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THE IMF AS JUST ONE CREDITOR WHO'S IN CHARGE WHEN A COUNTRY CAN'T PAY?

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EXECUTIVE SUMMARY

The international community's management of the 2010 financial crisis in Greece revealed a major gap in the international financial system. No single institution is any longer unambiguously in charge. Consequently, the path is open for narrow interests to predominate over global interests. An examination of postwar history shows that this problem has been growing gradually since the 1970s and has become much greater since the mid-1990s. To alleviate the problem, the International Monetary Fund (IMF) needs to develop an effective strategy for reducing the opportunities for creditor countries to intervene in decisions on how crises should be resolved.

INTRODUCTION

In October 2009, the newly elected government in Greece announced that the fiscal deficit was more than three times what had been previously reported. That revelation made it impossible for Greece to continue servicing its debt on the contracted terms, and it set in motion a series of events that culminated in the formation of an ad hoc committee of official institutions known as the Troika. From the spring of 2010, the Troika — the European Commission (EC), the European Central Bank (ECB) and the IMF — assumed responsibility for assembling official financing for Greece, determining the policy changes that Greece would have to make to qualify for that financing and setting guidelines for negotiations between Greece and private sector creditors aimed at restoring access to credit on normal market terms.

The Troika was unprecedented in form and scope, but the responses to international financial crises had been careening toward it for decades. At least since the debt crisis that engulfed Latin America in 1982, containment and resolution had been too complex a task for a single country or multilateral institution to manage on its own. Heavily indebted countries were increasingly likely to have a large and diverse number of creditors, both in the private sector (commercial banks, other financial institutions and individual bondholders) and among official institutions (central banks, other bilateral lenders and multilateral institutions). The need for creditor coordination became increasingly obvious, but the resulting processes exposed a gap in the international financial system: no one is any longer unambiguously in charge.

When a sovereign debtor cannot, or will not, honour its contracts with creditors, who has control over the workout? Who is, who should be and who can be in charge? And if the IMF is to have control, how can it manage the roles of other creditors?

BACKGROUND

A key element of the international financial system devised at Bretton Woods, New Hampshire, in 1944, was that the IMF (founded at that conference) would have the responsibility and the resources to lend to member countries when necessary to restore balance to the borrower's international payments. Each member of the IMF was assigned a quota linked to the size of its economy and the size and variability of its international trade. That quota determined how much the IMF could lend to the member, and the overall scale was thought to be large enough that a loan from, or a stand-by arrangement with, the IMF could tide a country over until it could bring its economic policies and conditions in line with its revenues.

This system, based on the IMF as the one residual creditor, worked well for about 30 years. Until the mid-1970s, the IMF never had to coordinate its lending with other official or private sector creditors, and only rarely did creditor countries interfere with IMF management decisions in response to members' requests for financial assistance. One prominent exception arose as a result of the Suez crisis in 1956, in a highly political context. Because of uncertainty about the outcome of the military campaign after British, French and Israeli forces attacked Egypt, speculators applied pressure against the fixed exchange rate of the pound sterling. The British government requested a stand-by arrangement from the IMF, but the US government refused to agree to it until the United Kingdom withdrew from Egypt. When bilateral diplomacy failed to resolve the political standoff, Britain withdrew its forces, and the IMF approved the arrangement (Boughton 2001a).

The outsized influence of the United States in this episode is explained by the fact that most of the IMF's lendable resources at that time were in the form of US dollars. Approval of the stand-by arrangement formally required only a simple majority of votes cast in the IMF's executive board, but no one wanted to force the issue over US objections. Without US support, the IMF could not function. Even today, when the US voting share is roughly half what it was in the 1950s and the dollar is only one of numerous currencies that the IMF pools in its lending arrangements, the political influence of the United States is strong enough that the executive board is seldom willing to override it when a country that is seriously out of favour in Washington requests financial assistance.¹

On one level, the subservience of IMF lending to influence from major creditor countries is perfectly appropriate. Those countries provide the assets that the IMF lends. They have a legitimate interest in ensuring that those assets are used for purposes that their governments support. It is possible, however, for those countries to cross a line and weaken the effectiveness of the institution's work by interfering excessively. That possibility is explored more fully below.

In addition to multilateral institutions and creditor countries, sovereign borrowers may have to deal with

1 The distinction implicit in the phrase "seriously out of favour" is between cases when the US Congress wishes to express displeasure at a country's policies and those when the US administration wishes to use its influence to try to force a country to change its policies. For example, under US law, the US executive director must "actively oppose" and vote against any proposal for the IMF to lend to a country with a "Communist dictatorship" unless the secretary of the Treasury makes an advance case to Congress for an affirmative vote (22 U.S. Code § 286aa). That provision has not prevented the IMF from lending to Belarus (1993–2009), China (1981–1986), Romania (1975–1982) and other countries with Communist governments. On the other hand, for more than three years after Poland rejoined the IMF in 1986, its requests for financial assistance were repeatedly rebuffed owing to strong US opposition (Boughton 2001b, 993).

private sector creditors: mainly commercial banks and bondholders.² During the Bretton Woods era (1946–1972), private sector portfolio flows were small enough not to be of systemic importance.³ That changed in the 1970s, after the onset of generalized floating of exchange rates, sharp increases in oil prices and weak aggregate demand in advanced economies. Floating created opportunities for speculative profits; high oil prices led to large dollar-denominated deposits at major international banks that had to be re-invested somewhere; and weak investment demand in the north induced banks to look for prospects in the developing world.

By the late 1970s, bank financing of development extended even to such low-income countries as Somalia and Sudan. When problems arose (domestic or external) and those and other countries were unable to service the loans, they turned to the IMF for help. Responding to those requests, the Fund had to take into account the possible reactions of bank creditors. Would they roll over their loans to a troubled country once an IMF-supported adjustment program was in effect, or would they take advantage of the influx of official financing to demand repayment and exit from the market? The answer to that question would largely determine whether the official support would bring the expected benefits to the indebted country.

