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EDITORIAL

The plans to improve the international financial architecture put forward since 2001 have mostly stalled. No real progress has been made in the reform of the Bretton Woods institutions. In order to overcome the current obstacles, the report by Daniel Cohen and Richard Portes makes two key recommendations. The first is the creation of a new 'indebtedness regime' under which indebted countries would undertake not to exceed a predetermined level of borrowing spreads. The second is the promotion of collective action clauses (CACs) in bond issues, so as to introduce a little order and solidarity between creditors. The IMF would play a greater preventive role in the context of the 'indebtedness regime', acting 'lender of first resort' rather than lender of last resort.

These recommendations are extensively discussed in the attached commentaries and supplements. Clearly, the voice of Europe is all the more likely to be heard in these matters if it manages to overcome internal divisions about the appropriate structure for the international architecture.

Christian de Boissieu
Executive Chairman of the CAE

Sovereign Debt Crises:
Working In and Working Out

Report by Daniel Cohen and Richard Portes

There has been a succession of financial crises in the emerging countries, from the 'lost decade' in Latin America to the recent crisis in Argentina, often with devastating effects. Is the international community now better armed to prevent and resolve these crises? Has the progress of market globalisation been accompanied by progress in the design of the international financial architecture?

Daniel Cohen and Richard Portes, the authors of the report, focus their attention on sovereign debt crises. In order to prevent a certain number of crises that turn out *ex post* to be sovereign debt crises, but which are initially crises of confidence, the authors make the original proposal that the IMF should become a 'lender of first resort'. In order to resolve sovereign debt crises, the authors trace out the roadmap for a comprehensive, rather than uniquely market-based, approach.

The report was presented at the plenary session on 3 October 2002 and then, in the presence of the French Finance Minister, on 2 April 2003. This newsletter, a joint CAE and CEPR publication, summarises the principal conclusions drawn by the authors.

The international financial architecture: what's new?

International financial architecture has been on the international agenda since the Mexican crisis of 1994-5, after a period of being in limbo in the aftermath of the Latin American crises of the 1980s. Proposals to refine it draw conclusions from the various crises subsequent to that of Mexico: the Asian crisis of 1997; the Russian crisis of 1998; the Brazilian and Ecuadorean crises of 1999; and, most recently, those of Turkey and Argentina in 2001-2. It has also been adapted to take into account the major transformations of the international financial markets during the past 20 years: the formidable explosion of private capital flows to the emerging countries and their extreme volatility; and the growing and now predominant role played by bond securities –held by a large number of investors– among the instruments for financing the external debt of the emerging countries.

A distinction is traditionally made in the exercise to improve the international financial architecture between crisis prevention, on the one hand, and crisis management and resolution, on the other. These two objectives– the former aimed at reducing the frequency of crises, the latter at reducing their cost –are far from independent of one another.

As regards management and resolution of crises, considerable confusion reigned until autumn 2001. The Rey Report, prepared by a working group of the G-10 set up just after the Mexican crisis, had nevertheless opened the way as far back as 1996. It warned against frequent recourse to large-scale financing by the international community and advocated an equitable burden-sharing between debtor

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countries and private-sector creditors –in other words, the involvement of the private sector in crisis resolution. In particular, the Rey Report reached the following conclusions:

- In the resolution of sovereign debt crises, a temporary suspension of payments (standstill) and debt restructuring have to be envisaged. The report advocates the inclusion of 'collective action clauses' (CACs) in bond issues, an idea taken up by Eichengreen and Portes (1995). These clauses, which are included routinely in bonds issued under UK law, but not in bonds issued under US law, in fact enable a 'super majority' of creditors, assembled in a bondholders' committee, to change the terms of a bond, or, put more simply, to restructure it, and to impose the changes on all bondholders;
- The IMF must apply, should it judge it to be useful, its policy of 'lending into arrears[1]' to a country in crisis in order to meet its needs for new money.

