Riding Out the Storm

Inutu Lukonga

Dealing with crises more effectively

Given that it is unrealistic to think that all financial crises can be prevented, where are we on efforts to at least reduce their number and severity? The IMF continues to place top priority on surveillance and macroeconomic and structural policy reforms, including appropriate exchange rate regimes, better debt and reserve management, sound budgets that leave room to maneuver in difficult times, and efficient and diversified financial sectors. However, crises can still occur if sufficiently large shocks hit a country or if it is unwilling or unable to implement sound policies. The remedial policy actions a country pursues will depend on its situation. But when countries amass unsustainable debts and have no feasible macroeconomic policy options to resolve the crises, the IMF is recommending restructuring sovereign debt—to the consternation of some developing countries and market participants.

At the IMF-World Bank Annual Meetings in Prague in September 2000, the international community backed a new framework for involving private sector creditors in crisis resolution. The framework relies on market-oriented, voluntary approaches but makes room for debt restructurings when absolutely necessary. The IMF’s proposed sovereign debt restructuring mechanism (SDRM) has no doubt captured the most attention, both flattering and unflattering. However, it is only one part of a multifaceted strategy to tackle the crises that began with Mexico in 1994. Other measures include strengthening the assessment of debt sustainability, improving the predictability of access to exceptionally large sums of IMF financing, revamping current lending facilities, and clarifying rules on IMF lending to countries that are behind on payments to private creditors—known as lending into arrears.

Working with the private sector

In most cases, the IMF can help countries overcome balance of payments problems without their putting pressure on private creditors to act against their will. Modest financial assistance and agreement on a convincing economic adjustment and reform program are normally sufficient to rebuild the confidence of private investors and lenders and thereby restore a country’s access to foreign private capital.

But what if a country faces a large short-term need for foreign currency (beyond that which the IMF and other official lenders are willing to provide) and has little chance of securing it quickly enough from the private sector? And what if a country faces a genuinely unsustainable debt burden—a solvency crisis rather than a short-term liquidity problem?

In such extreme situations, private creditors might need to share the burden of restructuring by limiting their demands for repayment or even agreeing to reduce the real value of their claims. However, rather than
face the unpalatable consequences of approaching their creditors, country authorities almost invariably gamble for redemption through less credible policy measures. Individual creditors, too, have an incentive to get out as soon as they can, before other creditors preempt them—the so-called collective action problem. The difficulties of achieving an agreement on how to allocate losses equitably may also prolong the process. As a result, both debtor countries and their creditors pay dearly in terms of lost economic activity and income to the country, economic hardships for the citizens, and lost value of claims for creditors. Often, uncertainty about how the situation in one country is going to be resolved hurts the value of other developing country debt.

To speed up needed reschedulings of unsustainable debts and to help countries tackle these problems at an early stage, the IMF is seeking a more orderly and transparent framework for restructuring sovereign debt. It is considering two complementary and mutually reinforcing approaches—both of which involve coordinating a group of scattered and diverse creditors who are able to seek enforcement of their rights in different legal jurisdictions.

**Collective action clauses**

The first approach—the *contractual approach*—involves the use of contractual provisions in international sovereign bonds. The collective action clauses (CACs) would limit the ability of dissident creditors to hold out against the majority and then litigate to seek full payment, as occurred in Peru in 2000. Bonds issued under English law typically include such clauses. But most bonds are subject to New York law, which does not include this majority-friendly feature and under which all bondholders must agree to any amendment of payment terms.

Why don't more markets use such clauses? Many private sector organizations and emerging market issuers worry that the first issuers who use CACs in jurisdictions where such a practice is not yet the norm will be hit with significantly higher costs. But there is no evidence that this will be the case once a new market practice is established. Indeed, about 20 percent of the total face value of the bonds in the global emerging market bonds index (EMBI) is currently governed by English law. Many emerging market issuers routinely apply English law to their euro- and dollar-denominated sovereign bond issues, and there is no evidence that these trade at a discount to New York law bonds.

To promote the use of CACs in debt contracts, it has been proposed that leading institutional investors and investment banks active in emerging market debt develop new model clauses. The major industrial countries, leading by example, could also adopt CACs in their own bonds or make the use of CACs a regulatory requirement in new bonds issued by other countries in their markets. While several industrial countries have now agreed to use CACs in some of their external debt, reactions to the possible inclusion of such clauses through a regulatory requirement or a requirement for listing on an exchange have been mixed.

