reputation in the international financial markets. Somewhat paradoxically, the result was that they would speak on behalf of their creditors instead of voicing their own concerns.

10 Of course, nobody assumed that bailouts would disappear completely, but rather that their size and frequency would be significantly reduced.

11 Creditors from G-7 countries complained that these countries' representatives at the IMF's Executive Board did not take their interests into account.

12 The most important difference is that there is no equivalent to the liquidation of a company in the sovereign context. Moreover, liquidation law establishes the relative priorities among creditors both ex-post and ex-ante, so it helps to resolve inter-creditor problems. Besides, whereas bankruptcy law places legal constraints on the company's activities during the negotiation period, this cannot be done in the sovereign context.

13 This is probably true. See Roubini and Setser (2004) and the discussion below.

14 Quoted in Clarin, 23 February 2006, from hearing on 12 January.

15 In which a Belgian Court interpreted the *pari passu* clause as requiring *pro rata* payments to all creditors, which prevented Peru from making payments on its new bonds (by blocking the payment through Euroclear) and led to the country's decision to pay the suing Elliot Fund.

16 The United States Attorney General also sent a "Statement of Interest" to judge Griesa in support of Argentina.

17 According to it, if the creditor recovers part of its claims through litigation before an SDRM restructuring agreement, it only has a residual claim under that agreement for the amount not yet recovered.

18 It is worth mentioning that the roll off of (long term) bonds has not been the main factor behind recent crises in emerging markets. In the cases of both Argentina and Uruguay, for instance, bank runs were much more decisive.

19 After Jean-Jacques Rey of the National Bank of Belgium, who led the group established in 1995 by the Ministers and Governors of the G-10 countries which worked on proposals for the orderly resolution of sovereign debt crisis.

20 The possible advantages of the alternative "statutory approach" were also considered, but it was deemed impractical.

21 As from March 2003 majority-restructuring provisions have become standard in bonds governed by New York law. They are likely to become the standard in German law bonds too in the near future. See IMF (2005b).

22 These model clauses were developed jointly by the Institute for International Finance, the Bond Market Association the Emerging Markets Creditors Association, the Trade Association for the Emerging Markets, , the International Securities Market Association, the International Primary Market Association and the Securities Industry Association. These creditor groups constitute what is known as the "Gang of Seven", which includes the seven most important financial industry associations.

23 For a detailed comparison between the G-10 recommendations and the private sector's effective adoption of CACs see Drage and Hovaguimian (2004).

24 Exit consents allow a qualified majority of bondholders (usually 50 per cent or 66 per cent) to alter a bond non-financial terms. They are used with the purpose of reducing the attractiveness of the "old" bonds'. The most common are the removal of the waiver of sovereign immunity, submission to jurisdiction, financial covenants and listing.

25 As has been mentioned before, the framework also includes an emphasis on greater private sector involvement, the encouragement of the use of collective action clauses and the effective enforcement of access limits to IMF lending. As originally envisaged it would have included the SDRM.

26 This is not strictly true in every case. Sovereigns typically privilege certain kinds of debts, like, for example, foreign bank's (trade-related) credit lines to domestic banks (which may also include public banks). As a consequence, these have a de facto seniority and are often partially rolled over, so they also represent DIP financing.

27 Though, in practice, it had already been implemented before in exceptional cases. See Boughton (2001).

28 In principle, the Fund can only lend to countries that have no arrears to their external creditors, be they public or private, banks or bondholders. However, several exceptions have been accepted to this so-called "non-tolerance of arrears". For example, the Fund can grant an arrangement if it has sufficient assurances that soon after its approval by the Board, Paris Club creditors will agree with a new scheduling of their claims which is compatible with filling the financing gap.

29 These changes were not, as is well known, limited to the sovereign debt market.

30 They were certainly "easier" but they never provided much debt relief.

31 Given the enormous costs of default for the incumbent government this concern seems to be unwarranted. However, and ironically, the possibility of creditor moral hazard cannot be disregarded.

32 At the time the IMF was working on developing the SDRM, LIA policy was seeing as a complement to it, together with the inclusion of CACs in bond contracts.

