

The International Financial Architecture: Official Proposals on Crisis Resolution and the Role of the Private Sector

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The absence of a clear framework for the resolution of international financial crises introduces many risks and raises legal uncertainties about how to deal with sovereign financial crises. While a fairly broad consensus exists on how to prevent financial crises, namely by strengthening macroeconomic policies and improving financial supervision and regulation, views on how to manage and resolve sovereign debt crises are rather diverse. At the International Monetary Fund's (IMF) annual meeting in Prague in the year 2000, the international community tried to address this issue by advocating the Private Sector Involvement (PSI) initiative.

PSI, however, never amounted to more than public statements that lack in substance. Consequently, this led to widespread dissatisfaction among the main participants of the international financial architecture. Debtor countries grew more discontented with the governance of the international financial system, and the private sector started to accuse the IMF of increasing the time inconsistency of its policies.

Finally, in November 2001, the Deputy Managing Director of the IMF, Anne Krueger, proposed a legal framework for the resolution of sovereign insolvency crises, a Sovereign Debt Restructuring Mechanism (SDRM). This mechanism would have rendered PSI more operational, in addition to addressing many market failures of today's international financial architecture. This paper addresses some of the key issues related to the international financial architecture and the resolution of sovereign debt crises. It is important to note that while support for an SDRM has waned for the time being, its discussion has nevertheless been beneficial and has produced several tangible results.

I Introduction

The absence of a clear framework for the resolution of international financial crises introduces many risks and raises legal uncertainties about how to deal with sovereign financial crises. At the IMF's annual meeting in Prague in the year 2000, the international community tried to address this issue primarily by advocating the PSI initiative.¹

The PSI initiative encapsulates the official sector's attempt to engage the private sector in crisis resolution more effectively.² It has three main objectives. First, PSI relates to the financing function the private sector has for capital-scarce emerging markets, in particular given the limited amount of official resources available for development. Second, the PSI initiative is meant to convince the private sector not to panic in the event of a sovereign's payment difficulties. An escalation might cause private sector

investors to retreat from emerging markets, which could amplify the crisis and, in addition, spark contagion. Third, PSI is the official sector's attempt to encourage the private sector to assume responsibility for its investment decisions. This is grounded in the official sector's conviction that a collectivization of private sector losses would distort the allocative efficiency of capital markets and would lead to moral hazard via increased risk taking.

PSI, however, never amounted to more than public statements that lacked in substance. Consequently, this led to widespread dissatisfaction in the international community. Debtor countries grew more discontented with the governance of the international financial system, and the private sector started to accuse the IMF of increasing the time inconsistency of its policies, which may have contributed to abrupt reversals of capital flows to and from emerging markets.

¹ On the concept of PSI, see in particular IMF (1999).

² The starting point for crisis resolution should be crisis prevention, which will, however, not be covered in this paper owing to space constraints. There are several excellent papers on this topic; see e.g. Fischer (2002).

Finally, in November 2001, the Deputy Managing Director of the IMF, Anne Krueger, proposed a legal framework for the resolution of sovereign insolvency crises, a Sovereign Debt Restructuring Mechanism. This mechanism would have rendered PSI more operational, addressing many market failures of today's international financial architecture.

This paper explores the main problems and initiatives in the context of sovereign debt crisis resolution. Section 2 describes the IMF's SDRM proposal in the context of PSI and the reasons why it failed to be supported by some of the main actors involved. Section 3 deals with the rationale for bankruptcy procedures and the increasing incidence of sovereign default. This is followed in section 4 by a closer look at the incentives for a more orderly sovereign debt restructuring process and the main market failures such a mechanism has to address. Section 5 briefly discusses the state of play and outcomes of the SDRM debate, and section 6 concludes.

2 How to Involve the Private Sector in Crisis Resolution

Many of the perceived shortcomings of today's international financial system are traceable to the shift in governance from an administered government-led system to a decentralized market-based system (Padoa-Schioppa and Saccomani, 1994). The latter purportedly offers an opportunity for greater efficiency and resilience, whereas the former is deemed as being too costly for national economies and too threatening to the stability of the international financial system. However, the current international financial architecture shows signs of a

discrepancy between the "old" model of bilateral or IMF crisis lending and the "new," yet imprecise, model aiming at transferring more responsibility to negotiations between creditors and borrowers, which has resulted in messy, difficult and uncertain crisis resolution (Kahler, 2000).

