

# Towards a sovereign bankruptcy procedure and greater restraint in IMF crisis lending. An interim assessment<sup>\*</sup>

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## 1. Introduction

The debate on the international financial architecture, if we take the Mexican crisis of 1994-95 as its starting point, has now been going on for almost a decade. While a sense of fatigue is inevitable in the circumstances, outright skepticism would be misplaced. Institutional reform, as everybody knows, is a complex process. At the international level, the process gets even more complex, due to both the greater number and diversity of actors, and the comparatively underdeveloped institutional environment.

Yet, successful institutional reform is not a novelty at the international level. The long-standing realist claim that international cooperation is but a cover for power-struggle has long been disproved. Two prominent examples suffice to make the case. Before World War II no one predicted that the major countries would ever agree on a formal treaty enshrining fairly precise rules of the game for their monetary relations. Yet, the Bretton Woods Treaty not only came into light, but can be considered to have been an astounding success, since the post war era has been the longest period of high growth and monetary stability that the West has ever known. In Europe, in the same vein, many predicted as late as the early 1990s that the project to decouple monetary union from political union would never

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take off. But fiat powers, we have learned, can also be shared, when countries perceive it is in their best interest to do so. As a result, we now do have the euro, which is also proving instrumental in paving the way for ever-deeper political integration across the EU.

Admittedly, the present debate has been hindered by a failure to build a consensus view as to what are the features of the present environment that need to be fixed, and why. As it happens, too many conflicting claims still coexist in the literature, often reverberating on policy statements. If identification of a market failure is clearly not sufficient to trigger a policy response, because of collective action problems or governmental failures, for sure we cannot expect determined action when there is no consensus regarding the market failure to be cured.

In this contribution I will not tackle all the issues raised in the debate on the international financial architecture. Rather, I will focus on only one area, which however does seem to lie at the core of the discussion – the area of sovereign debt crises and their resolution. In this connection, I will do the following. First, I will try to clear the ground from those exaggerated claims I referred to above. Second, I will restate the case for the new international financial architecture relying on the notion of cheapest-cost avoider, drawn from the Law & Economics toolbox. Then, I will assess the results so far achieved, arguing that they are far from negligible and that in the main they go in the right direction. Finally, I will discuss the reasons why the present opposition of the private financial community to the reform of the international financial architecture may have been overstated. Historically, the financial community has often opposed institutional change, only to join the ranks of its advocates *ex post*. And indeed, views within the private sector have already changed a lot since the inception of the debate. Further experience, especially in connection with the resolution of the Argentine crisis, may convince private investors that in this case, too, institutional reform may also be in their interest.

## 2. Three exaggerated claims

The debate on the international financial architecture has been hindered by a few recurrent claims, that in my view are vastly exaggerated, and therefore unproductive. I think it useful to clear the ground from them before moving on.

***Proposition 1.*** *The IMF cannot and should not act as lender-of-last-resort (LOLR) for countries.*

This is the easiest proposition to dispose of. One could argue that the IMF was indeed conceived to be a special type of lender of last resort from the outset. Art. I of the IMF Statute states that one of the fundamental purposes of the organization is

“to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity”.

Of course, the framers of the statute envisaged a limited LOLR role, as testified by the prohibition to lend against “a large or sustained outflow of capital” (art. VI), and the mechanism for adjusting exchange-rate parities in the presence of a “fundamental disequilibrium”. However, the environment in which the IMF operates has changed a lot since then, and the institution has adjusted to the new environment with the tacit (and sometimes explicit) consent of its membership. The prohibition of Art. VI, formally still in place, has been the first to give – a *memento* that statutory provisions are binding only to the extent that they are believed to be useful by at least some shareholders. With capital account convertibility, the IMF has gradually expanded its confidence-enhancing role, through not only its crisis packages, but also precautionary programs and surveillance.

The legal argument being found wanting or at best ineffective, there are two more ways to rationalize proposition 1 on economic grounds. The first would be by pointing at the inability of the IMF (due to its credit union structure) to create money *by fiat* (Capie 2002). But the idea that the LOLR needs under all circumstances unlimited access to resources rests on

a confusion between lending in support of market trades (which in our days is best portrayed as a form of monetary policy) and lending in support of individual institutions, which does not imply money creation powers. When referring to IMF dealings with borrowing countries, it is the latter concept that matters (Freixas *et al.* 2000). Hence, the key issue is not whether the IMF could or should be an international LOLR, but rather how LOLR activity could best be organized at the international level to allow for the greater complexity of the economic, legal and institutional environment. The second way would be by emphasizing the moral hazard generated by IMF's LOLR operations. But this, argument, too, is hard to square with the fact that IMF lending, at least so far, has contained no clearly discernible subsidy element (Jeanne and Zettelmeyer 2001). To produce moral hazard, a LOLR has to socialize at least some of the costs from private risk-taking. So far, this has not been the case. And the distinction between creditor moral hazard and debtor moral hazard *per se* is not helpful, because, in the absence of frictions, to avoid moral hazard it is sufficient that one of the sides in a creditor relation bears the cost of risk-taking – a straightforward application of the Modigliani-Miller theorem. If there are frictions, of course, the way costs are allocated may impinge on the overall efficiency of the institutional set-up – a theme I will return to in the next section. But this has nothing to do with moral hazard as such.

***Proposition 2.*** *The main market failure to be corrected through changes in the international financial architecture relates to creditor coordination.*

Coordinating creditors in case of default is always a problem, the more so in the typically highly fragmented bond markets. But is this the main problem we have? I would contend not. In the past, creditors did manage to coordinate themselves irrespective of collective action problems when they perceived a clear interest in doing so. Both in the second half of the nineteenth century and in the 1930s – two periods in which recourse to bond finance was widespread – creditors readily formed voluntary committees to foster their interests. And they were pretty effective in the endeavor, since actual yields on average compensated investors for interruptions to debt service and write-downs of principal (Eichengreen 1991). Nor can one attribute this striking outcome to greater involvement on the part of creditor countries' governments in the negotiations, since authorities rarely resorted to aggressive trade policy to extract concessions in favor of their citizens

from defaulting countries. The main reason behind such high *ex post* yields seems to be that, after defaulting, countries recognized that the sooner they settled old scores, the sooner they would be let to access the capital market again. Indeed, regarding the 1930s there is evidence that countries that interrupted debt service recovered more quickly from the Great Depression than did countries that resisted default (Eichengreen and Portes 1990).

