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The Architecture Exercise: What's New?

The origins of the architecture exercise were discussed briefly in chapter 1, which listed the main recommendations of the Halifax Summit in June 1995, soon after the Mexican crisis. The evolution of the architecture exercise is examined more thoroughly in this chapter and the next. This one looks at its achievements; the next looks at its shortcomings and what should be done about them.

We begin with a chronological account. It is meant in part to show how the focus of the architecture exercise was influenced by changes in the character of the financial crises that erupted as the exercise proceeded. Like generals preparing to fight the last war instead of the next one, participants in the architecture exercise seemed sometimes to be trying to ward off the last crisis. The chronology also introduces the key documents, recommendations, and decisions that represent the products of the architecture exercise. The chapter then moves on to an issue-by-issue account. Adopting the distinction often employed in the exercise itself, it looks first at efforts aimed at crisis prevention and then at efforts aimed at crisis management.[1] This review does not examine all of the issues raised in the course of the architecture exercise. The chapter does not discuss IMF lending to low-income developing countries—those that receive subsi-

1. A further distinction is often drawn between two types of crisis-preventing measure: those aimed at enhancing transparency and accountability in the public and private sectors of emerging-market countries, and those aimed at reforming the functioning and supervision of their financial and corporate sectors. But there is little to be gained by distinguishing sharply between them, because both types employ the same basic strategy—drafting various standards and codes and then promoting adherence to them.

dized credit from the Fund's Poverty Reduction and Growth Facility—and it does not discuss the HIPC Initiative, the program designed to reduce the debt burdens of highly indebted poor countries. It does not consider the supervision of hedge funds and other highly leveraged institutions, the attempt to enhance bank supervision in offshore financial centers, or the efforts of the Financial Action Task Force (FATF) to combat money laundering. And it does not revisit the exchange rate debate reviewed in chapter 3.

The Evolution of the Architecture Exercise

The history of the architecture exercise can be divided into three phases, each lasting two years. The first began in 1995 and included the Halifax and Lyon Summits. The second began in 1997 and included the Denver and Birmingham Summits. The third began in 1999 and included the Köln and Okinawa Summits. Measured by their contributions to the architecture exercise, some of these G-7 summits were more important than others. But all of them served their usual catalytic purpose—forcing a meeting of minds—and each helped set the next year's agenda.

Halifax and Lyon

The principal recommendations of the Halifax Summit were heavily influenced by the Mexican crisis. Because market participants had accused Mexico of concealing the size of the fall in its official reserves, the Halifax Summit called on the IMF to develop benchmarks aimed at promoting the timely publication of economic and financial data. Because the Mexican "bailout" was brought before the Executive Board of the IMF without prior consultation, on what amounted to a take-it-or-leave-it basis, the Halifax Summit urged the Fund to devise the Emergency Financing Mechanism (EFM)—a set of procedures designed to provide a crisis-stricken country with speedy access to Fund credit without depriving the Fund's board of its rightful role in the decision-making process. Because of the huge size of the financial package required to extinguish Mexico's *tesobonos*, the Halifax Summit called for a doubling of the bilateral credit lines available to the IMF—the recommendation that led eventually to the creation of the New Arrangements to Borrow (NAB) rather than enlargement of the existing General Arrangements to Borrow (GAB).

Finally, the Halifax Summit led to the creation of the working group that wrote the Rey Report (Group of 10 1996). Its main message was quoted in chapter 1. While affirming "the basic principle that the terms and conditions of all debt contracts are to be met in full," it warned that a temporary suspension of debt payments may be required in exceptional cases. Therefore, debtor countries and their private creditors should not "expect to be insulated from adverse financial consequences by the provision of large-scale official financing" and should not expect any type of debt to be exempt from a payment suspension or restructuring in the event of a future crisis. It even declined to rule out a suspension of debt payments on private-sector debt or using exchange controls to enforce it.

The Recommendations of the Rey Report

Having warned that debt suspensions might be needed in the future, the Rey Report made two recommendations aimed at resolving a crisis rapidly after debt payments are suspended.

First, it proposed the inclusion of collective action clauses in international debt contracts. These, it said, could facilitate dialogue between debtors and creditors, promote cohesion among the creditors, and reduce the power of dissident creditors to delay or block an agreement acceptable to the vast majority of creditors. It suggested that three sorts of clauses be included in debt contracts: (1) clauses providing for the collective representation of creditors; (2) clauses permitting a qualified majority of creditors to approve modifications in a debt contract, rather than requiring unanimous approval; and (3) clauses requiring any creditor receiving payments from a debtor to share them with all other creditors, thereby diminishing a creditor's incentive to bring suit against a debtor or seek preferential treatment.[2] As collective action clauses cannot be introduced retroactively into existing debt contracts, it would take several years to include them in the totality of outstanding debt. Furthermore, the Rey Report conceded that no single borrower might want to lead the way, for fear of raising the cost of issuing new debt. Nevertheless, it declined to recommend any concerted official effort to foster the use of such clauses, saying rather lamely that "it would be both natural and appropriate for the private sector to take the lead in the development of new clauses and

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2. The case for these clauses was set out initially by Eichengreen and Portes (1995). Bonds issued under UK law already contain clauses providing for collective representation and for qualified majority voting (but do not contain sharing clauses). Furthermore, UK Trust Deed bonds give the trustee the exclusive right to initiate litigation; an individual bondholder cannot do so. Petas and Rahman (1999) give examples of collective action clauses in existing bond covenants and explain in detail the differences between UK and US law on these and related matters. See also the discussion in the *Report of the Working Group on International Financial Crises* (Group of 22 1998a), which addresses common concerns about collective action clauses and notes that the inclusion of majority voting clauses in bonds issued under UK law has not made them more costly to issue. Recent work by Eichengreen and Mody (2000a, 2000b) has refined this result. Classifying issuers by their creditworthiness, they show that the interest rate spreads on UK bonds are smaller than those on US bonds for more creditworthy issuers but larger than those on US bonds for less creditworthy issuers. See also Eichengreen (2000a).

that such efforts should receive official support as appropriate'' (Group of 10 1996, para. 65).

Second, the Rey Report proposed a change in IMF policy. Normally, a country in arrears to its private creditors cannot obtain financing from the IMF until there is an actual or imminent agreement on the clearance of arrears. In an effort to resolve the debt crisis of the 1980s, however, the Fund undertook to ''lend into arrears'' in exceptional circumstances. A country that had not reached agreement with its commercial-bank creditors and was thus running up arrears on its outstanding debt could still obtain financing from the IMF when that was deemed to be essential for the implementation of an adjustment program and when the country was making a good faith effort to reach agreement with its commercial-bank creditors. In the future, the Rey Report said, the IMF ''might be well advised to extend this practice to debt owed to other groups of private creditors.'' Such lending would tell private creditors that the debtor's policies are strong enough to warrant their support, as well as official support, and would also prevent private creditors from delaying an adjustment program. Making the same point more bluntly, the Rey Report stated that IMF financing ''can improve the bargaining position of the debtor'' while serving as a signal to the unpaid creditors ''that their interests are best served by reaching agreement quickly with the debtor country'' (Group of 10 1996, para. 94). But the IMF was remarkably slow to adopt this recommendation. It did not do so until 1999, three years after the Lyon Summit had welcomed the Rey Report's recommendations.

The Private Sector's Response

The private sector took less time to make its views known. The Institute of International Finance (IIF), a global association of financial institutions, created its own working group soon after the creation of the G-10 working group that produced the Rey Report. This was its main finding:

> In mid-1996, the international financial system appears relatively immune to systemic defaults by developing countries, and any future crises seem unlikely to be associated with a generalized problem of excessive borrowing by sovereign entities in emerging market countries. Accordingly, the . . . approaches to resolving crises should be case by case and generally ad hoc, without predetermined processes. They should be geared to the expectation of isolated episodes in individual countries, most likely characterized by foreign exchange liquidity problems rather than difficulties with servicing medium-term debt. (IIF 1996, i)

When crises do arise, moreover, the agreed-on international approach should be ''market-based.'' The crisis-stricken country should adopt ''extraordinary'' fiscal, monetary, and exchange rate measures, but changes in market prices can also play important roles. Reductions in equity prices will tend to attract bargain seekers, and wider interest rate spreads will attract new capital—bank loans and bond issues—if the country's policies are deemed to be credible. As these should stabilize most crises and thus pave the way for restoring market access, there should be no need to reschedule debt. When crises do deepen, moreover, they are likely to be liquidity crises, not debt crises, and "their resolution" will have more to do with further policy action and the gradual rebuilding of confidence than with the rescheduling of debt payments" (IIF 1996, iii). Indeed, rescheduling bonds and other medium-term debt may be counterproductive, because it may lead to an extended workout process that could delay the restoration of market access.[3]

The IIF report did not object to the first recommendation of the Rey Report, that market participants should be free to adopt collective action clauses but should not be forced do so. But it objected vehemently to the second recommendation, that the IMF should broaden its policy on lending into arrears. Such lending, it argued, confers official approval on breaching contractual obligations, and the Fund should *rescind* its existing policy rather than broaden it from bank loans to bonds. The Fund should never lend into arrears unless the debtor has agreed to pay off those arrears.[4]

Crisis Prevention and Financial-Sector Reform

Apart from the change in Fund policy on lending into arrears, most of the reforms proposed or inspired by the Halifax Summit were adopted quickly. The next summit, however, launched another initiative. Recall the passage quoted in chapter 1, in which the 1996 Lyon Summit called for progress on three fronts: enhancing cooperation among the supervisors of internationally active financial institutions, strengthening risk management and enhancing transparency in financial markets, and encouraging emerging-market countries to adopt strong prudential standards (Group of 7 1996).

The last of these three goals was to become the principal crisis-preventing strategy of the architecture exercise. The Basel Committee on Banking Supervision (BCBS) was already working on its *Core Principles for Effective Banking Supervision;* and a new working party, this one including representatives of emerging-market countries as well as G-10 countries, issued a report that called on other groups to draft similar sets of principles (Work-

3. Although the IIF report did not explicitly endorse large-scale official financing, its emphasis on liquidity crises rather than debt crises and its opposition to the mandatory use of collective action clauses suggest that its authors disagreed strongly with the main premise of the Rey Report—that debt restructuring should be employed in lieu of large-scale official financing.

