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Introduction

Roughly once a year—if recent history is any guide—the managing director of the International Monetary Fund (IMF), the US treasury secretary, and in some cases the finance ministers of other Group of Seven (G-7) countries get a phone call from the finance minister of a large emerging-market economy. The precise details of each conversation differ, but the core does not. The emerging-market economy's finance minister indicates that the country is rapidly running out of foreign reserves, that it has lost access to international capital markets, and that it has perhaps even lost the confidence of its own citizens. Without a large rescue loan, the country will be forced to devalue its currency and either default on its government debt or be unable to help its banks avoid a payments standstill.

This book is about how to answer that phone call.

The list of countries that have asked the official sector[1] for help since 1994 is long and covers all parts of the globe. It includes major emerging economies like Mexico, Thailand, Indonesia, Korea, Russia, Brazil, Turkey, and Argentina—as well as smaller economies like Ukraine, Pakistan,

1. The IMF, World Bank, regional development banks, G-7, Group of Ten (G-10), and the group of bilateral creditors that meet in the Paris Club are collectively known as the official sector. The G-7 countries are the United States, Japan, Germany, the United Kingdom, France, Italy, and Canada. Belgium, the Netherlands, Sweden, and Switzerland join the G-7 in the G-10. Like the Big 10 conference, the G-10 has 11 members. The G-10 countries provide the bulk of the funds that the IMF, World Bank, and other multilateral development banks (MDBs) lend to emerging economies and have a correspondingly large say over how those funds are used. Regional development banks include the Inter-American Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, and African Development Bank.

Ecuador, Uruguay, and the Dominican Republic. The call rarely comes as a total surprise, at least when the phone rings. It is bad form to call the IMF's managing director, the US treasury secretary, or the finance minister of another G-7 country without giving their staff a heads up. But it is hard at times even for the flotilla of economists at the IMF, Treasury Department, Federal Reserve, and other G-7 finance ministries and central banks to predict with certainty who will call in the next six months.

Whether the call comes as a surprise or not, those receiving the plea for help almost always face the same core choice. One option is a rescue loan from an international financial institution (IFI), such as the IMF, or from a major country like the United States. The loan has to be big enough to enable the crisis country to make payments on at least those debts that are coming due immediately. The country uses the financial reprieve to take steps to correct its macroeconomic problems. If all goes well, it regains access to financing from private markets, money starts flowing back, reserves rise, and it can repay the IMF. Official rescue loans are not gifts: IMF loans have to be repaid with interest, as do loans from the G-7 or G-10, the World Bank, and other multilateral development banks (MDBs).

The other option is to encourage the country to ask its creditors to agree to roll over or reschedule their maturing claims. The debts coming due can be the obligations of the crisis country's government—for example, a maturing international sovereign bond. They also can be cross-border loans to private borrowers—most often banks—in the crisis country. In either case, convincing the country's creditors to defer payments, whether through a bond exchange or an agreement to roll over maturing bank loans, requires at least the implicit threat that the country will halt payments if the creditors do not agree. The IMF, G-7, and others can tell the country that it must reach agreement with its creditors in order to receive an IMF loan, or they can go one step further and help the country organize a rollover agreement or a bond exchange.

Both an IMF loan and a debt restructuring are ways of giving a crisis country time to put its economic and financial house in order. Neither typically works if the country does not take advantage of the financial breathing space to make the policy changes (adjustments) needed to address the major economic imbalances that gave rise to the crisis. A country with a current account deficit needs to let its exchange rate adjust to shrink its trade deficit and reduce the amount it borrows from the rest of the world. Countries with profligate governments running large budget deficits need to put their fiscal accounts in order. At the same time, agreement on a set of policy changes rarely is enough to stop all financial pressures. A financial rescue typically does not work without policy changes, but policy changes also often will not work without emergency financing.

There are no silver bullets: No option for providing a country with emergency financing is attractive. IMF loans—*bailouts* to their critics—are given to help the country honor its contractual commitment to pay its debts.[2] But they also help the country's creditors, particularly those who are lucky enough to have claims coming due soon after the country gets the rescue loan. Former US Treasury Secretary Paul O'Neill often speculated about the wisdom of spending the tax dollars of American "plumbers and carpenters" to bail out creditors who lent at high spreads to shaky emerging economies. Former US Treasury Secretary Robert Rubin has said that if he had his druthers, he would not have lent a "nickel" to bail out private creditors. He also has noted that it is often hard to help a country—or to avoid a default that spills over and damages other countries—without also helping those who lent to it (Rubin and Weisberg 2003; Rubin 1998).

A *bail-in*—either an agreement by creditors to roll over their short-term claims or a formal debt restructuring[3]—also can give a country some time to right itself. But it requires that the country, with the implicit backing of the IMF, break its contractual promise to pay creditors in full and on time. Doing so risks triggering a broader loss of confidence in the country's currency and banking system. Moreover, there is no guarantee that the country will be able to reach agreement with its creditors on a consensual rollover agreement or restructuring to avoid an outright default. Even if a restructuring were to leave both the country and its creditors collectively better off, every individual creditor would prefer to get paid in full while others agree not to demand full current payment on their debts.