If creditors managed to coordinate themselves so effectively in the past, why should they find it harder to do it today? One reason could be the existence of contract provisions, like acceleration clauses, which tend to trigger automatic responses in the face of an hostile act by the debtor, thereby making a pondered reaction by creditors more difficult to achieve. Another possible reason is that the availability of large sums of IMF financing in the presence of a capital account crisis alters the incentives under which both debtors and creditors operate: the nastier the crisis, the more likely an IMF package will be forthcoming (Miller and Zhang 2000). *Prima facie*, the latter reason is made plausible by the fact that the existence of the IMF is by far the most conspicuous difference between our present international financial environment and that of the 1930s.

Whatever the true reason, however, it is clear that creditor problems *per se* cannot explain why sovereign default is perceived to be a bigger problem now than it used to be the case. One must dig deeper to understand why the international financial architecture has become such a prominent issue in the authorities' agenda.

***Proposition 3.*** *Any attempt to establish an international analogue to domestic insolvency procedures would entail the disruption of the sovereign debt market.*

This proposition is often heard, and has been made most forcefully by Dooley (2000) and Shleifer (2003). The underlying idea is that the inability of debtors and creditors to quickly renegotiate contracts is an endogenous response to one peculiarity of international financial dealings involving sovereign entities – the impossibility of seizing assets held by the sovereign within its jurisdiction. Any attempt to dilute creditor rights, by making renegotiation easier, would impede the functioning of the debt market.

Plausible as it may sound at first blush, the proposition does not stand closer scrutiny. The purpose of bankruptcy proceedings is not that of prejudging the interests of one or the other of the parties involved in any

specific instance. Rather, they have a twofold objective: to preserve the debtor's assets from unnecessary dissipation; and to reduce uncertainty as regards the process through which assets will be allocated after default, thereby hopefully reducing overall transaction costs. The existence of procedures to achieve these ends is more important than the substance of any specific procedure. And in fact there is considerable variety around the world concerning the mechanics of insolvency rules, as a result of differences in local legal traditions and societal preferences. Those who fear that the sovereign debt market might be disrupted by the establishment of explicit rules for dealing with international insolvency assume that such a proceeding would resemble the US Chapter 11, which is often cited as a very pro-debtor insolvency regime. But, as mentioned, all insolvency procedures are to some extent 'pro-debtor', since they must avert unnecessary asset dissipation. The real question then is: how much protection should debtors be afforded in order to improve social welfare? An answer to this question cannot be given in abstract terms, and I will come back to it in the next section with reference to the sovereign debt market. But there are at least three reasons to find proposition 3 an unproductive oversimplification. First, Chapter 11 does not exhaust the range of possible insolvency regimes to be taken as a model. A recent report issued under the aegis of the G10 Deputies, for example, distinguishes between stakeholder-centred and official-centred insolvency rules, based on the role courts actually play during a firm's reorganization (Contact Group 2002). In light of the greater legal fragmentation of the international environment, there can be little doubt that any sovereign insolvency regime would have to be of the former variety, i.e. it should give greater voice to creditors in the resolution process than it is normally the case in official-centred regimes.

Second, to assess the extent to which a particular insolvency regime is pro-debtor one has to go beyond the surface of things. For instance, what are we to make of the fact that practitioners estimate that more than 50% of US corporate restructurings take place in the shadow of the law, i.e. without invoking Chapter 11?<sup>1</sup> Does this make the US bankruptcy regime overall more pro-creditor or more pro-debtor? Finally, it sounds somewhat paradoxical that opponents of sovereign insolvency rules, like Shleifer, should cite the US municipal bond market as a model, in terms of average spreads and default rates, for sovereign debt. US municipalities, in fact, are subject to a special chapter of the insolvency regime

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<sup>1</sup> See Gilson (1996).

– Chapter 9 – which on paper looks even more pro-debtor than Chapter 11. If Chapter 9 has delivered such good results, why should it not be replicated, with all the necessary adaptations, internationally?<sup>2</sup> Surely, either there must be some missing link in the argument, or one must admit that the distinction between pro-creditor and pro-debtor systems is too vague to be of any use.

In sum, there seems to be ground to believe that a sovereign insolvency system would disrupt the sovereign debt market no more than the development of national bankruptcy rules has disrupted national financial markets. This does not mean that anything would go. The devil, as always, will reside in the detail. But, as Ken Rogoff (2003, p. 2) has recently remarked, a well-designed sovereign insolvency proceeding, “is no more likely to encourage bad habits among responsible governments than a new lung cancer treatment would encourage non-smokers to start smoking”. As to irresponsible governments, it is not clear why creditors should feel that their rights are better protected in the current institutional vacuum than in a world featuring predictable and dependable procedures for dealing with sovereign insolvency.

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<sup>2</sup> The reason why Chapter 9 seems to work so effectively is related to the need of municipalities to raise additional money while in default. When the Orange County of California defaulted, in 1994, the County’s government issued a leaflet to explain its negotiating behaviour. To the question “why can’t we just forget about that debt?”, the posted answer was “if we don’t pay, it will have a tremendous and negative impact on Orange County. We would find it very difficult to enter the bond markets, which is how we pay for building roads, flood control facilities, jails, freeways, etc., to support a growing economy”. This motivation helps explain why governments, be they local or national, resist default to the greatest possible extent, and often try voluntarily to negotiate debt settlement agreements. More on this in the next section.

### 3. What is the problem?

The international environment has two features that distinguish it from the domestic environment. Both have to do with the notion of sovereignty. First, property rights at the international level are not backed by a universally agreed and predictable enforcement structure. This makes them fundamentally weaker than in a national context. Second, debtors' actions, either directly in the case of a sovereign borrower or indirectly in the case of a corporate borrower, are affected by the vagaries of domestic politics in the recipient country. This means that the 'debtor' is a form of collective action in disguise: its actions will be the outcome of a game between many principals (the various interest groups) with conflicting interests and an agent (the government) which may also have an agenda of its own. Treating the 'debtor' as an individual endowed with stable preferences and perfect rationality, as most of our analytical models do, is likely to have very little heuristic potential (Dixit 1998). Political economy considerations are an inevitable component of the debtor-creditor relationship at the international level.

These two features combined are a source of strain for international financial relations. Weak property rights tend to reduce the equilibrium level of international lending. 'Myopic' governments, i.e. governments that do not seem to maximize any discernible social welfare function, by contrast, produce a tendency to overborrowing. Painful debt crises can be considered a consequence of this tension. Let us defer once more to Rogoff (2003, p. 2) for a neat and concise description of the mechanism:

“by making defaults extremely costly, risky forms of debt – particularly those that are prone to collective action problems – provide a measure of confidence to international investors [...]. In other words default costs provide a punishment that in some sense substitutes for effective property rights at the international level”.