4. See the essays in Kenen (1996) for other assessments of the Rey Report and the recommendations of the Halifax Summit itself.

ing Party on Financial Stability in Emerging-Market Economies 1997). The International Organization of Securities Commissions (IOSCO) was urged to develop standards for regulating securities markets, and the International Association of Insurance Supervisors (IAIS) was urged to do the same thing for the insurance industry; the International Accounting Standards Committee (IASC) was asked to develop high-quality accounting standards; and other public and private bodies were asked to develop standards or codes in their own areas of expertise. Some of those groups were already at work, and the rest rose to the challenge. At last count, 64 standards and codes had been drafted or were being developed.[5]

An Odd Initiative

One more effort got under way late in this first phase of the architecture exercise—a campaign led by the G-7 countries and the management of the IMF to widen the definition of currency convertibility in the Fund's Articles of Agreement.[6] Under Article VIII, members of the IMF must not impose restrictions on payments or transfers for current account transactions.[7] But they may still impose restrictions on international capital flows. (In fact, Article VI forbids countries from using the Fund's resources to finance a large or sustained capital outflow, and it empowers the Fund to request that a country adopt capital controls to keep that from happening.)

To promote and complete the liberalization of international capital movements, it was suggested that Article VIII be revised to prohibit the use of capital controls (and that Article VI be rescinded). There would, of course, be transitional arrangements and well-defined exceptions. As

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5. The Financial Stability Forum maintains an up-to-date list on its Web site (FSF 2001) and identifies 12 standards and codes as being of key importance for sound financial systems (the names of the issuing bodies are in parentheses): the Special (or General) Data Dissemination Standard (IMF), the Code of Good Practices on Transparency in Monetary and Financial Policies (IMF), the Code of Good Practices on Fiscal Transparency (IMF), the Core Principles for Effective Banking Supervision (BCBS), the Objectives and Principles of Securities Regulation (IOSCO), the Insurance Core Principles (IAIS), the International Accounting Standards (IASC), the International Standards on Auditing (IFAC), the Core Principles for Systemically Important Payments Systems (CPSS), the Principles of Corporate Governance (OECD), the Forty Recommendations of the Financial Action Task Force (FATF), and a set of principles for insolvency regimes being developed under the auspices of the World Bank.

6. Delong and Eichengreen (2001) say that it was initiated by the British and French governments, which feared that the World Trade Organization (WTO) would interpret its mandate to liberalize trade in financial services as a mandate to liberalize capital flows. That task, they believed, belonged to the Fund. The Fund, not surprisingly, climbed onto the bandwagon quickly, and the US Treasury was not far behind.

7. A number of countries, however, including some that have been IMF members for many years, have not yet accepted this obligation; they operate under the "transitional arrangements" of Article XIV.

a matter of principle, however, the concept of currency convertibility would be broadened, and every member of the Fund would have to relax and eventually remove restrictions on capital inflows and outflows. This objective was endorsed in principle by the Fund's Interim Committee at its Hong Kong meeting in September 1997, two months after the collapse of the baht.[8] As the Asian crisis deepened and spread, however, the campaign for capital account convertibility ran out of steam. And this was no bad thing. The objective was not well defined and was fundamentally inconsistent with one of the main aims of the architecture exercise—reducing the worrisome gap between the fast pace of financial liberalization by emerging-market countries and the slow pace of financial-sector reform.

Denver and Birmingham

The Denver Summit took place in June 1997, just before the onset of the Asian crisis, and falls chronologically into the second two-year phase of the architecture exercise. Yet it said very little about the international financial architecture, apart from endorsing the recommendations of the working party that had called for the drafting of standards to strengthen financial systems in emerging-market countries.[9] The second phase of the architecture exercise really began with the outbreak of the Asian crisis and lasted through the Russian crisis, both of which strongly affected the course of the exercise.

The Impact of the Asian Crisis

The Asian crisis refocused the debate about using large-scale official financing to cope with capital outflows from crisis-stricken countries. What had been regarded as exceptional in the Mexican crisis was becoming

8. See Fischer (1997) on the case for the proposal and the papers by Cooper, Massad, Polak, and Rodrik in Fischer et al. (1998) for objections. See also Bhagwati (1999), Cooper (1999), and Stiglitz (1999), who reject the implicit analogy between the case for free trade and the case for free capital flows.

9. It also asked international regulatory bodies, the IMF, and the World Bank to report on their efforts to strengthen their roles ''in encouraging emerging market economies to adopt the principles and guidelines identified by the supervisory community'' (Group of 7 1997, 5). The IMF's reply is noteworthy for stressing the demanding nature of those principles and guidelines. As they draw on the experience of advanced economies to define ''best practice,'' they may need to be adapted to the different circumstances and less sophisticated financial systems of developing countries (Folkerts-Landau and Lindgren 1998). Failure to anticipate this need helps explain why developing countries insist that adherence must be voluntary and why they want to be ''graded'' in terms of the progress they make rather than their absolute level of compliance. We will come back to these matters later.

ordinary in the Asian crisis. In fact, it inspired the creation of a new Fund facility, the Supplemental Reserve Facility (SRF), which served to institutionalize large-scale financing and was first used to assist Korea. The Russian crisis inflamed the ongoing debate about moral hazard and inspired the creation of another Fund facility, the Contingent Credit Line (CCL), which was designed to combat contagion of the very virulent sort caused by the Russian crisis.

Furthermore, the Asian and Russian crises refocused the debate about private-sector involvement. The Mexican crisis had involved sovereign debt to private-sector creditors, but the Asian crisis involved private-sector debt, including both interbank and corporate debt. It also appeared to vindicate those in the official and private sectors who favor market-based ways of dealing with debt crises: the cooperative strategy adopted by Korea, they said, was vastly superior to the abrupt, disruptive, unilateral strategy adopted by Russia.

Finally, the Asian crisis triggered the debate discussed in chapter 1 about the wisdom of using IMF conditionality to reform the financial and corporate sectors of crisis-stricken countries and, more broadly, about the opportunistic use of conditionality to foster far-reaching reforms that do not clearly contribute to resolving the crisis at hand.

Although the Thai crisis began two months before the IMF's Annual Meeting in Hong Kong and had already spread to other Southeast Asian countries, it was not seen as posing grave problems for the countries already affected or for other countries. The Interim Committee's communiqué devoted just one paragraph to it:

> The Committee noted that recent disturbances in Asian financial markets have again underscored the importance for policymakers in all countries to ensure the internal consistency of macroeconomic policies, strengthen financial systems, and avoid external deficits and reliance on short-term borrowing. Although the impact of the recent financial market turmoil on some of the countries affected is expected to result in a slowdown of growth in the near term, the countries' economic fundamentals remain solid and their longer-term outlook is favorable, provided the required adjustment policies are sustained. (IMF 1997a, para. 5)

The same sentiments were heard in the corridors, where various pundits—including me—noted sagely that the crisis was being contained. Markets, they said, were distinguishing wisely between the two generations of Asian tigers.[10] Three weeks later, however, the crisis jumped generations, spreading northward via Taiwan to Hong Kong and Korea. And in December, the IMF issued a special interim edition of its *World Economic Outlook*

10. There was indeed more talk about the insults exchanged by Mahathir Mohamed and George Soros than about the crisis itself. Mahathir blamed the crisis on foreign speculators and called for the abolition of currency trading, and Soros called Mahathir an idiot.

(IMF 1997b), in which it took a grave view of the Asian crisis and its global implications.

The next Interim Committee communiqué, in April 1998, reflected that grave view, and much of the communiqué was devoted to the international financial architecture.[11] It called for the strengthening of financial systems and of IMF surveillance and for broadening the Special Data Dissemination Standard (SDDS) to cover additional financial data, including net reserves and reserve-related liabilities. It also emphasized the need, when warranted by crisis situations, ''to involve private creditors at an early stage, in order to achieve equitable burden sharing *vis-à-vis* the official sector and to limit moral hazard'' (IMF 1998a, para. 3e).

The Interim Committee's communiqué was strongly influenced by some special features of the Asian crisis. Jack Boorman and Mark Allen (2000) point out that the reference to net reserves and reserve-related liabilities reflected unpleasant surprises that came to light during the Asian crisis. Thailand had encumbered its reserves by huge foreign currency sales in the forward market, and Korea had deposited most of its reserves with the foreign branches of Korean banks, so as to strengthen their balance sheets. In the same vein, the communiqué asked the IMF to develop a ''tiered response'' under which it would issue ''increasingly strong warnings'' when it believed that a member's policies were ''seriously off course'' (IMF 1998a, para. 3b). Recall that Thailand had ignored several warnings from the Fund in the run-up to the crisis. The notion of a ''tiered response'' reappeared in the report of the G-7 finance ministers to the 1998 Birmingham Summit, and they went much further. ''In addition,'' they said, ''it may be helpful for the Fund to make public statements of concern about its assessment of countries' policy making and vulnerabilities'' (Group of 7 1998, para. 11). But the US Treasury, among others, had strong reservations about public warnings (Rubin 1998), and the idea died.

Apart from making the suggestion just noted, that the IMF might ''go public'' by issuing warnings to individual countries, the 1998 Birmingham Summit made no major contribution to the architecture exercise. Nevertheless, it raised an important issue. What can be done to encourage compliance with the various standards and codes already in place or being developed? The report of the G-7 finance ministers attached to the summit communiqué identified a ''gap'' in the international system:

> We see an urgent need for a system of multilateral surveillance of national financial, supervisory and regulatory systems. This could encompass surveillance of such areas as banking and securities supervision, corporate governance, accounting and disclosure, and bankruptcy. (Group of 7 1998, para. 17)

11. It was issued just after the speech, mentioned at the start of chapter 1, in which Secretary Rubin sought to shape the architecture exercise, and it was the first such document to speak about the international financial architecture.

And there is also a need, it said, to find ways of promoting compliance with the relevant standards and codes. But it made only one concrete suggestion: access by foreign financial institutions to major financial centers might be conditioned in part on the quality of prudential and regulatory standards in their home countries. Finally, it declared, there is a need for a framework to ensure continuing private-sector involvement when a country is facing difficulties in meeting its foreign currency liabilities as they fall due, but this matter requires further discussion with other countries and the private sector.

The G-22 Reports

At the time of the Interim Committee meeting in April 1998, the US Treasury invited the finance ministers and central bank governors of 22 "systemically significant economies" to meet for a discussion of issues relating to the stability of the international financial system.[12] The meeting agreed to establish three new working groups, which issued their reports in October 1998. Two groups focused on crisis prevention, and the third group focused on crisis resolution.

The G-22 and Crisis Prevention

The first working group dealt with transparency and accountability. Its report (Group of 22 1998c) stressed the need for transparency in the private sector and, to that end, the need for governments to require compliance with high-quality accounting standards in the corporate sector, as well as sound rules for loan valuation, loan-loss provisioning, and credit-risk disclosure in the financial sector.[13] It discussed at length the ways in which the SDDS might be broadened to furnish more information about official reserves, as well as the need to compile data on the foreign exchange positions of the public, financial, and corporate sectors and on the international activities of investment banks, hedge funds, and other

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12. The Group of 22 was also known as the Willard Group, because it met at the Willard Hotel near the US Treasury. It was convened to fulfill a promise made by President Clinton to involve emerging-market countries in the architecture exercise. The group grew eventually to 33 countries, but its successor is smaller. The Group of 20, established in 1999 as a forum for consultation on matters relating to the international financial system, includes the G-7 countries and 11 others (Argentina, Australia, Brazil, China, India, Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey).

