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Managing International Financial Crises: Alternatives to "Bailouts," Hardships and Contagion

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Summary

Since 1995, a number of measures have been adopted to help *prevent* future international financial crises. Similar progress, however, has not been made in the *management* of such crises. Currently there is no clear alternative to large loans (often called bailouts) by the IMF or letting the debtor country fend for itself (which may lead to severe recession in the debtor country and/or the spread of the crisis to other countries). Two recent proposals — one by Anne Krueger of the IMF and the other by John Taylor of the U.S. Treasury - aim to resolve this dilemma by establishing a more orderly and predictable way to manage financial crises.

Anne Krueger proposes to establish a framework, based on bankruptcy procedures in the United States, to restructure unsustainable sovereign, or country, debt. John Taylor proposes that collective action clauses (which specify the procedure to be followed when a country needs to restructure its debt) be included in debt contracts. The IMF proposal has been described as a more centralized, structured approach, while the Treasury proposal is considered a decentralized, market-oriented approach.

Both proposals are concerned with sovereign country debt owed to private creditors, such as banks or bondholders. Moreover, both proposals involve the private sector in managing crises, would probably reduce the need for large IMF loans in the future. A major difference is how they would be implemented. The IMF proposal would likely require a change in the IMF's Articles of Agreement, while the Treasury proposal might require incentives to encourage lenders and borrowers to use collective action clauses in their debt contracts.

Both proposals are fairly broad and do not specify all the details involved in implementation. The important contribution of these proposals is that they are stimulating a debate about how to better manage international financial crises.

Opinion in the international financial community is divided on support for the two proposals. Some economists favor the IMF proposal, and others the Treasury proposal. The private creditor community discouraged the IMF proposal, but supports collective action clauses along with establishment of a private sector advisory group. Many of the debtor countries oppose collective action clauses, which they believe will cause an increase in interest rates they pay. The major industrial countries support both proposals, but maintain that the Treasury proposal, which is easier to implement, should be acted on first.

More orderly procedures for sovereign debt restructuring are of interest to the Congress because they might reduce the number and severity of international financial crises. This, in turn, might reduce the need for additional funding for the IMF, or for direct U.S. loans (which were given in the Mexican crises of 1995). Moreover, if an amendment to the IMF Articles of Agreement were needed to implement a proposal, the Congress would have to vote on it.

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Managing International Financial Crises: Alternatives to “Bailouts,” Hardships, and Contagion

Introduction

International financial crises have become more numerous and serious since the Mexican peso crises erupted in 1995. The International Monetary Fund (IMF) has responded by supplying funds in larger amounts to debtor countries, resulting in the charge that the IMF bails out banks and bondholders. Currently there is no clear alternative to large loans or letting the debtor country fend for itself (which may lead to severe recession in the debtor country and/or the spread of the crisis to other countries). Two recent proposals — one by Anne Krueger of the IMF and the other by John Taylor of the U.S. Treasury — aim to resolve this dilemma by establishing a more orderly and predictable way to manage financial crises.[1]

The Krueger proposal would establish a framework, based on bankruptcy procedures in the United States, to restructure unsustainable sovereign debt. In the Taylor proposal, collective action clauses, which specify the procedure to be followed when a country needs to restructure its debt, would be included in debt contracts. Both proposals are fairly general and do not specify all the details involved in implementation. However, both proposals are stimulating a debate about how to better manage international financial crises.

The IMF and Treasury proposals are concerned with sovereign or country debt owed to private creditors, such as banks or bondholders. Both proposals seek to deepen the involvement of the private sector in managing the crises. Since low-income developing countries are usually unable to obtain loans from private creditors, the IMF and Treasury proposals would apply mostly to middle-income developing countries.[2]

The goal of the IMF and Treasury proposals is to better manage international financial crises. These proposals are part of continuing discussions on “reforming the architecture of the international financial system” which began shortly after the Mexican crisis of 1994-95 and gathered strength in the wake of the Asian crisis of

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[1] A number of other proposals are summarized in Eichengreen, Barry. *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*. Institute for International Economics. Feb. 1999, pp. 124-132. This CRS report focuses only on the IMF and Treasury proposals since they have received the most attention recently.

[2] Examples of middle income countries are Argentina, Brazil, and Thailand. Examples of low-income countries are Nigeria, Pakistan, and Azerbaijan.

1997-98. Broadly, reform efforts have focused on two aspects of financial crises — prevention and management. Although a number of steps have been taken to prevent future crises (see p. 8), less has been accomplished to better manage crises.

The main purpose of this report is to analyze the issues involved in sovereign debt restructuring and collective action clauses. The report begins with background information on the causes and effects of financial crises, and the IMF response to the crises. The IMF and Treasury proposals are next described and critiqued. The report concludes with an analysis of the two proposals, and their implications for Congress.

Questions posed in this report include: Why is a more orderly procedure needed to restructure unsustainable debt apparently needed? How are the IMF and Treasury proposals similar and how do they differ? What is the role of the IMF in each of the proposals? What are the views of leading economists, private creditors, sovereign borrowers, and the industrial countries on these proposals?

It is important to note that this is an economic, not legal, analysis. Furthermore, it is an overview of the main issues involved in the proposals, not an exhaustive study of all the details and ramifications.

Congress is interested in more orderly procedures for sovereign debt restructuring because they might reduce the number and severity of international financial crises. This, in turn, might reduce the need for additional funding for the IMF, or for direct U.S. loans (as in the Mexican crisis). Moreover, if an amendment to the IMF Articles of Agreement were needed to implement a proposal, the Congress would have to vote on it.

Background

Borrowing countries having trouble servicing their debt are generally extremely reluctant to declare default. A major incentive to avoid default is that creditors may be unwilling to make future loans. Without foreign capital, a country's economic growth rate will be restrained. In some cases borrowing countries put off defaulting until their situation is desperate, which makes the problem much more difficult to deal with.