But in what sense are defaults costly for the borrowing country? Even though waivers of sovereign immunity are in our days common practice, there are typically very few assets that dissatisfied creditors can attach when a sovereign defaults. If defaults are costly, it is because they entail in some sense a prohibition on future borrowing: unlike financial firms, and to some extent also unlike corporate borrowers, sovereign debtors after default incur a financing gap that, barring further external borrowing,



needs to be eliminated through a current account reversal. Of course, the country may well find a lender willing to take the risk of providing money while debt service is suspended, since the prohibition on lending has no legal status. But such lending may itself be attached by other creditors through the legal system. Thus, without legal protection the debtor is for all practical purposes unable to raise additional finance, and has to undergo output costs in order to achieve the needed current account reversal.

Now, as Rogoff himself remarks, default costs of this type are a very poor substitute for stronger property rights. That is, they may be seen as an inefficient solution to the problem. To see why, it is useful to turn to the notion of ‘cheapest cost avoider’, which is in common use in legal analysis and practice. When allocating the cost of accidents between the various parties involved, the law, and the judges that are asked to interpret it, may found their judgement on two alternative criteria. The first is ‘loss spreading’, which seeks to minimize costs to each party by spreading losses as widely as possible. The second is to assign losses to the ‘cheapest-cost avoider’ of whatever causes the losses, thereby minimizing the chance of the loss occurring. In other words the ‘cheaper-cost avoider’ principle, which in our days find wide application, amounts to identifying the party which, due to its means, skills, or resources, is in a position to take least-cost action to minimize the chances that the accident will occur again in the future. The principle, which is due to Calabresi (1970), is intrinsically dynamic, and aims at reducing social costs by modifying the incentives rather than focussing on the distribution of any *given* cost.

One can make the case that relying on default costs only (which clearly cannot be rationalized as an application of the ‘loss spreading principle’) tends to pick the wrong cost avoider, because it does not duly allow for the second peculiarity of the international environment, namely the intrinsically political nature of the debtor. The local taxpayer as a rule has in fact only a limited grip on its government’s actions, which as mentioned above are the result of a game among many principals. Moreover, incumbent governments may have an incentive, to prolong their stay in office, to conceal relevant information or act against the interest of the majority of their citizens. This does not mean that countries will always be unreliable borrowers. Domestic political constraints can be changed, and there are indeed countries that manage to strengthen their policymaking and their institutions. But in the short run domestic political constraints lead to delays in recognizing the existence of an external debt problem, and to gradualism in changing policy course when the need is finally recognized.

Above all, as explained by Johnson (1997), they make the probability of success of a given policy change endogenous, namely dependent on how consensus is built and preserved around the new policy regime. This gives incumbent governments an incentive to postpone recognizing the existence of a debt problem, to avoid unpopular action to stem it. All the while, by contrast, private investors, which consist in the main of financial institutions specializing in active portfolio management and information processing, are free to react in real time as they see fit. The result of this basic asymmetry is that most of the time there is a tendency, in the sovereign debt market, to ‘overborrowing’, or ‘overlending’, accompanied by episodes of what Guillermo Calvo has called “sudden deaths”, with potential international spillovers.

Notice that the very existence of the IMF is an implicit recognition of the inefficiency of the market solution to the tension. If we really thought that default costs were an optimal response to the peculiarities of the international environment, why care to have an institution mandated with the task indicated in the already quoted Art. 1 of the IMF’s statute?

Only, the nearly generalized move to capital account liberalization has scaled up the IMF’s task in this respect considerably. Under the pressure of events, the IMF, but I should here say the official community at large, has developed the notion of catalytic official finance (COF). This is not the place to review the theoretical underpinnings and historical evolution of the notion.<sup>3</sup> For our purposes, it suffices to say that COF is an attempt to avert outright default by applying a recipe made of three ingredients: strong policy conditionality, large but nonetheless limited (in the sense of not covering the whole financing gap) financial support, reliance on private finance to make up for the part of the financing gap not covered by official resources.

The problem with COF, however, is that it does not basically change the nature of the problem. Above all, COF does not make up for the lack of legal protection from which a country suffers in case of default: indeed, COF aims precisely at averting default. But this outcome cannot be taken for granted, and if default eventually occurs, like in Argentina, the IMF will be just another creditor in trouble – even more in trouble, given that COF implies by definition that large sums of money are lent. Thus, the IMF, like

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<sup>3</sup> For a survey of COF’s history and empirical record, see Cottarelli and Giannini (2002).

any other creditor, needs to protect itself from the risk of default. And this is done not only by imposing conditionality, but also through a careful rationing of disbursements, reliance on short term lending and the application, when the SRF is used, of a penalty rate. As a whole, these practices amount to a recognition of the resilience of domestic political constraints and of the uncertainty surrounding the success of the agreed policy package. And a side-effect of their use is that of increasing the burden for the local taxpayer, whose grip on its government's policies remains limited. But why should private investors, whose actions remain equally 'sovereign', i.e. voluntary, all throughout, feel reassured by a LOLR that needs to protect itself from the very risk it is supposed to insure against, thereby possibly also increasing this risk? As a consequence, COF may even be counterproductive: while *ex post* it may fail to restore confidence, knowledge that it will be forthcoming if things go wrong may discourage careful monitoring on the part of lenders.

The argument may be given a theoretical twist. What many often fail to realize is that a LOLR policy, at both the national and international level, is optimal only on the assumption that the LOLR itself has either superior information or superior enforcement powers with respect to private investors. In all other cases, a policy of debt service suspension can be shown to be socially preferable.<sup>4</sup> This fairly robust result of the theoretical literature on debt crises has been consistently ignored in the policy debate.