While the Fund adopted this latter recommendation, little effort was made to promote the inclusion of CACs. The private sector spoke out in favour of total *laisser-faire*, stressing the risk that flows might dry up. The emerging countries showed great reluctance, fearing an increase in borrowing costs. As for the G-7 countries, only Canada and the United Kingdom set the example.

At the time of the Asian crisis, the international community was very timid in following the advice of the Rey Report, except in the case of Korea, partly because the relevant debt was private and short-term rather than sovereign. The IMF adopted the strategy of restoring confidence by making its assistance, which was in the form of catalytic financing, conditional on a long list of economic and financial reforms. In the end, official financing was much larger than initially expected because of the slow pace of introduction of the reforms, leading Stanley Fischer (1999) to say that the Fund had de facto become the lender of last resort. Around the same time, the Fund modified its range of financing instruments through the creation of two facilities with unlimited access: the Supplemental Reserve Facility (SRF) in December 1997, for countries already in difficulties, and the Contingent Credit Line (CCL), in April 1999, for countries seeking to ward off contagion of liquidity crises. To date the latter has never been used.

The Meltzer Report (March 2000), prepared at the request of the US Congress, proposed a major overhaul of the Bretton Woods institutions. As regards the IMF, it recommended, among other things, that it should give up its daily current activities in order to limit its mission to the lending of last resort to countries that have been 'pre-qualified' on the basis of rigorous criteria of indebtedness and transparency, acting only in exceptional cases, when major liquidity risks arose. The Meltzer proposal was sharply criticised for not maintaining the principle of the Fund's universality. Finally, at the September 2000 IMFC meeting in Prague, the official community, aware of the emergence of a consensus that was hostile to large 'bail-outs', reaffirmed the need to involve private-sector creditors in crisis resolution, but without proposing concrete measures.

In November 2001, Anne Krueger, First Deputy Managing Director of the IMF, became the advocate of a statutory mechanism for the restructuring of sovereign debt (Sovereign Debt Restructuring Mechanism, SDRM), facilitating the declaration of bankruptcy for over-indebted countries, inspired by Chapter 11 of the United States Federal Bankruptcy Code. This proposal had the merit of dragging the debate out of its rut:

- it revived the approach favouring the inclusion of CACs;
- it also facilitated the emergence of a European position in Spring 2002, later endorsed by the G-7 in its Plan of Action, recommending the definition of presumed limits of access to Fund financing and the involvement of the private sector in crisis resolution, while affirming the complementarity between the contractual and statutory approaches and a determination to progress with their implementation.

The proposal for an international bankruptcy tribunal was also put forward at the same time by Stiglitz (who cannot be suspected of collusion with the Fund), together with the recommendation that the tribunal be completely independent of the Fund. The Krueger proposal was later refined to give rise to a second (April 2002) and then a third (January 2003) version in response to criticisms from the United States administration and the private sector, and then to an operational version to be submitted to the Spring meetings in 2003, before finally being buried. At the same time, the idea of a code of conduct was making progress, under the impetus of various economists and of the Banque de France, working out a comprehensive non-statutory approach to the resolution of sovereign debt crises: inclusion of CACs; the possibility of temporary suspension of payments (standstill); and the possibility of IMF lending into arrears during the suspension period. Finally, and this is an excellent sign for the future, last February Mexico issued bonds including CACs similar to those under British law, at no additional cost; Brazil and South Africa have followed suit.

The IMF as lender of first resort: a crisis-prevention strategy?

In economists' jargon, crises of confidence are described in second-generation self-fulfilling multi-equilibrium crisis models of the kind introduced by Obstfeld (1985). Under these models, in certain circumstances, beliefs become self-fulfilling because the fundamentals are themselves partly a function of these same beliefs. In other words, if the markets believe that a country is not going to default on its debt, it will succeed in not having to do so (this is the good equilibrium). On the other hand, if the markets do not believe this, it will not succeed (this is the bad equilibrium). This possibility of multiple equilibria generally arises when a country's fundamentals (notably the level of its external debt) are in some intermediate range. This explains why the economist John Williamson in August 2002 –at a time when the fundamentals of the Brazilian economy were in an intermediate position and when the country's public primary surplus amounted to 3.75 percentage points of GDP, but when investors doubted whether the incoming government's policies could be sustained– expressed himself to be strongly in favour of the agreement[2] between the IMF and Brazil for a package amounting to $30 billion, intended to reassure the markets. The agreement had the desired effect: whereas at one time interest-rate spreads had reached 2400 basis points, they are now around 800.