The IMF is encouraging the use of CACs in debt contracts and is starting to monitor the use of these clauses in new bond issues. But the IMF will not make their use a requirement for receiving financing—although the
use of CACs in new bonds issued under a debt restructuring could be required for "lending into arrears" programs (see page 22). Whether these actions by the IMF will have a major impact remains to be seen.

Overall, CACs are certainly no panacea because they do not automatically ensure an orderly restructuring or universal coverage of sovereign debt. Clauses work only on a bond-by-bond basis; therefore, the country would need a supermajority of holders of every bond to agree to a restructuring. When multiple bond issues need to be restructured, clauses cannot prevent difficulties if a group of holdout investors obtains control of an individual bond issue. Also, much of the current outstanding debt of sovereigns will continue to lack CACs, and change will be slow because it will take time for maturing obligations to be replaced with new issues containing CACs.

**The statutory approach**

The other approach—the statutory approach—aims to create a legal foundation for collective action among creditors. It would enable a sovereign debtor and a supermajority of its creditors to reach an agreement binding all creditors for all the debt of the sovereign while respecting the seniority of claims. Currently, there is no international insolvency code that can help a country and its creditors rapidly reach agreement on a restructuring, as is done with companies. The absence of a strong legal framework for collective action by different creditors can make the restructuring process slower, less orderly, and more unpredictable than is desirable; plus, it imposes undue costs on both the debtor country and its creditors.

The IMF hopes that the SDRM—proposed by the IMF’s First Deputy Managing Director Anne Krueger in November 2001 and subsequently revised to ensure that it is creditor driven—would encourage debtors with unsustainable debt to approach their creditors promptly, ideally before an interruption in debt-service payments occurred, without undermining incentives for countries with sustainable debt to service their debt. Under the plan, if a qualified majority of creditors agreed to a restructuring plan with a sovereign debtor, dissident creditors could not block it. This is like the provisions already found in English law bonds, except that the vote would be aggregated across multiple bonds, so different bonds could be restructured in a single vote. A supermajority could also vote to provide the debtor with temporary legal protection and give fresh private lending seniority and protection from restructuring, although the details will depend on the SDRM’s design. Moreover, an independent dispute resolution forum would be established to verify claims, ensure the integrity of the voting process, and adjudicate intercreditor disputes that might arise. The IMF's role would continue to be that of signaling its willingness to provide financial assistance for the government adjustment program, rather than getting in the middle of discussions between creditors and debtors. The IMF's support would encourage debtor countries to pursue policies that protect the value of creditors’ claims and limit the economic dislocation that inevitably accompanies debt restructurings.

Three characteristics distinguish the SDRM from the majority restructuring provisions found in CACs. The SDRM would immediately cover all existing external sovereign debt once the statute becomes effective, unlike in CACs where it will take some time before clauses are included in all outstanding sovereign debt. Second, whereas clauses bind holders only within the same bond issue, the SDRM would allow different bond instruments to be aggregated into a single vote on the proposed restructuring, as in a commercial debt
restructuring. Finally, the creation of a single dispute resolution forum would ensure integrity and help avoid ambiguities of language or interpretation.

Although substantial progress has been made, a number of issues need to be ironed out before the SDRM can become operational. To begin with, consensus is yet to be reached on the scope of debt that would be covered, and there are questions about the operation of the dispute resolution forum (see box). The IMF is also working on the appropriate macroeconomic policy framework to adopt during a restructuring and the steps that can be taken to limit the economic disruption that a decision to seek a sovereign debt restructuring almost inevitably will create. The SDRM would eliminate certain legal impediments to a rapid and orderly debt restructuring. It would not, however, remove the need to work out the macroeconomic policy adjustments required for the country to meet payments on its rescheduled debt, adopt a payments profile consistent with its adjustment path, or decide on the steps a country must take to preserve its banking system.

How a debt restructuring mechanism might work

Although it will be some time before all the details of the SDRM can be worked out—the IMF is trying to ready such a proposal by its spring 2003 meetings—the IMF’s Executive Board has considered two important aspects.