An attempt to bridge this gap was the Private Sector Involvement initiative. Instead of bridging the gap, the PSI initiative, however, quickly exposed a gap between the official position of no bailouts and the continued actual practice of bailouts. The official community never stated whether PSI was supposed to be voluntary or coercive and what a coercion mechanism would encompass. As Eichengreen et al. (2003) observed "(it was) a strategy built on statements of intent that (did) not change the underlying pay-offs (and thus) was not taken at face value. Because it was not credible, it will not change the strategies of market participants. Therefore, it will not change the results of their interaction with the multilaterals and the debtor."

While this strategy has seen countries, such as Mexico and South Korea, return to sustained growth with independent access to private sector finance, it has also resulted in a number of cases of extended reliance on international – usually IMF – support, e.g. in Indonesia, the Philippines, Turkey and Brazil.

PSI imposes a number of costs on the international financial system, with the great ambiguity that attends crisis resolution the most important factor. The various participants' roles and responsibilities are largely undefined, as are the debtor's chances of receiving any official money and the amount of money that might be forthcoming. Such uncertainty undermines

confidence during a crisis and makes it virtually impossible for creditors to price the risk of sovereign debt prior to a collapse. The prospects for cooperative behavior are severely reduced by uncertainty, and creditors have a natural inclination to rush to the exits at the first signs of trouble.

The prospect of receiving an uncertain, but potentially large amount of official lending discourages appropriate pricing of risk on the part of the creditors. In addition, it may encourage both creditors and debtors in pursuing profit-maximizing and/or rent-seeking tactics, which are unhelpful in an overall context since both parties have an incentive to postpone meaningful negotiations until they have extracted as much money as possible from the IMF or bilateral donors. Experience, such as from Argentina, suggests that serious negotiations do not start until the official channel has been exhausted. Bailouts may encourage debtors and creditors to exercise less caution in their borrowing and lending activities. However, the degree of such behavioral biases is probably overrated.³ Nevertheless, the trend towards ever-larger IMF packages may increase the odds of a serious moral hazard problem in the future.

The situation the official sector faces is similar to the lender-of-last-resort problem. Distinguishing between solvency and liquidity problems is difficult, and there has been a tendency to err on the side of optimism. Officials responsible for overseeing

crisis resolution efforts tend to have been involved in previous programs for the same country and may be reluctant to admit past errors. Although extending additional money is likely to lead to much larger problems in the future because of a potential negative signaling effect for other debtor countries, officials typically are preoccupied with the crisis at hand and are therefore unwilling to let the future take care of itself. Having recognized the danger of this time inconsistency, many domestic regulators enacted legislation to stiffen their resolve and to limit their ability to extend exceptional access to distressed commercial banks. No such disciplinary mechanism exists for the international community.

The framework for crisis resolution can only be successfully implemented if access to official financing is constrained by clear rules and underpinned by transparent decision-making criteria and procedures. Firm limits signal to the private sector and debtor countries that they cannot rely on open-ended assistance from the official sector. In September 2002, the IMF agreed on a set of principles to constrain its discretion in granting exceptional access to its resources.⁴ And while since 1994 over 90% of IMF arrangements fell within the normal access limits of 100% of the country's quota annually and 300% cumulatively by end-October 2003, 85% of the IMF's exposure was concentrated on five countries (Turkey, Brazil, Argentina, Indonesia

³ On moral hazard, see e.g. Dell'Arricia et al. (2002) or Kamin (2002).

⁴ The criteria for exceptional access encompass inter alia exceptional balance of payments difficulties resulting from financial account pressures that can only be relieved by Fund assistance above the normal limits; a high probability that the country's debt will remain sustainable; the member country has good prospects of regaining market access so that in the end the Fund's assistance would amount to a bridge loan; the country's policy program has a reasonably strong likelihood of succeeding, i.e. the administrative capacity and political will to implement an IMF program.

and Russia) that had received exceptional access.

Many tools needed for an orderly restructuring of sovereign debt crises were developed in the wake of the PSI debate, but the initiatives lacked an overarching edifice. In November 2001, Anne Krueger proposed establishing a legal framework, i.e. an SDRM, for the resolution of sovereign liquidity and insolvency crises. This framework was meant to limit creditors' ability to go to court against a sovereign debtor with an unsustainable external debt burden that is actively negotiating or implementing an IMF-supported program.

Many of these ideas had already been expressed in earlier proposals, e.g. by Jeffrey Sachs (1995). The international bankruptcy proposal initially made by Krueger was directed at countries with unsustainable debt burdens and was designed to promote orderly restructuring. The principal objective of the proposal was to induce sovereign debtors and their creditors to voluntarily negotiate the terms of the restructuring of an unsustainable debt position in cases where no voluntary agreement exists.