In the view of Daniel Cohen and Richard Portes, the reality of the crises is less clear-cut. What they propose is a typology making it possible to break down the origin of debt crises into three components: crisis of confidence; crisis of fundamentals; and crisis of economic policy. They calculate that roughly one-third of the crises recorded in the 1990s, which turned out *ex post* to be debt crises, were predictable two years before they broke out. These crises were the result of the existence of already large spreads even though the debt was not yet unsustainable, and could have been avoided if economic policy measures had been introduced in time to re-establish confidence and reduce interest rates. This was probably true of the Russian and Turkish crises.

The authors now make the original proposal that the IMF be given the function of 'the lender of first resort', at the crossing of crisis prevention and resolution. They suggest that all emerging countries should commit themselves *ex ante* to an 'indebtedness regime' with the IMF. Once interest-rate spreads reach 300 or 400 basis points, the country undertakes to have no further

(1) In other words, the IMF provides financing to a country which has halted its debt payments.

(2) In the form of a stand-by agreement and a supplemental reserve facility.

recourse to private financing but instead to seek financing from the Fund, with whose aid it would take actions so as to avoid a crisis and to restore confidence.

The search for a 'super code of conduct'

The now-sidelined Krueger proposal

The Krueger proposal (in its initial version dated November 2001) lists a number of points for the creation of an orderly mechanism for the restructuring of sovereign debt (SDRM):

- A government expecting problems with the sustainability of its debt would ask the IMF to confirm its own assessment;
- In the event of confirmation, the IMF would authorise a suspension of payments (standstill) and a stay of litigation; this period could be prolonged if the debtor country had undertaken negotiations in good faith with its private creditors;
- During this period, the country could obtain interim financing, both from private lenders by assigning priority to their new claims, and from the IMF thanks to its policy of 'lending into arrears';
- The debtor country and its private creditors would then negotiate a restructuring of the government debt (endorsement by the Fund of the terms of this restructuring would probably be necessary);
- An independent tribunal would be set up to adjudicate disputes between the debtor country and private creditors, and, among the latter, check the value of claims and supervise the equitable treatment of various classes of creditors;
- Dissident creditors would be bound by a majority vote.

In an attempt to respond to the reservations expressed by the United States administration and the financial institutions, the second version of the Krueger proposal (April 2002) gave greater powers to a 'super majority' of all creditors that could prolong the standstill and approve a final restructuring agreement. The third version (January 2003), still referred to as 'light', no longer provided for either the standstill or the stay of litigation to be automatic, but nevertheless proposed a substitute (based on the 'hotchpot rule' under British law[3]).

Leaving aside criticisms, such as the limits to the analogy between corporate and sovereign bankruptcy or the question of the competence or otherwise of the Fund to decide whether a country's debt is unsustainable, the authors stress that the Krueger proposal, in its different versions, runs up against two inescapable obstacles: it requires an amendment to the Fund's Articles of Agreement, a change that has to be approved by the US Congress; and it is probably incompatible with national legislation regarding bankruptcies. This means that it could prove politically difficult.

