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SOVEREIGN DEBTORS IN DISTRESS: ARE OUR INSTITUTIONS UP TO THE CHALLENGE?

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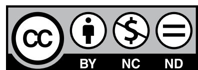

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From 1999 to 2007, Susan was the deputy director of the IMF's European Department, where she served as the organization's lead oversight for Turkey, the United Kingdom and Central and Eastern Europe. She also led several research teams, focusing on Europe's role in the global economy, economic choices of new European Union member states and institutions of European governance.

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EXECUTIVE SUMMARY

Global economic developments over the past two years have dashed hopes that the risks of sovereign debt crises have been tamed. The turmoil in Europe has, of course, been the most acute of these developments, but growing national fiscal imbalances, anemic prospects for growth and the expanding reach of private financial markets to newly emerging economies are potent, if less immediately threatening, signs of the risks ahead. After lying dormant for almost a decade, pressing questions about whether global institutions are capable of containing the costs of debt crises are again being raised.

On February 24–26, 2012, a conference at CIGI's Waterloo headquarters brought together experts on sovereign debt crises. Set against the deteriorating situation in Europe — and specifically the then-unfolding Greek debt restructuring — the conference examined issues around a central question: Are current institutions and procedures for resolving sovereign debt crises — and specifically the processes that are put in place when a country must restructure its debt — adequate for the challenges ahead?

Several component questions about the adequacy of institutions for resolving unsustainable sovereign debt burdens stand out. Perhaps the oldest is: Does the absence of a formal forum for creditor coordination and reliable information exchange between the debtor and creditors produce deadweight losses in resolving unsustainable debt burdens? Those who argue it does point to the distrust and gamesmanship that can arise in debt negotiations. These malign influences delay settlements, set the stage for creditor efforts to accelerate (or bring forward the payment of) claims and lead to holdouts among creditors hoping to secure better terms than those provided in the exchange offer. These bad outcomes can prevent debtor countries from resuming normal financial relationships for years. In this view, formal legal procedures that are triggered when voluntary negotiations fail to conclude quickly would motivate both creditors and debtors to settle expeditiously.

Another set of questions relates to whether intervention by global institutions creates moral hazard (especially among creditors) or delays needed restructurings. As IMF bailouts have become larger over the decades — from the Latin American crises of the 1980s, to the Asian crises of the 1990s and now the recent European crises — concerns have grown that creditor moral hazard (a perception among creditors that the IMF will fund repayment in almost any circumstances) has distorted creditors' perception of risk. Is the recourse to exceptionally large access to IMF resources for sovereign debt crises — some that have eventually ended in debt restructuring — guided by sufficiently clear criteria for distinguishing unsustainable debt burdens from liquidity problems? If not, the role of the IMF in delaying restructuring may actually raise the ultimate costs of restructuring and produce unwarranted socialization of sovereign debt.

A new set of concerns involves the coordination among official guarantors of a country's sovereign debt. Does the IMF reach better decisions — on the sustainability of a country's debt, the need for restructuring and the measures required to return a country to viability — if it acts as independently as possible of regional or other supporters? The role of the European Central Bank (ECB) and the European Commission alongside the IMF in managing the Greek crisis raised significant questions in this regard. While the explicit partnership between European institutions and the IMF is unique to the current European debt crises, it may be a precedent for crises in other regions.

In the early 2000s, in the wake of several major crises, reform proposals were vigorously debated. In 2000, the Prague framework was formulated to guide reforms to limit exceptionally large IMF bailouts and ensure private sector involvement in financing resolutions. In 2002, the IMF proposed a Sovereign Debt Restructuring Mechanism (SDRM) — legal procedures that would have provided a bankruptcy-type mechanism for sovereign debtors. Though ultimately unsuccessful, the SDRM initiative spawned two innovations: first, the introduction in international sovereign bond issues of collective action clauses (CACs), that set out procedures for, among other things, binding creditors to restructuring agreements reached in voluntary creditor-debtor negotiations; and second, the formalization, in 2004, of four criteria that must be met for heavily indebted sovereigns to gain access to exceptional levels of financing from the IMF.

The bruising debate over the SDRM, followed by a period of benign international economic conditions, pushed consideration of sovereign debt crises to the background. Some "voluntary" restructurings occurred, mostly without invoking CACs, and the exceptional access criteria were seldom tested. The euro debt crisis was the first major test of the voluntary approach and the criteria for exceptional access to IMF resources.

Three conclusions can be drawn from this experience. First, the criteria for exceptional access did not hold up under political pressure: the criteria were adjusted and weakened in response to Greece's request for financing. Second, once "voluntary" restructuring negotiations began, they were concluded rather quickly, albeit with a new twist of invoking a retroactive CAC — a twist possible only because the debt was governed by Greek law. Third, the negotiations could not be seen as an unmitigated success (the negotiation period was fraught with uncertainty, doubts remain about the adequacy of the writedown and the spectre of failure persisted until the last minute). In sum, although the episode seems thus far to have ended without calamity, it revealed the continuing weaknesses of

the institutional structure for sovereign debt restructuring and a tendency for political considerations to undermine sensible past reforms.

With this experience fresh in mind, a new look at global arrangements for resolving sovereign debt crises is needed. A five-point agenda is proposed: to document and assess how institutional innovations during the euro crisis affect crisis management procedures; to analyze whether the IMF is optimally organized for crisis management; to examine the current template for CACs and recommend changes that would efficiently expand their powers; to assess the robustness of current ad hoc procedures for debt restructuring in complex and difficult circumstances; and to draw up a formal legal framework for restructuring that could be activated should ad hoc procedures fail to produce consensus.

INTRODUCTION

In September 2010, staff at the IMF issued a policy paper entitled "Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely."[1] The IMF, in a joint effort with the ECB and the European Commission, had just approved a €30 billion bailout loan to Greece in support of government commitments to wide-ranging economic policy changes. The loan, together with funding from the European partners, was to meet all the medium- and long-term borrowing requirements until Greece returned to markets in mid-2012 (IMF, 2010). Widely criticized for unduly optimistic assumptions about how fast the Greek economy could be turned around, the projections turned out to be way off the mark. By July 2011, the troika (the IMF, ECB and European Commission) and Greece modified the strategy and started the process of restructuring debt to private creditors. March 2012 saw a debt exchange that was concluded more smoothly than many had expected, although most believed it did not reduce debt to a level that would be manageable.

This pattern of crisis, denial, large-scale financing and, ultimately, restructuring or default is not peculiar to Greece. Of course, not all sovereign debt crises have ended in restructuring or default. Some crises have been resolved through combinations of financing, fiscal and exchange rate adjustment, and economic recovery. But since 1998, eight sovereign debt crises (excluding those in low-income countries) have ended in restructuring or default.[2] In several of these, a significant period of official financing (with the IMF as the coordinating institution) preceded the restructuring.

Why is there often such a delay before restructuring? Does it help ensure that countries in difficulty are not pushed into restructuring precipitously? Perhaps this period is used to put in place policy changes that ultimately reduce the costs of restructuring. Perhaps it reflects the inherent uncertainty of decisions about when a country's debt burden is unsustainable and restructuring is the only viable option — that is, it helps avoid type B errors.[3] Or perhaps delay is the result of a bias in global governance against restructuring, a bias that produces deadweight losses. This bias could stem from the lack of adequate conventions for restructuring sovereign debt or from insufficient constraints on political resistance to the distributive effects of restructuring. Remarkably, these questions are seldom examined systematically (that is, outside the specific circumstances of a single crisis), despite their important implications for global governance.

The urgency of these questions should be obvious. Sovereign debt crises are costly. They typically result in large dislocations and output losses in debtor countries. Creditors suffer losses. Legal contracts are frequently abrogated. Costs to other, often completely blameless, countries can be significant (through disrupted trade relationships, contagion or participation in bailouts). Across the board, legitimate questions arise about the fairness of decisions on how costs are borne. Lingering uncertainty as unresolved crises fester raises all of these costs. Since sovereign borrowing by established advanced and emerging-market countries continues to grow, and many less-developed countries are poised to tap private credit markets, ensuring that global institutions are equipped to handle the risk of a new wave of crises should be a priority.