Borrowing from abroad to finance economic growth has a long history in both the United States and other countries. For example, foreigners in 1900 held $3.1 billion of U.S. railroad bonds.[3] Defaults have occurred many times in history, and the debtor countries have usually been able to borrow again in foreign markets after a period of time has elapsed if creditors perceive them worthy. Despite the fears of borrowers, defaults historically have not had a permanent effect on a country's ability to borrow abroad.

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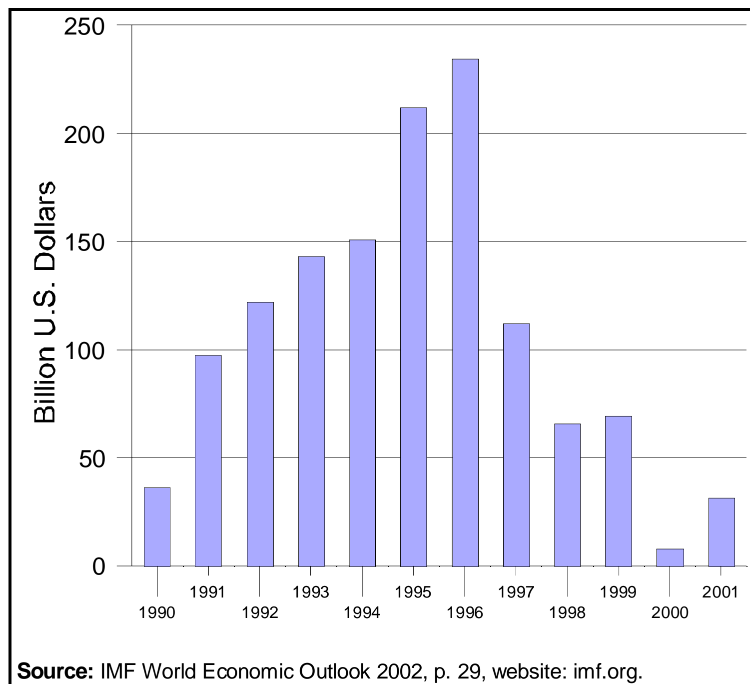
[3] Willis, James F. and Martin L. Primack. *An Economic History of the United States,* 2nd edition. New Jersey, Prentice Hall, 1989, p. 245.

Causes and Effects of Crisis

The important contribution of global private capital flows to economic growth, especially for developing countries, is well recognized. Investment opportunities are often high in developing countries, while domestic investment funds may be scarce. This means that interest rates rise, which attracts foreign funds, and the resulting investment increases productivity, gross domestic product (GDP), and living standards.

Capital inflows, however, can be abruptly reversed when foreign creditors lose confidence in the ability of a debtor country to repay. In recent years, advances in telecommunications and technology have meant that the spread of news is almost instantaneous. Thus, adverse economic or political developments may lead creditors to suddenly "run for the exit."

Figure 1. Net Private Capital Flows to Emerging Markets



Source: IMF World Economic Outlook 2002, p. 29, website: imf.org.

The large growth and volatility of capital flows to developing countries since 1990 are shown in Figure 1 above. Net capital flows to developing countries increased from $36 billion in 1990 to $234 billion in 1996. However, the flows fell abruptly in 1997 to $112 billion, and continued declining until they reached $8 billion in 2000. By the year 2001, net capital flows increased again to $31 billion, about the same as in 1990. Clearly, the Asian crises of 1997-98 and the Brazilian and Russian crises of 1998 had an adverse effect on international capital flows to developing countries.

The causes of financial crises are complex and may differ from country to country. Prevention of future crises requires at least a general understanding of the

causes of past problems. The causes listed below are often interrelated, and more than one factor may have contributed to overborrowing.[4]

- Relaxation of capital controls by emerging market economies in the early 1990s, along with perceived high growth opportunities, led to a surge in capital flows that was perhaps not justified by the risk;
- Weak national banking and financial systems along with poor supervision and inadequate regulation in emerging market economies contributed to lax lending standards;
- Overvalued exchange rates in some countries, such as Mexico and Argentina, led to a deterioration in export competitiveness and a growing current account deficit;[5]
- Poor debt management policies culminated in high short-term debt denominated in foreign currencies relative to central bank holdings of foreign currencies. (For example, before each crisis began, the ratio of short-term debt to reserves was 2.6 in Mexico, and 1.5 or higher in South Korea, Indonesia and Thailand.);[6]
- Lack of adequate information on emerging market economies meant that financial markets could not properly evaluate the true risk of an investment.

The financial crises left the debtor countries cut off from foreign capital flows that were important to their economic growth, at least for a while. The reduction in capital inflows drove up interest rates in the developing countries and slowed their investment. Higher interest rates also threatened the financial health of banks and firms in the debtor country.

As shown in Table 1 below, real GDP declined in all countries experiencing crises (see the shaded cells in the table), leading to unemployment and hardship.

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[4] See also *Safeguarding Prosperity in a Global Financial System; The Future International Architecture*. Report of an Independent Task Force Sponsored by the Council on Foreign Relations. Hills, Carla A. and Peter G. Peterson, Co-Chairs. Published by the Institute for International Economics. 1999, pp. 43-92.

[5] See also CRS Report RS21072, *The Financial Crisis in Argentina*, by (name redacted).

[6] Mishkin, Frederic S. Global Financial Instability: Framework, Events, Issues. *Journal of Economic Perspectives*, Vol. 13, No. 4, Fall 1999, p. 12.

Table 1. Growth Rate of Major Crisis Countries
(Annual Percent Change in Real (Inflation-Adjusted) GDP)

Country	1994	1995	1996	1997	1998	1999	2000	2001
Mexico	4.4	-6.2	5.2	6.8	5.0	3.6	6.6	-0.3
Thailand	9.0	9.2	5.9	-1.4	-10.5	4.4	4.6	1.8
Indonesia	7.5	8.2	8.0	4.5	-13.1	0.8	4.8	3.3
S. Korea	8.3	8.9	6.8	5.0	-6.7	10.9	9.3	3.0
Brazil	5.9	4.2	2.6	3.3	0.2	0.8	4.4	1.5
Russia	-13.5	-4.2	-3.4	0.9	-4.9	5.4	9.0	5.0
Argentina	5.8	-2.8	5.5	8.1	3.8	-3.4	-0.8	-3.7

Source: IMF World Economic Outlook, April 2002, pp. 158, 165-167.