The SDRM proposal envisaged that a country with an unsustainable debt burden may obtain a temporary stay of litigation by its creditors if the IMF agrees (1) that its debt is unsustainable, (2) that the country has or is negotiating a program with the IMF, and (3) the country promises to negotiate in good faith with its creditors. The IMF could extend the stay, provided the program remained on track and the country continued to negotiate in good faith with its creditors. A restructuring agreement approved by a majority of creditors would bind

all creditors once the IMF has approved it as being compatible with debt sustainability. The verification of claims, and of the majority required to bind all creditors, would be entrusted to a new quasi-judicial body that would be independent of the IMF. The legal basis of this approach would be statutory following an amendment of the IMF's Articles of Agreement.

This proposal would have contributed to making the PSI framework more operational. However, the SDRM proposal was subject to widespread criticism and, on the whole, received only lukewarm official support. Criticism largely focused on the IMF's role within the SDRM framework. NGOs, which had been demanding a fair and transparent arbitration process ever since Kunibert Raffer (1990 and 2002) espoused the idea of Chapter 9 proceedings for sovereigns,⁵ dismissed Krueger's proposal for excluding civil society and giving too much discretionary power to creditors.

The private sector held that the envisaged process would curtail contractual rights and would thus lead to a drying up of capital flows to emerging market countries, a fear echoed by developing countries. In addition, the private sector was reluctant to have the IMF play such a dominant role in the administration of the process in the light of the strong political pressures that it is sometimes subject to and the inherent biases that might arise from prior engagement with a given country. Furthermore, national governments would be hard-pressed to cede the legislative powers necessary to make the new system operable.

⁵ U.S. bankruptcy procedures for municipalities are based on Chapter 9.

Officials in the U.S. supported the proposal at first, although they also argued in favor of exploring alternative and more market-based solutions. Only European states welcomed the proposal with greater enthusiasm and saw it as a possible complement to the international financial architecture.

Subsequently, the IMF sought to address the criticism by offering an “SDRM light,” which would have placed all the key decisions in the hands of the indebted country and a majority of its creditors. While the statutory basis for this approach would still have been created by amending the IMF’s Articles of Agreement, the IMF would not have been given the power to limit the enforcement of creditors’ rights. That decision would have been based on a process like the one found in existing collective action clauses (CACs) in sovereign bonds, but would have ensured coordination and aggregation among the holders of various bond issues and debt instruments. The vote of a majority of all creditors, and not the vote of a majority of the holders of a given instrument, would have been binding. There would still have been a need for a quasi-judicial body to verify creditors’ claims and the majority needed to activate a stay or approve a debt restructuring.

These substantial modifications notwithstanding, the IMF failed to garner sufficient international official support, and by the end of 2002, it softened its proposals further and moved more and more towards a contractual approach (IMF, 2002c). The most serious shortcomings of the subsequent proposals included the exclusion of the automatic stay on creditor litigation, the absence of an authoritative independent assessment of the

sustainability of the debt, the lack of comprehensiveness and the aggregation problem.

Nevertheless a few marginal improvements over the contractual approach would have been achieved, such as an application to existing debt contracts, which would have overcome the stock problem under the contractual approach, the aggregation of debt across different instruments and the establishment of a certain seniority structure of claims for fresh funds. Lastly, if the SDRM had been established via an amendment of the Articles of Agreement, the IMF’s preferred creditor status would have been put on an explicit legal basis.

Ideally, an SDRM restructuring agreement would be reached without formal defaults or in the shadow cast by the law, and thus without an interruption of payments. An SDRM should facilitate such pre-crisis and pre-default agreements as much as possible. Under such circumstances a stay of litigation would be superfluous since there would be no reason at all to litigate. However, if a country that activates the SDRM cannot avoid payment interruption, it should be protected from litigation during the SDRM procedure.

3 Sovereign Defaults – The Rationale for Bankruptcy Procedures

An orderly process for dealing with insolvency is an essential institution in a well-functioning market economy. Well-designed bankruptcy procedures enhance market discipline, protect creditors’ claims and ensure a fair and predictable treatment of creditors. This requires, inter alia, that insolvency procedures be transparent. In all jurisdictions, the administration of bankruptcy procedures is largely

the responsibility of public authorities, particularly the courts or court-appointed administrators or liquidators. This notwithstanding, creditors themselves may have important collective decision-making powers under bankruptcy provisions.⁶

Both the IMF and the private sector insist that property rights need to be safeguarded to increase the attractiveness of an economy for foreign direct investment. Countries should therefore adopt adequate bankruptcy and foreclosure procedures. With orderly insolvency procedures being a necessary institution of a market economy, an orderly mechanism for restructuring sovereign debts – both external and domestic – should be an essential component of a well-functioning international financial system.