This paper is structured as follows: The first section sketches the path of sovereign debt crises, focusing on the roles, constraints and motivations of the institutional players. This description reflects the path of major crises since the 1998 Russia default.[4] The second section describes and

1 Cottarelli et al. (2010) use the term "default" to include restructuring. In this paper, default (a unilateral halt of debt servicing) is distinguished from restructuring (a change in terms or exchange of bond contracts usually accepted by the creditor). The difference is important because the former is usually more disruptive than the latter.

2 The definition of restructuring is not precise. Here the term refers to any exchange or renegotiation of sovereign debt that results in a significant reduction in net present value (NPV). (See Sturzenegger and Zettlemeyer [2005] for a discussion of complexities in measuring NPV). The eight countries are Russia, Ukraine, Pakistan, Ecuador, Argentina, Uruguay, the Dominican Republic and Greece.

3 A type B error occurs when a development is identified as a problem when it actually is not a problem (in contrast to a type A error when a development that is a problem is not identified as such).

4 Identifying sovereign debt crises is not an exact science. Most of the discussion at the conference was based on crises spanning from Russia in 1998 to Ireland in 2010.

analyzes past reform efforts. The third section examines the case for reform. The final section proposes an agenda for moving to a more systematic approach to handling sovereign debt crises.

ANATOMY OF A SOVEREIGN DEBT CRISIS

It is tempting to simplify the analysis of how to handle sovereign debt crises by likening the problem to that of over-indebted businesses. In fact, however, sovereign debt crises present unique challenges.

To start with, the concept of insolvency is difficult to apply to a sovereign borrower. A company can estimate with reasonable accuracy the present value of its liabilities and assets. But for a sovereign, the flow of future tax receipts and future spending depends on political and social, in addition to economic, considerations. For sovereigns, therefore, it is more realistic to think in terms of ability or willingness to repay — both highly subjective concepts — rather than solvency.[5] Also, because a company can be sold or dissolved, the task of bankruptcy proceedings is to determine whether it can continue to operate or should be liquidated and its assets divided among creditors. Countries that are unwilling or unable to repay continue to exist after resolution, so the parameters for the resolution must be negotiated. In this sense, sovereign debtors have more in common with individuals than business debtors. Finally, sovereign immunity makes the enforcement of sovereign debt contracts far more difficult than that of corporate contracts.

These are a few of the ingredients of the gamesmanship specific to sovereign debt crises. History is replete with satisfactory and unsatisfactory outcomes of these games: from return to viability through strong adjustment policies supported by large, official financing (the United Kingdom in 1976) to relatively civil negotiations over a period of a few months in which agreement is reached for the main players to share losses (Uruguay in 2002) to chaotic defaults (Argentina in 2002) to hyperinflation (Germany in 1923).

Since the establishment of the IMF, sovereign debt crises have been handled through a framework that is, up to a point, systematic.[6] Within this framework, every crisis presents certain peculiarities, but several broad phases define the institutional approach.

5 Reinhart and Rogoff (2011) propose the willingness/ability to repay criterion.

6 The IMF was established to protect the system of fixed exchange rates through a reserve-pooling arrangement that would help countries facing balance of payments strains to avoid taking measures destructive to international prosperity. Sovereign debt crises were not a specific target of the IMF founders, but as a frequent source of balance of payments problems, they have been central to the IMF's mission.

WHAT IS A SOVEREIGN DEBT CRISIS?

A narrow definition equates sovereign debt crises to episodes of default. Using this approach, Reinhart and Rogoff (2011) define default broadly to include any overt or covert action that significantly diminishes the value of the payout on bonds.[7] However, in considering the adequacy of institutions for handling debt crises — including those resolved through adjustment and exceptional financing that preempt default — a definition based on default alone is inadequate.

Participants at the conference therefore considered a wider definition — from situations that turn out to have been serious liquidity squeezes to those that end in full-fledged defaults. This approach, more or less, lines up with a filter that defines debt crises as episodes when yield spreads on a country's debt spike to unsustainable levels and/or market access is effectively suspended. Considering crises that did not result in default as well as those that did, gives prominence to the decision about whether a debt-stressed country has a temporary liquidity problem or is unable or unwilling to repay. How well institutions deliver this decision is an important part of how well they handle the whole process.

More often than not, sovereign debt crises overlap with other types of crises — currency, banking or capital account. These overlaps can take many forms. Almost all crises have been accompanied by large devaluations and could, therefore, be called exchange rate crises. When banking crises force governments to assume banks' bad assets or to recapitalize banks, they often cause a sovereign debt crisis. And conversely, when a sovereign responds to financing pressures by financial repression or default, a sovereign debt crisis can precipitate a banking crisis. How global institutions deal with all of these related effects is also part of an assessment of how they deal with debt crises.

ORIGINS OF SOVEREIGN DEBT CRISES: IS IT REALLY ONLY FISCAL?

Sovereign debt crises conjure up images of precursor periods of fiscal profligacy. Sometimes this is the case. Following years of weak fiscal policy despite boom conditions, Greece in 2009 had a primary fiscal deficit of almost nine percent of GDP. For decades, public debt had hovered around 100 percent of GDP and in 2009 it was 115 percent of GDP. Greece had other vulnerabilities — low competitiveness, a fixed exchange rate and weak productivity growth in the traded goods sector — but the proximate cause of the crisis was fiscal policy.[8] Ecuador,

7 This definition includes, for example, high domestic debt situations that end in aggressive inflations.

8 Contributing to the fiscal policy error was the implicit guarantee that markets perceived from Greece's membership in the euro area.

leading up to 1999, was also predominantly a case of fiscal profligacy.

Yet most sovereign debt crises occur when fiscal weakness has not been so exceptional. Contagion has been a problem in the past decade: for example, Uruguay prior to 2002 had what seemed to be solid fiscal policies, although, it turned out, not enough of a cushion to absorb a large negative shock from the 2002 Argentina default and devaluation. Some crises are preceded by boom conditions that mask structural fiscal weaknesses and feed asset market bubbles. This can set the stage for banking crises that spill over to, or worsen, already weak fiscal positions (Turkey in 2000-2001 was a combined fiscal and banking crisis, while Ireland in 2010 was largely a banking crisis).

Fixed or rigid exchange rate policies have been a factor in almost all debt crises. Such policies shut down what could have been an automatic adjustment mechanism to stimulate output growth as market confidence first started to slip. For countries that did not enter crises with unusually high public debt (Argentina's debt was a moderate 50 percent of GDP the year before its default), the drag on growth from an overvalued currency is often a key factor in raising the trajectory of the debt ratio and turning market perceptions of sustainability. Exchange rate flexibility is not, however, an insurance against crisis. "Fear of floating," as governments become concerned about the impact of depreciation on the value of foreign currency liabilities, can stiffen exchange rate policy quickly in the run-up to a crisis.

PRE-CRISIS ROLE OF THE IMF: WHY DON'T EARLY WARNING SYSTEMS WORK?

The IMF is considered by many to be the best international channel — apart from markets — to press for changes in policy in a country flirting with crisis conditions; however, it has both strengths and weaknesses in assessing near-crisis situations. The enormous expertise on how crises unfold that IMF staff bring to the table is a key strength. The innate problems with even the best early warning system (failure to predict crises that occur or — more frequently — predictions of crises that do not occur)[9] and the absence of independence from political influence in its executive board are weaknesses. The IMF therefore does not always sound alarms with great force prior to a crisis. And even if it could, statements on the likelihood of a crisis would risk actually precipitating the crisis.