Bank loans to developing countries dried up in the 1980s in the wake of the international debt crisis in Latin America and other less developed economies. When creditors renewed their interest in the early 1990s, private sector development finance increasingly took the form of negotiable securities rather than loans. The desire for a more flexible instrument was buttressed by the 1989 Brady Plan, under which banks could convert outstanding loans into negotiable Brady bonds, the principal of which would be guaranteed by the US Treasury.

For five years (1990–1994), bond financing soared, giving rise to the emerging markets phenomenon. An ever-increasing number of developing countries became active issuers of foreign currency notes and bonds marketed to international investors. These capital inflows were commonly used to finance domestic-currency investments, all too often fuelling unsustainable investment and property-price surges. The inflows slowed after a new crisis hit Mexico in December 1994, and they slowed much more widely and dramatically after a series of crises in East Asia in 1997. The vagaries of the international bond market had become a major destabilizing force in itself.

2 “Bondholders” is used here as a shorthand for holders of negotiable interest-bearing securities, not just bonds as technically defined.

3 Speculation against the pound sterling during the Suez crisis was primarily through leads and lags in trade settlements, not portfolio flows. The pound was not yet a fully convertible currency.

Michel Camdessus, then managing director of the IMF, famously characterized the speculative attack on the Mexican peso at the end of 1994 as “the first financial crisis of the twenty-first century” because of its speed and its disconnect from developments in the current account (Boughton 2012, 456). Indeed, the two decades since that event have been pockmarked by financial collapses that have been more complex and more difficult to resolve than their predecessors. The range of financial instruments and the scale of the events have been much greater than before; the speed with which crises have unfolded has accelerated; and the number, diversity and geographic range of creditors and other stakeholders has expanded. As a result, coordination of creditors has become increasingly difficult.

To illustrate: When the Mexican debt crisis erupted in 1982, most of its external sovereign debt was in the form of commercial bank loans. The major international banks formed a steering committee comprising 12 of the largest creditors. More than 40 percent of the debt was held by the 25 largest bank creditors. Holdings tapered off sharply after that number, and the task of involving the 500 or so smaller banks in the workout fell largely to a handful of national central banks. Short-term official financing was arranged within days after the crisis erupted in August. The IMF negotiated an adjustment program with the Mexican authorities during the 90-day reprieve granted by the initial financing, contingent on an agreement by bank creditors to increase their own exposure to co-finance the workout. Securing a participation rate covering 86 percent of the outstanding loans took less than six weeks. By May 1983, almost every creditor bank had agreed to increase its loan exposure by the agreed amount, and the initial crisis was resolved (Boughton 2001b, 306–16).

The response to the 2009 Greek crisis took much longer to assemble and activate. The Troika did not hold its first meeting with the Greek authorities until six months after the onset of the crisis. Another 20 months elapsed before private sector creditors formed a committee composed of 32 varied financial institutions headquartered in 10 different countries. It included commercial banks, but also savings banks, insurance companies, asset managers, diversified financial firms, and even state and regional public institutions, both foreign and Greek (Zettelmeyer, Trebesch and Gulati 2013, table 2). Once the creditor committee — which was estimated to hold between 30 and 40 percent of Greece’s outstanding bonds — agreed to a restructuring plan, participation by most other creditors was secured within a few weeks, but the crisis had now extended well into 2012.

Many reasons help explain the long delays, including some that are unique to the European Union or to Greece in particular.⁴ The Greek crisis involved serious structural economic problems in addition to the financial imbalances. Nonetheless, the problem is endemic in the modern system of globalized finance. Not only is a heavily indebted country likely to have many international creditors; those creditors are also likely to be highly diverse: commercial banks, nonbank financial institutions, bilateral official institutions and — especially after the fact — multilateral institutions such as the IMF. These varied groups have different interests and different perspectives on how to respond to a crisis. Decisions on which one will be allowed to dominate will alter the process and the outcome. If no one dominates, as in the Greek case, crisis resolution may prove elusive.

COPING WITH COMMERCIAL BANK INTERESTS

Historically, the first pervasive issue to arise was the existence of large outstanding debts to commercial bank creditors. As this situation developed, the IMF and other official creditors lacked a strategy for coping with it. Instead, they responded to each case as if it were *sui generis*. Gradually, a systemic strategy emerged.

One of the first instances arose in 1976, when the Democratic Republic of Congo — then known as Zaïre — requested a stand-by arrangement. The government had borrowed heavily from international banks from 1972 to 1975, both with and without guarantees from creditor governments, but had gone into arrears after the world price of copper (the country's principal export) collapsed. Zaïre initially drew on the Fund's small but low-conditionality Oil Facility. When that proved insufficient to stabilize its finances in the face of the banks' reluctance to extend new loans, the government committed to undertake an adjustment program supported by a one-year IMF arrangement. That catalyzed some new officially guaranteed bank loans, but prospects for normal access on commercial terms still looked poor.⁵

Restoring normal relations between Zaïre and its creditors was of critical importance to the Fund; otherwise, the government would effectively become a ward of the institution for years to come. In this case, it is unlikely that commercial interests differed substantially from those of

the country or the IMF. All parties wanted to restore good economic performance and normal credit access.

The Fund and the Zaïrean authorities negotiated a stand-by arrangement with standard terms aimed at strengthening the balance of payments. The next step was for the authorities to negotiate a rescheduling of debt service terms, both with official creditors (who coordinated their response through the informal grouping known as the Paris Club) and with commercial banks (which had their own coordinating group, the London Club). Standard practice up to this time had been for IMF staff to participate in Paris Club meetings, mainly to explain to bilateral creditors the Fund's outlook for the economy in light of the adjustment program that had just been activated. In the case of Zaïre, rescheduling commercial debts was important enough for the success of the program that the executive board authorized staff to participate in meetings with the banks as well.

This new hand-holding exercise initially worked well. It helped reassure the bankers, who agreed to continue rolling over their loans while Zaïre successfully carried out the adjustment program. After that first year, however, Zaïre — faced with internal strife and saddled with pervasive corruption — could not sustain the adjustment effort. For a time, the government continued servicing its bank loans while going into arrears on its bilateral official debts. Under pressure from creditor countries, the IMF continued to approve credits to Zaïre, and the Paris Club continued to reschedule its own credits conditional on the existence of the Fund's support. Commercial banks, though, delinked their decisions from those of the IMF and pulled out. Never again did Zaïre regain normal access to commercial credit markets.