The concept of sovereignty dilutes the corporate bankruptcy analogy, though. Creditor rights against sovereigns are very limited as the assets of sovereigns generally enjoy immunity from attachment unless it is specifically waived. Organizing an orderly debt restructuring mechanism would clearly enhance the protection of creditor interests. For this reason, the determination with which mainly the private sector continues to oppose any kind of statutory SDRM is quite puzzling.

Creditors' attitude points to a moral hazard connection. In other words, creditors seem to believe that in the absence of an SDRM their claims will be better protected on the assumption that they will be bailed out by the IMF and other public lenders. This is why strict lending limits for the IMF would be a welcome means to reduce creditors' propensity to reject a restructuring proposal.

Similar to corporate bankruptcy procedures, an SDRM would promote efficiency by overcoming the collective action problem that arises when multiple creditors confront an insolvent debtor. A bankruptcy procedure would help curtail a creditor "grab race" that can undermine the value of an insolvent debtor's assets. An SDRM would promote equity by offering debtors a fresh start by discharging debt, which frees debtors from future collection efforts. It also leaves debtors with some exempt assets and with a future income stream to meet certain obligations and to safeguard future debt-servicing capabilities.

One of the main objections to a sovereign insolvency procedure is said to be the lack of real collateral and the fact that countries do not have an intrinsic value. Therefore market participants hold that defaults need to be bad and ugly so that debtors are deterred from defaulting or postpone a default as long as possible and thus play gambles for resurrection. The paradox is that what is bad for a country *ex post* is considered good beforehand since it potentially increases the supply of credit. Many emerging market countries then have argued that, given this scenario, an SDRM may frighten creditors, lead to a decrease in private capital flows to emerging markets and precipitate crises which would not have occurred otherwise.

The difficulty lies in designing an incentive mechanism which creates *ex ante* economic efficiency for debtors and creditors alike. If the law is too hard, it can deter investment because the probability of failure is too high. If it is too soft, lenders will charge an enormous markup since it

⁶ For a discussion of different national bankruptcy procedures, see *e.g.* Bolton (2003).

is unlikely that they will be repaid in full in the case of default.

Credit rating agencies generally define “default as the failure to meet a principal or interest payment on the due date (or within the specified grace period) contained in the original terms of the debt issue” (Beers and Chambers, 2003). Given this fairly narrow definition, 26 sovereign issuers were in default on various financial instruments in the third quarter of 2003 with a total value of approximately USD 126 billion.

Standard & Poor’s observes that financial distress is a fundamental precondition for rescheduling both official and commercial debt and that local political and economic conditions remain the most important factors affecting the willingness and ability of governments to service debt. In the event of default, it is the capacity of governments to negotiate with creditors, rather than the framework under which negotiations occur, that remains key to the time it takes to resolve defaults.

One way of assessing whether a country is insolvent is by analyzing the sustainability of its debts.⁷ Such analysis has become a major activity of both the official and the private sector. Its purpose is to detect situations in which countries might become unable to pay off their foreign obligations at their face values. Yet, as Eichen-

green (2002) has observed, the assessment of debt sustainability is more art than pure science. In reality, it is hard to forecast future national output, interest rates and in particular a country’s willingness to devote a significant share of its output to repaying foreign debt (Edwards, 2001). From a current account perspective, an economy’s resource transfers to foreigners must be equal to the value of the economy’s initial debt to them. Thus, the intertemporal constraint holds, if – and only if – a country pays off any initial foreign debt through sufficiently large future surpluses in its current account.