13. Sound rules for loan-loss provisioning are, of course, essential for the proper enforcement of the Basel Capital Adequacy Accord. Alba et al. (1999) point out that Indonesian, Malaysian, and Thai banks adhered to the Basel capital-adequacy standard but underreported their bad loans; see also Caprio and Honohan (1999) and earlier work by Goldstein and Turner (1996).

institutional investors.[14] It urged the international financial institutions to adopt a ''presumption'' in favor of releasing information unless doing so would compromise confidentiality. Members of the Fund, it said, should permit publication of Letters of Intent, background papers to Article IV reports, and Public Information Notices (PINs) summarizing Executive Board discussions of Article IV reports. Most important, it called for ''transparency about transparency.'' The IMF, it said, should compile ''transparency reports'' assessing the extent to which each member meets internationally recognized disclosure standards. This was the recommendation that led the Fund to start compiling Reports on the Observance of Standards and Codes (ROSCs).

The second working group dealt with strengthening national financial systems, and its report (Group of 22 1998b) reflected clearly the concerns and reservations of the participants from emerging-market countries—more perhaps than did the reports of the other working groups. It started with recommendations aimed at avoiding reliance on ad hoc measures to resolve financial crises. While favoring ''structured early intervention'' to deal with troubled banks in normal times, it noted that this strategy may be inconsistent with some countries' legal systems, requires strong supervisory skills, and may be inadequate to resolve systemic crises. Even in crisis situations, however, the use of public money should be strictly limited, the owners of banks should not be bailed out, and banks should be allowed to fail if they would not be viable after recapitalization. The report also proposed sets of criteria for assessing the quality of deposit insurance plans and insolvency regimes.

Although the working group acknowledged the need to foster compliance with international standards and codes, it stopped short of recommending that the international financial institutions assess compliance on a country-by-country basis; it suggested instead that ''some type of collective private sector mechanism'' might take on that task.[15] It did

14. Although the working group favored the publication of comprehensive data relating to official reserves, including data on forward positions, it could not agree on the desirability of publishing data more frequently. The SDDS requires that data on gross reserves be published monthly with no more than one week's lag, and some members of the working group favored more frequent publication. The report of the working group noted, however, that more frequent publication ''could restrict the ability of the authorities to intervene discreetly in foreign exchange markets'' (Group of 22 1998c, 16).

15. For some countries, of course, assessments of compliance with standards pertaining to financial-sector stability might be riskier than similar assessments of compliance with standards pertaining to transparency, as the former might affect their creditworthiness. That might explain why the first working group could agree to endorse the compilation of transparency reports, but the second working group could not agree to endorse assessments of compliance with financial-sector standards. (The second group also divided on the proposal made at the Birmingham Summit that market access for foreign banks be conditioned on the quality of prudential supervision in the banks' home countries; it suggested instead

endorse the use of IMF conditionality to foster the implementation of financial-sector standards but said that ''appropriate time must be allowed for implementation, the right sequencing of measures must be carefully considered, and their impact on social stability should be weighed'' (Group of 22 1998b, 43).

The G-22 and Crisis Resolution

The report of the third working group (Group of 22 1998a) had much in common with the Rey Report but took account of issues raised by the Asian and Russian crises. It started, for example, by criticizing the use of government guarantees to the private sector, because they encourage excessive risk taking, but went on to say that the ''socialization of risk'' might be worthwhile during a crisis to halt a sudden withdrawal of credit or to catalyze orderly agreements with foreign creditors—an obvious reference to the Korean case. Similarly, the report opposed the granting of guarantees to the corporate sector, because corporate financial difficulties rarely constitute a threat to the payments system; but it also noted that widespread insolvencies in the corporate sector can generate problems for the financial sector and may therefore require special arrangements to facilitate rapid economywide restructuring—an equally obvious reference to the Indonesian case. Finally, the report went out of its way to criticize the use of controls on capital outflows to break the link between monetary policy and the exchange rate—a thinly veiled reference to the Malaysian case.[16]

The report recommended various forms of self-insurance against market volatility—holding adequate reserves, issuing long-term debt instruments and spacing the maturity of existing debt, and arranging contingent credit facilities with foreign banks.[17] It also endorsed the inclusion of

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that industrial and emerging-market countries might jointly devise principles to govern national practices concerning market access.)

16. The working group also commented cautiously on the relative merits of fixed and flexible exchange rates. Relatively rigid rates, it said, can be ''an important symbol of policy commitment'' and ''an integral part of a country's strategy for achieving and maintaining macroeconomic stability,'' but relatively flexible rates can help to prevent the accumulation of unhedged foreign currency exposure and can permit more macroeconomic policy flexibility. It conceded that countries will differ in the extent of their commitments to rigid rates but suggested that ''many would benefit from considering strategies for increasing flexibility during periods of macroeconomic and financial stability, when the costs of introducing increased flexibility may be quite small'' (Group of 22 1998a, 13-14).

17. The report noted, however, that these facilities may not provide much new money during a crisis, as banks may engage in dynamic hedging; they may offset the increase in their exposure to a crisis-stricken country by cutting back their other claims on that same country. Others, including Eichengreen (1999b, 2000b), make the same point; and Mussa et al. (2000) warn that this practice can contribute to contagion, as banks can offset their exposure to one country by reducing their claims on other countries. The IMF (1999e) notes

collective action clauses in debt contracts, going a bit further in this regard than the Rey Report. Although collective action clauses cannot by themselves guarantee that a qualified majority of bondholders will agree to restructure a bond issue in time to avoid a crisis, nor guarantee quick agreement on a workout if a crisis does occur, wider use of these clauses would help achieve coordination among the holders of a particular bond. Therefore, the governments of industrial countries should give consideration to (1) engaging in educational efforts to promote the use of collective action clauses in sovereign bonds issued in their markets, (2) identifying sovereign issuers likely to come to their markets soon and encouraging them to use collective action clauses, and (3) examining the use of such clauses when they themselves issue bonds in foreign markets.[18]

The working group devoted much of its report to debt problems and debt workouts. Without actually mentioning Russia, it noted that recent experience has ''underscored the fact that unilateral actions, especially if they substitute for reform and adjustment, are highly disruptive'' (Group of 22 1998a, x), and it went on to recommend that debt problems be managed cooperatively, in close consultation with the IMF:

> When the government of a country anticipates that the country may have difficulty meeting in full the terms of its contractual obligations, public or private, or that it may face serious balance of payments problems for other reasons, it should initiate a dialogue with the IMF. It should evaluate its policy options and rapidly develop and implement a program of policy adjustments to enhance the country's capacity to meet its obligations and to attract new private capital. . . .
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> The government of the crisis country is responsible for choosing among its various policy options. A government's choice, of course, will be influenced by the IMF's evaluation of the country's financing need and possible policy adjustments, as well as by preliminary indications from the IMF and other members of the official community of the amount of official support that is likely to be forthcoming if the government adopts strong policy reforms.
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> In extreme cases when an interruption of payments is unavoidable, a cooperative, orderly restructuring of contractual obligations, combined with the initiation of strong policy reform, could increase the collective welfare of both the debtor

that some banks threatened to reduce trade credits to Mexican borrowers when Mexico drew on its contingent credit lines in September 1998; for more on that episode and the banks' objections to Mexico's drawing, see IIF (1999). Mexico has since let its credit lines expire.

18. The report's phrasing was even more guarded. It said, in effect, that members of the working group representing industrial countries would recommend to their governments that they give consideration to examining the use of collective action clauses in their own foreign offerings—and you can't get more guarded than that. This phrasing is sometimes interpreted as a concession to private-sector views—recall the objections of the IIF to the mandatory inclusion of collective action clauses—but two other interpretations are more plausible. Some emerging-market countries feared that writing collective action clauses into their bond contracts might make borrowing more expensive (a matter discussed at length later). And Delong and Eichengreen (2001) suggest that the US Treasury feared that a major campaign on behalf of collective action clauses might crowd out efforts to achieve other, more important objectives.

> and its creditors by providing the debtor with the time and incentives needed to make appropriate policy adjustments necessary to enhance its payments capacity and encourage the rapid restoration of market access. (Group of 22 1998a, 24-25)

The report noted, however, that the IMF should not be expected to determine the size or the nature of the contribution to be made by private creditors. Although an IMF-supported program ''may implicitly indicate the need for a contribution from the private sector, it is the responsibility of the government of the crisis country and its private creditors to determine the form of this contribution'' (Group of 22 1998a, 27).

The report warned repeatedly that countries should avoid ''disruptive unilateral action'' and extolled the advantages of voluntary negotiations between a crisis country and its private creditors:

> In contrast to a unilateral or mandatory suspension of payments, a voluntary approach is less likely to have long-lasting effects on the country's access to international capital markets. It is also less likely to cause contagion. While a mandatory suspension of payments on some debt instruments could activate cross-default clauses in debt instruments not covered by the suspension, a voluntary approach may avoid triggering those cross-default clauses. Finally, a voluntary approach is less likely to generate litigation. (Group of 22 1998a, 29)

But it also conceded that there are ''certain extreme circumstances'' in which it may be difficult to pursue a purely voluntary approach. A voluntary debt exchange, for example, will necessarily reflect market conditions. A government may not have the bargaining power to obtain sustainable terms for the restructured debt instruments and creditors may then require interest rates so high that they generate destabilizing debt dynamics. Some creditors may refuse to participate in a purely voluntary scheme and thus prevent an overall agreement. Finally, a purely voluntary approach may take too much time and thus lead to an erosion of confidence that worsens the crisis country's problems. But even when a mandatory suspension is unavoidable, ''it is crucial for the government of the crisis country to maintain an open, transparent and cooperative approach to the country's creditors in the wake of its decision to interrupt payments'' (Group of 22 1998a, 30).[19]

Why devote so much attention to this working group's report? There are three reasons. First, it was drafted by representatives of emerging-market countries as well as industrial countries. Second, it demonstrates clearly the extent to which the course of the architecture exercise has been

19. This part of the working group's report concluded with a thoughtful discussion of the problems involved in designing a suspension—the scope of the suspension, whether it should cover private-sector debt payments, and whether those payments can be interrupted without imposing capital controls. The report also repeated the Rey Report's recommendation that the IMF should extend from bank loans to bonds its policy of lending into arrears (an action that the IMF had not yet decided to take).

influenced by the changing nature of financial crises. Third, it foreshadows the framework adopted by the G-7 governments and the IMF itself, as they strove to steer a course between the case-by-case approach favored by the United States and the rule-based approach favored by some other G-7 countries.