A key feature of the 1976 episode in Zaïre was that the dependency was unidirectional: bank lending was conditional on the IMF, but the Fund's approval of the stand-by arrangement did not require a normalization of relations with banks. That independence began to change two years later, in conjunction with a stand-by arrangement with Sudan.

The prospect of oil production in Sudan had induced large-scale bank lending to the government starting in 1974, until arrears began to accumulate in 1976. New bank lending essentially ceased in 1978, and that forced Sudan to ask for help from the IMF. The Fund approved an extended arrangement (a three-year stand-by agreement with a longer repayment schedule, under the terms of the Extended Fund Facility [EFF]) in May 1979. The Fund's provision of financial assistance, in combination with Sudan's promises to carry out policy reforms, prompted the banks (in the London Club) as well as official creditors (in the Paris Club) to begin negotiations with the authorities to reschedule outstanding debts. Moreover, the EFF arrangement required Sudan to eliminate its arrears

4 Trebesch (2011) estimated that in the decade prior to the Greek crisis, the average length of time from the beginning of negotiations (or from a default) to the final implementation of a restructuring was about 17 months. Twelve of the 16 cases that he examined were completed in less than two years.

5 See IMF (1983, 127–29), de Vries (1985, 493–94) and Boughton (2001b, 804–05).

on bank loans within the first year, as a condition for subsequent drawings on the arrangement (IMF 1979, 12).

The Paris Club agreed, in November 1979, to reschedule official debts, but the banks took a harder line. Knowing that Sudan had to eliminate arrears by the following April, and suspecting that Arab countries in the Middle East would likely bail out Sudan if necessary, the bankers had little incentive to soften their demands for timely repayment. In the event, Sudan did not clear its arrears, but it did reach understandings with creditors to continue negotiations while at least stabilizing the amount of outstanding arrears. Senior IMF staff met trilaterally with bank creditors and the authorities throughout 1980, without success. In 1981, a loan from Saudi Arabia provided some relief. After that, however, Sudan could no longer properly service its debts to the IMF, to other official creditors or to the banks. This second attempt to develop a strategy for accommodating commercial interest thus also failed. (As of 2015, Sudan still has not settled much of its arrears.)

When Turkey applied for a three-year stand-by arrangement in 1980, the IMF decided to go back to basics: lend to the country and just hope that commercial bank creditors would at least be impressed enough to maintain their loan exposure. The requested commitment was exceptionally large in relation to Turkey's quota (625 percent, at a time when the normal access limit for a three-year arrangement was 165 percent), but the authorities were already implementing a comprehensive economic reform program (see Aricanli and Rodrik [1990]) that the Fund and major bilateral creditors viewed as effective enough to warrant strong official support.

Under these circumstances, it was easy to hope that the official actions would induce commercial bank creditors voluntarily to participate in the financing, a tactic that later became known as private sector involvement (PSI). As Jacques de Groote — the executive director representing Turkey at the IMF — put it, commercial bank creditors “should respond in a positive way when the Fund expresses its confidence in a country's recovery program and gives them a clear signal.”⁶

Hopes were dashed. Turkey did successfully carry out its reform program; it drew the total amount of the stand-by arrangement, and it repaid the loan and the interest charges fully and on time. Bank creditors, however, were unimpressed and mostly chose not to renew their own loans to the government. As a result, much of the official support served merely to replace expiring bank loans. The net increase was sufficient to stabilize Turkey's external payments position, but the longer-term benefit to the country's economic performance was less than it might

have been if the catalytic effect had worked as planned.⁷ It appeared that the IMF needed a more direct way to engage private actors if its program support was going to succeed more broadly.⁸

Mexico's 1982 debt crisis provided the perfect opportunity for the first real PSI and the beginning of a general strategy for coping with the interests of commercial creditors. The crisis itself was initiated by bank creditors. Despite a spate of weaknesses in Mexico's economic policies, banks continued rolling over loans through July, albeit with widening spreads over the interbank rate. A presidential election in early July produced a winner (Miguel de la Madrid) who was viewed relatively favourably in the banking community, but creditors seem to have then begun worrying about the likelihood of a spending binge during the months until the new administration would assume office in December. In mid-August, the major creditors suddenly demanded repayment of maturing loans. Mexico did not have the money, and the authorities turned to the United States and the IMF for help (Boughton 2001b, chapter 7).

The official response was complex, but the essence of it for the present discussion was that the IMF negotiated a three-year extended arrangement to begin in December 1982, conditional on formal commitments from bank creditors to increase their own loan exposure to Mexico by seven percent. For the first year, the IMF would provide about US\$1.3 billion in new financing, bilateral official creditors would provide some US\$2 billion in export credits and bank loans would rise by US\$5 billion. To win over the banks, the Fund's managing director, Jacques de Larosière, convened a meeting with 17 leading banks, held at the Federal Reserve Bank of New York on November 16. He told them unequivocally that he would not recommend approval of the program unless and until the banks provided written assurances of their own and other banks' participation.

That the banks agreed to — and followed through on — this ultimatum may seem surprising. The simple explanation is that it was in their interests to do so. Without the IMF, Mexico would have had to default on many, perhaps most, of the outstanding loans. Moreover, because the prevailing interest rate was higher than seven percent, Mexico would be making net payments to the banks under this agreement. The approach was often called “new money”

7 Carlo Cottarelli and Curzio Giannini (2003) provide a comprehensive survey of the effect of IMF support on private sector capital inflows. They note that evidence shows that “catalytic effects, if any, are small.”

8 In 1982, reminiscing on the success of the strategy developed for Mexico, the IMF managing director lamented that “the Fund would have been happy to act in the same way in a case like that of Turkey.” (Minutes of Executive Board Meeting 82/168 [December 23, 1982]; quoted in Boughton [2001b, 276n]).

6 Minutes of Executive Board Meeting 80/92 (June 18, 1980), p. 8; quoted in Boughton (2001b, 277n).

when it was introduced, but this tag was a misnomer. More appropriately, it eventually came to be known as “concerted lending.”