No market can work if debt restructuring becomes a habit and if debtors do not take their promises to repay seriously. On the other hand, the additional return emerging-market debt offers over safer financial assets like US treasuries implies at least the occasional restructuring, if not outright default. Many look to the corporate bond market and dream of a world where sovereign governments—or, for that matter, the banking system of a major emerging-market economy—can go under without

2. Throughout the book, we use the terms "rescue loans" and "bailouts" as shorthand to refer to the IMF's financial support to crisis countries. Other terms sound too bland or too euphemistic. Analytically, though, we do not want to endorse fully either the positive connotation of the term "rescue loans" or the negative connotation of the term "bailout." Some "rescues" have failed to save the crisis country. And IMF "bailouts," as we will discuss later, differ fundamentally from many taxpayer-subsidized bank bailouts, like the bailout of the US savings and loans industry in the 1980s.

3. We use the term "debt restructuring" broadly to denote any change in the country's contractual payments profile. A restructuring could aim to do little more than defer principal payments on maturing debts, without any reduction in the contractual interest rate the country must pay. Such restructurings are often called a rescheduling. Alternatively, a restructuring could both defer principal payments and reduce interest payments. The loss associated with such restructuring terms is a function of both the length of time repayment of principal is put off and the interest rate on the new debt. Finally, a restructuring can reduce the face value of the country's debt. A restructuring may occur before a formal debt default and thus preempt it (as in the case of Uruguay) or after the country has formally defaulted on its obligations (as in the case of Ecuador).

drawing the IMF into the country's decision to default or into the often messy restructuring process that follows. To those opposing any official intervention, IMF or G-7 efforts to catalyze a consensual restructuring are just as bad, if not worse, than large bailouts: The involvement of the IMF tarnishes the official sector with the country's decision not to pay on time. It is not surprising that some would prefer a world where the IMF, MDBs, and governments of the G-7 and G-10 countries simply refuse to supply financing and make no effort to help the country get through its troubles. Letting nature take its course is an alternative to both an IMF bailout and an IMF sanctioned bail-in.

The debate on reforming the international financial architecture that followed the 1997–98 Asian and global crises has primarily focused on proposals for grand institutional reforms, often motivated by a desire to make decisions during crises easier. One notable example is the proposal for an international bankruptcy regime as an alternative to bailouts. Anne Krueger (2001a), the first deputy managing director of the IMF, has suggested a new treaty to provide some bankruptcy-style protections to sovereign debtors. Joseph Stiglitz (2002) has suggested a "super" Chapter 11 regime to facilitate an across-the-board restructuring of private borrowers' debts in the event of macroeconomic shocks. Stanley Fischer (1999) has suggested that the IMF be transformed into a lender of last resort able to put enough money on the table to be sure that it could stop runs on countries. Back in 1995, Jeffrey Sachs laid out the case for both an international lender of last resort and a sovereign bankruptcy regime.[4] Others have suggested new binding rules to substantially scale back the amount the IMF can provide in all crises. The International Financial Institutions Advisory Committee (IFIAC 2000), more commonly called the Meltzer Commission, suggested that the IMF get out of the business of lending to countries that discover macroeconomic virtue only when they are close to default and that instead it lend large sums only to countries with good policies that qualified in advance for extra protection—assuming those policies could be defined.[5] Adam Lerrick and Allan Meltzer (2001) have called on the IMF to support the secondary market for a country's sovereign bonds rather than to lend directly to the crisis country. To date, these calls for major reforms have not significantly changed the international financial system. Some grand proposals fail to address the real problems of

4. Sachs (1995) put particular emphasis on a bankruptcy regime's ability to provide administrative priority to new financing, since he envisions new private money as the solution to underfinanced IMF programs. For a history of the idea of a sovereign bankruptcy regime, see Rogoff and Zettelmeyer (2002b).

5. The International Financial Institutions Advisory Committee (IFIAC) specifically recommended that the IMF lend large sums for short-term loans—120 days with only one possible rollover—to countries that prequalified for support. The IFIAC also suggested that the strength of a country's banking system be the key criterion for determining eligibility. Others have proposed less draconian forms of prequalification.

crisis resolution. Others are just impractical or inappropriate ways to resolve crises.

A long, hard slog through the details of past financial crises suggests that there is no easy, glamorous institutional change to dramatically transform the options for resolving financial crises in emerging-market economies. More could be achieved by aiming a bit lower. The real challenge is not so much redesigning existing institutions as finding ways of using existing institutions and tools more effectively. We therefore focus on practical ideas for improving the official sector's capacity to respond to emerging-market financial crises. Some institutional reforms might make a bond restructuring or an interbank rollover easier. However, no institutional reform will either eliminate the need for those on the receiving end of pleas for help to make hard choices or make it substantially easier for them to tell a country that it has no choice but to seek a debt restructuring.

Why Crisis Resolution?

It is worthwhile to focus on how to respond to crises for three main reasons. First, IMF decisions matter. Refusing to give rescue loans to countries that have temporary financial difficulties risks pushing them into an economic and financial abyss. Often these are countries where the United States and the other G-7 countries, which provide the bulk of the IMF's funds, have strategic as well as financial interests at stake. Moreover, the economic and financial losses from an uncontained crisis typically spill over beyond the crisis country's borders, and its policy choices will influence expectations about how other countries will act when they get into trouble.

Yet spending large amounts of the IMF's ammunition on an *unsuccessful* attempt to help a country avoid a debt restructuring leaves almost everyone worse off. A few creditors get paid in full, and a few investors can sell their local currency for a foreign currency at a better price than otherwise would have been possible. But the need to repay the IMF will likely require that other creditors take larger losses in the subsequent debt restructuring.[6] The already-exposed IMF will not be able to lend more to try to avert a deeper crisis. Rather than being in a position to help shape the country's policies during its restructuring, the IMF is left negotiating to get its money back as the crisis country falls off a financial and economic cliff.