Köln and Okinawa

The third phase of the architecture exercise covered two more summits and important developments elsewhere, including attempts to involve the private sector in the resolution of debt-related crises, attempts to encourage adherence to international standards and codes, and changes in the policies and practices of the IMF. To shorten this long chronology, however, we focus here on the two summits and defer discussion of the other developments to the next part of this chapter.

The report of the G-7 finance ministers to the Köln Summit in June 1999 (Group of 7 1999b) devoted a great deal of attention to the roles, policies, and governance of the IMF and World Bank, the further development of standards and codes and the need to encourage adherence to them, and the strengthening of financial regulation in the industrial countries. It also contained the passages quoted in chapter 3, recommending that countries committed to fixed exchange rates ''institutionalize'' their commitments and endorsing the position taken earlier by Secretary Rubin that the international community should refrain from providing large-scale official financing to a country intervening heavily to support a particular exchange rate unless the rate is judged to be sustainable and is backed by supporting arrangements and policies. But the main contribution came at the end of the report, in a set of recommendations pertaining to private-sector involvement that closely resembled the recommendations in the G-22 report on international financial crises (Group of 22 1998a).

The report acknowledged the need for stronger efforts to broaden the use of collective action clauses. Their use, it said, should be ''best practice'' in debt management and a ''consideration'' in determining access to the CCL, and the G-7 governments should consider further ''the possible inclusion of such provisions in our own debt instruments and otherwise encouraging the use of such provisions in the debt instruments issued by other sovereigns in our markets'' (Group of 7 1999b, para. 42d).[20] The

20. Three months later, at the IMF's Annual Meeting in September, it was reported that the G-7 countries had considered a firm commitment to write collective action clauses into their own debt instruments but the United States had opted out. Thereafter, however, three G-7 countries acted unilaterally. Canada and the United Kingdom undertook to include collective action clauses in their international bond issues, and Germany affirmed the validity of the clauses under German law (IMF 2001b).

report also provided a "framework" for involving the private sector in crisis resolution, comprising a set of principles and a set of tools.

The Köln Framework

The principles were not new or controversial, perhaps because they were an attempt to paper over disagreements within the G-7 between governments that favored a case-by-case approach and those that favored a rule-based approach. They can be paraphrased briefly: (1) The approach to crisis resolution must not undermine the obligation of countries to pay their debts on time. (2) Market discipline will work only if creditors bear the consequences of the risks they take. (3) In a crisis, reducing net debt payments to the private sector can help a country meet its immediate financing needs and reduce the amount of financing provided by the official sector, but these effects must be balanced against the potential effect on a country's ability to attract new capital inflows and on other countries, *via* contagion. (4) No class of private creditors should be regarded as inherently privileged; claims of bondholders should not be viewed as senior to those of banks when both are material. (5) Wherever possible, crisis management should aim at cooperative solutions negotiated by the debtor country and its foreign creditors.

The report listed five tools that might be used to promote private-sector involvement: (1) The provision of official support can be linked to appropriate efforts by the recipient: efforts to initiate discussions with its private creditors to explain its policy program; efforts to elicit voluntary commitments of support, including commitments to provide new money and specific commitments by existing creditors to maintain exposure levels; and efforts to restructure or refinance existing obligations. (2) When a country's official debt needs to be restructured, Paris Club principles require a comparable restructuring of the country's debt to private creditors, but the Paris Club should adopt a flexible approach to comparability. (3) When official financing is provided, a reserve floor can be imposed to ensure that the recipient secures an adequate contribution from its private creditors, rather than using reserves to repay them. (4) In exceptional cases, a country may be unable to avoid the accumulation of arrears, and IMF lending into arrears may be appropriate if the country is seeking a cooperative solution with its private creditors. (5) In exceptional cases, a country obtaining IMF support may impose capital or exchange controls to implement a payments suspension or standstill needed to buy time for an orderly debt restructuring.

The finance ministers emphasized that the appropriate role for private creditors and the best ways of inducing them to play that role will depend on the circumstances of each case, and they dwelt on this theme in language that would be repeated in subsequent G-7 and IMF documents:

> There are circumstances where we believe emphasis might best be placed on market-based voluntary solutions to resolve the country's financial difficulties.

There are also cases where more comprehensive approaches may be appropriate to provide a more sustainable future payments path. Where a country falls on this spectrum will help to determine the policy approach best suited to its particular circumstances. Relevant considerations include the country's underlying capacity to pay and its access to the markets.

In addition, the feasibility of different policy approaches will depend on the nature of outstanding debt instruments. These will influence assessments of which claims need to be addressed to resolve the country's financing difficulties, the magnitude of possible concerns about equitable treatment of various categories of creditors, and the scope for voluntary versus more coercive solutions. (Group of 7 1999b, paras. 47, 48)

Finally, the finance ministers asked the IMF to address the legal and technical questions raised by this framework and to do so within three months—in time for the Fund's next Annual Meeting.

The Fund, however, could not meet that deadline. In his report to the International Monetary and Financial Committee (IMFC), the Fund's managing director said that the Executive Board needed more time to refine the Köln framework and listed some of the unresolved issues, including the role of standstills (IMF 1999f).[21] Hence, the G-7 countries undertook to develop the Köln framework on their own.

Implementing the Köln Framework

In September 1999, the G-7 finance ministers and central bank governors produced a reformulation of the passage quoted above, describing the spectrum of cases in which private-sector involvement would be appropriate (Group of 7 1999a). In April 2000, moreover, they agreed on another reformation and a set of ''operational guidelines'' for implementing the Köln framework:

With regard to crisis resolution, we agreed that the approach adopted by the international community should be based on the IMF's assessment of a country's underlying payment capacity and prospects for regaining market access.

In some cases, the combination of catalytic official financing and policy adjustment should allow the country to regain full market access quickly. In some cases, emphasis should be placed on encouraging voluntary approaches as needed to overcome creditor coordination problems. In other cases, the early restoration of full market access on terms consistent with medium-term external sustainability may be judged to be unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, may be warranted to provide for an adequately financed program and a viable medium-term payments profile.

In those cases where debt restructuring or debt reduction may be necessary, we agreed that IMF programs should be based on the following operational guidelines:

i. Put strong emphasis on medium-term financial sustainability, with the IMF determining the appropriate degree of economic adjustment required by the

21. These issues are discussed in Boorman and Allen (2000).

country and the IMF and the country agreeing on a financing plan compatible with a sustainable medium-term payments profile.

ii. Strike an appropriate balance between the contribution of the private external creditors and the official external creditors, in the light of financing provided by [the International Financial Institutions]. In cases where a contribution from official bilateral creditors (primarily the Paris Club) is needed, the IMF financing plan would need to provide for broad comparability between the contributions of official bilateral creditors and private external creditors. The Paris Club, if involved, should of course continue to assess the comparability desired and achieved between its agreement and those to be reached with other creditors.

iii. Aim for fairness in treatment of different classes of private creditors and for involvement of all classes of material creditors. The IMF should review the country's efforts to secure needed contributions from private creditors in light of these considerations, as well as medium-term sustainability.

iv. Place responsibilities for negotiations with creditors squarely with debtor countries. The international official community should not micromanage the details of any debt restructuring or debt reduction negotiation.

v. Provide greater clarity to countries at the start of the process about the consequences for their programs, including in terms of official financing, of any failure to secure the necessary contribution from private creditors on terms consistent with a sustainable medium-term payments profile. Such consequences could include the need for a program revision to provide for additional adjustment by the country concerned or the option of reduced official financing, or, conversely, a decision by the IMF to lend into arrears if a country has suspended payments while seeking to work cooperatively and in good faith with its private creditors and is meeting other program requirements.

vi. When all relevant decisions have been taken, the Fund should set out publicly how and what certain policy approaches have been adopted, in line with the Köln framework. (Group of 7 2000a, annex II)

This language was endorsed by the Okinawa Summit in July 2000, which also welcomed the contributions of private creditors, including bondholders, to several recent IMF programs (Group of 7 2000b). Those contributions are discussed in the next part of this chapter.

At its meeting in April 2000, moreover, the Fund's IMFC issued a communiqué containing language nearly identical to that in the first two paragraphs of the G-7 statement, but it replaced the ''operational guidelines'' with a single paragraph that assigned fewer responsibilities to the IMF and made no explicit mention of the Paris Club. Instead of stating that the IMF and the country should agree on a financing plan and that the Paris Club should oversee compliance with the principle of comparability, it said that IMF-supported programs should strongly emphasize medium-term sustainability and strike an appropriate balance between the contributions of private and official creditors. It also replaced item (v) in the operational guidelines with this brief statement:

> The Committee agrees that the IMF should consider whether private sector involvement is appropriate in programs supported by the Fund. In this regard, the Committee also agrees on the need to provide greater clarity to countries about the terms and conditions of their programs. (IMF 2000a, para. 16)

At its next meeting, the managing director reported that members of the Executive Board were not yet agreed on some of the issues raised by the Köln framework. Some favored a rule-based approach under which the extent of a member's access to IMF resources would depend on the member's pursuit of ''concerted'' private-sector involvement.[22] Others had reservations. Further research was needed, moreover, before the IMF could assume all of the tasks assigned to it under the operational guidelines endorsed by the Okinawa Summit (IMF 2000e).[23]

Achieving the Objectives of the Architecture Exercise

We turn now to the implementation of recommendations made in the course of the architecture exercise, stressing recent developments bearing on crisis prevention and crisis resolution. We focus first on two strategies aimed at crisis prevention: efforts to identify vulnerable countries before they succumb to crises, and efforts to foster compliance with international standards and codes in order to strengthen the infrastructure of emerging-market countries. We then examine two strategies aimed at crisis resolution: efforts to reform the policies and practices of the IMF, and efforts to involve private-sector creditors in resolving the debt-related problems of emerging-market countries.

Detecting Vulnerability

Many attempts have been made to develop early warning systems in order to identify vulnerable countries before they succumb to currency crises.[24] Such efforts involve four steps: (1) quantifying the definition of a crisis, (2) selecting indicators of potential vulnerability, (3) testing the

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22. The term *concerted* is the current euphemism for ''coercive'' or anything not purely voluntary.

23. Unfortunately, the next IMFC communiqué referred to ''the framework agreed in April 2000,'' by which it presumably meant the one presented in its own communiqué, not the Köln framework or the operational guidelines issued at the April G-7 meeting. In his long discussion of these texts, Roubini (2000) fails to mention the IMFC communiqués and thus leaves the misleading impression that the G-7 texts represent the view of the entire official community.