The banks could have called the managing director’s bluff and hoped that the United States and other major official creditors would force the institution to approve the arrangement even without their involvement, but no one was willing to take that chance. A default by Mexico would have been large enough to bankrupt many of the institutions present at the meeting. It also helped that the lead bank, the chair of the creditor committee on Mexico, was Citibank, which had a very substantial ongoing business relationship in the form of branch offices and other operations there. Restoring viability to the Mexican economy was a sensible business goal, and it could not be achieved without nearly full participation by Mexico’s 500-plus bank creditors.

Concerted lending effectively created the modern IMF, as the essential manager of every international financial crisis. It demonstrated both the need for creditor coordination and the possibility for the IMF to fill that need. As a specific process for involving bank creditors, however, it worked reasonably well, but only for a few years in a limited number of cases.

The IMF applied concerted lending in four large emerging markets: Mexico in 1982 and again in 1986; Argentina from 1982 through 1986; Brazil in 1983; and Chile in 1983 and 1985. It also tried it, with greater difficulty, in three smaller countries: Uruguay and Ecuador in 1983, and Côte d’Ivoire in 1984. Beyond that group and that time, the problem was that the vulnerability of bank creditors to a default was greatly diminished. Even in the early 1980s, the exposure of large banks in small countries was generally not of a magnitude sufficient to threaten the banks’ finances. After the onset of the crisis across Latin America, creditors gradually set aside provisions to cover potential losses. As it began to take longer and longer to assemble a so-called critical mass of creditor acceptances to participate, the implementation of policy reforms and the securing of IMF and other official financing was increasingly delayed.

In May 1987, Citibank announced that it was setting aside an additional US\$3 billion to cover potential losses on its sovereign loans. That amount seems small in relation to the massive capital flows of the early twenty-first century, but it was shockingly large at the time. As a result, concerted lending was no longer viable because the playing field had tilted in favour of the creditors. If the IMF had continued to insist that it would approve large stand-by arrangements only on the condition that banks would agree to increase their exposure, the banks could

have responded by demanding onerous and unacceptable terms from the indebted countries.⁹

The demise of concerted lending was accompanied by a new round of experimental efforts to engage the banks more flexibly. The IMF and major official creditors saw the essence of the challenge as finding ways to give confidence to commercial banks that heavily indebted countries were on a path toward financial viability. With that confidence would come a willingness to lend voluntarily on affordable terms.

Starting in 1984, the Fund and the Paris Club experimented with encouraging banks to negotiate Multi-year Rescheduling Agreements (MYRAs). The idea was to identify countries with strong reform programs in place, and then work with the banks to develop a plan to reschedule outstanding debts over a long enough multi-year period to bring the program to fruition. This rather optimistic strategy had some success in just four cases: Mexico, Venezuela, Ecuador (all three in 1984) and Yugoslavia (1985-1986).

To buttress the MYRA process, the IMF also introduced a new procedure that it called Enhanced Surveillance. At that time, IMF staff reports were normally kept confidential and were shared only with member countries. Under Enhanced Surveillance, reports would be given directly to bank creditors, still on a confidential basis, in the hope that a positive assessment would encourage banks to keep lending and agree to reschedule outstanding loans. In the event, the IMF’s assessments did not sufficiently alter creditors’ own negative views on expected returns to lending. After just three cases — Venezuela (1984), Yugoslavia (1985) and Uruguay (1986) — the Fund abandoned the program because it evidently was not having the desired catalytic effect.

The next attempt to revive the strategy was the Baker Plan, introduced by US Secretary of the Treasury James A. Baker III in October 1985. The idea was to get the IMF, the World Bank and regional development banks to work together to devise growth-oriented adjustment programs for the most heavily indebted emerging-market countries. The implementation of such programs was supposed to inspire commercial banks to increase their lending. Baker specified an “indicative target” of a three percent increase in loan exposure to the so-called Baker 15 countries,

⁹ Concerted lending was given one last, successful, ride at the end of 1997, when the IMF-supported adjustment program in Korea was faltering. Despite a large influx of financing from the IMF, other multilateral institutions and bilateral creditors, international commercial banks continued to pull out their own funds throughout December. After three weeks of reserve losses that threatened to undermine the whole effort, the Group of Seven and the IMF reluctantly agreed to set up an informal network of official encouragement and persuasion to reverse the declines. Within weeks, the program was on track. For details, see Boughton (2012, 539–70).

mostly in Latin America. The IMF and the World Bank both approved the plan, but it lacked any real substance. Neither institution had a model, or even a general plan, for reorienting policy reforms in a way that would reliably restore economic growth in developing countries, nor had anyone a plan for inducing commercial banks to take the desired actions. Three years later, the IMF estimated that net new lending to the 15 countries was essentially zero during the life of the Baker Plan. Although the actual figure was difficult to estimate with precision,¹⁰ most observers agreed that the Baker Plan fell well short of its catalytic objectives.

By 1986, the main focus in official circles shifted from trying to get the banks to increase lending to trying to get them to restructure the outstanding loans so as to reduce the overall burden on indebted countries.¹¹ For the next three years, the IMF experimented case by case and developed a menu of options for reducing countries' debt burdens. For Bolivia in 1986, the Fund set a precedent by agreeing to finance a program despite the continuation of arrears to commercial banks. As that program progressed in 1987, the IMF and bilateral creditors supported a scheme under which Bolivia used donated funds to buy back some of its bank debt at a discounted price. Chile, Costa Rica and Bolivia undertook conversion of debts into equities. Mexico organized a deal in which it converted bank loans into negotiable bonds that were partially guaranteed by the US Treasury.

The Mexican scheme — conversion of loans into bonds — proved to be the critical component of what became the Brady Plan in 1989. The challenge was to develop a viable process for determining the right price for the conversion. The Mexican deal, reached in December 1987, called for an auction of discounted negotiable zero-coupon bonds, with the principal guaranteed by the US Treasury. Relatively few banks showed an interest, but Mexico did manage to convert close to 20 percent of its offered debt at a discount of around 30 percent (Boughton 2001b, 490). As the secondary market for sovereign debt contracts continued to grow, an alternative strategy of directly negotiating a discount price became viable. Although the market was still small and volatile, IMF staff determined that the market prices were reasonably representative of the underlying value of the contracts. In the Brady Plan, therefore, country authorities would agree on a price with a committee of bank creditors,

and the IMF would augment its own financial commitment to help the country make the conversion.