Second, the emerging economies' ability to borrow reserves in a crisis from the IMF is a form of "insurance" against a liquidity crisis, just as holding reserves can be viewed as a form of insurance. The analogy to

6. Payments to the IMF are traditionally given priority over payments to other unsecured creditors. Using an IMF loan to repay existing private debts therefore substitutes debt that can be restructured with debt that by tradition is not restructured—in formal terms, it makes the country's debt structure more rigid.

insurance is imperfect. The size of the IMF's insurance policy and its price—the policy changes linked to the loan—that the IMF charges a country for its insurance are set during a country's crisis, not in advance. Still, the expectation that the IMF will try to prevent a temporary shortage of liquidity from producing a deep crisis means that the IMF, like all insurance companies, has to worry that its lending will alter the incentives of the country and its creditors alike. If countries are spared the costs of running dangerous policies and if creditors do not pay any price for financing sketchy countries, then risky policies and bets become more likely. Because of this risk of moral hazard, the IMF cannot just worry about the case in hand. It also has to worry about how its actions will shape the expectations of other countries and their creditors.

Third, the choice between a bailout and a bail-in, one that is often discussed under the euphemistic banner of whether "to involve" the private sector in crisis resolution,[7] has rightly been called the most difficult issue in the entire debate on international financial architecture reform. Policymakers, academics, and private-sector participants all continue to debate how to respond most effectively to crises. Despite recent efforts to clarify the IMF's access policy, its major shareholders—the countries that control the majority of the voting power on the IMF's Executive Board—simply don't agree on the right approach to resolving financial crises in emerging economies.

The key questions of crisis resolution are a source of near continuous disagreement. Should the IMF help a country avoid a crisis triggered in part by a creditor panic, even if it means letting some of the country's creditors off the hook? Or should priority be placed on the imposition of payment standstills that lock creditors in, even if it may hurt the crisis country? Is large-scale IMF lending acceptable only if it is balanced by a commensurate commitment by private creditors to restructure their claims to help the crisis country? If the IMF is going to lend less, should the IMF—or the G-7 countries—do more to help the country get a debt restructuring agreement with its creditors? Could protection from litigation substitute for official lending or, at least, make it easier for the IMF and the G-7 to refuse the country asking for a large bailout?

The official sector remains uncomfortable both with providing large financial bailouts to emerging economies and with the consequences of not providing large bailouts. The result is a policy framework that is in disar-

7. Private-sector involvement (PSI) in crisis resolution became the accepted jargon to describe the official sector's efforts to obtain crisis "financing"—deferring scheduled payments counts as emergency financing—from the private creditors of a crisis country. Other terms were also tried. Initially, some spoke of the need for "burden sharing." However, this term was considered too heavy-handed: No private creditor happily takes on a burden. At the other extreme, there was talk of the need for "constructive engagement" with private creditors. For the sake of directness and simplicity, we have opted to use "bail-ins" and "debt restructurings" rather than "PSI."

ray, with growing gaps between the rhetoric describing the official sector's goals and its actual actions. The G-7 countries agree in principle that IMF financing should be less forthcoming if a country's debts are unsustainable, yet they continue to support large bailouts for countries whose debt levels put their sustainability—and their ability to quickly repay the IMF—at risk. Bailouts that were reserved for countries with relatively modest overall debt levels have become the policy tool of choice to bring countries with substantially higher debt levels back from the brink.[8] There is much talk of the need to make IMF loans that exceed the IMF's normal access limits the exception, not the rule, but there is little desire to scale back the size of IMF loans during actual crises.

Confused signals are being sent on other issues as well. For example, there is no agreement on the role the IMF and the G-7 should play when a country needs to restructure its debts to avoid sinking deeper into crisis. The Bush administration believes that sovereign debt problems should be left to the markets to resolve, with minimal official interference. Yet the Bush administration encouraged the IMF to put money on the table—admittedly, too little way too late—to catalyze a private debt restructuring in Argentina and linked Uruguay's rescue loan to a restructuring of Uruguay's bonded debt. The major European members of the G-7 are no more consistent. They argue that financial contributions from private creditors should always accompany large rescues to avoid distorting private markets, but they often still support IMF programs that lack binding financial commitments from the country's private creditors.[9]

Purging Unhelpful Myths

The IMF and its major shareholders face difficult choices when an emerging economy may be close to default. But a number of myths have inhibited a clear, honest debate on the options. The biggest myth is that less talk about the theoretical virtues of large bailout packages has somehow made large bailout packages go away (see table 1.1 and figures 1.1 and 1.2). But

8. Argentina received $13 billion of its $22 billion IMF credit line (8 percent of precrisis GDP) before defaulting. Turkey has received $23 billion from the IMF, around 11 percent of its precrisis GDP. It also recently reached agreement to get an additional $8.5 billion low interest–rate loan directly from the United States. Brazil has borrowed over $30 billion from the IMF, around 5 percent of its precrisis GDP. Uruguay's $2.7 billion IMF credit line was 13 percent of its precrisis GDP. Argentina, Turkey, Brazil, and Uruguay all have substantially more debt relative to GDP than countries like Mexico or Korea that received large IMF rescue loans of a comparable size in the past.

9. Brazil's recent program did not contain any requirement to seek commitments from private creditors, and—after the dismal success of efforts to coordinate the rollover of interbank lines in Turkey—recent programs for Turkey have also excluded a requirement that the country seek private cofinancing. Neither program includes a meaningful bail-in.