Since 1998, several sovereign debt crises have occurred in countries with a surveillance-only relationship with the IMF. Usually, the IMF expressed concern about policy weaknesses in varying tones of urgency prior to the crisis. Surveillance, however, is essentially a process of peer pressure. Particularly when IMF warnings conflict with domestic political constraints on action, the absence of any enforcement mechanism makes surveillance a weak instrument for securing change.[10]

Many crises, however, occurred while a lending arrangement with the IMF was in place. These are awkward situations insofar as the IMF is party to policy decisions that prove inadequate. These crises arise for three reasons, often in combination: non-compliance of the country with agreed policies; unexpected shocks that push policies or the adequacy of reform strategies off-track; and basic flaws in the policy strategy agreed. Decisions to abandon the bailout effort and initiate restructuring are almost inevitably delayed by the creditor country governments wishing to limit the losses borne by their domestic financial institutions. The potential for conflict of interest of the Fund (staff, management and members) in decisions about whether to halt the lending arrangement and force a restructuring adds to these problems: not only is the risk of triggering a crisis high, but also there is, at least implicitly, an admission of error in previous policy judgments.

SUDDEN STOPS AND IMF FINANCING: ARE GOOD DECISIONS MADE UNDER STRESS?

When countries lose market access, the mechanics of crisis management move into overdrive. Conference participants who had been involved in financial crises at this emergency stage emphasized the often incomplete data on the dimensions of the financing problem, the role of idiosyncratic political constraints in often chaotic decision making and the tendency to overdramatize the adverse effects of debt restructuring options. These pressures create a push toward financing and attempts to right the situation over time, through policy reforms and hoped-for good fortune. This initial bias starts a process that — of its own inertia — can become difficult to abandon in favour of restructuring.

In principle, rules govern the financing role of the IMF. These rules prescribe the objectives for conditions on macroeconomic policy during the short- to medium-term life of the lending arrangement and limit the size of IMF financing. Adherence to these rules is the key step for forcing a consideration of whether the country is suffering a liquidity shortfall or an inability/unwillingness to repay. In practice, however, no rule has stood in the way of

9 A stark example is the comparison of Uruguay and Lebanon. The year before its 2002 crisis, Uruguay had a primary fiscal deficit of one percent of GDP and public debt of 43 percent of GDP, yet the Argentina devaluation triggered a crisis. Lebanon, with large fiscal deficits and, since the mid-1990s, government debt over 100 percent of GDP, has long been seen as high risk, but despite dire political instability, has eluded crisis (IMF, 2005 and Finger and Sdralovich, 2009).

10 See Boorman and Icard (2011) for a summary of the recommendations on strengthening surveillance from the Palais Royal Initiative.

immediate IMF support upon the loss of market access. Initial lending arrangements are backed by policy changes (deemed the best possible to be agreed to in a short and chaotic period) and financing (in IMF parlance, access) to cover needs during the period of the arrangement. Indeed, in the wake of a sudden stop, most countries are granted "exceptional access" to IMF resources — that is, lending in excess of the normal access limits.[11]

RESOLUTION: ARE RESTRUCTURINGS AS DISRUPTIVE AS FEARED?

The nature of the resolution of sovereign debt crises varies over a very large range, from a relatively quick return to market access and economic growth to years of financial market disruption and/or slow growth. Predicting how any crisis will turn out is notoriously difficult (Box 1). Usually, the nature of the outcome of a crisis becomes clear within one to two years of its nadir. Either signs of growth and renewed market interest in the country's debt begin to show, or signs of the recovery manifestly fail to materialize.

A return to growth and market access with no restructuring has not been the rule. Countries where this has happened (Brazil in 1998 and 2002 and Turkey in 2000-2001) experienced political changes that produced support for a strong adjustment program, continued to receive exceptional IMF support and benefitted from some (ex ante unknowable) good fortune, such as favourable terms of trade changes, strong growth in export markets that ramped up the benefits of crisis-driven devaluations and new relationships with strong trade partners.

Countries that restructured debt to private (and typically also official) creditors had a wide spectrum of experiences. The most disruptive were in Russia, Argentina and Ecuador, the three countries that defaulted unilaterally before restructuring.[12] Russia and Argentina's defaults followed on the heels of decisions by the IMF not to continue disbursing on an existing lending arrangement. Ecuador's default was implicitly a condition for IMF support. Participants at the conference who had followed these defaults closely felt that more cooperative options did exist, but were not pursued, largely because highly political decisions were required in very stressful conditions.[13] Following the defaults, Russia and Argentina abandoned anchoring exchange rate arrangements and experienced large depreciations, while output contracted sharply and banking systems were severely disrupted. Russia regained market access within two years, but Argentina has endured a long period of litigation and a very slow return to market access. Knock-on and contagion effects to neighbouring countries were significant (debt crises in Uruguay and Ukraine are seen as having been triggered by the Argentina and Russia defaults).

Substantially less disruptive were the pre-emptive restructurings in five countries: the Dominican Republic, Pakistan, Uruguay, Ukraine and Greece. Some of these (the Dominican Republic, Uruguay and Ukraine) were seen as liquidity crises, and restructuring was aimed at debt service relief rather than debt reduction. Various factors, however, including the IMF's interest in private sector involvement around the turn of the century meant that IMF financing was not deployed to fully cover financing needs. The others (Pakistan and Greece) were seen as clearer cases of an inability or unwillingness to service debt. In general, the negotiations or acceptance of exchange offers was orderly and quick. The process for Uruguay and Greece reflected the growing sophistication of modalities (see Box 2). Partly reflecting opportunities specific to those countries' debt, the use of a retroactive collective action clause (retro CAC) in Greece and exit exchanges was effective in securing a high degree of participation, albeit with a relatively low reduction in the net present value (NPV) of restructured debt in Uruguay.

For the most part, adverse macroeconomic effects of restructuring are sharp, but short lived. Some stylized facts on the 10 restructurings (excluding less-developed countries) during 1998–2005 are presented in IMF (2006). The analysis suggests that the major macroeconomic effects depend to a considerable extent on whether the restructuring was post default or pre-emptive. In part, this is because the three post-default restructurings achieved larger reductions in the NPV of restructured debt than the pre-emptive restructurings. In the aftermath of the post-default restructurings, the fall in GDP was far steeper, yet the recoveries far stronger than in the pre-emptive restructuring cases.[14] All except Argentina and Ecuador gained medium- and long-term market access at yields close to (and for Russia, Pakistan and Ukraine, below)

11 Normal access limits (raised in 2009) are 200 percent of a country's IMF quota annually and 600 percent of quota cumulatively. Exceptional access in the 2010 Greek arrangement, however, was 3,212 percent of quota.

12 Good sources on these episodes are Gilman (2005) for Russia, Fischer (2000) for Ecuador and Mussa (2002) and the Independent Evaluation Office (2004) for Argentina.

13 One puzzle is that Russia (which defaulted on only about a quarter of its debt and only on domestic law, domestic currency debt) did not instead print rubles to cover the debt service that came due right after the IMF stopped disbursement. Gilman (2005) argues that the decision reflected a determination to defend the hard-ruble policy that was less than one year old, rather than honour commitments that were largely to domestic banks.

14 See Smith (2011) on the strong recovery in Argentina during 2003–2011.

Box 1: Three Variations on the Resolution of a Debt Crisis

During 2001–2003, three major sovereign debt crises were resolved in very different ways. Tautologically, the facts of each were different and contributed to the specific nature of the resolution. Yet, a priori, obvious differences between the facts of each case would not explain the differences in the outcomes.

Basic Data on Crisis Conditions

Country	$t^* - 1$	t^*	$t + 1$	$t + 2$	$t + 3$
GDP growth					
Argentina	-4.4	-10.9	9	8.9	9.2
Turkey	0	-9.5	7.9	5.9	9.9
Uruguay	-3.4	-11	2.2	11.8	6.6
Public debt/GDP					
Argentina	54	165	140	127	87
Turkey**	59	90	78	70	64
Uruguay	37	96	104	92	69
Primary fiscal balance/GDP					
Argentina	na	0.9	3.4	5.4	4.6
Turkey	3.3	5.5	5.1	6.2	7.2
Uruguay	-1.6	0	2.7	3.8	3.9
IMF funding outstanding/GDP					
Argentina	5	14	12	8	0
Turkey	2	10	12	10	7
Uruguay	0.5	10	21	20	14

Sources: IMF World Economic Outlook database 2012, IMF staff reports, IMF financial statements.