The Brady Plan could have given great power to bank creditors, because each debt conversion required their agreement. What made it work was the existence of an *ex ante* market price that all parties understood to be representative. If creditors insisted on a higher price, or if the country insisted on a lower price, the deal would likely collapse and leave both sides worse off. Once the first few Brady deals were completed — Costa Rica and then five other Latin American countries in 1989 alone — the debt crisis of the 1980s was resolved, and the longer-term strategy for containing the interests of commercial bank creditors was essentially in place.

COPING WITH BONDHOLDER INTERESTS

Once the Brady Plan was active, portfolio capital poured into emerging market countries for the next five years. In contrast to earlier bursts, much of these inflows were through purchases of negotiable securities rather than bank loans. As a result, when a new wave of financial crises hit in the second half of the 1990s, creditor coordination was an even more severe problem than before.

The first test came, as it often did, in Mexico. In the early 1990s, the Mexican federal government was able to finance much of its borrowing needs by issuing treasury bills denominated in pesos. It supplemented that activity by issuing bills known as *tesobonos*, which were payable in pesos but at a guaranteed exchange rate. *Tesobonos* thus were effectively denominated in US dollars. In response to a series of adverse events in 1994, the government found that it had to sharply increase the share of *tesobonos* in its borrowing in order to maintain investor interest. By December, when speculation of an impending peso devaluation threatened to overwhelm the central bank's ability to hold the rate, the government was in an unsustainable position. Once it devalued, the cost of redeeming the outstanding stock of *tesobonos* would be unbearable.

Mexico turned first to the US Treasury and the Federal Reserve System for help, and then to the IMF for further help and coordination (Boughton 2012, chapter 10). US officials were especially concerned because a default by Mexico would not only destabilize an important neighbour and trading partner just months after the adoption of the North American Free Trade Area was hailed as a triumph of open trade, it also would threaten the health of US financial institutions that were major holders of *tesobonos* and other Mexican securities. The result was a US\$40 billion financial package comprising US\$20 billion from the US Exchange Stabilization Fund, an unprecedentedly large US\$17.8 billion IMF stand-by arrangement, and US\$2.2 billion in commitments from Canada, the World Bank and the Inter-American Development Bank.

10 Other estimates ranged from negative to positive, and even to close to the target figure. See Boughton (2001b, 427–29).

11 Efforts to get banks to maintain exposure were not abandoned altogether. As noted earlier (footnote 9), maintaining exposure was a key part of the 1997 program in Korea. More recently (since 2009), one component of the Vienna Initiative — a joint effort of European institutions, the IMF and the World Bank Group — has been to induce cross-border banks to maintain loan exposure to countries in “emerging Europe.” See <http://vienna-initiative.com/>.

This package was the first in what became a series of ad hoc multilateral financing arrangements for crisis-hit emerging markets. The US\$40 billion figure was set, primarily by US Treasury officials, as an amount that presumably would impress private creditors enough that they would cease worrying about default risks and would keep investing in Mexico. It also was large enough that Mexico could keep servicing its existing stock of *tesobonos* on the contracted terms.

Within several months, the Mexico package, buttressed by strong policy implementation by the Mexican authorities, succeeded in restoring economic growth, stabilizing the exchange rate and resuming normal relations with private creditors. As the economy rebounded, Mexico repaid all of the official loans fully, with interest and ahead of schedule. Bondholders, including holders of *tesobonos*, also were repaid in full without any need to renegotiate terms.

Many analysts have worried that this outcome gave rise to moral hazard for investors: a conviction that the risk of lending to emerging markets was minimal because the official sector would bail out any country in financial trouble. How large or important this effect was is a matter of conjecture. What is clear is that the official sector eventually learned that rescuing the country did not always have to mean — and should not always mean — rescuing its creditors from their own mistakes.

The lesson would take a long time to learn, largely because negotiating with bondholders is far more difficult than negotiating with commercial banks. In each of the crises in East Asia in 1997 and 1998, external debts were exclusively, or nearly so, in foreign currencies and in diverse negotiable securities. Domestic currencies were overvalued, but by the time the crisis hit, the debt structure meant that devaluation could not solve the problem. Wanting to avoid default (and strongly encouraged by the IMF and other official entities to do so), the affected countries undertook painful adjustment programs intended to resolve the underlying imbalances and structural deficiencies as quickly as possible. An exceptional case was Malaysia, which bought extra time in 1998 by imposing controls on capital outflows for several years while it adjusted its macroeconomic policies more gradually. The overall international strategy, though, was to preserve normal market access and focus on domestic policy adjustments to resolve the crisis.

The strategy was tested in August 1998, when Russia defaulted on much of its domestic and external debt. For two years preceding this crisis, the IMF had gone to desperate lengths to help the Russian government avoid default. It had entered into an unusually large extended arrangement with Russia in 1996, under which it lent more than US\$10 billion through July 1998. The Fund had agreed with the Russian authorities to liberalize the capital market by allowing foreign creditors to repatriate

both principal and interest on government securities. The problem was that the government was unable to overcome severe shortfalls in revenue collection and, therefore, was dependent on ever-increasing inflows of foreign capital. That situation became unsustainable in August, and the government responded by simultaneously defaulting on debts and devaluating the ruble.¹²

Russia's default was a major trauma for the international financial system. It ended the post-Mexico "moral hazard play," in which some investors would act on the assumption that the official community would always bail them out in case of trouble in an emerging market. More specifically, the Russian default helped trigger crises in Malaysia and Brazil over the next few months, along with the near-bankruptcy of the hedge fund Long-Term Capital Management. Nonetheless, the longer-term consequences were smaller than one might have predicted at the time. Financial globalization did not end, and Russia — aided serendipitously by a rebound in the world price of its oil and gas exports — recovered substantially over the next few years.