There is no reason to jump to the other extreme, and argue that COF will always be ineffective. There will be cases where the time gained through an IMF catalytic package will indeed be used to relax the domestic political constraints and set the country on the right policy course. Indeed, the recent crisis management history features a number of success stories, from Mexico (1994-95), to Brazil (1999),

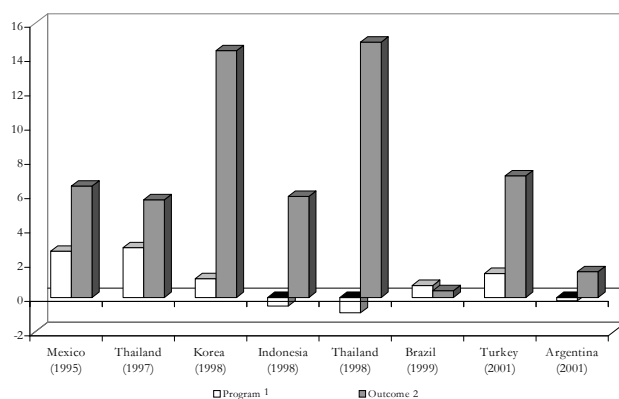
and possibly to Korea (1998). However, one could make the case that these success stories are better explained in terms of superior enforcement powers (Mexico) and reliance on moral suasion (Brazil and Korea) than on COF *per se*. Thus, it is fair to say that the record of COF is in general rather weak. Even when it appears to have finally functioned, it led, with the exception of Brazil in 1999, to a far higher amount of domestic adjustment than originally envisaged (Figure 1). Moreover, in some cases COF was clearly used, for lack of better alternatives, to handle unsustainable debt

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<sup>4</sup> See Wallace (1988) and Rogoff (1999).

situations, with Argentina being the most prominent example, although probably not the only one. And, finally, the frequent use of COF (and the need to regularly ‘augment’ official resources in the process to make up for the disappointing contribution of the private sector) has left the IMF with a concentration of risks in its portfolio never seen before (and probably very uncommon in central bank history, either), as shown in Figure 2. Jeanne and Zettelmeyer (2001) are probably right, as I have argued in Section 2, that IMF lending in the past has contained no subsidy element, since the repayment record of the IMF is so good that its loans can be considered significantly less risky than private loans, so that lower-than-market interest rates were justified. But does this result carry on to the present juncture? One hopes so, of course. But the fact

FIGURE 1

CURRENT-ACCOUNT ADJUSTMENT IN SELECTED CRISIS COUNTRIES  
(AS A PERCENTAGE OF GDP)

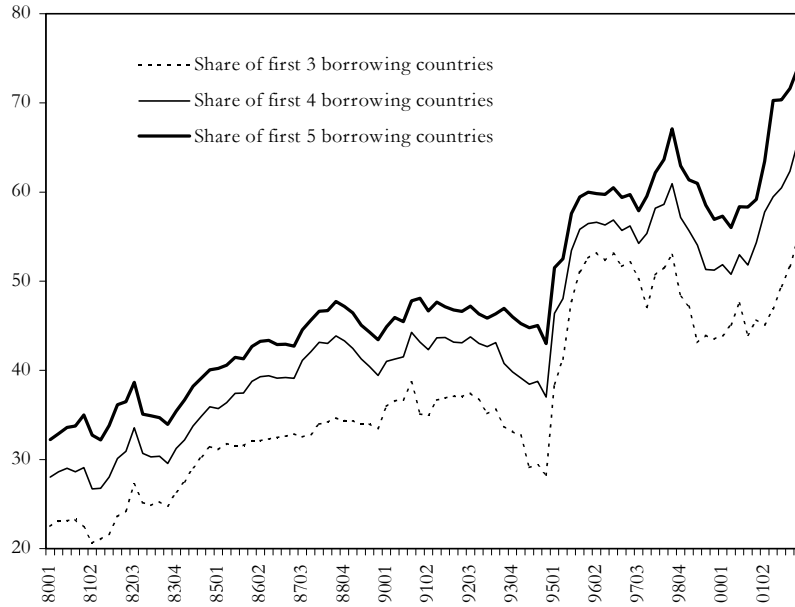
- <sup>1</sup> Implied adjustment equal to planned current account minus actual current account in the year before the program.  
<sup>2</sup> Implied adjustment equal to actual current account in the year of the program minus actual current account in the year before.

Source: IMF, *World Economic Outlook* database; Ghosh *et al.* (2002).

FIGURE 2

CONCENTRATION IN IMF LENDING (percentages)

Source: Based on IMF data.



that Argentine authorities have used the threat of default on IMF loans as a bargaining chip should be taken as a further warning that COF is a two-edged sword, to be used more sparingly than it has been the case.

Overall, I think these are good reasons not so much to disavow COF, but rather to complement it with tools that make it feasible for the debtor countries to take earlier action to counter a dangerous debt path. To make sense, such tools must allow the country to raise additional money while a debt restructuring is pending, along the lines of the ‘debtor-in-possession financing’ common to many domestic insolvency proceedings. To the extent that they do so, they will have the immediate impact of reducing default costs, and therefore of shifting part of the burden for crisis handling from the local taxpayer to the international investor. But this form of burden sharing has no punitive purposes, nor is it based on equity considerations.

Rather, it is predicated on the assumption that the private investor is a better cost avoider, namely that it is better placed to assess risks and take meas

ures to discipline borrowers than the local taxpayer. The existence of the IMF simply cannot substitute for responsible risk-taking at the international level. At the end of the process, if the strategy is implemented consistently, there will hopefully be fewer crises, and the resolution costs of those that will break out will be lower. But there can be no guarantee that this result will come about. All depends on achieving the right blend of determination and pragmatism on the three key components of the strategy, which are: *a*) action to reduce the immediate cost for the borrower of approaching its creditors to negotiate a debt settlement (so that the debtor will be encouraged to take early action); *b*) action to make more rigorous the access policy of the IMF (so that IMF resources will not be used to postpone facing a problem of debt unsustainability); *c*) action to develop rules and procedures to keep the inevitable conflict of interests between debtors and creditors from turning into open hostility (to minimize negotiation costs).

#### **4. Are we making progress?**

Institutional reform simply cannot be expected to take place overnight, the more so since any genuine act of institution-building is un-precedented. The future being unknown, contracts fundamentally incomplete, and interests often conflicting, the pros and cons must be carefully identified and assessed at each step of the reform process. Theory will provide at best limited guidance. Bearing this statement in mind, I think that the answer to the question in the title of this Section is yes, with the proviso that much remains to be done, especially at the level of implementation of the new principles which have been agreed in the meantime. The discussion in this section will be organized around three themes. First, I will tackle the issue of the rules governing access to IMF resources by members or the IMF's 'access policy', as is usually called. Then I will turn to the so-called 'two-pillar approach' to crisis resolution laid out by the International Monetary and Financial Committee (IMFC) at its Fall-meeting. The two-pillar approach aims at:

- the inclusion of collective action clauses in sovereign debt contracts;

– the establishment of a statutory framework through a sovereign debt restructuring mechanism.