Table 1.1 IMF financing

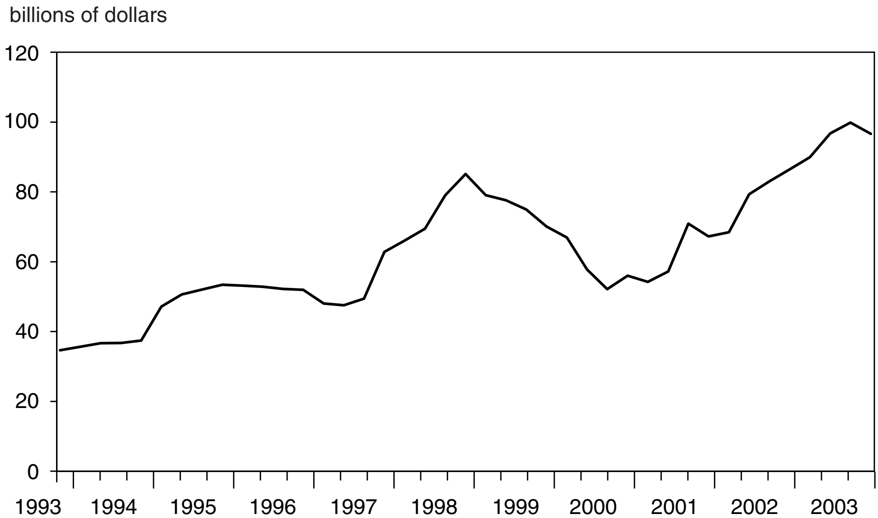
	Amount agreed			Total disbursed			Disbursed in the first year		
	As percent of quota	In billions of dollars	As percent of GDP	As percent of quota	In billions of dollars	As percent of GDP	As percent of quota	In billions of dollars	As percent of GDP
Mexico (1995)	688	18.0	4.4	500	13.1	3.2	500	13.1	3.2
Thailand (1997)	505	3.9	2.2	470	3.7	2.0	366	2.8	1.6
Indonesia (1997)	557	11.3	5.0	555	11.3	5.0	245	5.0	2.2
Korea (1998)[a]	1,938	20.8	4.0	1,802	19.4	3.7	1,757	18.9	3.6
Brazil (1998)	600	18.4	2.3	436	13.4	1.7	363	11.1	1.4
Russia (1998)	186	15.1	3.5	63	5.1	1.2	63	5.1	1.2
Argentina (2000–01)	800	22.1	7.8	461	12.7	4.5	461	12.7	4.5
Brazil (2001)	400	15.6	3.1	375	14.6	2.9	261	10.2	2.0
Brazil (2002)	752	29.3	5.7	567	22.1	4.3	566	22.1	4.3
Brazil (combined)	900	35.1	6.9	770	30.1	5.9	340	13.3	2.3
Uruguay (1999–2001)	694	2.7	14.5	560	2.2	11.7	434	1.7	9.1
Turkey (1999–2001)	1,560	20.7	10.4	1,218	16.2	8.1	900	11.9	6.0
Turkey 2002	1,330	17.6	8.9	1,154	14.8	7.7	1,030	13.7	6.9
Turkey (combined)	2,548	33.8	17.0	1,709	23.1	11.4	900	11.9	6.0

a. Korea's quota was unusually small in relation to its GDP.

Note: Combined programs = Outstanding disbursement plus new commitment; however, some of the new commitment was intended to refinance the IMF's existing exposure. Special drawing rights (SDR) are converted into dollars at the SDR/dollar exchange rate at the time of the initial program.

Sources: Financial data from International Monetary Fund, www.imf.org/external/fin.htm. GDP data from Moody's Investor Service.

Figure 1.1 IMF loans outstanding, 1993–2003



Note: Data are for April, August, and December of the years indicated. Data for 1993 are for December only.

Sources: International Monetary Fund data and authors' calculations.

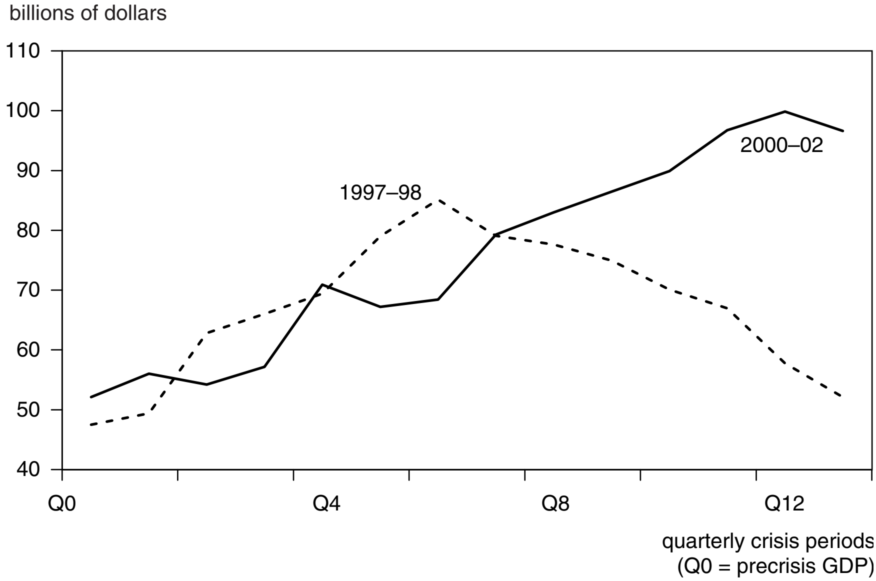
perhaps more pernicious is the myth that a better way of restructuring sovereign bonds would significantly reduce demand for large bailout packages. Eight myths have far more influence than they should.