More lasting consequences followed a few years later, from a debt — and political — crisis in Argentina. As with Russia, the IMF lent large sums in the years leading up to the crisis, while the persistence of policy shortcomings led gradually to a disillusioned creditor base and, thus, to the government's gradual loss of access to international capital on favourable market terms. As with Russia, the Fund practically exhausted the scope for financial support *before* the crisis climaxed. In this case, the Fund lost confidence in the Argentine authorities' ability to stabilize the economy only after disbursing the equivalent of more than US\$10 billion in 2001 alone, and only after capital markets had already demonstrated a loss of confidence by sharply driving up yields on Argentine debt. That December, the Argentine government fell, and its successor defaulted on much of the external sovereign debt.

Throughout the run-up to the default, the hope of the IMF and the Argentine authorities was to buy time through a combination of official financing packages and voluntary debt reschedulings to avoid unilateral action while the government got its fiscal position under control. In this case, the size of external debt was not the problem. The problem was the structure of the debt — dollar-denominated and increasingly of short maturities — combined with an exchange rate regime equivalent to a currency board (Lischinsky 2003). The only way the regime could be sustained was to convince investors in both domestic and international capital markets that it could and would be sustained. The circular and not very convincing logic of the situation meant that private financial markets at least loosely controlled the steering wheel unless and until

12 The Russian crisis is covered in Boughton (2012, 324–42).

the government wrested it away from them, as it did by defaulting in December 2001, and then abandoning the currency board arrangement.

After the Argentine debacle, the IMF adopted a policy intended to ensure that it would lend large sums (i.e., grant “exceptional access”) only when the country had a viable plan to put and keep its debt on a sustainable path. Such a plan might require reaching agreement with private sector creditors on a restructuring to reduce the net present value of outstanding obligations. However, if the country was judged to be negotiating in good faith, but creditors were reluctant to reach an agreement, the IMF would be prepared to lend notwithstanding the resulting arrears to those creditors.¹³

IMF officials and others also advocated establishing default-averting mechanisms akin to the bankruptcy proceedings used in domestic markets. The most well-known proposal was made by Anne O. Krueger, then the first deputy managing director at the IMF, to create a Sovereign Debt Restructuring Mechanism (Krueger 2001; 2002). That specific proposal did not gain traction, but it did help spur the increased use of collective action clauses (CACs) — binding all holders of a debt issue to accept a rescheduling supported by a qualified majority — in subsequent issues of sovereign debt. CACs had been widely discussed as a partial solution to emerging-market debt crises since the 1995 Mexican crisis, but without much result.¹⁴ Consequently, offers by sovereign debtors to restructure outstanding bonds had to contend with holdout creditors through ad hoc arrangements. Since 2003, CACs have facilitated some debt restructurings, both with (for example, Argentina) and without (for example, Greece) a prior default, by effectively eliminating the possibility of holdouts.¹⁵

In principle, even without a new statutory mechanism such as that proposed by Krueger, the new IMF policies and the increased use of CACs should have largely resolved the issue of excessive control by bondholders and effectively restored control to the IMF and other official creditors. Unfortunately, when the Greek financial crisis hit in 2009 — the first instance where the IMF was called upon to act according to these principles and procedures — the Fund punted under pressure and weakened the requirement that the country’s debt profile would have to be sustainable once the program was implemented. Specifically, if the crisis posed a systemic threat, the Fund would be prepared to lend even if it projected that the debt

profile might well be unsustainable (Schadler 2013). That set the stage for the prolonged effort in which Greece was forced to undergo a severe economic contraction in order to satisfy the demands of international bondholders.

What this history shows is that the requirements for containing bondholders are well understood, but fulfilling those requirements is made difficult by excessive interference from creditor countries. Going forward, containing that interference becomes the major challenge.

COPING WITH OFFICIAL BILATERAL INTERESTS

As noted in the first section of this paper, creditor countries have a natural and legitimate interest in the amount, direction and purpose of IMF lending. It is their money that the IMF is lending. For that reason, every lending arrangement that the IMF undertakes has to be discussed and approved by the IMF’s executive board, on which creditor countries hold the majority of the voting power. The question to consider, then, is whether it is beneficial for creditor countries to intervene and attempt to dictate or influence the policy conditions attached to Fund lending.

Creditor countries might intervene to influence IMF conditionality for two reasons. First, officials might believe that they have superior knowledge or ability to dictate terms that are in the best interest of the indebted country or the global economy. Second, they might have national interests at stake. Even in the second category, the first is more likely to be the publicly stated reason. In either case, the wisdom and propriety of the intervention can and should be subjected to the test of whether it benefits the global interest.

Until the mid-1990s, creditors intervened in conditionality only rarely and indirectly. As noted above, in 1956, the US government demanded that the United Kingdom withdraw its troops from Egypt as a precondition for allowing the IMF to approve a stand-by arrangement. In a later, unsuccessful case, in 1981, the US Congress tried to prevent the IMF from lending to India at a time when the Indian government was preparing to purchase a number of Mirage fighter jets from France. In that case, the US executive director abstained from the vote, the IMF approved the lending arrangement and India proceeded to purchase the airplanes.¹⁶

In the early 1990s, the IMF developed a plan for reviving economic activity and restoring financial stability in the CFA franc zone. The plan involved devaluing the CFA franc and then entering into conditional lending arrangements with most of the 13 African countries that used the currency.

13 See IMF (2002; 2003a; 203b). For an analysis, see Schadler (2013).

14 For an early influential analysis, see Eichengreen and Portes (1995). For an overview of the argument, see Kletzer (2004).

15 For a survey, see IMF (2012). For a discussion of the limitations of CACs and the increasing need for a statutory mechanism, see Brooks et al. (2015).

16 The US executive director, Richard D. Erb, was subsequently called up to explain his vote in a subcommittee hearing in the House of Representatives. See Boughton (2001b, 713–15).

The rub was that this plan required the approval of all 13 countries *plus France*, which was the guarantor of the solvency of the system and had a strong national interest in preserving it. For nearly three years, Camdessus met separately with senior officials in France and throughout the zone in Africa, until he was finally able to forge an agreement in January 1994. France's concurrence was the *sine qua non*, and it hinged on the government's acceptance of devaluation as a policy tool. Once the agreement was reached, however, the French authorities did not intervene overtly in the determination of further policy adjustments as conditions for IMF financial support.¹⁷

Creditor involvement ratcheted up at the beginning of 1995, when Mexico requested financial support from both the IMF and the United States in the wake of its decision to devalue and then float the peso. Fund management and the US authorities consulted closely to coordinate their responses and to assemble a large enough financial package to resolve the crisis. Neither had the resources to manage the situation on its own, and each one had its own views on what Mexico needed to do to reform the economy and to qualify for external support.