To provide a comprehensive approach to the solution of debt crises, that is not uniquely market-based: CACs on a standard model…

The authors are in favour of the inclusion of a range of CACs in all bond contracts and bank lending instruments, using a standard model recently advocated by the US Treasury and the G-10, close to that of British law. In particular, it would include as key clauses the following:

- A clause setting out the modalities of the restructuring;
- A clause defining the representation of creditors (preferably including a trustee);
- A clause concerning majority action; this would allow –for change, by a qualified majority and with different thresholds, in reserve and non-reserve matters, the reserve matters being those relating to the terms of the debt – including the amounts and the repayment dates;
- A clause enforcing the acceleration of payments in the event of a payment default, and also the rescission by a qualified majority of the acceleration in order to prevent the non-observance of a repayment date from forcing the debtor to make total and early repayment of its debt;
- A clause giving solely the representative of the bondholders the power to initiate litigation;
- A distribution clause, imposing *pro rata* sharing between the bondholders of any payment received by one of them;
- A clause regarding information (on request).

Two problems, often highlighted by those in favour of the SDRM, should not pose insuperable difficulties. First, the existing debt –which does not include these CACs– should be capable of being exchanged with the help of the regulatory authorities and the IMF and will, in any case, disappear in the course of the next ten years. Furthermore, the need for a 'meta CAC', that would impose restructuring on all bondholders by applying to all debt instruments from a given debtor, does not seem indispensable[4]. Finally, in order to provide an incentive for debtor countries to introduce CACs into their debt instruments, the authors propose that these be required by the regulatory authorities in the interests of the proper functioning of markets and protection of investors.

… IMF policy of lending into arrears, New York Club

While the inclusion of CACs represents a first step, it can at best be just one element in a comprehensive non-statutory approach to the resolution of sovereign debt crises. The authors are favourable to an approach similar to that of the code of conduct recently proposed by the Banque de France and Roubini and Setser (2003). This would include not only the introduction of CACs in all sovereign and private debt contracts, but would also cover the modalities of the financing of the debtor country in periods of standstill –the possibility of lending into arrears on the part of the IMF and/or the introduction of a rollover option in the claims; and the possibility of reducing a country's debt when it is clear that this is excessive. This code of conduct, to which the various parties –debtors, private and public creditors and especially the IMF– would adhere on a voluntary basis, would constitute a powerful instrument for both crisis prevention and crisis resolution: it should make it possible both to resolve debt crises *ex post* and also, through the *ex ante* undertaking it represents, to avoid self-fulfilling crises. In this respect, it would incorporate the indebtedness regime proposed earlier. Finally, the authors propose two simple innovations: first, the creation of a bondholders committee (that might be called the New York Club alongside the Paris Club and the London Club), bringing together the bondholders and facilitating their negotiations with a given debtor; second, a lean institution given the task of coordinating these three Clubs and possibly supervising the implementation of the code of conduct could also be set up. Cohen and Portes are confident about the future. Even if there remains a certain amount of reluctance, immense progress has been made: the private financial sector, the G-10 and the US Treasury have proposed a standard CAC model; and emerging countries like Mexico and Brazil have already introduced CACs into their bond issues. In conclusion, the 'architects' have traced out plans and provided a roadmap. It is now up to the 'builders' to put it into practice, with the support of the official sector.

Comments

Olivier Davanne and ***Sylviane Guillaumont-Jeanneney*** are both intrigued by the novel proposal of an indebtedness regime to ward off crisis. However, they think that the idea ought to be explored in greater depth and wonder about how it could be applied. What should be the criteria for determining the spread at which the emerging country would stop borrowing on the

(3) In order to ensure equality of treatment between creditors and to neutralise 'free-rider' behaviour on the part of those who might seek to recover their assets through litigation between the activation of the SDRM and the vote by the creditors in favour of the restructuring, the plan would be to deduct the sums obtained by litigation from the claims finally recovered as part of the restructuring agreement.

(4) The creation of a permanent committee bringing together the bondholders –to be called the New York Club– covering all bond negotiations with a given debtor, would help to resolve the problem of the aggregation of claims; its authority could also be strengthened by the threat of 'exit consents'.

markets and turn to the IMF? Should it be the same for all countries?