33 Which build upon the principles that guided the operation of bank steering committees in the 1980s.

34 Obviously, the meaning of "appropriate" is highly subjective, and despite the proclaimed efforts to achieve greater "clarity" regarding the conditions for access to IMF lending, this leaves ample room for discretion.

35 This does not refer to the SDRM but, as it should be clear, to the principles mentioned in this section.

36 In the case of Argentina there was intense trading in the secondary market in the months immediately preceding the final restructuring agreement.

37 In the case of the IMF, being predictable is not necessarily a virtue.

38 Even the need to strike this balance may be unfair on equity considerations. Since the functioning of capital markets is affected by a multitude of factors, and moral hazard in relation to LIA policy does not seem to be a first order problem (at the very least), this "balance" should probably not be a primary consideration in the formulation of that policy. LIA policy should, on average, be biased in favour of debtor countries.

39 LIA policy has also been applied in the cases of Dominica and República Dominicana. The application of LIA policy in low-income countries has been subject to specific considerations and will not be assessed in this paper.

40 This gives the IMF the necessary flexibility to accommodate to specific circumstances. That the IMF did not take advantage of it with regard to the good faith criterion may reflect that there was a deliberate attempt to regain credibility by "punishing" Argentina.

41 For example, TFA (the Associazone per la Tutela degli investitori in titoli Argentini) claimed to represent bondholders for free on the basis of a "mandato". But members of TFA were required to have clients holding Argentine bonds and to be active members of the Italian Banking Association (ABI). There were reasons to believe that TFA represented the interests of the Italian banks more than the interests of retail bondholders, to whom they had sold Argentine bonds held in their own investment portfolios in the run up to the crisis without warning about the risks involved. The banks were worried about the legal risks from their dishonest behaviour and recommended that retail investors reject Argentina's offer, which turned out to be a very bad advice. Those who retained the bonds and "bottom fishers" who bought to wrongly advised retail investors have made enormous capital gains. Others self-appointed representatives of retail investors collected significant amounts in fees without "adding any value" to creditors, as they finally recommended to accept the offer (as was the case with ABRA, headed by Adam Lerrick).

42 This became fully operational in February 2003. See IMF (2004).

43 In the first months of 2002 the Argentine Government asked for financial support to implement a gradualist programme (a "shock" programme was out of the question because of the extremely difficult political and social situation). But, according to Claudio Loser (former Head of the IMF's Western Hemisphere Department), both Kohler and Krueger were of the view that there would only be support once Argentina had an "integral" programme on track. The then president Duhalde said at the time: "I do not see the way out. We have very low reserves, which are our only defense against an uncontrolled rise of the dollar. The IMF demands that we pay with reserves. If we do it everything will blow up. If we do not, then we will remain isolated and its also a disaster". Loser says that "(in the IMF) they wanted Argentina to pay without any conditions". Quoted from Tenembaum (2004).

44 Argentina cancelled all its remaining obligations to the Fund in early 2006.

45 Though by mid-2003 it should have already been obvious that the risks had been overestimated. The flawed assessment of risks in Argentina were in no minor part due to the wide-off-the-mark catastrophic "prophecies" of IMF staff regarding future economic developments in Argentina. In a prophecy worthy of Nostradamus, revealed in a private conversation with a well-known Argentine economist in mid-2002, Anoop Singh (who was then leading the IMF's team working on Argentina) said solemnly that "the markets have not been tested yet", referring to his view that the government's "gradualistic" monetary and banking policy would lead to high inflation and capital flight. The opposite happened and interest rates would drop sharply in the years following his "prophecy".

46 It is remarkable how in a just few years the Fund's exposure has decreased so much that may have generated the opposite problem: a lack of enough "high yielding" assets to cover its expenses.

47 Uruguay's small economic size surely facilitated this.

48 According to Loser (Tenembaum, 2004), Kohler and Krueger created an ad-hoc department that would deal with the Argentine case so that Argentina would not be treated under the usual criteria. He says: "... the reign of the ayatollahs then began ...". He also says "... the traditional approach would have suggested that the IMF support the country while it implemented the reforms necessary to normalize the situation. The top leadership of the IMF established a list of very hard reforms which the country had to adopt even before negotiations would start".