The US authorities reportedly tried to insert a prohibition on diplomatic recognition of Cuba, and they required Mexico to commit future oil receipts as collateral. The collateral requirement threatened to undermine the IMF's status as a preferred creditor, but the Fund and the Treasury eventually worked out satisfactory sharing arrangements. In addition, the Treasury conditioned its own support on a commitment by Mexico to be more open in reporting data on its international reserve position. IMF officials did not disagree with that objective, but they did not believe that it was a necessary condition for its own lending.¹⁸

Although the US conditions did not directly impinge on the IMF-supported program, they did affect it indirectly. The IMF's own rules prohibit it from imposing cross-conditionality. That is, the IMF cannot refuse to dispense funds under a stand-by arrangement simply because the country is failing to meet conditions imposed by another creditor. However, the IMF's rules also require it to ensure that each program is fully financed. Therefore, in this case, if the United States were to refuse to dispense funds under its own agreement with Mexico, the program would be underfinanced, and the IMF would likely suspend its own lending as well. The very existence of a jointly financed package deal introduces effective cross-conditionality. To

be sure of continuing support from the IMF, Mexico also had to meet the conditions set by the US Treasury.

In the Mexican workout, the insertion of additional policy conditions by the US Treasury was fairly benign, and it did not demonstrably delay resolution of the crisis. Success in this case did, however, embolden US and other creditor-country officials to get more involved in the management of subsequent financial crises. The increasing need for large-scale financing by multiple creditors in subsequent cases also enabled them to do so.

An opportunity for further intervention arose in August 1997, when Thailand asked for help to recover from a severe loss of foreign exchange reserves that resulted when a commercial property boom collapsed. The central bank was reporting that it held about US\$23 billion in foreign exchange reserves, but it was not reporting that all of those reserves were committed to cover forward swaps. In other words, net reserves were virtually zero. IMF staff and management initially concluded that it would be unwise for the Thai authorities to reveal this "hole in reserves" until a recovery program was approved and operational. The US authorities, in particular the chairman of the Federal Reserve System, Alan Greenspan, believed otherwise. Transparency, in their view, was always to be desired. Until Thailand revealed the hole in reserves, they would oppose the Fund's involvement in the workout.

In this case, the IMF retreated and made its financing contingent on the revelation of the true reserve position. The result was not a happy one, as investors reacted more to the exposure of the hole (US\$23 billion) than to the announcement of the official support package (US\$17 billion). Because the net effect was negative, and because the adjustment program did not appear to be adequate to overcome it, the package did nothing to stem the outflow of private capital from Thailand. Only after the government fell and a strengthened reform program was put in place did the financial position finally stabilize (Boughton 2012, 498–514).

The next potential conflict arose a few months later, in the response to a financial crisis in South Korea. The US government took the position that Korea needed to undertake major structural reforms, including by opening its markets more fully to foreign direct investment. Throughout December 1997, while the IMF was negotiating and renegotiating terms for a stand-by arrangement aimed at resolving the crisis, the most senior US officials — Robert E. Rubin (secretary of the Treasury), Lawrence H. Summers (deputy secretary) and David A. Lipton (under secretary for international affairs), as well as President Bill Clinton — were working behind the scenes to use the crisis as a means of forcing Korea to liberalize its economy. IMF officials did not necessarily disagree with the liberalization message, but they were focused more on the financial measures that were needed to stop the bleeding of foreign

17 The preparations and aftermath of the CFA franc devaluation are covered in Boughton (2012, 698–710).

18 Subsequently, the IMF conducted an internal review that concluded that the lack of transparency in reporting reserves had been a major contributing factor to the crisis. The Fund then gradually established procedures to encourage countries to strengthen their reporting of reserves and other financial data. See Boughton (2012, chapter 10).

exchange reserves and resolve the immediate crisis. After some hesitation, the newly elected president of Korea, Kim Dae-Jung, endorsed the US demands, and the program was adopted and implemented.

Although the Korea episode was resolved to general satisfaction, it did undermine the IMF's authority and credibility. The US interference in the policy conditions on the stand-by arrangement was widely reported in news accounts and in books and other academic and polemical writings about the crisis. Despite the resulting pervasive condemnation, US and other creditor-country officials were no doubt emboldened by the success of the endeavour to insert themselves further into subsequent negotiating situations.

In 2008, Latvia requested financial assistance from the IMF and the EC to help resolve a banking crisis that was threatening the national economy. Latvia had joined the European Union in 2004 and was struggling to adhere to the requirements for maintaining fiscal discipline, exchange rate stability and a viable path toward adoption of the euro. These circumstances compelled the EC to be involved in the planning, and they compelled the IMF to accept Latvia's commitment to the euro area as a constraint on program design.¹⁹ With exchange rate adjustment ruled out, Latvia had to undertake severe "internal devaluation" through declining wages and a rise in unemployment above 20 percent. In this case, the country did persevere after a change of government. Despite persistently high unemployment, Latvia completed the program and then joined the euro area in 2014.

These and other episodes set the stage for the creation of the Troika in 2010. That arrangement took the role of bilateral creditors substantially further than the earlier, ad hoc, developments. For the first time, a formal arrangement was established in which all three parties had to reach a consensus on the conditions to be imposed on Greece as a condition for the joint financing package. The arrangement also had some unique anomalies, notably that Greece is a member of the EC and the ECB and, thus, formally is part of the creditor group as well as being the debtor. But the facet that is relevant for the present analysis is that the IMF ceded its role as the primary arbiter of policy conditions to a wider group of official creditors.