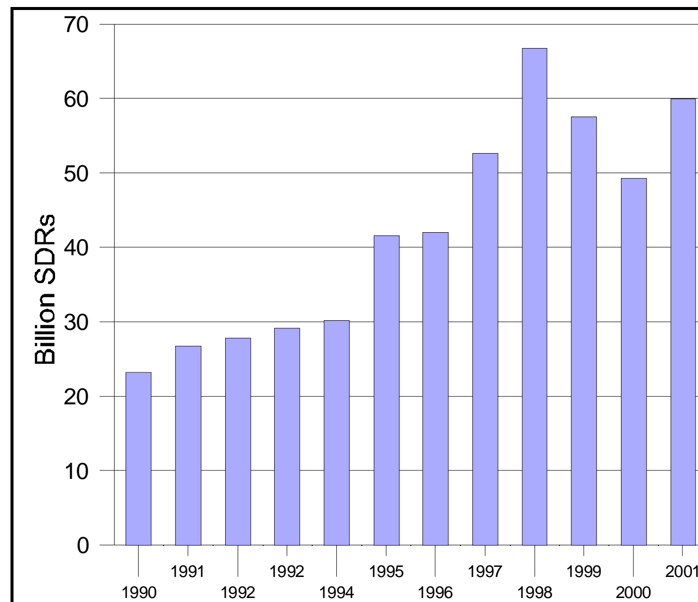
In almost all cases, though, growth resumed the year after the crisis. Mexico's economic activity declined 6% percent in 1995 but grew 5 percent in 1996. In Thailand and Indonesia, where real GDP fell more than 10 percent in 1998, growth resumed the next year. South Korea was able to recover substantially in 1999 after a decline of almost 7 percent in real GDP in 1998. Brazil appeared to avoid a serious recession, and Russia recovered fairly rapidly from the 1998 recession. In Argentina the financial crises began in late 2001, although it was preceded by a recession.

Response of the International Monetary Fund

The immediate response of the IMF was to coordinate a package of loans for each crisis country. In addition to the IMF, other contributors were the multilateral development banks and individual countries. For example, loan commitments to Indonesia totaled $42 billion, of which the IMF share was $11 billion, the World Bank and Asian Development Bank share $10 billion, and the bilateral loan share $21 billion.

A major purpose of the loans was to prevent the crisis from spreading to other countries. Contagion can occur in one of several ways. Investor confidence can be shaken by real or perceived similarities between the crisis country and other countries. For example, if the crisis country's short-term debt is greater than its foreign-currency reserves, investors may withdraw funds from other countries that are in the same situation. Crises can also spread though the trade account of affected countries, especially among major trading partners. If the crisis country imports less, the exports of its trading partners decline, raising their current account deficit. There is considerable debate over the extent to which contagion actually occurs. Nevertheless, officials of governments and multilateral institutions tend to be risk averse, and when a crisis occurs, they are likely to take steps to contain it.

Figure 2. IMF Credit Outstanding Year End



Source: Website: imf.org

Note: The special drawing right (SDR) is an international reserve asset created by the IMF in 1969 which serves as the unit of account of the IMF. Its value is based on a basket of key national currencies and fluctuates over time. At the end of 2001, 1 SDR= $1.26.

The increasing number and size of IMF loans raise the question whether IMF resources are adequate to meet future demands for funds. As a result of the Asian crises, the IMF's lending capacity dropped dramatically. As measured by a liquidity ratio,[7] the lending capacity declined from 104 percent in 1996 to 48 percent in 1998 and to 32 percent in 1999.[8] Since then it has increased and was 115 percent at the end of 2001.

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[7] The liquidity ratio is the ratio of the IMF's net uncommitted resources to its liquid liabilities.

[8] Website: imf.org

Over the past five years, several steps have been taken to increase IMF resources. In 1997, the Supplemental Reserve Facility (SRF) was created to provide additional financial assistance to members facing a sudden capital outflow. In 1998, IMF quotas were increased by $89 billion (of which the U.S. share was $14.5 billion). Also, in 1998, the New Arrangements to Borrow (NAB), a backup source of financing, was established (the U.S. share was $3.5 billion).

IMF Resources

The principal source of funds for the IMF are quota subscriptions. Each IMF member country is assigned a quota (based on its economic size) which determines its maximum financial contribution to the IMF, its voting power, and is the basis for determining access to IMF loans.

In addition, the IMF can borrow under two supplemental credit arrangements. Eleven countries make funds available under the General Arrangements to Borrow (GAB), established in 1962 and renewed periodically. Twenty-five member countries make funds available under the New Arrangements to Borrow (NAB) established in 1998.

Currently, total IMF resources are $307 billion, of which quotas account for $265 billion, the GAB $21 billion and the NAB $21 billion.

Criticisms of the IMF

A major criticism of IMF loans is that they contribute to moral hazard of creditors and debtors. Moral hazard, in the international context, occurs when a creditor takes excessive risks when lending to developing countries because of the likelihood of an IMF "bailout." The lender has come to believe that, in the event of the debtor's inability to pay, the IMF (or another institution or group of countries) will come to the aid of the debtor and the creditor will not lose his investment. In other words, the creditor stands to gain if the investment is successful, but losses will be mitigated if the investment fails. Thus, the creditor may more easily take imprudent risks, since he is not bearing the full cost of the risks. Some argue that the IMF loan to Mexico in 1995 reduced the incentives of creditors to properly evaluate the economic conditions of other countries before making loans, and thus it contributed to the financial crises of countries in the late 1990s.

The debtor countries themselves can also be subject to moral hazard. If they perceive that IMF or other loans will be forthcoming in the event of difficulty servicing their debt, they might borrow more than is justified by their potential economic conditions. Furthermore, debtor countries might be less inclined to pursue responsible economic policies if they rely on the IMF to come to their aid if their economy falters.