Myth 1

The era of large bailouts has ended. Some date the end to Lawrence Summers's departure from the US Treasury, others to Argentina's default. In reality, bailouts have not gone away. Turkey, Uruguay, and Brazil all have obtained very large rescue packages after Argentina's default. Moreover, Argentina went through a large "bailout"—nearly $15 billion—before it defaulted. Between mid-1996 and the end of 1998, the IMF increased its outstanding credit by $38 billion in response to the crises in Asia, Russia, and Brazil. Between September 2000 and September 2003, the IMF increased its outstanding credit by $48 billion in response to the crises in Turkey and a series of Latin American economies.[10]

10. As important, three years after the Asian crisis, the crisis countries made large net repayments to the IMF. In June 1997, the IMF had $48 billion in outstanding loans. That rose to a peak of $85 billion at the end of 1998 before falling back to $58 billion in June 2000. The IMF had $97 billion outstanding at the end of 2003 with no clear prospects of a major reduction in its exposure to its largest borrowers in the near term. All data are from the IMF and refer to its nonconcessional (general resources account) lending.

Figure 1.2 IMF lending, 1997–98 versus 2000–02



Source: International Monetary Fund data.

Myth 2

The IMF—and the official sector more generally—is small in relation to the international bond market. The IMF's total "usable" resources are around $200 billion. A reasonable estimate of the amount of outstanding international sovereign bonds issued by emerging economies is $370 billion.[11] Bonds are long-term obligations, so the IMF can usually put more money into a country than international bondholders can take out in the short run. The IMF, for example, provided more money to Turkey in two years than it had ever borrowed from the international bond market. Of course, maturing international bonds are not the only source of financial pressure on crisis countries. The pressures that can come from cross-border bank lending and the roll-off of domestic debts and bank deposits can overwhelm even large IMF packages.[12]

11. The IMF (September 2003a) estimated the stock of original sovereign bond issues outstanding at $290 billion. The stock of outstanding Brady bonds and the bonds that emerged from Russia's 2000 restructuring are not included in this total.

12. International bonds are governed by the law of an external state or country (usually the law of New York state, England, Germany, or Japan, with New York state and England the two most important jurisdictions), and domestic bonds are governed by domestic law. Other definitions of external debt are discussed later in this chapter and in chapter 7.

Myth 3

The bond market has displaced banks as the key source of emerging-market financing. It is true that in the 1990s banks got out of the business of providing medium- to long-term external financing to sovereigns. But they did not get out of the game of providing short-term external financing to other banks or firms. Because bank lines are usually short-term, they can roll off faster than longer-term credits. Local banks often use short-term loans from international banks to finance the purchase of the high-yielding sovereign debt of an emerging economy, even though this combination is particularly risky. At the end of 2000, banks held $530 billion of a total of $875 billion in external claims on nine major emerging economies; bonds held abroad accounted for $345 billion. At the end of 2001, total exposure had fallen to $809 billion, bank claims to $477 billion, and the stock of outstanding bonds to $331 billion.[13] Cross-border bank claims remain an important source of financing.

Myth 4

A better means of restructuring international bonds would eliminate the need for bailouts.[14] As former US Treasury Assistant Secretary Edwin Truman has noted, the international bonds of sovereign governments were at the center of one of the past eight major emerging-market financial crises (Truman 2002). Mexico had difficulty refinancing the government's domestic dollar-linked debts (tesobonos), not the government's international bonds. Russia also had difficulties mostly with the government's domestic debts—the ruble-denominated GKOs. Short-term cross-border bank loans—from international banks to local banks and other financial institutions and, in some cases, to local firms as well—were the source of difficulty in Indonesia, Korea, and Thailand. In 1999, Brazil had problems with international cross-border bank lines and prospective problems with the government's domestic debts. Turkey had difficulties with the government's domestic debt and the roll-off of short-term interbank loans. Only in Argentina were international bonds a major source of financial distress, but even there, a domestic bank run put more pressure on reserves.

13. Data are from the World Bank's *Global Development Finance* (2003). Bond data include bonds issued both by the public and private sectors, and bank loan data include bank loans to both the public and private sectors. The nine countries are Mexico, Thailand, Indonesia, South Korea, Russia, Brazil, Turkey, Argentina and Uruguay. Since these numbers include bonds issued by private borrowers as well as emerging-market governments, they cannot be directly compared to the earlier data that only count sovereign bonds.

14. See, among others, Taylor (2004a).

Myth 5

The IMF responded to the crises of the 1990s and the first part of the 21st century with large bailouts that let private creditors entirely off the hook. In reality, getting through these crises required both large bailouts and, in some instances, large concessions from the country's private creditors. The second Korean program was built around the rollover of bank lines. The official sector refused to support the country in the absence of a bond restructuring in Ecuador, Ukraine, Pakistan, and Uruguay. Private creditors have also contributed when rescue programs failed. Russia, Argentina, and Indonesia defaulted well before the majority of private creditors could get out.

Myth 6

Concerted bank rollovers are a feature of the 1980s, not the 1990s. In reality, in Korea at the end of 1997 and with less success in Indonesia during the course of 1998, commercial bank creditors were "bailed in," and interbank credits were restructured. In Brazil, a program was put in place to monitor banks' commitment to roll over their interbank positions in 1999, though unlike in Korea, monitoring did not morph into a formal restructuring. Turkey also put in place a system to monitor the rollover of interbank credits in 2001, though the program hardly prevented international banks from dramatically reducing their lending to Turkey's banks.