Who makes the decisions in such a case does matter, as the experience with the Troika arrangement for Greece clearly demonstrates. One element that the arrangement has affected is the restructuring of Greek debt, which has

been achieved more slowly and less completely than IMF officials would have preferred. As the IMF staff put it, delicately, in a 2013 report, "debt restructuring had been considered by the parties to the negotiations but had been ruled out by the euro area" (IMF 2013a, 27).²⁰ Another related element is that the program was constructed so as to ensure the preservation of the euro area, without regard to whether the crisis might have been resolved with less pain to the Greek economy through other means. As collateral damage, the IMF's authority and credibility have been further diminished, and the international financial system has thereby been further fragmented.

An important source of the problems associated with the Troika is that it included an understanding that the participants would reach a consensus and not air any internal disputes publicly (IMF Independent Evaluation Office 2014, 7). If the IMF had had the opportunity and the will to make a public case at the outset for a substantial restructuring of Greek debt, it would have applied pressure on the other Troika members to at least explain more thoroughly their own arguments for not doing so. As it was, once the Europeans ruled it out in private, the IMF had no practical option other than going along.²¹

The more general problem was that the *interests* of the Troika members did not fully coincide. If all parties truly shared the same goals — just achieving the best possible outcome for the global economic welfare, and for that of Greece — then private discussions within the group on how best to reach the goals would be normal and appropriate. Instead, the dominant issue, implicitly, was how to reconcile competing goals: improving economic welfare for Greece, the global economy and the European Union. Conducting those discussions *sub rosa* meant that the IMF would inevitably be relegated to a junior role. The European interest in preserving the euro area was bound to prevail.

SUMMARY AND POSSIBLE SOLUTIONS

Starting in the mid-1970s, the IMF was confronted with the conflicting interests of commercial bank creditors when it tried to help countries resolve balance-of-payments problems. Gradually, the institution developed a strategy for coping with bank creditors, with three

19 According to Anders Åslund and Valdis Dombrovskis (2011, 42), the IMF mission chief "accepted the Latvian argument for maintaining the peg to the euro, but most of his mission was skeptical." The IMF's own post-mortem (IMF 2013b, 9), noted that the staff had been particularly skeptical of the authorities' ability to deliver the fiscal contraction that would be needed in the absence of exchange adjustment, without losing public support.

20 Note that the problems with the Greek program do not necessarily invalidate the Troika concept altogether. The Troika's handling of other European cases, notably Ireland and Portugal, was broadly more successful.

21 Paul Blustein (2015, 1) offers a blistering critique of the Fund's participation in the Troika, arguing that the institution "succumbed to pressure from powerful European policy makers, who maintained heavy influence over the Fund's levers of control....despite grave misgivings among many of its top officials, the Fund joined in emergency loan packages that piled debt atop of existing debts, extracted crushingly high interest charges and imposed inordinately harsh conditions on the countries that were borrowing the money."

basic elements. First, whenever possible, organize — or at least encourage — a rollover of existing credit lines, so that the IMF's financing will be fully additional to what the country had been obtaining from the private sector. Second, if a rollover is not forthcoming, then try to find a way to convert maturing bank loans into other assets, viz. negotiable securities or equities, or arrange for the debtor to buy them back at a discount. Third, if all market-based solutions fail, let it be known that a unilateral standstill by the sovereign debtor will be tolerated and will not prevent official multilateral lending. Once these elements were in place by the end of the 1980s, banks understood that they would have to negotiate in good faith if they hoped to retain as much value as possible from their assets.

Resolution of that issue led to a new problem. When market financing for developing countries resumed in the 1990s, it was mostly through negotiable securities rather than bank loans. The challenge then became to ensure that sovereign debtors would be able to service those securities on the contracted terms without resorting to overly restrictive economic policies. When it became obvious that international credit markets were inherently unstable and prone to sudden adverse shifts in sentiment, debt sustainability became an elusive goal. Over time, the IMF again developed a three-point coping strategy. First, design and apply metrics for assessing a country's debt sustainability under a range of realistic scenarios. Second, limit large-scale lending to cases where the IMF's support will plausibly restore debt sustainability. Third, where necessary, organize a debt reduction ("haircut") as part of the initial program.

Conflicts with the narrow interests of official bilateral creditors have proved to be more intractable. Moreover, such conflicts have made application of the aforementioned strategies more difficult. To this point in time, as evidenced by the conflicts inherent in the management of crisis cases such as Mexico in 1995, Thailand and Korea in 1997 and Greece since 2010, the IMF has not developed a general strategy for containing bilateral interference. To the contrary, the Troika experience demonstrates a serious risk that the IMF's views on the best way to manage a financial crisis can be overridden by creditor capture. This risk does not depend on an assumption that the IMF always be right in its assessment of what is needed to resolve a crisis. All that it means is that when the underlying interests of official creditors might differ, a means must be sought to reconcile those interests openly and transparently so that narrow interests will be less likely to trump global interests.

The IMF could reassert a global preeminence in crisis management by adopting a three-point strategy for defining and accounting for the legitimate interests of bilateral creditors within a broad framework.

First, formally establish the principle that creditor countries *as a group* have a legitimate interest in deciding whether the IMF should lend to a country. This principle is implicit in the structure of the IMF, because creditors hold a majority of the voting power on the executive board, which must discuss and sign off on every loan request.

Because the IMF's Articles of Agreement make no distinction between creditor and debtor countries, and because countries do still alternate between creditor and debtor status, any such distinction is only implicit and, thus, is subject to various interpretations. The second step, therefore, would be to ring-fence creditor privilege by establishing the principle that the determination of specific policy conditions and other elements of crisis management are best left to the institution. The executive board would still define the general rules and guidelines, and executive directors would still be expected to express their authorities' views and wishes in the context of the board's consideration of a financing request. Independent *ex parte* pressure on staff or management to modify or add program conditions would, however, be deemed unacceptable.

Third, because deeming a practice unacceptable would not necessarily prevent it from happening, the IMF should develop the practice of stating its own views publicly at the earliest practical stage of deliberations. If, for example, the Fund's management were to state publicly at the outset that a country applying for assistance could resolve its predicament only through a substantial reduction in the value of its outstanding debts, it would be much harder for a creditor country — or a group of countries — to block such an outcome. At the very least, such a stance would provoke a more open debate while it was still possible to influence the outcome. One would not have to wait for a post-mortem report by an evaluation team trying to explain why the program had not succeeded.

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