I will deal with each of the pillars separately.<sup>5</sup>

**IMF access policy.** With hindsight, it is fair to say that the IMF was caught unprepared by the challenge of promoting financial stability in a world of freely mobile capitals. In the world of capital account inconvertibility, measuring and filling financing gaps was a relatively easy task. And the experience with the first spate of capital account crises, in the early 1980s, was made under relatively favorable conditions, including bank-dominated capital flows and the time respite provided by recourse to suspension of debt service. In the 1990s, things were quite different, as we all know. At the operational level, the IMF entered the decade armed with a set of ordinary access limits (100% of quota annually and 300% of quota cumulatively), an “exceptional circumstances” clause that allowed it to go beyond ordinary limits in unspecified circumstances, and a range of facilities optimized for dealing with standard macroeconomic and structural problems. Under the pressure of events, two new facilities, embodying considerable departures from previous practice, were set up. Of these, the Contingent Credit Line (CCL) was on paper the most innovative, as it was meant to prevent crises through a form of *ex ante* conditionality, but it had no practical impact. As of today, in spite of a subsequent revision to make it more attractive to eligible borrowers, no country has yet applied for the CCL. The story of the SRF is somewhat more complex. Established in 1998 in the midst of the Asian crises, the Supplemental Reserve Facility (SRF) was built around Walter Bagehot’s old idea that LOLR operations should be unlimited in size and based on penalty rates and a short-term lending horizon. Accordingly, the facility was subject to no access limit, so that it could be used for large loans without invoking the exceptional circumstances clause. However, from the standpoint of the debtor country borrowing large amounts of money short-term and at penalty rates implied a heavy burden, difficult to meet under the stress conditions typical of a capital account crisis. Thus, over time the IMF developed the practice of blending the SRF with other facilities subject to ordinary limits. To achieve the required blend, in most cases the exceptional circumstances clause had to be invoked. The result of

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<sup>5</sup> Although the two-pillar approach was endorsed by the IMFC only in the Fall of 2002, its origin lies in the Action Plan drafted by the G7 in April of the same year.

all this was a great confusion as to the rules being followed by the IMF in its access policy. Were ordinary limits meant to apply to all lending, or just to some facilities? And were capital account crises meant to be handled through SRF lending only, or through a varying mix of facilities according to circumstances? And what were people to make of the exceptional circumstances clause, given its increasingly frequent use? What was the meaning of an exception recurring more often than the norm?

Against this background, it is no surprise that access policy should have figured so prominently in the reform effort. In early 2003, the IMF Board reconsidered both the facilities to be used and the criteria to be followed in dealing with capital account crises. As regards the CCL, the review process is still underway, and will not be completed before November 2003, when the facility is due to expire. But there is now much skepticism within the official community as to the facility's real potential.<sup>6</sup> With relation to the overall access policy, the Board has agreed on a set of criteria and procedures to be followed when exceptional access is invoked in connection with a capital-account crisis.<sup>7</sup> Of the four substantive criteria, the most important is that the country should face a debt burden that appears sustainable under rather unfavorable circumstances. Procedural requirements include instead early Board involvement in the decision process and an *ex post* evaluation of the decision eventually taken. Since criteria and procedures apply to IMF lending, irrespective of the facility used, it follows that they will have to be met also for SRF financing.

The new access policy represents an important progress over past practice. Exceptional access in connection with capital account crises from now on cannot be taken as a matter of course. But what if a country faces a large current account crisis? The question is not trivial, since all countries hit by a capital account crisis since 1994 also ran a current account deficit, with figures ranging from 2 to 8% of GDP (Ghosh *et al.* 2002). And, after all, the exceptional circumstances clause has not been explicitly abrogated. Thus the possibility exists that the existence of a large current account deficit be used to exert pressure on the IMF to grant exceptional access to a country whose external debt does not appear to be sustainable. Recognizing the loophole, at its 2003 Spring Meeting the IMFC has clarified that the

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<sup>6</sup> At the Spring Meetings, the IMF has been urged by the IMFC to explore other ways, including precautionary programs, to foster the CCL's objective, especially concerning crisis prevention.

<sup>7</sup> The new policy has not changed the definition of normal access, which remains set at 100% of quota annually and at 300% of quota cumulatively.



new procedural requirements will apply to all exceptional access proposals, irrespective of the underlying causes. But nothing was said of the relevant criteria – and it is often criteria, rather than mere procedures, which matter most when political pressure starts mounting. Probably, an explicit abrogation of the exceptional circumstances clause would have been preferable, but is hard to tell how important the loophole actually is. So, one cannot but concur with the Managing Director, who at the Spring Meeting made the point that “the ways in which these criteria and procedures are applied in practice in reaching judgements about access *will* be decisive.”

**Collective Action Clauses (CACs).** When CACs were advocated for the first time, in the G10 *Key Report* (Group of Ten 1996), it was made clear that their evolution should be “a market-led process if it is to be successful”, and that “such effort should receive official support as appropriate”. Well, the reverse is probably closer to what has actually happened. Given the lack of enthusiasm on the part of the private sector, the G10 Deputies took the initiative of designing model clauses. The private sector followed suit, proposing its own set of model clauses. The main difference between the two sets lies with the required majority for changing the terms of the original claim, which is higher in the private sector’s version. But on the whole the two sets are broadly consistent, and the fact that the official and the private sector now find themselves in agreement on the need to promote CACs is an important achievement. Wisely, the IMF has acknowledged that it does not bfit it to endorse model clauses, as it is for debtors and creditors to find which formulation suit them best, in keeping also with local legal traditions.

The growing consensus on the desirability of CACs in the private sector has also had the effect of mollifying the debtor countries’ reluctance to adopt them, which was the most serious obstacle perceived within the official community. Thus, Egypt, Lebanon, Qatar, and finally Mexico, have issued significant amounts of bonds governed by New York Law and including CACs. The European Union, which had announced already in 2002 it would issue bonds with CACs, has now agreed to pass to the operational phase, with Italy, the most important sovereign issuer in terms of outstanding bonds, already committed to doing so by June 2003. Since the reception of the new bonds has been very favorable in a number of countries, it seems likely that other important emerging market countries will adopt CACs in the near future. On its part, the IMF has committed itself to promoting CACs through its surveillance and outreach activities.

The main task now is that of embodying CACs within a Code of Good Conduct regulating relations between debtors and creditors in the delicate phase of CACs' activation, to prevent the inevitable conflicts of interest from degenerating into hostile acts. Following an initiative by the Banque de France, the G7 is taking leadership on this front, in collaboration with eminent personalities of the private sector.