* Crisis *t* Argentina = 2002, Turkey = 2001, Uruguay = 2002

** Net debt of public sector

These three experiences underscore the difficulty of prescribing rules — whether for IMF financing decisions or for restructuring procedures — but also highlight the importance of having them.

After adopting a currency board arrangement in 1991, **Argentina** became the poster child of successful stabilization. Trouble started, however, in the late 1990s: the terms of trade worsened, competitiveness weakened and output started to fall. By late 2000, faced with growing fiscal and external payments imbalances, Argentina lost market access, despite an ongoing lending arrangement with the IMF and a relatively modest public debt burden (about 50 percent of GDP). Two small debt exchanges were concluded in 2001. But by mid-year, the lack of political consensus for policy changes needed to restore stability made the currency board unsustainable. Still, as late as September, the IMF not only disbursed a tranche of its lending arrangements, but also augmented what

was already exceptional access. In December, the IMF pulled the plug and a month later Argentina unilaterally defaulted on its external bond payments, starting a long and chaotic process of retrieving relations with its external creditors. Debt exchanges were carried out in 2005 and 2010, but litigation of holdout creditors continues and discussions on restructuring debt to official creditors have just begun. Market access remains limited.

Why did the IMF wait so long to bring the crisis to closure? The words of one IMF board member representing a large shareholder who voted for the last pre-default disbursement are telling: "no one ha[d] proposed a different strategy that, risk adjusted, [would] promise a less costly alternative."[1]

As the Argentina crisis was unfolding, **Turkey** also moved through a crisis. Attempting to tackle persistent inflation of close to 100 percent, Turkey, backed by an IMF Stand-by Arrangement, put in place a crawling peg exchange rate in 1999 and reversed decades of sizable fiscal deficits. Two major earthquakes and a terms of trade loss, together with problems erupting in the far-weaker-than-perceived banking sector, brought the program down in February 2001. Alhough public debt had been below 60 percent of GDP prior to the collapse, it rose to almost 100 percent of GDP owing to a large devaluation and government assumption of attendant bank losses.

From the outset, Turkey opted for strong adjustment and reform policies with no debt restructuring.[2] Primary fiscal surpluses were held at about five percent of GDP through 2007, the exchange rate was floated, inflation targeting was introduced and sweeping privatization and banking reform were undertaken. Questions about whether the response of growth, interest rates and market take-up of debt would be fast enough to prevent failure persisted through the first two years of the effort and restructuring options were considered within the Fund. Nevertheless, helped by a strong majority government that came to power in late 2002, (for the most part) disciplined program implementation, exceptional IMF support through 2007 and a strong global economy, Turkey enjoyed a strong recovery during 2003–2007 while its public debt ratio fell to some 40 percent of GDP.

Uruguay, long a darling of international capital markets and a Latin American success story, stumbled into crisis in 2002, hurt by domestic shocks and the Argentine and Brazilian devaluations, which triggered vulnerabilities of domestic banks and (given its own crawling band exchange rate arrangement) a loss of competitiveness. Drawing on an existing precautionary arrangement with the IMF started immediately.

After several months implementing significant banking reforms and trying to hold the line as bank deposits fled the country, the government floated the peso in June and then mounted a large pool of funds to put the central bank in a position to play a full lender of last resort role — each supported with an augmentation of IMF resources. Banks were largely stabilized by the end of August, but public debt had soared from below 40 percent of GDP before the crisis to almost 100 percent by year-end. With IMF encouragement, an exchange offer was made for all traded debt (about half of total debt) in early 2003 and settled before the end of May with 90–99 percent participation. The exchange aimed mainly to stretch average maturities by two years and, depending on the methodology used, secured only a 13–20 percent reduction in NPV. The offer included sweeteners on the new bonds and exit exchanges, but did not involve activation of CACs. By the end of 2003, Uruguay regained private market access.

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1 Another cloud hanging over the decision was a legal decision that had just been handed down in the United States granting an attachment order to Elliot & Associates, a vulture firm that had, in 1997, bought commercial loans guaranteed by Peru, against Peruvian assets used for commercial activity in the United States.

2 A US$7.7 billion debt swap (supported by the IMF) occurred in June 2001. It involved no haircut, was entirely voluntary and was aimed only at re-profiling currency denomination and maturity.

Box 2: Greece: How Was Such a Large Restructuring Agreed to So Quickly?

Every restructuring is crafted around the specific facts of a country's debt structure. The facts in Greece permitted some novel restructuring mechanics that facilitated relatively quick restructuring, but these are not necessarily generalizable outside the euro area.

In early 2012, outstanding bonds amounted to about €275 billion — about €206 billion held by private creditors, about €50 billion (purchased since May 2010) held by the ECB and about €20 billion held by other euro area central banks. Of total bonds outstanding, about €246 billion (including all held by the ECB) was issued under domestic law and about €30 was issued under foreign law (mostly English, but some Swiss). Domestic law bonds did not have CACs. Foreign law contracts had bond-by-bond CACs.

Domestic law debt offered distinct opportunities for restructuring because the law governing the bond contract could be changed through a parliamentary vote. For example, the terms of the bond repayment could be changed, a retro CAC could be imposed, or taxes could be levied on holders of the contract. Implementing such legal changes would diminish the chances of successful litigation, but would certainly trigger a "credit" event — the standard for activating credit default swap (CDS) contracts and complicating the Bank of Greece's access to ECB credit.[1] Also, domestic law made it possible to deal with the ECB's determination that its mandate precluded it from taking a loss on its Greek bond holdings. The ECB was allowed to swap its bonds for a new bond with identical financial terms to the old bond but not subject to any change in domestic law applying to the old bond issue.

Of several options for restructuring its remaining domestic law bonds, Greece chose a hybrid exchange offer cum retro CAC. In a two-step process, an offer was made to exchange old bonds for a new bond that had a roughly 50 percent reduction in face value with sweeteners (a cash component, a GDP warrant and English law jurisdiction). Apart from offering better-than-default terms, the offer was attractive because markets widely expect Greece to restructure again, and the new bond (by virtue of being issued under English law) was expected to have seniority to the old bond.[2] In the second step, take-up of the offer was assessed: if accepted by over 95 percent of holders (by value), the exchange would go ahead; if it was accepted by less than 65 percent of holders, it would be cancelled; or if it was accepted by 66–94 percent of holders, acceptance of the offer would be accompanied by a vote for an aggregate retro CAC. The CAC would then bind holdouts to accept the exchange.

It was hoped that offering the exchange under the threat of imposing a CAC would encourage acceptance of the offer by enough bond holders to make activation of the CAC unnecessary. In fact, 85 percent of bondholders initially accepted the exchange offer, so the CAC was put in place and activated. This, in turn, made the exchange a credit event.

Foreign law bonds proved far more difficult to restructure. Faced with insufficient interest in an exchange offer to activate CACs for many of the 36 bond contracts outstanding, the government extended the deadline for acceptance multiple times. Press reports suggest that vulture fund interest in the foreign law bonds was far greater than in the domestic law bonds owing to the higher likelihood that litigation through English or Swiss law, as opposed to Greek law, would be successful. Ultimately, all foreign bondholders that did not exchange were paid in full.

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1 Credit default swaps are insurance-type instruments through which investors can protect themselves from default.

2 Also, as in any exchange, the new (larger issue) bond would have a far more liquid market than the relatively small old bond that would remain in circulation.

the Emerging Markets Bond Index within three years of the restructuring or the outbreak of the crisis. Also within this timeframe, most had what the IMF deemed to be broadly sustainable fiscal positions. These instances of debt restructuring are small in number so generalizations on costs and effectiveness can be only suggestive.