24. Goldstein, Kaminsky, and Reinhart (2000) survey and extend those efforts, and the following discussion draws on their work. The discussion here is narrower, however, because they also cover banking crises and the track record of the rating agencies. On the latter, see also Reisen and von Maltzan (1999) and Reinhart (2001), who find that downgrades of sovereign debt ratings have tended to reflect currency and banking crises rather than predict them.

explanatory power of those indicators, and (4) asking how often the most useful indicators correctly predict *subsequent* crises, how often they fail do so, and how often they issue false alarms.[25]

Currency crises are usually defined for this purpose as instances of abnormally large depreciations, large reserve losses, or combinations of the two, and most studies have found that the following variables are good leading indicators of those crises: appreciation of the real exchange rate, low growth rates of output and exports, a high or rising ratio of the money supply to reserves, and large amounts of short-term foreign borrowing or short-term debt.[26] Morris Goldstein, Graciela Kaminsky, and Carmen Reinhart (2000) find, in addition, that rapidly rising equity prices, a large current account deficit, and the onset of a banking crisis raise a country's vulnerability to a currency crisis.[27] Contradicting the conventional wisdom, however, their study and most others find that big budget deficits have little crisis-predicting power.[28]

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25. One can evaluate models of this sort without making out-of-sample forecasts, by asking how often the models fail to identify crises that actually occurred within the sample period and how often they falsely identify crises that did not occur. But out-of-sample tests are more rigorous. Therefore, Goldstein, Kaminsky, and Reinhart (2000) base their early warning model on the crises that occurred in 1970-95 and ask how well it predicts crises that occurred in 1996-97. Similarly, Berg and Pattillo (1999) reestimate models devised by Frankel and Rose (1996), Sachs, Tornell, and Velasco (1996a), and Kaminsky (1998) and subject them to out-of-sample tests. They find that the first two models do poorly in predicting the Asian crisis and that the reestimation of those models also alters the statistical significance of certain explanatory variables. Kaminsky's model is more stable and successful, and it is the precursor of the Goldstein-Kaminsky-Reinhart model. For an interesting variant of the Goldstein-Kaminsky-Reinhart strategy, see Osband and Van Rijckeghem (2000), who search for country characteristics (and sets of characteristics) that enable them to define crisis-free zones and ask which countries lie within them.

26. As various studies use different ways to disaggregate capital flows and debt, their findings are hard to compare. When Berg and Pattillo (1999) reestimate the model employed by Frankel and Rose (1996), they find that vulnerability is reduced when capital inflows consist largely of concessional borrowing and foreign direct investment and is raised by large public-sector borrowing, but they find that vulnerability is unaffected by the ratio of short-term debt to total debt. Yet Goldstein, Kaminsky, and Reinhart (2000) find that vulnerability is raised when short-term capital inflows are large relative to GDP; see also Radelet and Sachs (1998). Rodrik and Velasco (1999) find that a high ratio of short-term debt to reserves helps predict reversals of capital inflows, but their result may merely indicate that reversals can more readily occur when foreign creditors hold large short-term claims that they can liquidate quickly.

27. Most of the earlier studies, by contrast, attached little explanatory power to the current account deficit. For a list of explanatory variables used in various studies and the numbers of studies in which they were shown to be statistically significant, see Kaminsky, Lizondo, and Reinhart (1998, table A4).

28. Studies that focus mainly on the timing of crises, rather than potential vulnerability to them, also attach importance to world interest rates and to the growth rate of output in the industrial countries; see, e.g., Meese and Rose (1998) and Milesi-Ferretti and Razin (2000).

Most studies of this sort use standard econometric methods (e.g., probit regressions) to test the explanatory power of the country characteristics chosen as promising candidates. But Goldstein, Kaminsky, and Reinhart (2000) attack the problem differently. They use a two-step strategy proposed initially by Kaminsky and Reinhart (1999). First, they compute a threshold for each crisis indicator, making it flash a danger signal whenever it crosses that threshold. The threshold for each indicator is obtained by minimizing the noise-to-signal ratio for that indicator taken by itself. (The noise-to-signal ratio is the number of times that an indicator wrongly warns of a crisis divided by the number of times that it rightly warns of a crisis.) Second, they use a weighted sum of the number of flashing indicators to estimate the probability that a particular country will suffer a crisis within two years. The weights used in adding the flashing indicators are the reciprocals of their noise-to-signal ratios, a device that gives the heaviest weights to the most reliable indicators. When they used their strategy to make out-of-sample forecasts for the Asian countries, it assigned a high probability to the Thai, Malaysian, and Philippine crises but a low probability to the Indonesian crisis.[29]

What use might be made of these results? First, they draw attention to sources of vulnerability, indicating the need for remedial action. If a high ratio of money to reserves raises vulnerability, then hold more reserves. If a rising ratio does so too, then hold down the growth of the money stock or raise the stock of reserves apace with the money stock. If large short-term borrowing or large short-term debt raises vulnerability, then take steps to reduce short-term capital inflows. Goldstein, Kaminsky, and Reinhart (2000) note that these remedial actions would deprive their indicators of predictive power. But that result, they say, would be highly desirable.

Second, the publication of reliable leading indicators might induce more prudent behavior by the private sector. Unlike a fire alarm, which goes off suddenly and demands the immediate evacuation of a building, the signals sent by leading indicators tend to grow loud gradually and thus call for a measured response by investors, not for capital flight. (In the Thai case, however, they grew loud quite rapidly; the probability of a Thai crisis rose from under 30 percent in mid-1996 to more than 90 percent before the end of the year. But other loud alarms were also ringing, and the Thai authorities were almost alone in refusing to heed them.)

If a highly respected private-sector institution, such as the Institute of International Finance, began to publish on its Web site a set of leading indicators for emerging-market countries, together with summary mea-

29. When used to predict currency crises in the 12 months starting with June 1996, their strategy put South Africa, the Czech Republic, Thailand, Korea, and the Philippines at the head of the list, and four of them suffered currency crises in 1997-98 (South Africa did not); but it put Indonesia in the middle of the list.

sures of their previous track record, no one could object. But what about the IMF? Should it also do that?

Clearly, the IMF and other public-sector institutions should make similar calculations and use them to focus their attention on potentially serious problems. If a fairly reliable set of early warning signals shows that a country is courting a crisis, the staff of the Fund should look closely at the country without waiting until the next Article IV consultation. And if the signal is loud enough, the Fund should enter promptly into consultations with the country. But to take the next step—to issue a public warning whenever leading indicators and other information suggest that a country is courting a crisis—would be risky for the Fund because of the prominent role it plays.

The Birmingham Summit (Group of 7 1998) suggested that the IMF might issue public warnings, and others have said so too. William Cline (2000a), for example, has argued that the IMF should have warned private investors about Thailand's problems before the Thai crisis erupted. It had, after all, warned the Thai government that it faced serious trouble. But there are compelling objections to public warnings by the Fund. If it fails to issue a warning, private investors may blame the Fund for the losses they suffer after a crisis erupts. That is the risk emphasized by Alexandre Lamfalussy (2000). Conversely, if it issues a warning, it may be accused of provoking a crisis that would not have erupted had the Fund not done so. That is the risk emphasized by Barry Eichengreen (1999b). Hence, the Fund may be damned whatever it does, and there may be no way to decide whether it was in fact culpable. Early warning indicators can detect vulnerability. A vulnerable country, however, may not succumb to a crisis unless it suffers a run of bad luck of the sort suffered by Mexico in 1994, and no econometric model can predict assassinations, insurrections, or political crises.

The *threat* to issue a public warning could perhaps be useful. Such a threat might have made the Thai authorities sit up and take notice. But the Fund cannot threaten to ''go public'' unless it is ready to do so when its warnings are ignored, and its Executive Board would be reluctant to do that or to let the managing director do it.[30]

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30. In an earlier paper (Kenen 2000d), I suggested that the Fund threaten to go public when its confidential warnings are ignored, and a similar suggestion was made by the French finance minister, Dominique Strauss-Kahn (''A Fix, Not a Fudge,'' *Financial Times,* 16 April 1998). I now believe that my suggestion was unrealistic politically. There may be some merit in an alternative proposal made by an IIF working group:

> In some cases, countries may not respond effectively to warning signals coming from an IMF surveillance report, or private sector warnings such as an IIF country assessment or a rating agency action. In such circumstances, senior representatives of the private sector . . . could visit the country to explain to the authorities why the country's policies appear unsustainable, and could recommend that the country initiate intensive consultations with key financial firms and, in most cases, with the IMF. (IIF 1999, 34)

Strengthening the Infrastructure in Emerging-Market Countries

The international financial institutions have been engaged for many years in efforts to strengthen the institutional infrastructure and policymaking processes of their member countries. The most comprehensive efforts were those undertaken in the countries of Central and Eastern Europe, to help them move from planned to market economies. They included advice, technical assistance, and the use of IMF conditionality. And the use of conditionality to foster reform was not new: the Fund had used it even earlier to accelerate structural reform in developing countries—especially those that qualified for drawings under the Extended Fund Facility (EFF), which had been designed in the 1970s for countries with balance of payments problems that could not readily be resolved unless the countries made fundamental changes in their institutional arrangements and policies.

With the advent of the Asian crisis in 1997, the Fund sought once again to use conditionality as a way to promote fundamental reform. It did not confine itself to the subset of reforms deemed essential for resolving the crisis. Recall the long list of conditions attached to Fund programs for Thailand, Indonesia, and Korea. Those countries were asked to dismantle domestic monopolies, end the preferential treatment of certain industries, liberalize trade in goods and financial services, privatize state enterprises, strengthen corporate governance and combat corruption, introduce bankruptcy regimes, and overhaul the financial sector. Little attention was paid to priorities—what must be done immediately to solve the countries' acute problems and what might be done later on to reduce the risk and severity of future crises.