49 Again, talking about Koehler, Loser says (Tenembaum, 2004): "I believe Koehler is a religious man. He had a completely moralistic view. He was a man according to whose view Argentina should have repented and should have suffered because of its sins ... Argentina had to pay for what it had done".

50 According to Loser (Tenembaum, 2004) this was "... against the will of Koehler. He says it literally when he signs: "they have forced me to do this". In other words, the G-7 decided to deprive (him) of authority". Critics of the decision questioned Argentina's commitment to implementing the macroeconomic policies needed to restore stability and emphasized the uncertainty as to the potential inflationary consequences of the monetary programme.

51 The usual practice is for the country to agree to budget targets that define its capacity to repay its debt over the life of the IMF programme. In the case of Argentina, the "excess" primary surplus above the 3 per cent "floor" was supposed to equal what Argentina had to agree to pay its creditors.

52 Nor should it, if it is to be able to fulfil a positive constructive role in the international financial architecture.

53 Despite the fact that it had complied with the programme's fiscal and monetary targets.

54 The Argentine Government had decided not to pay if the second review was not approved. Facing $3.2 billion in payments coming due (equivalent to around 30 per cent of central bank reserves), the Government feared that reserves would fall below acceptable levels and made it clear to the IMF that it was willing to default if necessary. The risk was aggravated by the context of confrontation with the IMF, which could have had a negative impact on domestic markets. In the end, the IMF "disbursed" $3 billion.

55 It may, of course, be argued, from a "legalistic" point of view, that the Fund did help Argentina, by partially "rolling over" its debt with the multilateral institution. But this was forced by the circumstances and was done reluctantly. Argentina would have probably defaulted on its debt with the Fund if it had been required to pay on an "expectation" basis.

56 Partly being financed by incurring in arrears.

57 In practice, when lending into arrears it is most likely that the Fund will operate within two sets of (partly overlapping) constraints: the criteria guiding the implementation of LIA policy and the exceptional access framework.

58 Relative to Uruguay's economic size.

59 According to Sturzenegger and Zettelmeyer (2005) haircuts were as low as 5 per cent in NPV terms, the lowest of all recent sovereign debt restructurings. Kozack (2005) concludes that it is not clear that Uruguay's restructuring has contributed to a restoration of debt sustainability. This conclusion is probably an understatement, since it appears in an IMF paper. Moreover, NPV calculations are not sufficient to evaluate the degree of debt relief generated by a restructuring and may be too sensible to the specific discount rate chosen. Ultimately, debtors do not pay the present value of the debt (unless they can purchase it on the secondary market). They pay the full nominal value as debts come due.

60 It is surprising to see how some economists were not willing to acknowledge the obvious beneficial impact of debt relief until quite recently. Thus, Peter Kenen (2003), referring to the reason why there were no initiatives to reduce the debt burden of LA countries in the 1980s says: "... we did not have a convincing rationale for debt reduction –why it might stimulate growth. That had to wait the arrival of what Krugman (1989) called the Debt Relief Laffer Curve."

61 This does not mean that the IMF should not have supported Uruguay's restructuring. On the contrary, given the country's desperate situation at the time it was the IMF's duty as a multilateral organization to do as much as possible to help it to avoid default. The point we are trying to make is simply that the IMF was not consistent with what it preaches and with its own principles as embodied in the "framework for crisis prevention and resolution", and that its treatment of different countries often depends on geopolitical considerations (in a broad sense).

62 Largely because of the relatively high level of non participation.

63 Not in the SDRM sense, but rather like a court in a national context.

64 A relevant result in the theoretical literature due to Helpman (1989) is that uncoordinated voluntary debt reduction will typically be sub-optimally low.

65 The correlations are not modelled.

66 Even "mere" data limitations may complicate the task.

67 The IMF's DSAs have proved to be consistently overoptimistic. See IMF (2003c).

68 It is interesting to note how much de private sector (and the IMF) underestimated the value of Argentina's GDP warrants. They traded as low as 1.5 cents at the time of the debt exchange and are trading at 9.5 cents at the time of this writing.

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