To the extent that moral hazard does occur, the perceived availability of "bailouts" leads to making decisions that contribute to crises, and are not in the long-run interest of either the creditor or the debtor. Although moral hazard has been widely discussed, both by academics and the media, there are no actual data to suggest that it plays a large or small role in the behavior of creditors or debtors. Nevertheless, it is important in the debate over the future role of the IMF in making large loans to developing countries.

Another criticism concerns the "conditionality" attached to IMF loans. Typically, when a loan is negotiated, the borrowing country agrees to certain

conditions, which may specify limits on budget deficits or limits on increases in the money supply. Conditions are generally aimed at strengthening the debtor country's economic and financial situation. The IMF maintains that conditionality is necessary to ensure that IMF loans will be repaid. Unlike domestic lenders, the IMF cannot attach the assets of a defaulting borrower.

In the late 1990s, some critics thought that the macroeconomic conditions, especially for countries that did not have huge fiscal deficits, were too severe. It was argued that requirements for tighter budgets and high interest rates worsened the economies of the debtor countries far more than was necessary. Furthermore, some suggested that lower-income people in the debtor country bore most of the brunt of conditionality.

IMF conditionality was also criticized for going beyond macroeconomic and financial conditions to include structural conditions. For example, the conditions in the Indonesian case included elimination of the Clove Marketing Board and changes in the structure of the sugar, flour and cement markets. Some argue that the World Bank is better qualified to suggest structural changes. Others maintain that coordination of structural and stabilization policies is needed, and it may be more effective to put them in the same package.

Finally, the IMF was criticized for not providing the private sector with sufficient information to evaluate the potential risks of investment. Some also argue that the IMF kept information confidential or did not provide reliable information in a timely way.

IMF Reforms to Prevent Future Crises

Preventing financial crises is part of the process of "reforming the international financial architecture." The IMF and other institutions have taken a number of steps in recent years, although implementation and enforcement of some of the measures remain weak. These measures include:[9]

- Improved transparency by providing timely, reliable data and information about countries' policies to the financial markets and the public;
- Developed internationally accepted standards and codes of good practice in areas such as accounting, auditing, and monetary and financial policies;
- Strengthened the financial sector by enhancing assessment of financial systems and addressing gaps in regulatory standards;
- Involved the private sector in the prevention and management of crises by establishing a dialogue with private creditors and

[9] For more information on these reforms, see CRS Report RL30272, *Global Financial Turmoil, the IMF, and the New Financial Architecture*, by (name redacted).

encouraging mechanisms that might facilitate the orderly resolution of crises; and

- Created the Contingent Credit Line (CCL) at the IMF which makes funds available to countries with strong economic policies where problems might arise from international financial contagion.[10] (To date, the CCL has not been used by any country, possibly because of the perception that such use would damage the country's reputation as a responsible borrower).

Managing Financial Crises

Although improved crisis prevention may reduce the number of future crises, many argue that better procedures to manage crises are still needed. At present, there is no clear alternative to loans by the IMF and other lending institutions. This raises the question of moral hazard, on the one hand, and letting the debtor country fend for itself, on the other hand, which poses a hardship on the borrowing country and may allow the crises to spread to other countries. Moreover, as described earlier, IMF resources are not unlimited.

Collective Action Problem and Clauses

The collective action problem is at the heart of the IMF and Treasury proposals for managing financial crises. In fact, the economic rationale for both international bankruptcy procedures and the use of collective action clauses in bond contracts is to deal with the collective action problem. Consequently, it is explained in this section.

Why can't a country facing an unsustainable debt problem simply initiate negotiations with creditors itself? It can, but it runs the risk that a few creditors will immediately withdraw their funds to get their money before the other creditors do (since there is not enough to go around for all creditors). Also, a holdout creditor could initiate a lawsuit in order to get full payment, thereby disrupting the negotiating process.

This is just what happened in the case of Elliot Associates versus Peru.[11] In 1995, Peru announced that, under the Brady Plan, it would restructure loans to two Peruvian banks that had been guaranteed by the government. In 1996, 180 creditors agreed to exchange the old debt for a combination of Brady bonds and cash. Elliot Associates, a firm that specialized in purchasing securities of distressed debtors, bought Peruvian bank bonds at a price significantly below face value. Elliot did not participate in the Brady exchange, but instead filed suit in New York State's

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[10] International Monetary Fund. *Progress in Strengthening the Architecture of the International Financial System, a Factsheet.* July 31, 2000.

[11] For a fuller description of the Elliot Associates versus Peru case, see *Economic Report of the President*. March 2002, p. 296.

Supreme Court seeking payment for the face value. Ultimately, after several rulings and appeals, Peru was close to defaulting on its restructured debt, and chose to settle by paying Elliot $56.3 million. Since the case was not litigated to conclusion, no precedent was established. Thus, there is concern that in future cases, holdout creditors could block a country from restructuring its debt. This case is widely cited as evidence that a more formal process is needed to restructure debt.

Generally, creditors as a whole are better off in a debt restructuring if they cooperate in resolving the debt problem. The assets of the debtor are usually worth more if held together, and creditors gain by negotiating together. At the same time, an individual creditor can gain more by pulling his money out first. Moreover, if one creditor is not sure the others will cooperate, he is likely to "run for the exit" and get his money out safely. If all creditors feel this way, however, a creditor panic ensues.

Bonds issued in the United Kingdom include collective action clauses (CACs). A key provision of such clauses is that changes in the terms of payment of a bond (restructuring) accepted by a substantial or super majority (perhaps 70-75%) of the creditors is binding on all creditors. Bonds issued in the United Kingdom must also have a procedure for appointing a representative of the creditors to negotiate with the debtor. This effectively prevents holdout creditors from blocking a restructuring agreement which benefits the majority of creditors. Holdout creditors cannot sue to block payment under the restructuring agreement. Under U.K. law, bond covenants can prohibit individual creditors from pursuing litigation against the debtor and require that proceeds of litigation be shared equally with all the creditors.