There is a more basic objection, however, to using conditionality to promote fundamental reform, especially crisis-preventing reform. The Fund can attach conditions to Fund-financed programs for countries already beset by crises, but that is like locking the barn door after the horse is stolen. Conditionality cannot be used to impose reforms on countries that are not in crisis and do not need help from the Fund. Further-

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Furthermore, Goldstein (1998) has suggested that the Fund can issue public warnings rather routinely and undramatically in Article IV reports, in the *World Economic Outlook,* and in speeches by the managing director. The same suggestion was made obliquely by the group of outside experts appointed to assess the effectiveness of IMF surveillance; they urged the Fund to sharpen its surveillance by focusing on the sustainability of countries' policies, debt profiles, and exchange rates and by paying less attention to other policy issues (IMF 1999c). But some of the Fund's executive directors politely rejected that advice because it ''ran counter to the demands of the membership and international community for increasing emphasis on the interactions between macroeconomic, structural, and social policies'' (IMF 1999c, 4). (The executive directors agreed, however, on the need for the Fund to pay more attention to vulnerability—that it should enhance its analysis of the capital account, the financial sector, and the treatment of contagion.)

more, conditionality does not last long enough to foster reforms that require much time to complete, and this objection will hold with more force now that the Fund has moved to reduce the number of multiyear programs by limiting access to the EFF (IMF 2001b). The objection is particularly applicable to financial-sector reform:

> [R]eal reform in the banking system takes years to accomplish because it entails new ways of measuring and managing risk, new regulations, and new supervisory procedures. These changes are both politically difficult (because the politically powerful must forgo subsidies) and technically challenging. The time horizon necessary to implement successful reform is at least five years (judging from the successful examples of Argentina and Chile, which did so very aggressively and voluntarily). Building effective financial institutions, and reforming the legal and regulatory environment in which they operate, is a protracted and difficult learning process, even when countries have the political will to do so. The horizon of IMF crisis assistance and conditionality . . . is simply not suited to achieve true reform in the banking sector. (Calomiris 1998b, 280)

Many have made the same point.[31]

In the course of the architecture exercise, however, a different approach gradually developed. As various bodies, including the Fund, began to promulgate standards and codes by which to judge the quality of bank supervision, securities-market supervision, bankruptcy regimes, corporate governance, and other institutional arrangements, the official community began to devise ways of using the standards and codes to assess the quality of those arrangements in individual countries.

In 1999, the IMF and World Bank introduced the Financial Sector Assessment Program (FSAP). Under that program, a team from the Fund and Bank, augmented by other experts, undertakes an intensive examination of a country's adherence to certain key standards and codes—the Fund's data dissemination standards, the code on transparency in monetary and financial policies, and the codes on banking supervision, securities-market supervision, insurance supervision, and payments systems.[32] Participation in the FSAP is voluntary, and the assessments are not published. The Fund uses the results to prepare a Financial Sector Stability Assessment (FSSA) for the participating country. This assessment is then used to help Fund missions identify problems that call for attention in subsequent Article IV consultations, as well as in program design and the Fund's technical assistance programs. The World Bank uses the results to prepare a Financial Sector Assessment (FSA), which is used for analogous pur-

31. See, e.g., Ahluwalia (2000), Lamfalussy (2000), and Minton Beddoes (1999); on the analogous problems of gearing up to make effective use of a new bankruptcy regime, see Eichengreen (1999b).

32. Self-assessments have sometimes been used in lieu of external assessments, but they have not always been very reliable; some participants in self-assessments readily concede that they were not sufficiently critical of their own countries' regimes.

poses within the Bank. Twelve countries agreed to participate in the first experimental round of assessments under the FSAP, and the Fund has since decided to continue the program. But participation will still be voluntary, and the assessments will remain confidential. (The Fund did decide, however, that an FSSA could be published with the consent of the country concerned.)

The Fund has also begun another voluntary program—the preparation of Reports on the Observance of Standards and Codes (ROSCs). These are developed on a ''modular'' basis and may contain as many as 11 modules—one for each standard or code covered by the FSAP and others covering fiscal transparency, corporate governance, accounting and auditing standards, and insolvency regimes.[33] Once again, publication requires the consent of the country concerned, but most of the countries involved thus far have agreed to publication, and ROSCs have begun to appear on the Fund's Web site. More than 110 modules had been completed by the end of March 2001, and 73 had been published; but the Fund and Bank have warned that seven to eight more years might be needed to produce as many as four ROSC modules for each member of the Fund (IMF and World Bank 2001).

The publication of the assessments produced by the FSAP and of the ROSCs themselves can perhaps encourage compliance with international standards and codes if the private sector is willing and able to use them when forming its judgments about credit risk and related matters. In fact, the official community appears to count heavily on market discipline to foster compliance with these standards and codes (see Crockett 2000; FSF 2000b; Fischer 1999; IMF and World Bank 2001). Thus far, however, the private sector seems to know little about the various standards and codes or the Fund's efforts to publicize its findings concerning compliance with them (see FSF 2000a; IMF 2000c). For this and other reasons discussed in chapter 5, it may be imprudent to rely mainly on market discipline. Other carrots and sticks may be needed.

Limiting Reliance on IMF Financing

Throughout the architecture exercise, the official community has insisted that large-scale official financing has been and should be ''exceptional'' rather than ordinary practice. But words and deeds do not always match. Although the numbers usually quoted often overstate the amounts of official financing actually available to crisis-stricken countries, the amounts obtained by Thailand, Indonesia, Korea, and Brazil and, more recently, Argentina and Turkey were abnormally large. Furthermore, the

33. All these key standards and codes are included in the list of 12 produced by the FSF (reproduced in n. 5, above), but the FSF also lists the Forty Recommendations of the FATF.

Fund has institutionalized large-scale financing by creating the SRF; it is designed to provide larger amounts of official financing than a country can obtain under a standby arrangement (i.e., an ordinary quota-based drawing).

The Risks and Costs of Large-Scale Financing

Some participants in the debate about the international financial architecture have favored large-scale financing. Recall the recommendation of the Meltzer Report (IFIAC 2000), which called on the IMF to serve as the lender of last resort to a limited group of countries with sound banking systems. Yet most participants in the debate have taken the opposite view, that the Fund's normal quota-based limits should be applied more strictly. They give several reasons for their view.

First, large-scale financing runs the risk of encouraging governments to follow imprudent policies and encouraging private-sector lenders to make imprudent loans—the familiar versions of the moral hazard argument. These risks are often overstated, but they are not negligible.

No sensible government will knowingly court the risk of a currency crisis in the belief that it will obtain large-scale official financing. The economic and social costs of the Asian crisis were enormous, despite the amounts of financing provided. And few governments rush to the Fund when they see trouble ahead. In fact, some governments wait too long, believing that they can solve their problems without having to pay the political costs of submitting to conditionality. Nevertheless, the prospect of large-scale financing can have two worrisome effects. It can encourage governments to cling too long to pegged exchange rates, and it can tempt them to rely excessively on foreign currency borrowing when running budget deficits and managing their debts.

The official community sought to discourage governments from clinging too long to pegged rates when it warned that large-scale financing might not be forthcoming for countries that intervene heavily to defend pegged rates. David Lipton (2000) argues, however, that governments may ignore that warning unless the amount of official financing is limited ex ante rather than denied ex post. Thus far, moreover, the official community has not done enough to dispel the belief that governments facing debt problems can count on large-scale financing to resolve them. It has warned private creditors repeatedly that the official community will not provide large-scale financing to keep them from suffering losses should a debt crisis occur. But it has not addressed the same warning explicitly to debtor governments, and there has been a striking disjuncture between its words and deeds.

The problem of creditor moral hazard has likewise been overstated. No one has adduced compelling evidence that the scale of financing in the late 1990s raised the volume of new lending to emerging-market countries—apart from the Russian case.[34] Nevertheless, routine recourse to large-scale financing may eventually have that effect, especially if the official community declines to adopt a more forceful approach to private-sector involvement. When large-scale financing is used to buy time for a crisis-stricken country to reach a voluntary agreement with its private-sector creditors, one should not expect the terms of the agreement to treat the creditors harshly. Voluntary agreements cannot be reached without offering them ''sweeteners.'' The record shows that clearly.[35] Therefore, they are not an adequate antidote to creditor moral hazard.

One more consideration is relevant here. Michael Mussa et al. (2000) argue quite rightly that the denial of large-scale financing in the Mexican case would have imposed huge losses on the innocent victims of the crisis in order to impose rather moderate losses on imprudent investors. But repeated resort to large-scale financing may tip the balance of benefits and costs by raising the likelihood of future crises and thus raising the number of innocent victims.

There is another objection to large-scale official financing. The privatization of international capital flows calls for the privatization of crisis management—the participation of private-sector creditors in the resolution of financial crises—but the availability of large-scale financing masks the need for that involvement. This ''burden-sharing'' argument is logically distinct from the moral hazard argument. The latter is concerned with the future behavior of private investors and lenders; the former is concerned with their previous behavior. If investors and lenders come to believe that they were unduly optimistic about the outlook for a particular country, and thus halt capital inflows suddenly, they should have to help the country cope with the consequences. Sometimes, of course, the change in investors' views is the result of worrisome changes in a country's policies. Too often, however, foreign investors change their views abruptly. Rather than tap the brake pedal at the first sign of danger, they wait until they must hit it hard because they have no other way to avoid an accident. Financial markets may not be ''unstable'' but they are very

34. See, however, the paper by Dell' Ariccia, Godde, and Zettelmeyer (2000), cited in chapter 2, which raises doubts about the validity of previous research on this issue.

35. When ''haircuts'' on bond exchanges are computed using the initial prices of the old bonds, the calculations show that investors have taken large losses. But when they are computed using the market prices of the bonds just before the terms of the exchanges are announced, the calculations show that investors have come out ahead, and that is a sensible way to measure impact on a mark-to-market investor; see IMF (2000e) and Roubini (2000). But see also Cline (2000b, 26), who argues that ''the fulfillment of an obligation should be judged against its original value, not the level to which it has fallen under distress.'' (It should also be noted that the market price of a bond just before an exchange may be unduly depressed by uncertainty about the terms of the forthcoming exchange, and use of the market price may thus overstate the net gain to the investor.)

volatile, and the inhabitants of those markets have an obligation to mitigate the consequences of that volatility.[36]

Finally, official financing in excess of normal quota-based limits cannot be provided routinely without imparting more elasticity to the financial resources of the IMF. The NAB and GAB are the only reliable source of additional financing, and they are not easily activated. The Fund can create Special Drawing Rights (SDRs), but only to meet a global need for additional reserve assets, not to finance its own operations.

Reconfiguring the Fund

Those who favor a return to the normal quota-based limits on access to IMF credit do not necessarily rule out large-scale financing in truly exceptional circumstances. The task force convened by the Council on Foreign Relations proposed that the Fund's facilities be reorganized to draw a sharp distinction between ''country crises'' and ''systemic crises'' and to treat them differently.[37] Most country crises would be handled by ordinary quota-based drawings. But truly exceptional country cases, requiring unusually large amounts of financing, would be handled by activating the NAB and would therefore require the consent of the countries participating in the NAB.[38] The task force defined systemic crises as multicountry crises requiring large-scale official financing because they threaten to impair the performance of the world economy or the ability of financial markets to judge the creditworthiness of individual borrowers. Those crises, it said, should be treated differently. A new ''contagion

36. Lamfalussy (2000) offers a similar ''ethical'' argument for burden sharing; see also Geithner (2000). Cline (2000b) argues, however, that there is no ''burden'' to be shared when a crisis reflects a pure creditor panic. Official financing will restore confidence all by itself and thus induce a resumption of capital inflows that will permit repayment of the official financing. Therefore, the official sector will bear no burden unless it provides financing on concessional terms. And the crisis-stricken country will bear no burden, because it will not have to make any painful policy changes. Roubini (2000) makes a similar point. If action is taken promptly, at the first sign of a creditor panic, a full bailout of private creditors is formally equivalent to a full ''bail-in.'' They are equally able to keep a pure creditor panic from affecting the capital account of the crisis-stricken country, obviating the need for the country to modify its policies. If, indeed, the official community can commit itself credibly to a full bailout, the country will not have to ask for it, as the panic will end right away. But this formal equivalence holds only under strong assumptions about private-sector behavior. Roubini concedes, moreover, that pure creditor panics are rare and that policy changes are usually needed to bring about a restoration of investor confidence. That, he says, is the justification for the current approach to crisis resolution, which relies on a combination of policy adjustment, official financing, and voluntary private-sector involvement.