Countries borrow to smooth their intertemporal consumption (Obstfeld and Rogoff, 1999). Very simply put, low-income countries generate too little domestic saving to take advantage of profitable investment opportunities, and so they must borrow abroad. Capital-rich countries have more limited profitable investment opportunities but relatively high savings. Savers in developed countries can thus earn higher rates of return by financing investments in developing countries. Consequently, world welfare will be enhanced when capital flows from capital-abundant to capital-poor countries. There will be additional welfare effects if countries can use the current account and capital flows to stabilize their economies when faced with a negative shock.⁸

⁷ *Ideally, the first step in activating a sovereign insolvency procedure would be a judgment by some independent body that a country’s debt is unsustainable. Given its mandate to protect the stability of the international financial system, its near-universal surveillance and its financial role, the IMF seems an obvious first choice. That the IMF is itself a creditor should not affect its judgment since its own claims will remain immune to debt restructuring owing to its preferred creditor status. So far, the IMF’s privileged creditor status is justified by its willingness to provide cheap new money when private creditors refuse to do so. The IMF’s claims will therefore remain exempt from restructuring. So should any new money claims that private creditors provide after activation of the SDRM.*

⁸ *A dissenting view states that due to governance problems in emerging market economies, the marginal productivity of capital is so depressed in such countries that an international capital transfer would be inefficient. For ways to overcome the original sin problem via, say, GDP-indexed bonds, see Borensztein and Mauro (2002).*

Yet, many countries cannot borrow in their own currencies, i.e. they face what is referred to as the original sin problem.⁹ Then, shocks to the real exchange rate can increase the difficulties a country has in servicing its debt. This, in turn, leads foreigners to restrict their lending.

Persistent current account imbalances are viewed as a portent of future borrowing problems. Most recent crises originated in the financial account, though. Therefore the focus has shifted from assessing only potential current account problems to the composition of their financing and thus to vulnerabilities that may originate in the financial account.

The debt crisis of the 1980s and the losses incurred by banks can be seen as a reason for the shift from medium-term syndicated lending towards shorter-term interbank lending and equity financing. Generally, the change in emerging market financing is positive for sovereigns owing to an increase in the investor base. Investors, in turn, can diversify risk better. However, emerging markets face a greater challenge when public and private borrowing is largely in foreign currency. After all, they not only have to accommodate the domestic fiscal balance but also satisfy an external constraint. By extension, future hard currency debt service will have to be paid with net export receipts. Otherwise countries would be able to run external Ponzi schemes that would depend on ever-growing future capital inflows for coping with pre-existing hard currency debt service. Eventually, though, exports must grow rela-

tive to imports for such countries to be able to clear those debts.

An added difficulty is that the switch from loans to bonds boosted the number of contracts. With bank loans, usually only a small number of banks are involved. Bonds, by contrast, are held directly or indirectly by thousands of retail and institutional investors, which naturally multiplies the communication challenges in case of restructuring. In the light of this, herding behavior coupled with negative externalities can cause fire sales, making PSI more difficult.

While sovereign default appears to be a pervasive problem,¹⁰ markets still lend to countries that have defaulted or share characteristics of weak fiscal structures and weak financial systems.¹¹ This may be traceable to irrational exuberance, costly information acquisition by investors and initially positive feedback from investors' herding behavior, the procyclical nature of capital markets¹² as well as a constant search for yield. Governments may lack the institutional capacity to monitor the amount of inflows and the risks involved when confronted with a sudden reversal of funds. Multilateral institutions may lack the leverage to warn emerging markets of the downside risks of "hot money" flows. Bulow and Rogoff (1990) already called for legal and institutional modifications to change the composition of capital flows from debt towards foreign direct investment and other forms of equity. An SDRM would probably constitute such an institutional change. It could have the positive effect of reducing

⁹ For a recent review of the original sin problem, see Eichengreen et al. (2003).

¹⁰ For an overview, see Beers and Chambers (2003).

¹¹ Such countries are dubbed "debt-intolerant economies." For a discussion, see Reinhart et al. (2003).

¹² For a review of the procyclicality of capital flows, see e.g. Kaminsky et al. (2003).

the incidence of overborrowing and debtor moral hazard, maybe changing the nature of capital flows at the expense of output losses, though.

4 The Rationale for an SDRM: Incentives and Market Failures

The current crisis resolution framework is a game of three parties, i.e. the private sector, the sovereign and the IMF. Given the absence of a clear framework for crisis resolution, both the private sector and the sovereign have a strong and shared interest in generous insurance arrangements to be provided by the third party, the IMF (Goldstein, 2001). Neither the private sector nor the sovereign has strong incentives to change the rules of the game as long as the IMF covers a major share of a potential downside risk. Both perceive the IMF to be time inconsistent¹³ since its stated policies on private sector involvement, non-bailouts for sovereigns and strict enforcement of access limits have repeatedly been broken.

Nevertheless, when we take a look at the incentives of all three parties involved, it becomes clear that an SDRM would be in the interest of each one of them. For the private sector and the sovereign, it basically boils down to preserving the “going concern value” of the debt or the economy. For the IMF, an SDRM would resolve, among other problems, the time inconsistency of its current lending practice.