In contrast, collective action clauses are not used in bonds issued in the United States. Changes in the terms of payment of a bond must be approved by all the bondholders. Thus, a restructuring agreement must have unanimous approval, which is generally impossible to obtain. Since much of the emerging market debt is denominated in dollars, the U.S. practice has a large effect on sovereign debt.

Collective action clauses were, however, included in many corporate U.S. bonds until passage of the Trust Indenture Act of 1939 (15 U.S.C. 77ppp.(b)) made them illegal. Section 316(b) of this Act prohibits any change in the principal amount of a corporate bond without the consent of all bondholders. The rationale for ending collective action clauses was to prevent insiders from gaining control of a bond issue and then destroying it for their own benefit.[12] Although the prohibition does not apply to sovereign debt, by tradition sovereign bonds issued in the United States do not include CACs. Presumably this means that CACs could be included in sovereign bonds issued in the United States without a change in U.S. law.

The IMF Proposal for a Sovereign Debt Restructuring Mechanism (SDRM)

On November 26, 2001, Anne Krueger, First Deputy Managing Director of the IMF, proposed consideration of an international bankruptcy procedure for sovereign

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[12] Roe, Mark J. The Voting Prohibition in Bond Workouts. *Yale Law Journal*, December 1987.

debt.[13] The goal is to provide a statutory basis for debtors and creditors to restructure unsustainable debt in an orderly, predictable way. The proposal, called a sovereign debt restructuring mechanism or SDRM, was endorsed by the International Monetary and Financial Committee (IMFC) which represents the interests of the IMF's 184 member countries at the IMF's annual meeting in September 2002. The SDRM is based on and similar in many respects to Chapter 11 of U.S. bankruptcy law. Key principles of the SDRM are:

- *The debtor is given access to working capital while the reorganization plan is being devised. The working capital would have priority over old debt in repayment.* Access to working capital by debtors is important to help preserve the debtor's ability to generate resources to meet its obligation to service debt. Working capital can also mitigate the hardship faced by the debtor. To encourage private creditors to provide such capital, they need to be given priority in repayment so the new loans do not get caught up in the restructuring.

- *The completed reorganization plan is voted on by a qualified majority of the creditors, and is binding on all creditors.* According to Anne Krueger,[14] the use of a qualified majority of creditors to bind a dissenting minority to the terms of the restructuring agreement is the most important element of the SDRM. It prevents free riders from insisting on full payment after an agreement is reached, which is unfair to other creditors and reduces the ability of the debtor to service the restructured debt. Majority voting also speeds up the debt restructuring process.

In the original proposal for an SDRM, the IMF included clauses requiring an automatic stay on litigation during the stand-still on debt-servicing in order to allow the debtor time to formulate a reorganization plan in which all creditors are treated equally.[15] This was considered one of the most important components of the SDRM, protecting the debtor nation as domestic debtors are protected under Chapter 11 rules. It also proved to be the one of the most highly contested issues concerning the SDRM and was eventually removed.[16]

It should be emphasized that the IMF proposal applies only to sovereign or country debt owed to private creditors, including bank loans and bonds. The proposal applies only when the debt burden is clearly unsustainable (when there is

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[13] Krueger, Anne. *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring*. Speech, November 26, 2001. Website: [http://www.imf.org]

[14] *Ibid*., p. 14.

[15] Krueger, Anne O. *A New Approach to Sovereign Debt Restructuring*. International Monetary Fund 2002. 40 pp. Website: [http://www.imf.org]

[16] Blustein, Paul, *IMF Cuts Disputed Clause from Debt Plan*, Washington Post, January 8, 2003, Page E01.

no feasible way the debtor could resolve the crisis unless the value of the debt were reduced).

The rationale given for the IMF proposal is twofold. First, lending to developing countries has increasingly taken the form of bond issues, not commercial bank loans. Emerging market bond issues have grown four times as quickly as syndicated bank loans since 1980.[17] This means that it is now much more difficult to coordinate debt restructuring than in the past because bondholders are far more numerous and diverse than banks. Moreover, bondholders have fewer incentives to cooperate in restructuring and are less likely to have common interests than banks.

Second, as discussed earlier, IMF resources may not be adequate to provide loans if multiple crises occur simultaneously in the future. Unlike domestic central banks, the IMF cannot print money. Its resources are limited to the quotas paid in by its members and the funds it can borrow from the industrial countries through the General Arrangements to Borrow and a wider group of countries in the New Arrangements to Borrow. Furthermore, the widespread moral hazard concern that IMF loans would bail out private creditors puts some limits on the use of IMF resources in a crisis.

The IMF proposal would, according to Dr. Krueger, reduce the cost of restructuring and would encourage debtor countries to restructure sooner than they do now, perhaps avoiding some of the economic dislocations that occur with a disorderly restructuring. Creditors also would benefit since the value of their loans would decline less than in a disorderly restructuring.

The proposal would also encourage sovereign debtors and private creditors to negotiate a restructuring agreement outside of bankruptcy. The threat of using the bankruptcy procedure in case negotiations fail may lead to unofficial bankruptcy workouts which are quicker and less costly. For this to happen, however, a formal bankruptcy procedure needs to be in place.

The role of the IMF in the SDRM is one of the issues to be worked out in future discussions of the proposal. Initially, Anne Krueger proposed that the IMF would approve a debtor country's request for a temporary standstill, and would review the debtor country's policies to ensure that they were appropriate during the standstill. A qualified majority of the creditors would approve the restructuring agreement based on a determination by the IMF that the remaining debt is sustainable.

In the discussions that followed Anne Krueger's November 26, 2001 speech, some objected to the increased power that would be given to the IMF in the proposal. It was argued that IMF "mission creep" would arise from the its role in deciding whether or not a country could impose a standstill and in determining the sustainability of the restructured debt. Moreover, since the IMF itself is a creditor and the member countries of the IMF include both debtors and bilateral official

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[17] Krueger, Anne. *New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking*. Speech, April 1, 2002, p. 4. Website: [http://www.imf.org].

creditors, some are concerned that the IMF would not be impartial in approving a standstill or judging whether restructured debt was sustainable.