**Sovereign Debt Restructuring Mechanism (SDRM).** When, in November 2001, Anne Krueger made her by now famous speech advocating an SDRM, many were taken aback, interpreting the new policy as a U-turn with respect to past practices. This interpretation, however, is inaccurate. Already at the time of the drafting of the *Rey Report*, in fact, the IMF had made the point that sovereign bankruptcy proceedings might facilitate orderly workouts, provided the IMF's Articles of Agreement were modified to provide adequate legal backing. It was the Rey Group which, after prolonged discussions, concluded that "the establishment of a formal international bankruptcy procedure would not be feasible or appropriate under present circumstances or in the foreseeable future" (Group of Ten, 1996, p. iii). In the following years, the IMF simply took stock of its main shareholders' view, and concentrated on making the most out of the existing tools. The main merit of Anne Krueger's speech lays in drawing everybody's attention to the need of reopening the discussion on the 'rules of the game'. It was in some sense a provocation, and a welcome one, for which she deserves full credit.

Krueger lamented that the lack of a sovereign bankruptcy mechanism had two undesirable consequences. First, "it can lead a sovereign with unsustainable debts to delay seeking a restructuring, draining its reserves and leaving the debtor and the majority of its creditors worse off". Second, "it can complicate the process of working out an equitable debt restructuring that returns the country to sustainability" (Krueger 2002, p. 2). Taken together, these two features justified action aimed at "preserving asset value", namely at reducing the immediate cost for the country of approaching its creditors to seek a restructuring. This raised two practical problems, though. By how much should costs be reduced? And how? The original proposal made by Krueger appeared to many (the present writer included) as too intrusive, since it implied giving the IMF the authority to endorse a stay on creditor litigation, so that the sovereign debtor would have automatic protection from disruptive legal action while restructuring negotiation were underway, and also the power to adjudicate dispute at the

end of the process. This expanded role of the IMF appeared inappropriate not only because the institution lacked the necessary competence (a gap that could be filled over time) but, more deeply, because the IMF, as a privileged lender, would have conflicting interests with the creditors it would be expected to rule. As discussions progressed, two further reasons for being more flexible on the matter of the stay emerged. On the one hand, legal experts pointed out that the risk of a ‘grab race’ on the part of dissatisfied creditors in the sovereign debt market appears rather remote. As a matter of fact, litigation is an extremely rare phenomenon in sovereign dealings, and tends to take place, if at all, after a restructuring has been agreed with the majority of creditors. An automatic stay would therefore be in some sense redundant, an unnecessary complication. On the other hand, since the key feature, from the debtor’s standpoint, of a formalized work-out would be its ability to guarantee “debtor-in-possession” financing, and given that the IMF’s lending into arrears policy (LIA) looked like the natural candidate for such financing, it seemed more sensible to find ways to make LIA acceptable to creditors and not too generous for sovereign debtors than unnecessarily depriving creditors of their rights.<sup>8</sup>

As a result of these considerations and of the ongoing dialogue between the IMF, the private sector, the legal community, and policy circles, the original proposal has gradually been modified, becoming on the whole more flexible and at the same time more consensual than originally envisaged. The possibility of a stay on creditor rights has been preserved, but its enactment has been left to creditors themselves to stem free-riding behavior within their ranks. At the same time, the role envisaged for the IMF within the mechanism has been greatly reduced. Under the present scheme, the IMF would be given no new legal power, and it would continue signaling its stance through its willingness to support and provide assistance for a country’s adjustment program. To this end, in the meantime (in September 2002) the Board revisited LIA policy to clarify the “good faith” criterion introduced back in 1999. This review, which aimed at making LIA more palatable to private investors in a context where creditor rights have not been suspended, resulted in the listing of a number of steps

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<sup>8</sup> The problem of protecting LIA from legal dispute is often neglected in public discourse, but it has played an important role in the development of the IMF’s legal thinking on crisis management. That the issue is still unresolved can be gauged by the fact that the program agreed with Argentina in early 2003, which provided a limited cash relief to Argentina interpretable as LIA, was crafted in such a way as not to imply actual disbursements of new money from the IMF.

the debtor country's government should undertake when seeking a restructuring. These guidelines could and should usefully be integrated into the code of good conduct being drafted in relation to CACs, already mentioned above. The new formulation appears to place the SDRM, in terms of the costs it might entail for the debtor, somewhere between a purely voluntary restructuring and outright default, with a desirable incentive structure (Bossone and Sdravovich 2002). Implementation of the scheme, therefore, may well result, as is presently the case in several national contexts, in most restructurings taking place 'in the shadow of the law'. Although there are still several open issues to be settled (among which the possible merits of including into the SDRM bilateral official finance and the structure and functioning of the dispute resolution forum), one can safely argue that much progress has been accomplished in the design of a reasonable and realistic sovereign bankruptcy mechanism. The time may not yet be ripe for its implementation, an issue I will turn to in the next section. But the technical work is almost done, which is *per se* proof of the seriousness with which the IMF and the official community at large has gone about the task.

## 5. What are the main stumbling blocks?

With access policy having been redefined and only awaiting a consistent implementation and the spread of CACs gaining momentum, the main stumbling block on the road to a new crisis resolution framework is the insufficient support the SDRM still enjoys among IMF membership. At the Fall 2002 meeting, the IMFC had requested the IMF staff to develop a “concrete proposal” regarding the SDRM by the Spring meeting of 2003. This the IMF staff duly did, on the basis of intense internal work and external consultations with private sector representatives, legal experts, and national authorities. But the “concrete proposal” was not endorsed by the IMFC at the Spring 2003 Meeting. Rather, the conclusion of the IMFC was that:

“The Committee, while recognizing that it is not feasible now to move forward to establish the SDRM, agrees that work should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises [...].

The IMF will report on progress at the Committee’s next meeting”.

The language chosen in the IMFC’s Communiqué gives little clue as to why establishing the SDRM is at present “not feasible”, but in its report to the Committee, the Managing Director of the IMF is more adamant in this respect:

“Although there is substantial convergence of views within the Executive Board on the key features of the SDRM, differences remain on a number of issues. More fundamentally, however, not all Directors agree on the desirability of a statutory sovereign debt restructuring mechanism”.

It appears from the words of the Managing Director that opposition to the SDRM has more to do with the mechanism *per se* than with any of its specific features. This makes the present stalemate more worrisome than it would otherwise be. But how big is the stumbling block, and what are the chances that the position of the various interested parties might change as time goes on?