The private sector has a strong incentive to negotiate debt restructuring early on because of the growing share of bonds in sovereign debt and the fact that most sovereign bondhold-

ers must use the marking-to-market method. Protracted negotiations will damage the economy and lower the market value of creditors’ claims. Therefore this results in a convergence of interests between a debtor and its creditors.

For the sovereign debtor the incentive structure is similar. A more orderly restructuring of a sovereign’s unsustainable debt would limit the damage to the debtor’s economy and improve creditors’ repayment prospects. Also, if rightly designed, the mechanism would significantly enhance the incentives for both the borrowers and lenders. The risk of moral hazard for creditors would lessen as lenders would no longer expect protection against loss if the borrower encounters severe difficulties. At the same time, creditors would be better able to manage their country risks, provided the SDRM is applied early in a crisis. This may limit the depth of the needed restructuring and contain the losses incurred by creditors who, under a disorderly and protracted procedure, would be unable to withdraw their credit before the borrower’s default.

The IMF would benefit from an SDRM because under present circumstances the IMF’s use of its resources does not appropriately affect the debt restructuring process. In recent years the IMF faced problems where bailing out private creditors was the only alternative to triggering a financial meltdown with huge costs to the debtor country and the danger of destabilizing the international financial system via contagion. There was no way of achieving a timely debt restructuring that would have reduced the

¹³ A policy is deemed to be time inconsistent if it oscillates between clear rules and total discretion and therefore is not credible.

need for finance and adjustment. While the IMF's policy of lending into arrears has helped, it does not create sufficient room for working out an orderly debt restructuring. Hence, it is argued, an SDRM is called for as a credible alternative to choosing between large financial bailouts and the destruction of national and international prosperity.

Financial markets are often portrayed as perfect and said to lead to an optimal allocation of resources. This, though, is only correct if markets are complete and efficient. However, neither a market nor insurance for all future states of the world exists. Derivative instruments are meant to fill this gap. Yet financial markets are prone to market failure since the assets traded in them yield a return over a prolonged period. These returns depend on future states of the world and are therefore subject to uncertainties and information asymmetries. Herd behavior and externalities are endemic because individual asset values depend on collective expectations of future outcomes. Moreover, the public good of financial stability is likely to be undersupplied in the absence of conscious intervention by public authorities.

The international financial architecture must address in particular three market failures:¹⁴ (1) information asymmetries, (2) aggregation effects and externalities and (3) the deficient supply of public goods.

(1) Complete information is necessary for market efficiency. Financial markets are by nature information based and are thus subject to information asymmetries. This

gives rise to two specific problems: first, adverse selection, which basically refers to how an insider can credibly transmit private information to an outsider concerning some exogenous key characteristics of a good. Second, moral hazard, which is a product of information asymmetries where the insider can affect economic outcomes but the outsider is unable to observe or infer correctly the actions taken by the insider. This entails time inconsistency, which typically results in suboptimal outcomes relative to the full information equilibrium.

(2) Decisions by individual agents are conditional on the expectations of what others will do. The resulting uncertainty about other agents' future actions introduces costs that in principle might, but in practice often cannot, be alleviated by insurance.¹⁵ In financial markets, the inability to enter binding conditional contracts on future states of the world means that individual agents have to protect themselves against the consequences of potential actions by others. But individual rational behavior, if simultaneously followed by a large number of agents, can produce suboptimal outcomes. Such aggregation effects lie behind the phenomena of overshooting and multiple equilibriums. Once a market movement away from an initial equilibrium is initiated, it may gather speed. A new equilibrium may not be quickly established, nor is it guaranteed that it will be socially superior to the previous equilibrium.

¹⁴ See Mas-Collel et al. (1995) for an excellent overview on market failures and references or Sachs (1995).

¹⁵ A classical example is the prisoner's dilemma.

(3) Public goods benefit everyone but cannot easily be charged for, which is why there is a danger of undersupply. Information in itself has elements of a public good, and so has financial system stability (whose functioning also depends on a host of public goods). In the absence of an infrastructure providing for public goods, uncertainties will be greater and financial contracting will be more costly. Markets will be smaller in size and more prone to disruptions.

What are the consequences of these market failures for the international financial system?