Subsequently, a revised SDRM proposal was announced in a speech by Dr. Krueger on April 1, 2002.[18] It differs from the original proposal in two main ways. First, it supports wider use of collective action clauses, but suggests that they alone are not enough. Second, while it retains the general procedures of the SDRM, the role of the IMF is reduced. A qualified majority of creditors would approve the initial standstill and the final restructuring agreement.

At the September IMF meetings, the IMFC requested the IMF to present a concrete proposal for an SDRM at the Spring IMF meetings on April 12, 2002. The most complete and recent proposal, *The Design of the Sovereign Debt Restructuring Mechanism-Further Considerations,* was discussed by the IMF Executive Board in December 2002 and released to January 7, 2003.[19]

Implementation of the IMF proposal could be through an international treaty or by national legislation, which could be circumvented if all countries did not enact appropriate legislation. Anne Krueger proposes using the treaty option to implement the SDRM. The easiest way to establish a treaty would be through an amendment to the IMF's Articles of Agreement, which could provide the legal basis for the SDRM. An amendment would be binding on all IMF members once it is accepted by three-fifths of the members with 85 percent of the total voting power. With more than 17 percent of the voting power, U.S. approval would be necessary. It should be noted that this would only gives the SDRM a statutory basis, it would not by itself give the IMF any additional authority.

One criticism of the IMF proposal is that an SDRM is not needed for several reasons. First, governments already can unilaterally declare a standstill. Second, even though some creditors might initiate lawsuits, it is not easy to attach the assets of sovereign borrowers, which are often in a different jurisdiction. Since creditors are unlikely to sue, it is argued, the stay on legal action is not really necessary. Third, provision of working capital during a restructuring process can be done by the IMF which, for the past several years, has been "lending into arrears" (providing loans to sovereign borrowers who have not yet completed negotiations with private creditors, but who are negotiating in good faith).

Another criticism is that the SDRM could lead to moral hazard for the debtor country. In a corporate bankruptcy procedure, the judge can seize control of a firm's financial affairs and replace its management. In an international bankruptcy procedure, seizing control of a sovereign country or replacing its leaders would not be possible. Thus, a debtor country, knowing that it would be protected by a standstill, might be more likely to declare bankruptcy. The counter argument is that countries avoid bankruptcy primarily because they don't want to be cut off from international financial markets for a period of time. Since countries have more to

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[18] Ibid.

[19] See *The Design of the Sovereign Debt Restructuring Mechanism-Further Considerations*, International Monetary Fund, November 27, 2002, 76 pp. Website: [http://www.imf.org].

lose than gain from filing for bankruptcy, the moral hazard of the SDRM is considered small by some observers.

The U.S. Treasury Proposal for Collective Action Clauses (CACs)

In a speech on April 2, 2000, John B. Taylor, Under Secretary of Treasury for International Affairs, proposed a decentralized market-oriented approach for sovereign debt restructuring.[20] Under this plan, creditors and sovereign borrowers would include clauses in their debt contracts which would describe the procedure to be used when a country decides it has to restructure its debt. Guidelines for the clauses would include the following:

- *A majority action clause*. This clause would allow a super-majority (perhaps 75 percent) of creditors to change the terms of the contract, which is then binding on the minority. In this way, a small minority of creditors could not delay or disrupt a restructuring agreement.

- *A clause describing the process through which debtors and creditors come together to negotiate a restructuring.* This clause would specify how the creditors would be represented and the data that the debtor must provide to the creditors' representative. The creditors' representative would negotiate with the debtor and would have authority to initiate litigation (on instructions of a certain proportion of the creditors).

- *A clause describing how the sovereign country would initiate the restructuring* This clause would allow for a suspension of payments between the time the sovereign requests a restructuring and the time the creditors' representative is chosen. A fixed limit of perhaps 60 days is suggested, and during this time no creditor could initiate litigation.

One criticism of the Treasury proposal is that it might be difficult to get bondholders and debtors to incorporate CACs in bond covenants. Several proposals to include CACs have been made by the G-7 and G-10 countries in the past few years, with very little success.[21] Thus, the Treasury proposal suggests that incentives may be necessary to encourage countries to adopt CACs. One incentive might be to make CACs a prerequisite for a country to have an IMF program. Another might be to lower charges on IMF loans for countries with CACs.

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[20] Taylor, John B. *Sovereign Debt Restructuring: A U.S. Perspective.* Speech, April 2, 2002. Website; treas.gov.

[21] The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. The G-10 countries include, in addition to the G-7 countries, Belgium, the Netherlands, Sweden, and Switzerland (11 countries, but the name G-10 remains unchanged).

Another criticism of the Treasury proposal is that collective action clauses would only be included in new bonds, not existing bonds. Without complete coverage, it is not clear how effective collective action clauses would be. Others maintain that since much debt is short-term, after a few years CACs would be included in most bonds. Also, bondholders and debtors might be given incentives to swap old bonds for new ones that included CACs; however, it is not clear how successful this would be.

Finally, if CAC's are included in loans or bonds on an issue-by-issue basis, as the Treasury proposal suggests, aggregation of different types of debt issued in various jurisdictions may be difficult. The Treasury proposal suggests that any inconsistencies could be handled in an arbitration process for which the contracts could provide.

Analysis of the IMF and Treasury Proposals

The goal of both proposals is to reduce the uncertainty surrounding the debt restructuring process. If the procedure is more predictable, sovereign borrowers will be better able to resolve debt problems in a timely way. Moreover, either proposal, if successfully implemented, would likely reduce the need for large IMF loans, and thus reduce moral hazard. Both proposals address the collective action problem. Generally, the IMF and Treasury proposals are in agreement that something needs to be done, and that the private sector should be involved in debt restructuring, but there is disagreement about how to do it.

The IMF proposal has been described as a more centralized, structured approach, while the Treasury proposal is considered a decentralized, market-oriented approach. Looked at another way, the IMF proposal is statutory, while the Treasury proposal is contractual.