Myth 7

International sovereign bonds cannot be restructured, either because bondholders are dispersed and difficult to contact or because many bonds lack collective action clauses.[15] In reality, bonds and other widely traded debt instruments can and have been restructured by Pakistan, Ukraine, Russia, Ecuador, and Uruguay. Ecuador, Ukraine, and Uruguay all restructured some bonds that lacked collective action clauses.

Myth 8

Restructurings were easy and orderly in the bank-dominated 1980s. In reality, in the 1980s, hundreds of different banks initially had exposure to indebted countries, and many banks wanted to reduce, not increase, their exposure. Getting agreement among them to both roll over maturing

15. Collective action clauses allow a supermajority of bondholders to amend the bond's financial terms. Some bond contracts also include provisions that make it difficult for an individual creditor to initiate litigation and keep all the proceeds of the litigation for itself.

principal and provide "new money" to help the country make interest payments on its existing debt was difficult from the beginning and became more difficult with time. Banks were also reluctant to recognize the need for some debt forgiveness: It took a very long time for serial restructurings to give way to the Brady plan, which restructured bank loans into long-term bonds.[16]

Summing Up

Many of these myths are both pervasive and pernicious. The IMF is widely perceived as being in the business of bailing out bondholders, despite the reality that relatively little of the IMF's lending has gone directly into the hands of international bondholders.[17] This should not be a surprise: Holders of long-term bonds who sell their claims in a crisis put pressure on the bonds' market price, not on the country's reserves. Holders of short-term debt, in contrast, have a contractual right to exchange their claims for the country's scarce cash the day their debt comes due.

The "bailing out bonds" debate paints a misleading picture of the largest beneficiaries of IMF lending and postulates a solution—making bonds easier to restructure—that would only marginally impact on the demand for IMF loans. Debates these myths have framed result in a set of false and oversimplified choices that have hindered a real debate about the IMF's role in resolving emerging-market financial crises.

Closing the Gap Between Rhetoric and Reality

A better starting point would be to both clearly examine the full range of financial vulnerabilities that give rise to demands for rescue loans—demands that come only in part from the sovereign's international bonds—and honestly examine the options the country, the IMF, and the IMF's major shareholders face when a country needs a large loan to avoid defaulting on its debt.

This, alas, requires defining a number of often poorly understood terms. "Bailout" sounds pejorative. But there is a meaningful difference between the type of "bailouts" the IMF has provided to crisis countries

16. For details of the IMF's role in these debt restructurings and in the development of the Brady plan, see Boughton (2001) and Cline (1995).

17. A strict definition of "international bondholders" would exclude international investors in domestic instruments like Mexico's dollar-denominated tesobonos or Russia's ruble-denominated GKOs. However, even with a looser definition of "bonds" that includes all traded securities bought by international investors, bonds have not been as large a source of pressure as international banks and domestic residents seeking to move their savings abroad. See chapter 4.

and the type the US government, for example, provided to the savings and loan industry. An IMF loan no doubt lets some of the crisis country's creditors off the hook, just as a loan from a domestic lender of last resort lets a troubled bank pay off its depositors. However, most domestic bank "bailouts" do more than just provide the bank with emergency liquidity from a lender of last resort. They also typically require giving a troubled bank a government bond—a new financial asset—to make up for its bad loan portfolio. This bond is a true financial loss to taxpayers, but it also avoids the need for depositors (and sometimes even the shareholders) in the bad bank to take losses. To be sure, international taxpayers put up the money needed to make an IMF loan. But they also expect to get repaid in full. The IMF lends at rates that are often lower than the market rate, but this does not imply the IMF lends at a subsidized rate. It can lend at lower rates because crisis countries, by long-standing convention, pay the IMF even if they are not paying their other creditors. We use the term "bailouts" as shorthand because terms like "official crisis lending" sound bland and bureaucratic, not because we want to imply that IMF loans are costing taxpayers' money.[18]

The use of IMF loans can also cause confusion. Does the IMF "bail out" a country or the government of that country? The correct answer is both. The IMF helps a crisis country by lending to its government. An IMF loan often does rescue a country in trouble because its government is having difficulty repaying its own debt. The additional reserves from an IMF loan are used to avoid a default on the government's foreign-currency debt. However, an IMF rescue loan has other potential uses. IMF lending to a crisis country's central bank can finance emergency lending to support a country's banking system, which otherwise would have had trouble paying domestic depositors or international bank credits. The foreign exchange the IMF supplies also can be sold to prop up the value of the crisis country's currency, which helps all those who had faith in the financial assets denominated in that currency, as well as those who need to buy foreign currency to pay off their external debts. Foreign-currency reserves borrowed from the IMF can be used in as many different ways as the government's own reserves.

One additional term warrants discussion, if not a precise definition: a country's debt. Let's consider an actual country like Argentina to make the discussion more concrete. The classic meaning of "the debt of Argentina" is the external debt of Argentina's banks, firms, and government. External means debt sold to foreigners—nonresidents, in neutral economic language. A country can get into trouble on the back of the external borrowing of private firms even if its government has borrowed little

18. See chapter 3 for detailed discussion. Klingen, Weder, and Zettelmeyer (2004) found that the ex post return on IMF lending was similar to the ex post return on private lending.

from abroad, as the world learned in Thailand, Indonesia, and Korea. Another common meaning of "the debt of Argentina" is the externally issued debt of the government of Argentina. Most emerging-market economies can sell debt abroad only if a trusted foreign law—usually the law of New York state or England—governs the debt contract. Economically, what matters is that the debt is owed to foreigners. In a debt restructuring, however, the governing law of the debt instrument becomes crucial.