PREVIOUS ATTEMPTS TO REFORM: OBJECTIVES AND OUTCOMES

Private sector involvement (PSI) became a central feature of the effort to improve the "international architecture" for crisis prevention and resolution in the aftermath of the Mexico and Asia crises and the Russia default. The term PSI had a broad reach. It encompassed informal agreement between a country and private creditors to stop capital flight, new resources provided by private creditors in crisis or near-crisis conditions and private debt restructuring.

The first phase of the "international architecture" reform of the late 1990s resulted in the "Prague framework" — recommendations for action and further work agreed at the September 2000 annual meetings of the IMF in Prague, Czech Republic. The communiqué endorsed the principle of PSI in the prevention and management of crises. However, the guarded language of the communiqué reflected divisions in the views on how far along the spectrum of "coercive" techniques for PSI in crisis resolution the IMF should go. The communiqué advocated relying "as much as possible on market-oriented solutions and voluntary approaches" (IMF, 2000). It also endorsed reliance on the IMF for assessing the underlying payments capacity of a country in crisis and its prospects for regaining market access. It called for a differentiation in the way three types of severe debt situations should be handled:

- When justified by prospects for success and risks of alternative approaches, catalytic (i.e., IMF) financing at high access levels with policy adjustment should be considered.
- In other cases, voluntary approaches to overcome creditor coordination problems should be encouraged.
- In yet other cases, when early restoration of market access at terms consistent with external sustainability are unrealistic, a broader spectrum of actions by private creditors, including comprehensive debt restructuring, temporary payments suspension or standstill may be warranted.

This "framework" left many difficult questions critical to application open. Two such questions were at the centre of the debate that lasted for the next three years: first, what procedures should drive "voluntary approaches to overcome creditor coordination problems" or, in the most severe circumstances, "a broader spectrum of actions by private creditors"; and second, what was to constrain the IMF's discretion in decisions about the circumstances in which exceptional finance should be provided.

CONCEPTUAL UNDERPINNINGS OF THE REFORM DEBATE

The case for introducing a formal and more systematic framework for sovereign debt restructuring rested on two economic considerations: reducing potential for creditor moral hazard and for deadweight losses, and one mainly political consideration, creating a system for allocating the burden of debt overhangs that is perceived to be fair.[15]

Limiting creditor moral hazard requires a clear and credible threat of losses through restructuring when lending has been excessive. The public policy problem is to dispel the expectation, built on the past record of IMF lending, that the IMF will bail out sovereign debtors in virtually any situation in order to avoid a costly default or long period of restructuring negotiations. The solution is to commit to time-consistent procedures that lower the costs of pre-emptive restructurings enough to be credible. Adopting formal restructuring procedures and clear constraints on IMF exceptional financing could accomplish this goal.

Deadweight losses from restructuring have traditionally been seen as the result of problems in coordinating decisions among diffuse creditors. Inefficiencies in a process that has no central direction are typically characterized as resulting from poor information (for example, on the debtor's ability or willingness to repay) and poor coordination purely among creditors, which prevent individual creditors from knowing that better outcomes might be available from cooperation with other creditors than from acting as individuals.

Fairness in burden sharing is, from a political perspective, an important intangible in resolving debt crises. However, at least partly because fairness is not measurable, it receives little attention in the purely economic analysis of debt restructuring. Yet, from the standpoint of political economy, it is crucial for gaining political acceptance of debt restructuring processes. In general, fairness objectives are best served by processes where there is symmetry in verifiably accurate information available to all creditors and debtors and where taxpayers' interests are well represented in financing decisions.

These views were (and are) considered controversial.

One conceptual argument — the so-called Mussa theorem[16] — holds that IMF lending can do no harm (in terms of moral hazard, deadweight losses or fairness) if two conditions are met: it is done at actuarially fair

15 Eichengreen (2003) succinctly presents the two economic rationales but does not mention fairness.

16 See Mussa (1999).

interest rates with repayment protected by what the IMF sees as genuinely adequate conditionality; and borrowing governments act in the interests of their populations. Jeanne and Zettlemeyer (2005), however, point out that this theorem simply transfers the debate about moral hazard to questions of whether IMF lending rates are appropriate, the implementation and adequacy of conditionality is credible and debtor governments act in the interest of their populations. In effect, the question becomes "Are IMF decisions on these issues credible and objective?" An added consideration is whether the IMF's implicit preferred creditor status distorts the IMF's risk assessment in ways that could contribute to moral hazard.

Empirical evidence on creditor moral hazard is mixed. Some studies find that changes in bond prices, especially in the immediate aftermath of major IMF financing decisions *or* decisions not to finance (as in the lead-up to the Russia crisis), are consistent with moral hazard.[17] But others find no evidence of moral hazard.[18] To some extent, these differences reflect the complexities of measuring moral hazard when IMF financing decisions influence financial markets through multiple channels. Some might cause moral hazard but others might raise efficiency.

Skepticism about creditor coordination problems has grown in the past decade. Roubini (2002) argues that in most restructurings, creditors overcome these hurdles relatively easily. Porzecanski (2003) argues that formal procedures may even be counterproductive because they would add to the asymmetry that sovereign immunity laws already imply for creditors. More recently, Trebesh (2010), analyzing 294 restructuring episodes (broadly defined) since 1980, finds that characteristics traditionally thought to influence creditor coordination — including size and diffuseness of creditor groups — are relatively unimportant determinants of the length of debt-restructuring negotiations. IMF financing was also not found to be a major source of delay. Instead, debtor characteristics, especially political instability, have been far more important sources of delay.

PROCEDURES FOR RESTRUCTURING — STATUTORY APPROACH

The 2001 Argentine crisis propelled the debate on procedures for restructuring to centre stage. In November 2001, as it became apparent that default was unavoidable, Anne Krueger, then first deputy managing director of the IMF, notched up the PSI debate with a proposal for an SDRM.[19] Krueger minced no words in pointing to one of the gaping holes in the Prague framework: "we lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only available mechanism requires the international community to bail out private creditors."[20] At the time, a sharp drop in net private capital flows to emerging markets (from an annual average of about US$185 billion during the 1990s to US$112 billion in 2002) was also a concern. The fear was that the drop reflected, in part, the unpredictable manner in which debt crises in the 1990s had been resolved (Eichengreen, 2003).

The SDRM outlined a set of procedures, which were intended to be enshrined in an international treaty, for debt restructuring. The process was to encompass:

- IMF approval of a request by a severely distressed debtor for a temporary standstill on its debt repayments and any creditor litigation;
- a forum for negotiations on a restructuring agreement between creditors and debtors;
- provisions for seniority and protection to new private lenders and assurances to creditors that their interests would be protected during the stay;
- binding of all creditors to an aggregate bond majority agreement on a restructuring arrangement; and
- a dispute resolution forum.

An SDRM would operate in tandem with the IMF's policy, introduced in 1989 and broadened on several subsequent occasions, of lending to countries that were in arrears to private creditors provided the country was negotiating with creditors in good faith.

The SDRM was actively debated through early 2003 and then relegated to further study. The proximate cause of failure (in the sense of the proposal never being actualized, although it did have other effects, which are discussed below) was the opposition of the IMF's largest shareholder.[21] But beyond this, two other, deeper problems contributed.

The first was the absence of a constituency for a statutory approach. This stemmed partly from the complexity

17 See Haldane and Scheibe (2004), Dell'Ariccia et al. (2002) and McBrady and Seasholes (2000).

18 See Lane and Phillips (2000) and Jeanne and Zettlemeyer (2001). Kamin (2002) examines financial market pricing and finds no evidence of moral hazard.

19 The proposal had been considered within the IMF during the 1990s, but given the opposition of the Clinton administration, had not been made public. See Rogoff and Zettlemeyer (2002) and Setser (2008).