37. Task Force on the Future International Financial Architecture (1999), cited hereafter as CFR Task Force (1999).

38. Furthermore, the credit risk would be borne by those countries rather than the IMF.

facility'' should be created and financed by a onetime issuance of SDRs.[39] It would replace the SRF and CCL and would provide unconditional assistance to countries adversely affected by temporary shocks largely beyond their control—a fall in commodity prices, a contraction of capital flows to emerging-market countries, or an increase of interest rate spreads. Disbursements from the contagion facility would be made swiftly and would be front-loaded, but activation would require the consent of a supermajority of the countries providing the SDRs. (This last proposal has much merit and could be adopted without adopting the other reforms and the new financial arrangements proposed by the task force. A supermajority could be required to approve a drawing on the present SRF. That in itself might diminish the frequency with which the Fund provides large-scale financing.)

Others have also proposed the reconfiguration of IMF facilities.[40] But the details matter less than the basic issue raised by the task force and others. They have sought to distinguish between systemically important countries and systemic crises. Admittedly, the two are not unrelated. A country is systemically important if its problems are likely to impair the functioning of international financial markets, and that is most likely to be true if the country itself is large or a large participant in those markets. But the size of the country is less important than the nature of its problem. Thailand is not a large country, and the Thai crisis of 1997 was not deemed initially to have systemic implications. Nevertheless, it drew attention to serious vulnerabilities in other Asian countries.

Consider another example. If Argentina's current problems were due to a large current account deficit resulting from the appreciation of the US dollar and the depreciation of the Brazilian real, they would not be systemic. The policy changes required to reduce a current account deficit rarely have calamitous effects on other countries or international financial markets. But Argentina's problems are due largely to the belief that it will not be able to service its large foreign currency debt. Therefore, they have a systemic dimension, not because Argentina is large but because its bonded debt is large compared to the total of emerging-market debt traded on international markets. Yet two more requirements must be met before one can make a compelling case for large-scale official financing to resolve this sort of problem. First, there must be reason to believe that large-scale financing will avert—not merely delay—the need to restruc-

39. To meet the requirements of the Fund's Articles of Agreement, the SDRs would be issued to all of the Fund's members, but they would then transfer them to the Fund to finance the contagion facility. (As in the case of financing via the NAB, the credit risk attached to lending by the contagion facility would thus be borne by the Fund's members providing the SDRs, not by the Fund itself.)

40. See, for example, the plans proposed by Knight, Schembri, and Powell (2000) and Williamson (2000b), discussed in chapter 3.

ture the country's debt. Second, there must be reason to believe that the restructuring of that debt would have ramifications that could not be contained without extending large-scale assistance to other countries.[41]

The architecture exercise has not confronted this issue squarely. Late in the course of the exercise, several changes were made in the terms and conditions attached to the use of IMF credit. But most of the changes were aimed at reducing the demand for IMF credit, not at reducing the supply.

Speaking at the London Business School in December 1999, soon after his appointment as secretary of the treasury, Lawrence Summers called for a ''streamlining'' of the Fund's facilities (Summers 1999a).[42] The Fund, he said, should phase out long-term lending and rely primarily on three ''core'' facilities: short-term standby arrangements for countries with non-systemic balance of payments problems, the SRF for countries suffering systemic capital account crises, and the CCL for countries seeking to ward off contagion. ''We also believe,'' he said, ''that the pricing of these facilities needs careful consideration'' (1999a). Higher charges should be attached to normal standby arrangements, and the terms of access to the CCL should be made more attractive than those of the SRF, as countries will then be encouraged to make the policy changes needed to protect them from contagion. Summers went on to say what he and others had said before—that the IMF must be capable of providing ''very large-scale financing'' in the event of a ''truly exceptional systemic threat,'' but that normal quota-based limits should apply ''to all but a fraction of cases'' (1999a). But he made no attempt to explain how to define a systemic threat.

Shortly thereafter, the Fund's Executive Board began an exhaustive review of all Fund facilities. It abolished three special-purpose facilities that were no longer being used. It liberalized the terms of access to the CCL, which was not attracting applicants. It shortened the time periods

41. If the first condition is not met and the country has then to restructure its debt, large-scale assistance for others may still be required. This was, of course, the rationale for assisting Brazil in August 2001, even before a decision was made about further help for Argentina. The subsequent decision to provide $5 billion of additional Fund credit for Argentina was not meant to resolve its debt problem but rather to combat a credit crunch caused by large withdrawals from Argentine banks. An additional $3 billion was earmarked for future use but could be made available earlier to support a ''voluntary and market-based operation to increase the viability of Argentina's debt profile'' (IMF *News Brief*, 21 August 2001). But the nature of that operation was not disclosed immediately, and it is far from clear that the $3 billion will suffice to catalyze a major restructuring of Argentina's debt, even if Argentina uses the money to buy zero-coupon dollar bonds, uses them to collateralize new long-term bonds of its own, and then swaps its new bonds for existing debt, as was done in the case of the Brady bonds.

42. Delong and Eichengreen (2001) suggest that some of the proposals made in that speech were designed to demonstrate that the US Treasury did not reject out of hand all of the recommendations in the Meltzer Report.

within which countries are ''expected'' to repay conventional IMF drawings—those made under standby arrangements and those from the EFF. And it agreed to impose higher charges on large balances outstanding as a result of conventional drawings.[43]

To make the CCL more attractive, the Executive Board decided that a country will not have to provide as much supporting documentation as was previously required when submitting a quantified framework describing its future policies. Furthermore, the country must be making good progress in meeting the requirements of the SDDS and a ''critical mass'' of other standards, rather than each one separately. Finally, it will not have to undergo a detailed review of its policies when it seeks to activate its CCL. There will be an expeditious review at the time of activation, in which the country will be given ''the strong benefit of the doubt'' (but there will be a postactivation review, in which the Fund and the country will reach understandings regarding the country's future policies). Finally, the Executive Board reduced the commitment fee for a CCL and the surcharge for a drawing on a CCL. Previously, the surcharge was the same as the one for a drawing from the SRF, which starts at 300 basis points above the charge for a conventional drawing but rises to 500 basis points with the passage of time. Now, the CCL surcharge will start at 150 basis points and rise to 350 basis points.

To speed up the repayment of conventional drawings, the Board adopted ''time-based expectations'' that will hold ahead of the mandatory deadlines. Under a standby arrangement, for example, a country must start to repay a drawing 3¼ years after the drawing and repay it completely 5 years after the drawing. Hereafter, it will be ''expected'' to start making repayments 2¼ years after a drawing and repay it completely 4 years after the drawing. The board did not adopt the suggestion, made by Secretary Summers, that higher charges be imposed on all conventional IMF drawings. Instead, it imposed a surcharge on conventional drawings in excess of certain cumulative limits; hereafter, a country must pay an additional 100 basis points when its drawings exceed 200 percent of quota and 200 basis points when they exceed 300 percent of quota.

Applying the Köln Framework

The history of the architecture exercise outlined in the first part of this chapter focused on the evolution of official views about private-sector involvement in crisis resolution. It paid little attention to the ways in which the official community was trying to achieve private-sector involvement, apart from describing the initial effort to restructure interbank claims on

43. For more on these changes, as well as those described below, see IMF (2000b) or Goldstein (2001).

Korea. But several efforts were made to restructure sovereign debt in and after 1999, using some of the ''tools'' listed in the Köln framework. It has indeed been suggested that the Köln framework did little more than codify the strategies devised to deal with those cases.[44] Three cases deserve particular attention, because of the issues they raised and the precedents they set.[45]

Ukraine and Debt Sustainability

The first case involved Ukraine. In September 1998, just after the Russian crisis, Ukraine faced the need to redeem a tranche of treasury bills denominated in domestic currency. To prevent the Ukrainian government from using official funds to repay private creditors, the IMF imposed a reserve floor—one of the tools subsequently listed in the Köln framework. Therefore, Ukraine offered to exchange the maturing bills for zero-coupon eurobonds. The offer was quite successful, because the maturing bills were held by a small number of institutional investors and the terms of the exchange were very attractive. Ukraine made up-front cash payments, and the new eurobond carried a high interest rate. Furthermore, the holders of the maturing bills had no satisfactory alternative. They had little chance of winning a lawsuit, because the treasury bills had been issued under Ukrainian law; those who did not swap their bills for new eurobonds would be paid off in Ukrainian currency and could not convert it into foreign currency.

The 1998 exchange, however, stored up problems for the future, because the new eurobond had a short maturity. Those problems were compounded in 1999 when a bond held mainly by one foreign investor came due for repayment. At first, Ukraine refused to repay it, citing the reserve floor imposed by the IMF. But when the bondholder refused to consider restructuring and threatened to invoke cross-default and acceleration clauses, Ukraine was obliged to redeem it by issuing a new tranche of an existing eurobond, which was due for redemption in 2001. Hence,

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44. See IMF (2000c), where this view is ascribed to private-sector critics.

45. Comprehensive accounts of those cases are provided by the IMF (2000c, 2001a); see also Cline (2000b), Eichengreen (2000a, 2000b), Eichengreen and Rühl (2000), and Roubini (2000). Two more cases are often cited. In 1999, the IMF required Romania to roll over 80 percent of its maturing debt. As Romania could not do that, the IMF told it to issue new debt in order to redeem its maturing debt. Before its new IMF program came into effect, however, Romania drew down its reserves to repay its maturing debt. This action did not cause the IMF to cancel the new program. Instead, the Fund required Romania to issue new debt in an amount sufficient to rebuild its reserves. And when Romania did not do that either, the IMF backed off. The other case involved commercial-bank claims on Russia, representing old Soviet-era debt. Russia had defaulted on those claims in August 1998, along with its other debt. In early 2000, however, it reached a debt-restructuring agreement with its London Club creditors, although the debt involved had been restructured previously, in 1997.

Ukraine faced an ‘‘insurmountable repayment peak’’ (Eichengreen and Rühl 2000) and sought therefore to flatten that peak by making another debt exchange.