A final meaning of the term "the debt of Argentina" is the domestic and external debt of the government of Argentina. A statement like "Argentina has too much debt" can, depending on the context, mean that Argentines—private banks and firms as well as the government—have borrowed too much from abroad, that the government of Argentina has borrowed too much from abroad, or that the government of Argentina has borrowed too much both at home and from abroad.

We focus on the financial difficulties experienced by countries that are able to borrow from private banks and private capital markets at home and from abroad when times are good but that cannot always access capital markets when financial trouble emerges. They are not the advanced economies—such as the G-7—whose government debt is considered to be a nearly risk-free asset and who can count on market access at a reasonable price in bad as well as good times. Nor are they the poorest of the poor: Such countries can almost never access private international capital markets and depend exclusively on concessional lending from other governments and institutions like the World Bank. These countries often do end up with too much debt, but the resolution of their debt problems does not typically require the restructuring of debts owed to private creditors. It simply requires a decision by taxpayers of wealthy countries to forgive their claims on the poorest countries.[19] Emerging economies are stuck in the middle. They do not necessarily have more debt than advanced economies, but they do lack the policy credibility advanced economies have built over time. They tend to finance themselves in ways that create financial vulnerabilities—whether by relying on short-term debt, foreign currency–denominated debt, external debt, or all three.[20]

19. See "Debt Relief under the Heavily Indebted Poor Countries (HIPC) Initiative: A Factsheet" (IMF April 2004) at www.imf.org/external/np/exr/facts/hipc.htm for a summary of the process of forgiving the debts the poorest countries owe to other governments. Critics of this process, like Jeffrey Sachs, argue that the HIPC process is too slow and does not provide enough debt relief. Sachs has called for full debt forgiveness and a major increase in concessional, multilateral development aid to jumpstart growth in the poorest countries (Jeffrey Sachs, "Doing the Sums on Africa," *The Economist*, May 20, 2004).

20. Eichengreen, Hausmann, and Panizza (2003) argue that emerging markets cannot borrow abroad in their own currency because they suffer from "original sin." Goldstein and Turner (2004), in contrast, emphasize that sound policies sustained over time can allow a country to build a market for its own local-currency debt.

Different Countries, Different Crises, Different Solutions

A surge in demand for foreign currency, at a time when private markets are unwilling to provide the crisis country with access to foreign currency it needs, marks all crises. Indeed, private creditors are usually looking to get back the money they have already lent to the country in a crisis, not supply more funds to it. Nonetheless, countries are exposed to a wide range of potential sources of financial difficulties.

Countries can sustain current account and budget deficits only so long as they have the capacity to issue new debt. Trouble often starts when they lose market access and draw on their reserves rather than taking steps to reduce the size of their current account or fiscal deficits. Countries need to raise money not only to finance current account and budget deficits but also to refinance their existing debt as it matures. Financial trouble quickly develops if a country's government cannot raise the needed money in private markets to pay its own maturing debt or if private firms and banks that borrowed from abroad have trouble refinancing their existing debts.[21]

Countries that lack reserves to cover their maturing foreign-currency debts are vulnerable to a run. Concerns that other creditors will want to get out and therefore won't roll over their short-term debts as they come due can lead all creditors to demand payment as soon as possible. Such runs usually don't happen entirely by accident. Creditors are understandably reluctant to lend to countries with poor macroeconomic policies or weak financial systems with long maturities. Moreover, growing doubts about a country's policies—or the disclosure that it has fewer liquid reserves than creditors thought—often trigger the run. As the run intensifies, a country can be pushed toward default well before it has time to show whether it can make the policy changes to ensure its long-run solvency.

A country that is not running a current account deficit and has little maturing external debt—and thus little need to borrow from abroad—can still get in trouble if its citizens want to shift their savings abroad. Depositors in the banking system can decide to pull their funds out of the local banks (a local asset) and deposit them abroad. The depositors need foreign currency to purchase foreign assets. Consequently, the shift from domestic to foreign assets places enormous pressure on the country's reserves under a fixed exchange rate, on its exchange rate under a float, or if the country has a managed float, on both reserves and the exchange rate. Sergei Dubinin, the chairman of Russia's central bank in the 1998 crisis observed, "We can play games against the market, against the banks

21. The government's own debt was central to the crises in Mexico, Russia, Brazil, Ecuador, Pakistan, Romania, Ukraine, Turkey, Argentina, and Uruguay; private-sector debt was the obvious source of weakness in Thailand, Indonesia, and Korea as well as in other cases.

even, but we can't do anything if the entire population wants to change rubles into dollars" (Blustein 2001, 266–67).