They are also concerned about the perverse effects of such spread limits. Is not a limit of 300-400 basis points already too high, and does it not already imply very substantial sovereign debt, with a high probability of default risk? Guillaumont-Jeanneney asks whether the IMF's new role as lender of first resort, like that of lender of last resort, might not require considerable resources that the IMF does not have.

Davanne draws a parallel between interest-rate spreads and exchange rates. Recalling the EMS turmoil and then the Mexican and Asian crises, he wonders whether the proposed indebtedness regime might not share the same drawbacks as the system of fixed exchange rates: the warning from markets would come too late, at a time when crisis had already become inevitable.

Davanne also regrets the authors' timidity in their approach to resolving sovereign debt crises. Rather than following the course charted by the IMF and the international community in recent years (international bankruptcy court, introduction of CACs, etc.), would it not be better to propose doing away with all IMF support except in strictly-defined cases?

Complements

Michel Aglietta and ***Charles Wyplosz*** stress that the IMF cannot be an international lender of last resort. A lender of last resort must have the resources at its disposal to be able to inject an indeterminate quantity of fresh liquidity or have perfect information regarding solvent and insolvent financial intermediaries. Since this latter assumption is ruled out, the former is tantamount to giving the IMF the power to create liquidity from scratch. At a time when it has already shown itself extremely difficult to set up the European Central Bank, it seems totally unrealistic to imagine such a transfer of monetary sovereignty to the IMF on a world scale. The authors advocate, rather, cooperation among a network of central banks.

The dissemination of common codes and standards is an essential element in crisis prevention policy. Aware of the difficulty of transposing these standards directly for use in emerging countries, ***Helmut Reisen*** proposes that, as for the openness of the capital account, appropriate institutions must be in place before such standards can effectively be implemented.

Vincent Marcus introduces a historical perspective by considering the financial crises in the period 1980-2002: the Latin American debt crises (1982), which brought three groups into play –commercial bank syndicates, official lenders and debtor countries; the crises of the 1990s (Mexico 1994-5, Asia 1997-1998), characterised by large capital movements and a growing share of bonds at the expense of loans in the total debt instruments; and lastly, the more recent crises since 1998 (Russia, Brazil, Turkey, Argentina, Ecuador, etc.), which stemmed not from problems of private debt, as at the time of the Asian crisis, but from public debt. These all illustrate the willingness to involve the private sector.

Following the lines of Stiglitz, ***Dominique Plihon*** is critical both of the functioning of the IFIs and of the economic doctrine governing the action of the IMF: a 'democratic deficit' both internally and *vis-à-vis* sovereign peoples with the preponderance of the United States in the decision-making; a doctrine based on the 'Washington consensus' (financial and commercial liberalisation, total freedom of capital movements). He argues for a rebalancing of power between countries of the North and South within the IMF, with control exercised by each national Parliament with the collaboration of society at large, and recommends strict regulation of capital movements. This recommendation comes at a time when many economists, especially those from the Bank and the IMF, acknowledge that it is difficult to establish a robust causal relationship between financial integration and economic growth and that the liberalisation of capital flows is accompanied by increased macroeconomic instability.

Finally, ***Pierre Jacquet*** proposes a return to the Lerryck-Meltzer (2002) approach, considered to be the most developed argument in favour of grants versus loans to poor countries, and emphasises its interest for the development of public-private partnerships.

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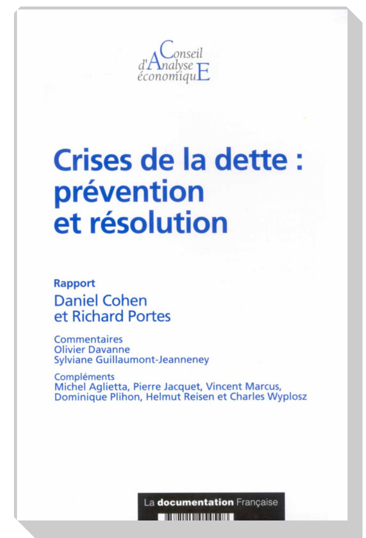

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