20 See Krueger (2001).

21 Krueger proposed the SDRM after an explicit statement of support from then US Treasury Secretary Paul O'Neill. In April 2002, then Assistant Secretary for International Affairs at the US Treasury, John Taylor, upstaged O'Neill by supporting the competing proposal of expanded use of collective action clauses in bond contracts (Taylor, 2002).

of the issue and, therefore, the many perspectives or prejudices brought to the debate: on what caused excessive accumulation of sovereign debt (for example, incentives for excessive borrowing, incentives for excessive lending, roles of bad policy vs. bad luck); on the predominant type of crisis (illiquidity vs. an unwillingness/inability to repay); on incentives for repaying or agreeing to restructuring agreements; and on how procedures for restructuring would affect financial markets.

Positions on these issues tended to align with roles in a crisis:[22]

- Private creditors were almost universally opposed to changes from the existing "market-based, voluntary approach."
- Emerging market countries (synonymous at the time with debtors) were torn among three desiderata: improving conditions for restructuring; keeping open the option of large-scale IMF financing; and maintaining access to private inflows at low cost. Most opposed the SDRM on the latter two considerations.
- Creditor countries straddled two broad objectives — representing the interests of their private creditors and representing taxpayers' opposition to large bailouts.
- The non-governmental-organization community tended to advocate for an SDRM crafted to shift power toward debtor countries and give them opportunities for a fresh start. They also, however, tended to oppose any plan that could be interpreted as giving the IMF — viewed as operating in the interests of creditors — more power.
- The academic community was divided among three camps: those who felt anything that reduced the costs of restructuring would remove a major incentive to repay; those who saw almost all crises as liquidity problems and advocated large financing packages; and those who tended to support the SDRM as a way to give debtor countries and debtor country law more power in restructurings.

The second, deeper and more unifying problem was a basic uneasiness or downright opposition to giving the IMF more power. Ironically, this concern brought together those who felt the IMF was not able to act independently of national political interests and those who did not want the handling of crises to be more constrained by transparent rules.

The IMF was quick to respond to the anti-IMF sentiment. Krueger (2002) offered a revised proposal that reduced the role of the IMF in the operation of the SDRM. The IMF would validate debtor-initiated requests for a standstill, but would then hand the process over to the debtor and a creditor committee. That said, the SDRM would still require a universal treaty and an international judicial panel to oversee voting and arbitrate disputes. This modification failed to persuade skeptics, possibly because the SDRM had, by that stage, been branded as an IMF initiative or even an IMF grab for power. But low support was also seen to reflect a more general lack of consensus on how formal international agreements should be, even on patently global issues.

PROCEDURES FOR RESTRUCTURING — CONTRACTUAL APPROACH

After the 1995 bailout of Mexico, policy makers began to consider how bond contracts could be changed by including CACs in bond contracts to facilitate restructuring. While many provisions could facilitate or remove impediments to collective action, the term CACs is typically applied when two such provisions are included: a majority action clause, enabling a supermajority of bondholders to change the payment terms of a bond and bind all bondholders to the change; and a majority enforcement clause, enabling a majority of bondholders to prevent individuals from accelerating the bond or litigating if a default occurs.[23] Bonds issued under UK law had long included CACs, while bonds issued under New York and German laws did not.

The Group of Ten (G10)-commissioned Rey Report (1996) considered whether a single bond contract with properties that would facilitate restructuring could be developed and used in all bond issuances. The report recommended rather modest changes in contracts to include majority action and majority enforcement clauses. Private creditors and sovereign issuers were generally unenthusiastic (for reasons similar to their later opposition to the SDRM, absent the transfer of power to the IMF), and the proposal was not taken further.

Interest re-emerged in 2002 when opponents to the SDRM saw CACs as a "less bad" alternative and consistent with a so-called "decentralized market-oriented approach." In March 2003, Mexico issued a New York law bond with a CAC — a step widely seen as sealing a move to CACs and ending the SDRM debate. Thereafter, almost all hard-currency, emerging market bonds issued under foreign

22 See Setser (2008). Setser also observes that dividing lines on perspectives did not match up with representation on the IMF's Executive Board (for example, directors who might have represented taxpayers' anti-bailout interests also represented the interests of private creditors). Thus, no strong advocates for the SDRM emerged. Indeed, diverse and non-homogeneous opponents formed a loose opposing alliance.

23 Boorman (2003) provides a CAC-skeptical perspective. Buchheit, Gulati and Moody (2002) and Calomiris (2003) present arguments for CACs.

law included CACs. A second G10 working group in 2003 considered a more elaborate template for CACs, but the effort went nowhere.[24] Proponents of the SDRM accepted that wider use of CACs would be a step in the right direction. But without enshrinement in an international treaty, aggregation clauses and jurisdiction over developments during negotiations (such as the seniority of new lending), CACs would, in the words of Krueger, "take us only part of the way" to a robust framework.[25]

Alongside the push for CACs in bond contracts, the Institute for International Finance, the association of major creditor banks, introduced a code of good conduct, *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets* (Institute for International Finance, 2005). This has spawned forms of regular consultation between creditors and debtor countries, but is widely viewed as being far short of a framework for resolving problems in debt-restructuring negotiations.[26]

CONSTRAINING IMF DISCRETION IN CRISIS CONDITIONS

Although exceptional financing had not been used frequently in the years running up to the Prague framework agreement, the size of exceptional access in crises of the mid-1990s (Mexico, Thailand, Indonesia and Korea) had a shock-and-awe value. The Prague framework did not call for guidelines on exceptional financing, but questions of how to constrain discretion were clearly hanging in the air.

In 2002, the IMF established such guidelines. Instead of quantitative limits, the approach was to specify four criteria that should be fulfilled for exceptional access to be extended:

- the country is experiencing exceptional balance of payments pressures that cannot be met within the Fund's normal access limits;
- there is a high probability that the country's public debt is sustainable in the medium term;
- the country has prospects of gaining or regaining access to private capital markets within the period that Fund resources are outstanding; and
- the country's policy program provides a reasonably strong prospect of success.[27]

The four criteria parsimoniously distinguish situations of illiquidity (or where inability/unwillingness to repay is legitimately disputable) from situations with a high probability of unwillingness/inability to repay. In other words, the criteria distinguish the types of circumstances in which large-scale financing is likely to maximize collective welfare from those in which restructuring is likely to be necessary to get a crisis country back in business. Procedures to be followed in exceptional access cases — consultation with the executive board as negotiations for the arrangement occur and ex post evaluation of the experiences with exceptional access — are also specified.

Although adherence to the criteria was not exemplary through 2009, few flagrant violations occurred. A major change came with the Greek arrangement in May 2010. Proposed access at a record-breaking level in conditions many observers saw as a fundamental inability to repay, forced careful attention to the four criteria. IMF staff were unable to state with the requisite degree of confidence that the fiscal position would be sustainable in the medium term (second criterion). This criterion was then amended to exempt countries with a "high risk of international systemic spillover."[28] The decision raises a critical question: Why would the deadweight loss from financing a country unable to repay its debt be reduced because of a "high risk of international systemic spillover"?

A 2012 PERSPECTIVE ON MANAGING SOVEREIGN DEBT CRISES: IS THERE A CASE FOR REFORM?

Ten years after the SDRM debate, the European crisis, together with the troubling outlook for global sovereign indebtedness, is a reality check, reinforcing a point often overlooked during the benign conditions of the intervening decade: debt crises will remain a feature of the financial landscape. Failing to reconsider whether global institutions are well equipped to handle them would be an act of hubris.

Some conference participants argued that improving the early detection of imminent crises and creating more biting pressure on profligate countries to adjust before crises occur are the most urgent reforms. While there can be little disagreement about the virtue of better crisis prevention, it is not going to eliminate debt crises. Early warning indicators have a poor record in predicting crises, and

24 Haseler (2009) describes other efficiency-enhancing provisions including: collective representation clauses specifying how bondholders are represented in negotiations with sovereigns; sharing clauses requiring that any proceeds from legal action against a sovereign be shared among all bondholders; and aggregation clauses, prescribing that voting on restructuring take place across all bond issues.