The first is what debt to include. Claims held by private creditors that either are governed by foreign law or fall under the jurisdiction of foreign courts would need to be covered, because they represent the main collective action problem. Sovereign debts governed by domestic law and subject to the jurisdiction of domestic courts would be excluded from the SDRM, at least initially—this is a bone of contention because domestic law debt is a central issue in many crises. The Paris Club already provides an effective and flexible mechanism for restructuring claims of official bilateral creditors and these would also be excluded from the SDRM. Of course, in many cases it will be necessary to restructure claims governed by domestic law and claims held by the Paris Club, as well as those governed by external law that are held by private creditors, in order to obtain the needed reduction in debt and debt service. Thus, it will be important to introduce appropriate mechanisms for coordinating the restructurings of private external debt and other debts.
The second aspect is the possible establishment of a dispute resolution forum that would operate independently of the IMF. This forum would have the very limited role of administering the voting process that allows supermajority decision making and resolving intercreditor disputes that arise during the voting process. Such a forum would prevent conflicts arising from different interpretations in different jurisdictions and would ensure uniform interpretation of the SDRM’s provisions.

Finally, the IMF’s 184 member countries would need to approve the proposal and, possibly, change their domestic laws. At present, many emerging market countries fear that the SDRM might raise their borrowing costs or impede market access. Many private sector participants worry that the SDRM would eliminate certain rights of existing bondholders. Given these concerns, there is a lot of doubt that such a radical proposal will ever become a reality. However, cynics might take note that for the first time in over a decade, there is a tremendous amount of political will to design a better system and a stronger legal framework for dealing with unavoidable restructurings.

**Other tools**

As useful as the SDRM and CACs would be, they are not the right solutions for all crises or even the entire solution for those crises that make a sovereign debt restructuring necessary. Countries will continue to need temporary financial support to see them through a genuine liquidity crisis, especially one that has its origins in external market conditions rather than in domestic policy. In such cases, official financial support, at times possibly quite large in comparison with historical limits on access to IMF resources, may be appropriate. For that reason, the IMF is engaged in a batch of other reforms.

**Clarifying policy governing IMF lending into arrears.** Since the late 1980s, the IMF has provided loans to countries that are in arrears on debt payments to private external creditors, provided that these countries pursue appropriate policies and make a good-faith effort to reach a collaborative agreement with their creditors. The policy, initially covering commercial bank credits, was broadened in 1998 to include arrears on international sovereign bonds and other nonbank forms of financing from private creditors.

The IMF recently revised its lending into arrears policy to clarify what countries could reasonably be expected to do in terms of a timely and substantive engagement with their private creditors. The IMF’s Executive Board approved a new set of principles and procedures to promote an effective dialogue during the restructuring process. First, when a member country has reached a judgment that a restructuring of its debt is necessary, it should engage in a dialogue with its creditors, which should continue until the restructuring process is complete. Second, the country should share relevant, nonconfidential information with all creditors on a timely basis. Third, it should provide creditors with an early opportunity to give inputs on the design of restructuring strategies and the design of individual instruments. In cases where a formal negotiating framework is warranted and creditors have formed a representative committee promptly, the country would be expected to negotiate with the committee.
A **clearer and more predictable access policy.** The IMF has strengthened the policy framework for "exceptional access" to its resources to help countries facing capital account crises. The IMF is prepared to approve larger amounts of financing than would normally be allowed if the country meets the following criteria:

- It is experiencing exceptional balance of payments pressures on the capital account resulting in a need for IMF financing that cannot be met within the normal limits.
- A rigorous and systematic analysis indicates that the country's debt is sustainable.
- The country has good prospects of regaining access to private capital markets within the time IMF resources would be outstanding.
- The country's policies—including not only adjustment plans but also the institutional and political capacity to implement these plans—have a strong chance of success.

A number of procedural safeguards have been introduced to enhance the accountability of decisions to grant exceptional access.

**Revamping facilities.** The IMF has revamped its lending instruments, eliminating little-used ones, introducing new ones, and strengthening existing ones. One facility, the Contingent Credit Lines (CCL)—created in 1999 to help countries hit by financial contagion—has so far not been used and is therefore being redesigned. The idea behind the CCL is to have a precautionary facility for countries that have strong economic policies and sound financial systems but that are vulnerable to contagion. If a crisis strikes, a prequalified country could immediately receive a substantial portion of the loan. More generally, the IMF has been engaged in a major overhaul of its conditionality (see "In Brief" on page 2), an issue that has ramifications well beyond capital account crises.

**Improving sustainability analysis.** Finally, a more systematic framework for judging debt sustainability has been developed and is now being put in place (see "Debt: How Much Is Too Much?" on page 12). It is intended to help strengthen the diagnosis of problems, improve the design of economic programs, and underpin financing decisions.

---

**Finding out more**


**Inutu Lukonga** is a Senior Economist in the IMF's Policy Development and Review Department.