In February 2000, Ukraine offered to exchange four maturing eurobonds and two so-called Gasprom bonds for two new eurobonds with seven-year maturities. Once again, the offer was attractive; it did not involve debt forgiveness, there would be no interest-free grace period, and the accrued interest on the old bonds would be paid in cash. Furthermore, Ukraine made clever use of the collective action clauses embedded in three of the old eurobonds.[46] It declined to convene a bondholders' meeting until it had collected binding proxies from investors favoring the bond exchange and thus had the votes required to bind in all of the bondholders.

Pakistan and Paris Club Comparability

The second case involved Pakistan. In 1999, as a condition for restructuring Pakistan's debt to its official creditors, the Paris Club required Pakistan to seek comparable treatment from the private holders of its eurobonds. (The Paris Club has always insisted that debtor countries obtain comparable treatment from their private creditors. In previous cases, however, it applied that principle to bank loans, not bonds, because the debtors with which it was dealing did not have significant amounts of bonded debt.) Pakistan demurred at first; but when a military government seized power, Pakistan was unable to raise new money by issuing new bonds. Therefore, it offered to exchange three maturing eurobonds for a six-year eurobond, and the offer was accepted by holders accounting for 99 percent of the maturing eurobonds. (Those bonds were held mainly by investors in the Middle East, which may help explain the success of the bond exchange.)

As all of the old eurobonds had been issued under UK law, they had collective action clauses. But Pakistan did not invoke them, because of concerns about the possible outcome of a bondholders' meeting. Bondholders had been angered by the Paris Club's demand for comparable treatment and might have expressed that anger by rejecting Pakistan's offer. Once the exchange was completed, moreover, the only remaining holders were those who had rejected it, and they could not be expected to show approval at a bondholders' meeting. Fortunately, the handful of dissident creditors never initiated legal action.

Ecuador and Exit Consents

The third case involved Ecuador, and it raised a number of controversial issues. Because Ecuador faced serious economic problems in 1999, its

46. Because the three bonds had been issued under Luxembourg law, which resembles UK law, they had collective action clauses. The fourth bond did not have them, but it was held

president announced in August that the government had decided to withhold the interest payment due on one of its Brady bonds. According to Barry Eichengreen (2000a), the government and its foreign advisers believed that this announcement would force the bondholders to agree to a restructuring. To buy time for that to happen and to avoid an immediate default, Ecuador asked the bondholders to let it pay the interest due by using the collateral earmarked for that purpose. Instead, the requisite number of bondholders, 25 percent, voted to accelerate repayment.[47]

Just before that vote, however, the IMF announced that it would not require Ecuador to reach agreement with its bondholders before approving Ecuador's request for an IMF program. This statement did little more than reaffirm the Fund's existing policy: it was prepared to lend into arrears when a country was making a good faith effort to reach agreement with its creditors. But Eichengreen and Christof Rühl (2000) suggest that Ecuador's creditors saw it to be something more—an endorsement of Ecuador's default on its Brady bonds. William Cline (2000b), likewise accuses the Fund of making Ecuador a ''guinea pig'' for a new, more aggressive policy toward private-sector creditors and notes that Ecuador's program, approved later by the Fund, was based on cash-flow projections that implied the restructuring of Ecuador's whole foreign currency debt—its eurobonds as well as its Brady bonds.

Eight months after it defaulted on its Brady bonds, Ecuador made an exchange offer. It would swap all of its defaulted foreign bonds, eurobonds and Brady bonds, for a new 30-year eurobond. The offer was successful, even though Ecuador's foreign bonds were more widely held than those of Pakistan or Ukraine—and by a more heterogeneous group of investors. In addition, the defaulted bonds lacked collective action clauses, having been issued under US law, and there was thus no way for Ecuador to bind in dissident creditors. But one of its advisers hit on a novel device for dealing with dissident creditors: the use of exit consents. Under US law, the payment terms of an existing bond cannot be altered without the unanimous consent of the bondholders. It is nevertheless possible to make other changes with the consent of a simple majority, and that is the route that Ecuador took. Every bondholder accepting Ecuador's offer had to endorse several changes in the terms of the defaulted bonds (so-called disfiguring amendments) that made it harder for dissident creditors to reject Ecuador's offer and initiate litigation.[48]

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by small investors, and Ukraine's investment bankers succeeded in persuading them to accept the exchange offer.

47. Although Ecuador's bondholders did not actually meet, this episode is often cited as proof that bondholders' meetings can lead to ''strange and exotic'' outcomes (IMF 2000c).

48. The disfiguring amendments deleted the following provisions: the requirement that all defaults be cured before an acceleration can be rescinded, the prohibition of Brady bond purchases by Ecuador during a default and of any further Brady bond restructuring, the

Precedents and Problems

These recent attempts to secure private-sector involvement have been strongly criticized. Eichengreen and Rühl (2000) raise three objections. First, the countries involved are comparatively small, and bondholders may therefore conclude that they should shun small countries' bonds in favor of large countries' bonds. Small countries could then lose market access, and the concentration of bondholders' exposure on a few large countries could raise systemic risk. Second, Ecuador's attempt to single out its Brady bonds had unforeseen consequences. Ecuador's aim was to preserve its ability to issue additional eurobonds.[49] But this selective strategy failed when Ecuador's eurobonds and domestic debt were contaminated by the activation of the cross-default clauses in its Brady bonds. Furthermore, Ecuador's strategy undermined the prevailing seniority structure—the supposition that Brady bonds were senior to eurobonds and foreign debt was senior to domestic debt. Finally, Eichengreen and Rühl criticize the official community for failing to exploit the opportunity afforded by these episodes to promote the inclusion of collective action clauses in new bond issues. Until those clauses are widely used, they argue, there will be no way to drive bondholders to the bargaining table, because there won't be a bargaining table. Restructuring will be too costly for debtor countries, and the IMF will be unable to stand aside when restructuring efforts fail. Investors, moreover, will anticipate intervention by the Fund, so they will have no incentive to restructure their claims.

This assessment is too pessimistic. It was written before Ecuador had worked its way back from default with the aid of exit consents. It can indeed be argued that exit consents represent a viable substitute for collective action clauses. They can be used to modify the terms of bonds already issued, whereas collective action clauses can be included only in newly issued bonds. There is, however, an obvious objection to relying on exit consents. If debtors employ them frequently, investors may start to insist that new bond covenants be written in ways that preclude their future use. It would take several years, of course, to complete that process—as much time as it would take to add collective action clauses to all bond covenants. But the process could start quite soon if debtors begin to rely routinely on the use of exit consents.

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cross-default and negative pledge clauses, and the requirement that Ecuador maintain the listing of the old bonds on the Luxembourg stock exchange (IMF 2001a). Buchheit and Gulati (2000) discuss in detail the legislative and case-law basis for the exit consent strategy.

49. Recall that Brady bonds embody commercial-bank claims that were reduced and restructured in order to close out the debt crisis of the 1980s. Because they represent previously restructured debt, they were commonly regarded as being senior to eurobonds. As no one can issue new ones, however, Ecuador and its advisers saw no obvious reason to take that view; for more on the issues involved, see Petas and Rahman (1999) and Roubini (2000).

Furthermore, Eichengreen and Rühl may attach too much importance to collective action clauses. Cline (2000b) and others maintain that they had little to do with the success of recent bond exchanges. Pakistan did not invoke them, although they were available; Ukraine did make use of them, but only after the fact, soliciting proxies from bondholders who had already accepted its offer. And Ecuador could not use them, because its bonds were issued under US law. Nouriel Roubini (2000) goes so far as to say that collective action clauses are an ''empty shell,'' though he concedes that their absence may help explain why some bond exchanges have been generous to investors.

The truth may lie between the polar positions taken by Eichengreen and Rühl (2000) on the one hand and Roubini (2000) on the other. The mere existence of collective action clauses cannot be expected to influence decisively the behavior of any bondholder, unless the bondholders are few in number and can play strategic games. Nor can collective action clauses bind in dissident creditors, unless the terms of a bond exchange are sufficiently generous to attract the support of the many bondholders whose votes are needed to invoke the clauses—usually those who hold 75 percent of the bond issue being retired. Once those bondholders are satisfied by the terms of an offer, they should be willing to join with the debtor in seeking to forestall harassment by the remaining bondholders. Absent those clauses, however, a country trying to restructure its debt may indeed be obliged to make an extravagant offer—one designed to elicit support from virtually all of the bondholders, especially those whose holdings are sufficiently large to make it worthwhile for them to initiate litigation.[50]

Overly generous offers can have two worrisome consequences. First, they can get in the way of combating creditor moral hazard. Second, and more important, they can produce destabilizing debt dynamics. The risk of that outcome was foreseen by the G-22 (Group of 22 1998a), and it was the problem facing Ukraine following the debt exchanges of 1998 and 1999.

Pakistan's experience posed an additional difficult problem—how to interpret and apply Paris Club comparability. Cline (2000b) and others assert that the concept itself is flawed. Official creditors, they say, are motivated partly by political concerns when they make loans to developing countries and when they reschedule debt. Private creditors are differently motivated and should not be forced to mimic the offers made by Paris Club creditors. There are practical problems, too. The interest rates on official loans are lower than those on private loans, and official and private creditors use those different interest rates when computing the net present values of the concessions they make to their debtors. As a

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50. Although there was no litigation in the cases considered here, there was successful litigation in an earlier case, Elliott Associates vs. Republic of Peru; see IMF (2001a).

result, a dollar of debt rescheduled for one year by an official creditor has a higher net present value than a dollar of debt rescheduled for one year by a private creditor, and the two are hard to compare. Finally, private creditors believe that the Paris Club should be bound by the same strict principle of comparability. This argument was made when Russia restructured its debts to commercial banks and arose again when Ecuador restructured its foreign bonds. In both cases, the debtor country asked the Paris Club for ''reverse comparability,'' and its private creditors were happy to chime in.[51]

Note, in conclusion, that none of the cases considered here involved a large emerging-market country—a fact that led Daniel Tarullo (2001, 37) to write, ''I know of no official at the Fund or in a G-7 country who would argue with a straight face that an economically or strategically significant country would be treated similarly.'' Furthermore, those cases involved the restructuring of sovereign debt, not private-sector debt. In fact, recent discussions of private-sector involvement have focused almost exclusively on sovereign debt. The problems posed by the volatility of short-term private debt—especially interbank debt, which Alan Greenspan (1998) described as being potentially the Achilles' heel of the international financial system—ceased to attract attention as soon as the Asian crisis ended. They could crop up again, however, and we will return to them in the next chapter.

51. The complex issues raised in this paragraph are discussed at length in IIF (2001), IMF (2000e), and Roubini (2000).