From all that has been said in the previous two sections, it should be clear that the stumbling block is a serious one. Even if CACs became standard practice for all new bond issues, there would remain two problems:

retroactivity and aggregation. As regards retroactivity, how are we to make sure that CACs will gradually be extended to all outstanding bonds? Early on in the discussion on the two-track approach, the option of introducing into the legal system of the main financial centres so called meta-clauses was contemplated, but soon discarded on the ground that the move would be too intrusive and possibly difficult to implement. The next-best alternative would appear to be swapping old bonds with new ones featuring CACs. But these swaps would be difficult to organize unless the issuing country already had a debt problem and was willing to approach its creditors for a restructuring. An interesting experiment is going on in this respect in Uruguay. This country has recently launched a swap operation by about \$ 5 bn, which, relying on the use of exit consents, aims at: reducing the debt burden by lengthening the maturity of the relevant bonds; introducing CACs in the new bonds accepted by its creditors. The main obstacle ahead lies in the very high participation rate (90% of principal) required for the operation to go through, which cannot be taken for granted given that exit consents were not originally conceived to alter pecuniary aspects of existing bonds. To increase the chances of success of the operation, the IMF has thrust its weight in support of Uruguay, by making it clear that the conclusion of the swap will be a precondition for a new IMF program. At the time of writing, however, there is yet no indication as to creditors' reactions.

Where, however, the room for experimentation appears rather limited is in the area of aggregation. Even if all bonds (new and outstanding) included CACs, a country seeking a restructuring would have to approach (and await a response from) as many groups of bondholders as there are issues. In the case of Argentina, for example, which has more than 100 different bond issues outstanding, accomplishing this part of the task would already have appeared nightmarish. Aggregation is the one issue over which the SDRM has a clear comparative advantage over the contractual approach (of course, if we are willing to concede that voluntary swaps can take care of the retroactivity problem). Turning to the second question ("might positions change?"), the temptation to blame the present stalemate on political divergences within the official sector, with the Europeans keener on the SDRM and the Americans much cooler, is great, but should be resisted because it would be an oversimplification. The existence of differences on the two shores of the Atlantic cannot be denied, but it does not seem to me to be the key issue. The SDRM is supposed to change the framework within which debtors and creditors interact. It is to them, then,

that one should turn to understand the present resistance to change, and whether such resistance might eventually be overcome.

As regards private creditors, there can be no mistake: they are at present strongly opposed to the SDRM, regardless of their nationality.<sup>9</sup> This is understandable. No one would like to be singled out as the cheapest-cost avoider in any given context. It takes much persuasion, and possibly some hard fact, to show that a short-term cost may be the necessary price on the road to a larger long-run gain. As Bolton (2002) remarks, bankruptcy reform at the national level has always been the subject of political strains and important ideological divisions, and it has often been enacted with very thin majorities, although *ex post* the usefulness of the reform has rapidly established itself. Why should the international discussion prove different? As he puts it (Bolton 2002, p. 13):

“while similar ideological divisions on the necessity and orientation of a statutory sovereign debt restructuring exists today, the day may well come when such a procedure is seen as an essential building block of the international financial architecture”.

Two precedents taken from post-war international financial history indicate that Bolton might indeed be right. People have long forgotten that the Bretton Woods scheme, and in particular the establishment of the International Monetary Fund, were strongly opposed by the two major financial establishments of the time, Wall Street and the City, on the ground that, if implemented, it would fuel moral hazard on the debtor side. In the words of the influential American Bankers Association (1943, pp. 14-15):

“[...] a system of quotas or shares in a pool which gives debtor countries the impression that they have a right to credits up to some amounts is unsound in principle, and raises hopes that cannot be realized. Such a system would encourage the impression that credits received may not have to be liquidated, and would invite abuses of the facilities”.

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<sup>9</sup> As proof of this, it suffices to look at the composite membership of the Institute of International Finance, the most vocal private-sector opponent of the SDRM. Informal outreach initiatives undertaken by the official community have confirmed that opposition to the SDRM within the private sector is not confined to the United States. The lukewarm attitude of the US authorities toward the SDRM is simply a reflection of the greater influence the financial lobby has on Congress in that country, not the result of an absolute preclusion by the current administration. This is also shown by the fact that the debate on the SDRM has been ignited by Ann Krueger, the US national appointed in 2001 to the post of First Deputy Managing Director on the initiative of the Bush Administration.

The American Banker's Association fought strenuously against the Bretton Woods agreement, and was defeated only because the US administration was willing to stage an impressive campaign to convince public opinion that a resumption of growth worldwide and multilateralism would better serve American interests than a narrow defense of the creditor community.<sup>10</sup>

The second example is more recent, and perhaps even more telling. When CACs were first propounded, in combination with LIA and recourse to temporary standstills, in the G10 *Rey Report* (Group of Ten 1996), the reaction of the financial community was incredibly harsh. Even before the publication of the document, the Institute of International Finance (IIF) issued a letter in which the *Report's* recommendations were called "misguided", on the ground that they would run against the principle that contracts are to be honored and would therefore fuel (again!) moral hazard on the debtor's side. Well, some further years of experience and reflection have apparently convinced the IIF that the *Rey Report's* recommendations had some merit after all, since CACs now figure prominently in the organization's list of recommended actions!

All in all, although the views of the various parties in the negotiations should all be respected and factored into the policy agenda, history instructs us not to overemphasize the financial sector's opposition to institutional reform, which is a long-standing feature of capitalist development (Arrighi 1994). Financial firms, like all other parties, act on the basis of the options they perceive. In this light, the true tests of whether an SDRM is desirable, and feasible, will be the costs involved in the resolution of the Argentine crisis and the ability of the

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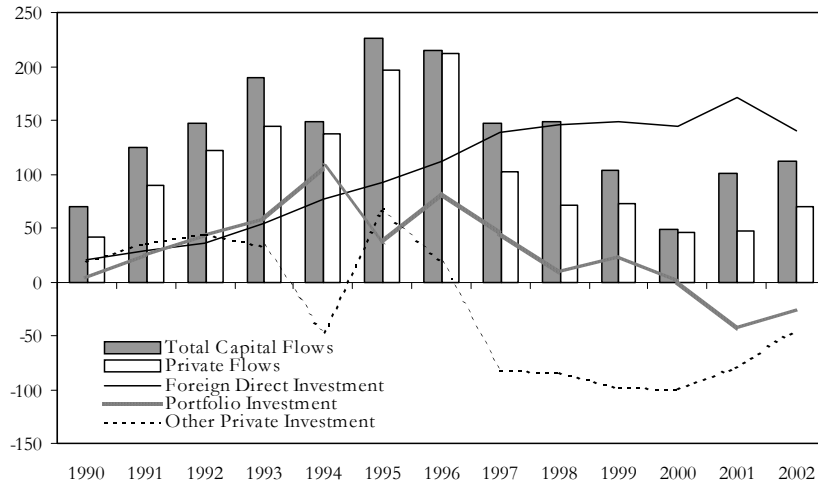
<sup>10</sup> Gardner's (1969) account of the Bretton Woods negotiations still makes illuminating reading.