25 See Bedford et al. (2005) for a critique of the effectiveness of and need for improvements in CACs in use since 2003.

26 See Herman (2008) for a critique.

27 The full text of the criteria is in an Annex to this paper.

28 The change was announced in the IMF Staff Report for Greece's request for a Stand-by Arrangement in May 2010. See IMF (2010).

some crises result from shocks and contagion in conditions of modest vulnerabilities, rather than from outright bad policies. But perhaps more importantly, current risks in the global economy are great. A significant number of countries are in structurally weak fiscal positions that render them accident prone. Encouraging them to adjust is important, but preparing for the accidents is prudent.

NEW DIMENSIONS OF THE REFORM DEBATE: LANDSCAPE, ANALYSIS AND EXPERIENCE

A lot of water has passed under the bridge since the 2002-2003 debate on the SDRM. In 2012, the debate on whether the still largely ad hoc approach to managing sovereign debt crises is up to the challenges it will face in the next decade must take into account the many fundamental changes in the global economic landscape, refinements of our understanding of how the ad hoc system works and the experience gained from the recent European debt crisis.

Changes in the global economic landscape have all been in the direction of presenting greater and more complex risks.

First, the European crisis destroyed one of the tenets of past debates — that sovereign debt crises are an emerging market phenomenon. True, debt crises in Europe have played out against the particular constraints of a currency union, which eliminated solutions in the form of depreciation, inflation or significant financial repression. But it is far from obvious that any of these on a scale that could be needed in debt crises in other advanced countries would be the lowest-cost method of addressing future advanced country crises.

Second, current fiscal strains in several advanced and emerging countries are at postwar peaks. The IMF (2011) shows that for many advanced countries, returning the debt–GDP ratio to a comparatively safe 60 percent of GDP would require ten-year periods of primary surpluses that exceed those previously maintained over a ten-year period. Many of these countries have plans for such adjustments. But whether they will be executed and whether they will run into headwinds from weaker-than-hoped global economic conditions are major uncertainties. Prospective demographic pressures make the low margins of safety all the more disturbing.

Third, the rapid growth of domestic law (and domestic currency denominated) debt of emerging market countries has thrown on its head the notion that the global dimension of debt crises is the stock of foreign law bonds denominated in major currencies. Even apart from the increased risk of crises in advanced countries with their predominantly domestic law debt, is the fact that emerging market law debt is increasingly held in international portfolios.

Fourth, the extraordinary growth of cross-border financial intermediation creates extra risks of contagion and crisis transmission. Although these risks raise many challenges for international financial governance that are separate from (although closely related to) sovereign debt crises, they heighten the urgency of recognizing that future sovereign debt crises may need to be managed in significantly more complex conditions than in the past.

Analysis of the ad hoc approach has been honed over the past decade.

Researchers have subjected the concentration of defaults/restructurings around the turn of the century to scrutiny. To the extent that there is a consensus emerging, it seems to be in the direction of two views: creditor collective action problems have not been as large as thought a decade ago; and restructuring in a bond-dominated world may even be easier than in a bank credit-dominated world.[29]

Why the apparent about-face? Mainly because new techniques used in debt exchanges in the past decade — the effectiveness of which were probably underappreciated in the 2001–2003 debate — have proved successful. Conditioning debt exchange offers on minimum participation rates have secured creditor coordination and exit consents, through which a simple majority of bondholders can change non-financial terms on a bond issue, have discouraged holdouts.[30] Through these techniques, most highly indebted sovereigns in crisis have been able to conclude voluntary debt exchanges even though bond issues have not had CACs as an implicit threat. And even when CACs have existed, for the most part, they have not been activated. Except for Argentina, litigation has not been a major problem.

The evolving experience in Europe is likely to create some wrinkles in this sanguine assessment.

These are early days for drawing lessons from this first very serious debt crisis in a decade. But a few new concerns are likely to emerge.

First, creditors may reassess their vulnerabilities in restructurings of domestic law debt. The relatively quick conclusion of the Greek domestic law debt exchange once negotiations started required important innovations — a unilateral change in Greek law to impose a retro CAC (which had to be activated to achieve near-universal participation with a large NPV writedown) together with pecuniary and non-pecuniary sweeteners on the new bond. These new techniques — harsher than those used in other recent bond restructurings — raise several questions. How

29 See especially Chamon and Zettlemeyer (2011) for a recent and comprehensive view of creditor coordination issues.

30 The literature supporting this view is sizable. See Buchheit and Gulati (2000) for the original proposal.

will investors respond to the innovation of having debt contracts rewritten by changing the sovereign's law? Will investors now shun domestic law debt because risks are more apparent? Will investors seek greater legal protection and, if so, how? Were the harsh techniques an indication that the positive experiences from ad hoc restructuring procedures when low NPV writedowns were targeted may not be replicated when larger writedowns and high participation rates are needed?[31]

Second, the Greek restructuring was caught in one of the long-recognized traps of crisis management — delay. Coordination among guarantors (or institutions providing official financing) was a far greater problem than creditor coordination, which happened relatively quickly. This guarantor coordination problem in turn caused paralyzing uncertainty and costly delays in creditor and creditor/debtor coordination. An offshoot of these problems was the large-scale socialization of debt, which seriously eroded the base of private debt for restructuring.[32] Political pressures are to be expected in very difficult conditions, but an important constraining factor absent in the Greek crisis was a *transparent* objective assessment of risks from an early restructuring on the one hand and from a delay on the other.

Third, the decision to change one of the four criteria for exceptional access to IMF resources effectively removed the main constraint on any inherent bias in the IMF to fully finance countries in crisis and delay restructuring.[33]

Fourth, the preference for "voluntary" agreements on restructuring may pose problems for CDS markets. During the negotiations, considerable concern arose about the fate of outstanding CDSs on Greek debt. If the intention of European institutions to make the exchange "voluntary" had been successful, CDS contracts would not have been activated. The retro CAC in this case, however, activated the CDSs, and, despite procedural problems in setting their value, the outcome was largely viewed as satisfactory. The experience, nevertheless, raises two questions: How will the CDS market function if voluntary debt exchanges involve large haircuts? How should the discovery price of a CDS be established in a debt exchange?

31 For a discussion of these issues, see Zettlemeyer (2012).

32 In March 2012, private creditors held some 40 percent of total Greek debt (including exceptional financing from the IMF and European Financial Stability Fund), down from close to 100 percent when the crisis erupted in early 2010. Gulati (2012) suggests that a comparable improvement in Greece's debt profile could have been achieved in March 2010 with only a 30 percent writedown in NPV, against the 70 percent actually imposed in 2012.

33 Spiegel (2012), for example, reflects skepticism about the application of the criteria to the new Greek loan approved in March 2012.

DO WE NEED A NEW DEBATE ON REFORM?

These observations on the global landscape, the analysis of past restructurings and the experience in Europe could justify some optimism about the adequacy of global institutions for handling severely indebted sovereigns. The success of most debt exchanges (apart from Argentina's) since the late 1990s and the continued vibrancy of sovereign debt markets offers some assurance that creditor coordination, moral hazard and fairness have been managed adequately.

Yet there are even stronger reasons to be concerned about the adequacy of current global arrangements for handling debt crises. The tests (in terms of sovereign debt crises) of the global system during 2003–2009 were not as severe as future ones could be. Plausible medium-term scenarios raise red flags about the risks of more severe crises ahead. In these circumstances, two major concerns about the status quo stand out. First, with the watering down of the four criteria for exceptional access to IMF resources, is there any effective constraint on the political forces that bias the IMF toward financing even unsustainable debt burdens? Second, are the questions raised in analyses of current techniques in debt exchanges — whether they would ensure creditor coordination in all circumstances, especially when large NPV writedowns are required — being given sufficient attention?

In view of the high stakes of any potential break down in the response to a major debt crisis in the future, a reconsideration of processes for addressing sovereign debt crises is obviously needed.