Even though the revised IMF proposal reduces the role of the IMF in the SDRM, it still requires some involvement of the IMF or some other not yet created institution to make decisions along the way. Some institutional involvement would probably also be necessary in the Treasury proposal, especially in establishing incentives for countries and in aggregating claims of different types of debt. Still, the Treasury proposal is clearly more decentralized than the IMF proposal.

The concept of an international bankruptcy court has never been tried. The only precedents are domestic bankruptcy procedures, especially Chapter 11 in U.S. law on which an international bankruptcy court would be modeled. There are a number of differences between a corporate bankruptcy and sovereign bankruptcy procedure, so that the two are not directly comparable. Thus, it is difficult to know in advance what the possibilities and problems might be. In contrast, as discussed earlier, collective action clauses were in use in the United States until 1939. In this respect, then, CACs would involve less risk than the SDRM.

Both proposals are relatively broad and only provide a general outline of how the procedures would work. A number of important issues would need to be worked out. For example, the proposals apply only to sovereign debt. What about debt owed by the private sector to foreign creditors (which was important in the Asian crises)? Could the IMF and Treasury proposals apply to such debt? Should the SDRM and/or CACs be used only for solvency crises, or for both solvency and liquidity crises?

Perhaps the most important issue is the implementation of each proposal. Although it appears that the Treasury proposal would be easier to implement, many obstacles remain. As discussed earlier, getting creditors and debtors to include CACs in new bond covenants could be difficult. The likelihood that an amendment to the IMF's Articles of Agreement is necessary to implement the SDRM is also a major hurdle. It usually takes a long time to get agreement that an amendment is necessary, and the actual amendment process is also lengthy.

Solvency Versus Liquidity Crises

A liquidity crises occurs when a debtor temporarily cannot pay some of his debts, but has good long-term prospects. In a solvency crisis, it is unlikely the debtor will ever be able to pay his debts. The appropriate remedy for a liquidity problem is usually to rollover the debt, or to provide additional funds to tide the debtor over until the temporary problems end. For a solvency situation, however, the discharging of some or all of the debt is the most useful approach. In U.S. domestic law, a firm facing a liquidity crisis would file a Chapter 11 bankruptcy petition, while one facing a solvency crisis would be dissolved under Chapter 7.

In one sense, countries do not become insolvent because, over time, they have important assets in the productivity of their people and in their natural resources. To the extent that countries cannot, however, tax their populations enough to pay their debts, they may be considered insolvent. It should be noted that it may be difficult to know whether a country is illiquid or insolvent in the midst of a financial crisis.

Perspectives of Economists, Private Creditors, Emerging Market Countries and Industrial Countries

Some economists support an international bankruptcy court and others support adding collective action clauses to debt contracts. The views of a few well-known economists are discussed below.

Many of the issues involved in an international bankruptcy court were identified and discussed in proposals made since the late 1970s.[22] A speech by Jeffrey Sachs, Professor of International Trade and Director, Center for International Development at Harvard University, gave new impetus to the concept of an international

[22] See Rogoff, Kenneth and Jeromin Zettelmeyer. *Early Ideas on Sovereign Bankruptcy Reorganization: A Survey.* IMF Working Paper WP/02/57. 18 pp. Website: [http://imf.org].

bankruptcy court based on Chapter 11 of U.S. bankruptcy law.[23] In Dr. Sachs' plan, the IMF would play a central role in resolving both liquidity and solvency crises. V.V. Chari, Professor of Economics at the University of Minnesota, and Patrick J. Kehoe, Professor of Economics at the University of Pennsylvania, in a recent article, also support a bankruptcy court.[24] They argue that it would have been useful to Mexico in 1995, where the country's economy was fundamentally sound but facing a creditor panic, as well as for countries whose debt is unsustainable.

In a study by Barry Eichengreen, Professor of Economics and Political Science at the University of California, Berkeley, and Richard Portes, Professor of Economics at the London Business School, and Director of the Center for Economic Policy Research, the authors suggested, among other things, that "loan contracts and bond covenants should specify that a majority of creditors be entitled to alter the terms of the debt agreement...."[25] More recent studies by Eichengreen have continued to support the use of collective action clauses.[26] Peter Kenen, Professor of Economics and International Finance at Princeton University, advocates the inclusion of collective action clauses in all of the countries' debt contracts, both public and private.[27] In addition, Professor Kenen suggests that all such debt contracts should include a 90-day rollover option, which each debtor country would be required to utilize if its government found that the country was in a financial emergency. This would eliminate the possibility of litigation because the creditors would already have agreed to the rollover option.

A majority of private creditors discouraged the use of the SDRM after it was announced in November 2001. Some of the concerns of the Institute for International Finance (IIF), a global association of financial institutions, were that an international bankruptcy court could inhibit investor confidence, delay renewed access of debtor countries to capital markets that use the SDRM, and might lead to contagion of other emerging markets.[28] According to the IIF, the SDRM also might encourage moral hazard by sovereign borrowers who believe they would be protected by a standstill if payment problems arose.

Instead, the IIF, in an action plan announced in April 2002, recommended a three-pronged approach, which includes, but is not limited to, collective action

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[23] Sachs Jeffrey. *Do We Need an International Lender of Last Resort.* Frank D. Graham Lecture, Princeton University, April 20, 1995. 26 pp.

[24] Chari, V. V. and Patrick J. Kehoe. Asking the Right Questions About the IMF. *Federal Reserve Bank of Minneapolis*, 1998 Annual Report Special Issue. pp. 1-21.

[25] Eichengreen, Barry and Richard Portes. *Crisis, What Crisis? Orderly Workouts for Sovereign Debtors,"* Center for Economic Policy Research, London, 1995, p. 56.

[26] See, for example, Eichengreen, Barry. *Toward a New International Financial Architecture: A Practical Post-Asia Agenda.* Institute for International Economics, p. 15.

[27] Kenen, Peter B. *New Strategies for Dealing with Debt Crisis in Emerging Market Countries.* January 31, 2002.