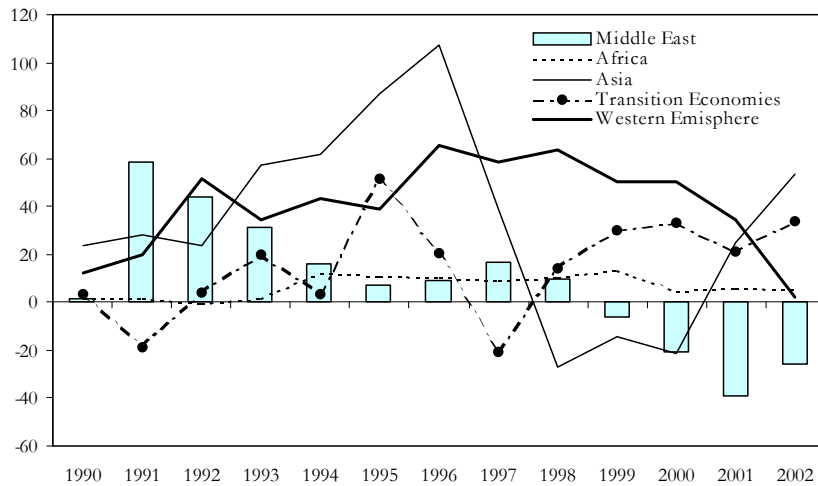
FIGURE 3

NET PRIVATE CAPITAL FLOWS TO EMERGING MARKETS, 1990-2002  
(in billions of US dollars)

A) By type of investment



B) By region



Sources: IMF, *World Economic Outlook* database; Ghosh *et al.* (2002).

IMF Executive Board to stick to its own commitments as regards access policy in future capital-account crises. If these two tests are passed, perceptions in the private sector may rapidly change, as they already have in the past.

It is perhaps more striking that some debtor countries should oppose the SDRM. But here there seems to be some ground for optimism. Many emerging market countries clearly perceive the SDRM as a progress. Misgivings still loom only in some Latin American countries, like Mexico and Brazil. But again this is understandable, since these are the two countries where COF seems to have functioned, namely which managed to stem a crisis without resorting to debt restructuring. Why should they now support a reform that might result in the short run in higher risk premia, or in a reduction of capital flows to emerging markets as a whole? To the concerns of such countries, one might respond in two ways. First, by pointing out that the present level of capital flows to emerging market countries is already pretty low as compared to the early 1990s, and this clearly has nothing to do with the SDRM, which does not yet exist (Figure 3). More likely, it has to do with changes in perceptions as to the availability of official finance to make up for emerging markets' financing gaps, a feature that is bound to stay. Given this, the SDRM can only improve the outlook for emerging markets as a whole. Second, institutional reform can never be tailored to specific needs. If well conceived, it expands the range of options, not the opposite. As I have argued before, and in keeping with repeated official community's statements, COF will remain an option for countries whose external debt burden appears sustainable under alternative scenarios. Mexico and Brazil may well continue to fall in this category in the future. If so, they may voluntarily opt-out from the SDRM, in the sense of committing themselves not to invoke the scheme. Their own not-too-distant past, however, should instruct them to question the wisdom of such an approach.

## 6. Conclusion

I have argued that the main objective of the present effort to revise crisis management practices is to encourage countries to take early action to counter an unsustainable debt path. To do so, creditors must be willing to take a greater share of the immediate burden of a coun-

try's suspension of debt service, on the assumption that they are better cost-avoiders than sovereign debtors. At the end of the process, if the strategy is implemented consistently, there will hopefully be fewer crises, and the resolution costs of those that will break out will be lower. Successful institution-building does not consist in choosing a point along a given trade-off. Rather, it is a conscious attempt to shift the curve so as to improve *global* welfare.

I have also made the point that to look at the SDRM in isolation would be dangerous. More than the specific details of the scheme, what matters is that sovereign bankruptcy proceedings be cast within an overall 'vision' of the role of the IMF. A vision, I would add, which in respect to capital-account crises places less emphasis on the role of lender and more emphasis on the role of certifier of sound economic policies and manager of an agreed code of good conduct. This twofold role of certifier and manager is already in the facts: it needs only be acknowledged and refined, with determination and pragmatism, rising the financial lever more as a means to affect the various parties' incentives than as an end in itself. Recent developments in the area of access policy, CACs and the SDRM are only making it more visible, and cogent. Two steps, however, are of fundamental importance to win sufficient consensus around it among private creditors and sovereign debtors alike. First, access limits will have to be taken seriously. This is a task more for the IMF shareholders than for the IMF management, since the latter has already shown awareness that large-scale packages often create more problems than they solve. Secondly, the IMF must endow itself with the right skills, refraining from relying too much on oversimplified macroeconomic recipes, as has often been the case in the past. An unsustainable debt path is often the result of structural problems. As such, it will require a policy mix that allows for the specifics of time and space. In this regard, one may argue that there is a relation between the role of certifier and the role of manager. The more the IMF as manager of a code of conduct is content with the degree of compliance with the code itself, the more the IMF as certifier will be in a position to exert flexibility as regards the required policy course. It will be for the IMF management to seek the appropriate balance between the two functions.

A notable omission in this paper regards whether and how to amend the IMF's Statute. I frankly believe this issue to be of secondary importance. Not because the task would be extremely complex. After all, we live in a challenging world, so we should not be deterred by a specific challenge, daunting as it might be. But much of value could probably be

achieved through more modest moves, such as marginally changing national legislation in key financial centers, or reviving, if necessary through new interpretations, passages of the IMF Articles of Agreement that have laid dormant or simply unexplored for decades. Legal experts tend to be wary of partial moves, fearing they would not stand the test of an unsympathetic court. But courts, like everybody else in the ‘market’, respond to signals and incentives. The lack of a fully worked-out international legal system need not be seen only as a hindrance. Under certain circumstances, it could also prove a blessing, if sufficient political consensus were to be mustered on the desired innovations. And consensus grows out of persuasion and experience. On both fronts, time is working in favor of the reformers.

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