WHERE TO GO FROM HERE? A CONCISE AGENDA

As the early stages of the European crisis come to a close, there is a great deal of experience to inform a fresh look at the institutional framework for managing severe sovereign indebtedness. The aim should be to review the past decade of experience with debt crises in the context of the substantial body of analysis that has provided a rigorous basis for assessing what has worked, what has not worked and what institutional arrangements are likely to help going forward.

This effort should not be approached as a replay of the 2001–2003 debate on the SDRM, with the risk of it turning into another yes or no vote for a statutory approach to handling sovereign debt crises. Indeed, any debate about how to respond to these concerns must take into account several critical new aspects of the institutional status quo:

- The "voluntary, market-based" approach to restructuring now has clearer form. Effective practices and conventions have emerged and these would

have a definite place in any debate about optimal procedures for restructuring.

- CACs are now institutionalized. In contrast to 2001, virtually all foreign law bonds issued in major financial centres now have CACs. This "given" means that any debate on reform would start from a consideration of whether CACs have value and/or whether changes to CACs would be both effective and more safely evolutionary than wholesale reform, such as introducing a statutory mechanism.

- The effort to constrain IMF financing of countries with unsustainable debt burdens has failed. The weakening of the four criteria for exceptional levels of access to IMF financing in the face of the decision to bail out Greece raises profound questions about whether it is possible to constrain the political bias toward financing rather than restructuring.

Against these changes in the scene is one constant. As in 2001, there remains no obvious constituency for reform. Broadly, the political lineup in the SDRM debate would probably remain intact, were a statutory approach to be placed on the table again.

What would a new look at processes for addressing sovereign debt crises entail? A thorough agenda would address five central questions.

How have institutional innovations during the euro crisis affected crisis management procedures?

Undertaking a full review of the actual decisions involved in the euro crisis while their first-round effects are still evolving would not be possible. It would, however, be possible and desirable to review three aspects of the institutional underpinnings of the response to the crisis:

- the appropriateness of the change in the criteria for exceptional access and the justification of excluding situations at high risk of systemic spillover;

- the efficiency of the procedures for agreeing on the debt exchange offer; and

- the modalities for the cooperation between the IMF and regional partners in defining the nature of the crisis, designing conditionality and financing.

Is the IMF optimally organized for crisis management?

In conjunction with decisions on increasing resources for IMF lending, the role of the IMF in crisis management should be reviewed. The European crisis once again brought the IMF under enormous pressure to provide exceptional financing in circumstances where the ability and willingness of the borrower to repay and the strategy for recovery were highly questionable. Two questions should be considered:

- How can the discretion of the IMF in financing decisions be effectively constrained so that large bailouts are provided only in appropriate circumstances? In this context, the effects of the IMF's preferred creditor status, particularly in exceptional access lending, on the thoroughness of its risk assessment should be examined carefully.

- Does the IMF have sufficient independence from political influences to make efficient and timely decisions on the balance between financing, adjustment and restructuring? Should a separate, independent body, charged with assessing the nature of crises — specifically whether a crisis stems from illiquidity or an inability/unwillingness to repay — be set up? Would such a body, serving its judgment in advance of decisions on financing and adjustment made by the IMF itself, help to offset political interference?

Does the CAC template accomplish as much as it could?

The decision to actively encourage the inclusion of CACs in foreign law bond contracts was an important outcome of the 2001–2003 debate. Building on subsequent analytical work that offers rather tepid support for the usefulness of CACs in improving creditor coordination, two questions should be addressed:

- Have CACs been effective in spurring debt restructuring even when they have not been activated?

- Would a single-contract template including more CAC-type features help secure adequate creditor coordination in substantially more complex and challenging circumstances?

Are current procedures for debt restructuring robust enough for more complex and difficult crises?

The robustness of the recent legal techniques for debt restructuring agreements together with the ongoing use of CACs must be assessed. Key questions are:

- Is this duo likely to continue to prove effective in producing timely and adequate restructurings that are perceived to be fair?

- Will these procedures stand up in circumstances when very large NPV losses are needed, the quality of information about a debtor's situation is very weak or some other aspect of negotiating conditions is unusually adverse?

- How could variations on procedures for, and the modalities of, debt restructuring — especially when it is "voluntary" — affect the CDS market?

Is there a case for a formal legal restructuring framework that could be activated should ad hoc procedures fail to produce consensus?

Attendant on the conclusions from the preceding lines of inquiry, a final question emerges: Should there be a legal framework for guiding restructuring in very difficult conditions that could overwhelm the capacities of current ad hoc procedures? Such principles might cover standards for the provision of information, rules of conduct for negotiators and procedures for dispute resolution. Insofar as the IMF is widely viewed as having a conflict of interest in these issues, an independent board outside the IMF might be formed to oversee these functions. Such a framework would not be aimed at replacing current ad hoc procedures, as long as they work effectively. But by creating more certainty about processes that would be activated if ad hoc arrangements were to break down, a formal framework and supporting legal provisions would stand to strengthen the effectiveness of the more informal processes.

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ANNEX

CONSTRAINING IMF DISCRETION IN FINANCING DECISIONS: THE FOUR SUBSTANTIVE CRITERIA FOR EXCEPTIONAL ACCESS

The four criteria for exceptional financing were originally approved by the IMF's executive board on February 6, 2003, and announced to the public on March 21, 2003 in a public information notice that included the following statement of the criteria (IMF, 2003):

(i) The member is experiencing or has the potential to experience exceptional balance of payments pressures on the capital account, resulting in a need for Fund financing that cannot be met within the normal limits;

(ii) A rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable;

(iii) The member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund's financing would provide a bridge; and

(iv) The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

Two significant modifications of the criteria have been made since 2003. The first, in 2009, extended the situations described in criteria (i) in which exceptional access could be granted to include exceptional balance of payments pressures on the current and capital account.[34] The second, introduced at the time of the approval of the 2010 Stand-by Arrangement with Greece, was to significantly ease the second criterion, effectively removing it as a constraint on financing in situations where there is a "high risk of international systemic spillovers." The revised condition (ii) is:

(ii) A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. However, in instances where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over this period, exceptional access would be justified if there is a high risk of international systemic spillovers. Debt sustainability for these purposes will be evaluated on a forward-looking basis and may take into account, inter alia, the intended restructuring of debt to restore sustainability. This criterion applies only to public (domestic and external) debt. However, the analysis of such public debt sustainability will incorporate any potential contingent liabilities of the government, including those potentially arising from private external indebtedness.[35]

34 See IMF (2009) for a summary of the executive board meeting where this modification was discussed in detail.

35 See IMF (2010b) for an IMF staff review of the decision to revise criteria (ii).

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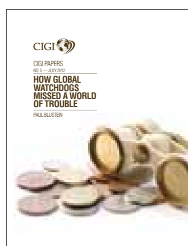

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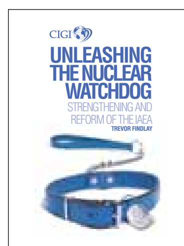

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Trevor Findlay

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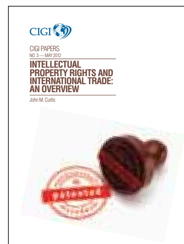

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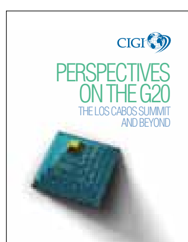

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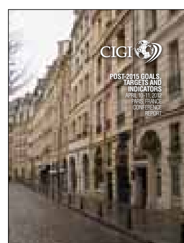

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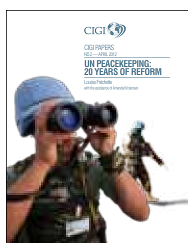

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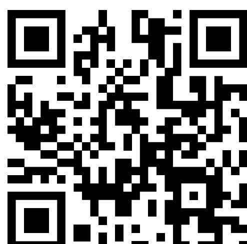

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