[28] *Action Plan of the IIF Special Committee on Crisis Prevention and Resolution in Emerging Markets*, April 2002, p. 36. Website: [http://iif.com].

clauses.[29] The IIF plan involves establishing a Private Sector Advisory Group to sustain investor confidence and facilitate orderly debt restructuring, developing a number of market incentives (including collective action clauses), and designing a legal strategy to address disruptive litigation by holdout creditors.

Many emerging market countries are reluctant to include CACs in bond covenants. One argument is that borrowing countries are being singled out and that the wealthier developed countries should lead the way by using CACs. In fact, Canada did include clauses in its foreign currency debt beginning two years ago.[30] Only two countries — the United Kingdom and Canada - to date do so.

Borrowing countries also maintain that the inclusion of CACs would suggest to creditors that they may have difficulty repaying their loans. As a result, creditors would only loan to them at a higher interest rate than borrowers who did not include CACs in the contracts. However, one recent study compared interest rates on bonds issued in the United States (where CACs are not used) to the United Kingdom (where CACs are used). It found that, for the most credit-worthy borrowers, CACs lead to lower interest rates, while less credit-worthy borrowers find their interest rates higher than without CACs.[31] Although the less credit-worthy countries would be dissatisfied with higher interest rates, from the perspective of avoiding financial crises, such a distinction might be beneficial. Higher interest rates might discourage lending to countries whose economies are less than healthy and whose payment prospects are uncertain.

The finance ministers and central bank governors of the G-7 countries have, in statements issued over the past several years, supported the use of collective action clauses in bond covenants in order to better manage international financial crises. On April 20, 2002, the G-7 countries announced an Action Plan in which they support both the Treasury and IMF proposals for debt resolution, stating that the two proposals complement each other. The G-7 countries focus more on the Treasury plan, however, in the short run, since the IMF plan will take more time to work out.

More specifically, the G-7 Action Plan supports a market-oriented approach of incorporating contingency clauses in debt contracts (the Treasury plan) which would describe what happens in the event of a sovereign debt restructuring. They suggest that clauses should include super-majority decision-making by creditors, the process by which a restructuring would be initiated (including a standstill) and a description of how creditors would engage with borrowers. The Action Plan, however, also supports further work by the IMF on proposed approaches to sovereign debt restructuring (the IMF plan) that may require new international treaties, changes in national legislation, or amendments of the IMF's Articles of Agreement. Since this

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[29] *Ibid*.

[30] Martin, Paul. There's a Better Way. *The Globe and Mail*, May 8, 2002, Website: [http://www.globeandmail.ca].

[31] Eichengreen, Barry and Ashoka Mody. *Would Collective Action Clauses Raise Borrowing Costs?* Website: elsa.berkeley.edu, p. 4.

work is expected to take longer, in the immediate future the contingency clause approach should be pursued expeditiously, according to the G-7 statement.

Two other provisions of the G-7 Action Plan are also significant. In crisis prevention, the G-7 countries will work with the IMF to improve the quality, transparency and predictability of official decision-making. Regarding future IMF loans, the G-7 countries want to limit lending to normal access levels (usually 100 percent of each member state's quota) except in emergencies.

Implications for Congress

If the IMF and/or Treasury proposal were effectively implemented, it might reduce the need for crisis lending by the IMF and G-7 countries, which has been substantial at times. For example, the United States contributed $12 billion to the rescue package for Mexico in 1995, and contributed contingent financing of $3 billion to Indonesia and South Korea in 1997 and $5 billion to Brazil in 1999. Mexico repaid the loans, usually ahead of schedule, and none of the contingent funds was drawn on. Increases in IMF quotas, which require a vote by the U.S. Congress, might also be less likely.

Under the IMF proposal, it is likely the IMF's Articles of Agreement would need to be amended. As mentioned earlier, the United States, with more than 17 percent of the voting power in the IMF, would need to approve the amendment. To approve an amendment, the Congress would have to amend the Bretton Woods Agreement Act of 1944, which would require approval by a majority of both houses of Congress (in contrast to a treaty which requires a two-thirds vote of the Senate). The entire process of amending the IMF Articles of Agreement could be quite lengthy, contentious, and politically difficult, both among countries and within the United States.

It appears that no U.S. legislative action may be necessary for sovereign debtors to issue bonds in the United States that include collective action clauses.

Conclusion

Neither the IMF nor the Treasury plan provides a quick or easy solution to the management of international financial crises, primarily because of the difficulties in getting agreement among and within countries over the most appropriate plan, working out the details of the plan, and beginning to implement it. Still, the proposals do offer guidelines for dealing with crises that, in combination with measures such as strengthening the economies of the emerging market countries, might prove beneficial. Perhaps the main contribution of these proposals is to stimulate debate and discussion on an important issue.

In some ways the two proposals are more similar than different. Both address the collective action problem and involve the private sector in debt resolution. In

fact, it could be argued that the two proposals are complementary.[32] Anne Krueger suggests that a bankruptcy procedure could be used for solvency crises, and collective action clauses for liquidity crises. The major difference is in the way each would be implemented. The IMF plan would likely need to amend the Articles of Agreement to achieve a statutory basis for the sovereign debt restructuring mechanism while the Treasury plan would need to amend contracts.

Moreover, the two plans are not mutually exclusive. The current administration and the G-7 have yet to endorse either a purely SDRM or CACs approach and are urging the IMF and the private sector community to pursue research on both proposals as well as looking at a two-track approach utilizing both strategies.

The two proposals are part of a broad effort to reform the architecture of the international financial system. There is much agreement on the importance of preventing and managing international financial crises, involving the private sector in debt resolution, and avoiding large loans by the IMF to debtor countries. Although there has been considerable progress on crisis prevention, no major measures to manage crises have been adopted to date. Each of the two proposals discussed in this report aim to do that. If successfully implemented, either one of them would involve the private sector in debt restructuring and would likely reduce the need for IMF loans to emerging market borrowers.

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[32] See Miller, Marcus. *Sovereign Debt Restructuring: New Articles, New Contracts — or No Change?* International Economics Policy Briefs. Institute for International Economics. April 2002. 12 pp. Website: [http://www.iie.org].

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