- (1) Information asymmetries tend to be quite acute in cross-border lending due to exchange and transfer risks. Sovereign immunity and the absence of international insolvency procedures further complicate matters.
- (2) Externalities and aggregation effects are a major problem at the international level. Kaminsky and Reinhart (1999) have shown how a domestic banking crisis can lead to a currency crisis, which then intensifies the banking crisis and adds to its real economic costs. Traditional domestic mechanisms, such as the provision of safety nets or the existence of a lender of last resort, do not exist at the inter-

national level. The IMF performs some of these functions but it has neither the resources nor the authority to provide a fully credible protection against financial disturbances.

- (3) Another factor are collective action problems, such as a “rush to exits,” when creditors try to minimize their individual losses and cause a crisis that has real and avoidable costs; a “rush to courthouses” or a “grab race,” when creditors start litigation and can attach assets if they move first; and the “holdout” or “rogue creditor” problem, when minority holdout creditors may wreck a restructuring that is advantageous to the majority of creditors.¹⁶ In addition, debtors may have an incentive to default opportunistically; i.e. if defaulting is made too easy, debtors may exhibit unwillingness rather than inability to pay (Bulow, 2002).

Given the largely positive incentives for all three parties involved as well as the possibility of correcting market failures, we may observe a “tragedy of the commons” problem (Hardin, 1968). No individual party has a sufficiently strong incentive to set up this mechanism even though collectively everybody would be better off if an SDRM was established.

¹⁶ In game theoretic terms, this would constitute a noncooperative Nash equilibrium, which is inferior to a cooperative one.

5 SDRM Fallout: Collective Action Clauses and a Code of Good Conduct

The proposals for an SDRM induced some private creditors to act in the shadow of the draft law. In a letter sent in April 2002 to the International Monetary and Financial Committee (IMFC), the Institute for International Finance expressed its strong belief in the usefulness of collective action clauses (CACs)¹⁷ for easing the resolution of sovereign financial crises. Basically, this was intended to forestall progress on an SDRM. This was in stark contrast to the agnosticism the idea of such clauses had met with before the IMF advanced the SDRM proposal.

The contractual approach had been on the agenda of the international financial community since it was recommended by the G-10 in its Report on the Resolution of Sovereign Liquidity Crises in 1996 (Group of Ten, 1996). However, until the start of the SDRM debate the results were disappointing. Only the United Kingdom and Canada had voluntarily introduced collective action clauses in their sovereign debt instruments. The Member States of the EU followed suit in June 2002 in an effort to lead by example. Finally, when Mexico decided to introduce CACs in an international bond, such clauses garnered support also in many emerging markets. Since then a host of emerging market countries, such as Korea, South Africa and Uruguay, have introduced CACs in their inter-

national bonds without experiencing any noticeable price effects (IMF, 2003).

The official sector saw as an advantage of this approach that it would create a universal statutory basis without necessitating an amendment of the Articles. However, it was left open how debtors and creditors could be persuaded to include such contractual provisions in their contracts. Also, since it was recognized that a legal framework was needed to organize relations between creditors and sovereign borrowers in case of payment difficulties, it would have been more straightforward to organize such a framework by law and at the international level, rather than provide legislation at the national level. The latter would force parties to agree on any such mechanism in line with specifications spelled out by national laws that would not necessarily be coordinated among jurisdictions.

Rather than negotiating a statutory approach, the Banque de France as well as the Institute for International Finance each started to develop a Code of Good Conduct. It would be part of the nonstatutory toolbox, containing a set of high-level good faith principles, which should govern the relationship between sovereigns and the private sector, and building upon the IMF's "good faith criterion," which is a building block of the IMF's lending into arrears policy.

Such a Code of Good Conduct would be based on several principles for sovereign crisis prevention and

¹⁷ CACs typically include (1) majority restructuring provisions, which enable a qualified majority of bondholders to bind all bondholders of the same issue to the financial terms of a restructuring; (2) majority enforcement provisions, which enable a qualified majority of bondholders to prevent a minority of bondholders of the same issue from accelerating their claims following a default, and to reverse an acceleration that has already occurred; and (3) trust deeds, which confer the right to initiate legal proceedings on behalf of all bondholders upon a trustee, who can act only if requested to do so by the requisite percentage of bondholders, and ensure that the proceeds of any litigation are distributed evenly among all bondholders.

resolution and would apply to the resolution of all types of potential payment problems between a sovereign debtor and its creditors. The code would be a voluntary and nonbinding declaration of good practices already followed in the market and would be used on a case-by-case basis.

The principles spelled out in the code are designed to ensure that the process of sovereign payment problem resolution is timely, transparent, representative, expeditious and equitable among creditors, and equitable between the debtor and its creditors. The code includes, for example, provisions for ensuring an early dialogue between a sovereign debtor and its external private creditors, for achieving inter-creditor equity and for making the negotiation process predictable and transparent to reduce market uncertainty and its adverse effect on the value of claims. Moreover, it affords creditors the opportunity to contribute to the design of the restructuring agreement.

While the code is to be welcomed, it remains without muscle given its voluntary character. In particular, it can only address contentious issues, such as the size of debt relief when a country has serious solvency problems, without offering a binding solution. A case in point is the question of how large a reduction in the net present value of creditors' claims is needed. Here, a delicate balance must be struck between preserving the growth capacity of the debtor's economy – and thus its capacity to pay over time – and creditors' legitimate interests or, more precisely, rights to be repaid. Also, how much additional fiscal effort can be required from the debtor to repay its creditors even if this would reduce the debtor country's growth and per capita disposable in-

come? It is doubtful whether a voluntary arrangement can achieve such a balance without an independent arbiter.

In other words, an independent arbiter may be necessary for the following reason. By deciding to lend into arrears, the IMF considerably narrows the room for negotiations, between a debtor country and its creditors, aimed at determining how much of the country's external debt should be serviced. Granted, the IMF is obliged to make such decisions with the highest degree of impartiality, but, at the same time, it has to make sure that medium-term economic recovery prospects are not jeopardized. In determining the fiscal effort to be required from a country, the IMF must make a balanced judgment not about what is politically feasible in the debtor country but about what should be delivered. The degree to which a country can make fiscal efforts to service its external debt depends, *inter alia*, on its relative income per capita. Also, the IMF must be aware that by lending into arrears it is setting precedents that may influence the markets' expectations about when a country is likely to reach debt levels that the IMF considers too large for the country to service in full. And private creditors have no power to veto any such arrangement.

6 Conclusions

While academic consensus on and political support for an SDRM have waned for the time being, its discussion nevertheless has been beneficial and has produced several tangible results:

- A renewed awareness of the problem of sovereign debt and a greater focus of the IMF on operationalizing concepts, such as debt

- sustainability and the balance sheet approach;
- a search for and partial implementation of intermediate solutions, such as collective action clauses;
- possible consensus between the private and official sectors on elements of a Code of Good Conduct.

Despite these positive developments, the international financial system still lacks an effective mechanism for a more orderly restructuring of the sovereign debts of countries that are unable to service their debt fully and on time. Such a regime would be in the interest of the international financial system since a disorderly default of a country with an unsustainable debt profile can impose costs that are socially inefficient and thus can hurt both debtors and creditors. The various proposals put forth by the IMF for establishing more orderly procedures have considerably advanced the understanding of how to reconcile creditors' legitimate interests with the need to preserve the economic potential of a debtor country, which is the best protection of creditors' claims.

There has also been considerable progress towards determining which procedures can best guarantee that decisions aimed at such a reconciliation of interests are balanced and fair and preserve the culture of credit. The latter is very important and possibly the main objective of the SDRM: how to ensure that emerging market countries have access to international credit at the lowest possible cost,

while preserving market discipline and thereby avoiding or minimizing creditor and debtor moral hazard. An SDRM should thus only be used when a problem cannot be resolved via voluntary or market-based approaches. It should not replace well-functioning debt restructuring procedures already in use or encourage opportunistic defaults.

History suggests that the probability of significant change in the international financial architecture is limited.¹⁸ Proposals for reform tend to be cyclical both in terms of the sympathy evinced for such measures and the regularity with which old ideas seem to resurface – only to be rejected. Interest in ambitious reform measures typically peaks shortly after a crisis breaks and gradually recedes as the crisis begins to subside and market sentiment improves. It will probably be a long time before a statutory insolvency regime is considered an essential building block of the international financial architecture. Besides, such a future regime is likely to involve significant exemptions and opt-out clauses to start with, while nevertheless proving its worth. In the end, both the statutory and the nonstatutory approach are initiatives that propose an alternative to making the IMF a lender of last resort (Fischer, 1999). Even though opposition to a large institutional change is strong and forceful, it may only seem impossible until it happens at which point it seems foreordained (Rogoff, 1999).

¹⁸ *Even in the sovereign context, bankruptcy procedures can be very controversial and politically divisive. As a case in point, it took at least seven attempts to introduce bankruptcy legislation in the U.S. starting in 1789 with a first proper bankruptcy procedure only enacted in 1898. See also Bolton (2003).*

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