Just as the precise source of the surge in demand for foreign currency that marks a crisis will vary, so too will the country's underlying ability to emerge from the crisis. Some countries have more debt relative to their GDP (or relative to other measures of their ability to pay, such as exports or government revenues) than others. Countries with the same overall amount of debt can differ in other ways. Those with lots of short-term debt risk losing reserves because short-term debt can roll off quickly. Those with lots of foreign-currency debt risk seeing the burden of their debt in local currency increase sharply after a large devaluation. Those that depend on oil for most of their revenues often are vulnerable to adverse oil-price shocks. The ability of countries with the same level of debt to deliver on promises to change their economic and financial policies also will differ. All these variables will influence the country's ultimate ability and willingness to pay and its chances to avoid a catastrophic crisis.[22]

No matter what the precise cause of a crisis is, getting out of it almost always requires a combination of policy adjustment and emergency financing, whether from an official loan or a restructuring of private debts. Policy adjustment—less spending, higher taxes, or both to close a fiscal deficit and more exports, fewer imports, or both to close an external deficit—serves two purposes. First, it directly reduces the overall amount of new financing that the country needs to raise, whether from official or private creditors. Second, steps to make the country a better long-term credit can help raise private financing, or at least help convince existing creditors to roll over their claims—though the improvement in long-term solvency has to be balanced against the fact that adjustments may be contractionary in the short run.[23] Runs on countries with no policy weaknesses are rare: Those that get into trouble usually need to take steps to correct their underlying macroeconomic policy weaknesses.

Yet policy changes, while necessary, are unlikely on their own to close a country's financing gap—the difference between what a country needs to raise to pay its maturing debts and to cover any ongoing deficits and what it is projected to be able to raise from private investors and creditors. Closing the financing gap usually requires combining economic policy

22. A more precise definition of solvency is provided in chapter 2.

23. The precise set of policy conditions that should be associated with an IMF program has been the subject of intense debate. Sachs and Radelet (1998) in particular criticized the IMF for putting too much emphasis on structural conditionality in Asia. Stiglitz (2002) has criticized the IMF's call for fiscal and monetary tightening in Asia and elsewhere. We do not directly tackle the debate on the details of IMF conditionality or assess how individual countries have performed on each and every element of their IMF program. However, we clearly believe that countries with overvalued exchange rates need to let their exchange rates adjust, and countries with large government debt stocks and large fiscal deficits going into a crisis will need to adjust their fiscal policies as well.

changes with some form of bailout or bail-in. However, not all bailouts or bail-ins are alike. It is also important to distinguish among different types of bailouts and bail-ins.

- A full bailout provides the country with enough money to cover all debts that are coming due. This is how a domestic lender of last resort usually handles a bank run: It promises to lend the bank as much money as it needs to honor its existing deposits in full and on time.
- A partial bailout provides the country with a substantial sum of money but not enough to cover all its maturing debts. The hope is that the policy changes that accompany the lending and the financial vote of confidence from official lenders will lead most external creditors to agree to refinance the debt they hold and most domestic investors to keep their funds in the country. One might call this strategy "lend and pray." The IMF and the official sector call it the "catalytic" approach. If all goes well, policy adjustment and official lending will catalyze the private financial flows the country needs.
- A partial bail-in limits the scale of possible outflows by convincing some creditors to agree not to ask for immediate payment on their maturing debts, thus reducing the overall amount the country needs to raise to service its debts. A country can always bail in some creditors by not paying them as the claims come due (a formal standstill or default). However, this works only if creditors and domestic investors that are not locked in opt not to flee. Creditors and investors who have not been forced to defer payments need to be convinced that the partial bail-in, combined with policy changes and official financing, will solve the country's problems so that it will be a worthwhile place to continue to invest in. One might call this strategy "restructure and pray."
- A full bail-in comes only from a comprehensive standstill on all external debt payments—and often capital and exchange controls that limit the ability of those with domestic assets and domestic currency to trade them for foreign assets and foreign currency. This eliminates the need to raise external financing but also severely disrupts economic activity.

Much of the academic debate has focused on the relative merits of a full bailout from a lender of last resort and a full bail-in from a comprehensive debt standstill. But actual policy decisions often amount to choosing among a small partial bailout, a large partial bailout, a small partial bail-in, and a large partial bail-in. Full bailouts and full bail-ins are both very unusual.

The IMF rarely provides enough funds fast enough to cover all maturing payments for more than a short period. For example, Mexico received enough money to cover payments on the government's maturing tesobonos and to help Mexican banks repay their external debt for several months but not enough to cover all potential sources of capital flight. A rescue loan typically covers only the most obvious sources of payment difficulties. It works only if additional sources of financial pressure do not materialize.

Countries are also extremely relucant to impose a comprehensive standstill that locks in everyone who has invested in or lent to the country at the early stages of a crisis. A total standstill—full suspension of sovereign payments, comprehensive capital controls on private payments, suspension of currency convertibility, and a bank holiday—is only imposed at the very end of the day, when total loss of confidence has eliminated all other options. Targeted restructurings are more common.

Academic models often try to clarify the core choice between a bailout and a bail-in. In practice, however, it is often possible to combine a partial bailout with a partial bail-in. For any set of debts, there is a binary choice between a bailout and a bail-in. But sources of existing or potential financial pressure on a crisis country are usually diverse. Consequently, it is possible to bail out some creditors and bail in others.

Agenda for Reform

Our willingness to defend a world where partial bailouts and partial bail-ins are linked to policy changes in the crisis country—and our doubts about grand institutional reforms—does not mean that we have a Panglossian view that we live in the best of all possible worlds. Three critiques of the current framework for crisis resolution stand out:

- The G-7 needs to stop pretending that a return to low levels of access is just around the corner. The gap between the rhetoric of limits and the actual practice of continued large loans impedes policymaking.
- There has been too little differentiation in the official sector's response to different crises.
- The IMF should be more willing to use its lending capacity to soften the blow during a debt restructuring. Lending to a country that is going through a debt restructuring is one way to limit the risk of the decision to seek restructuring of some debts triggering a broader run. It also gives the official sector more leverage over the policies of the restructuring country.

First, the stated goal of limiting IMF lending over time has failed to provide a useful framework for deciding how to respond to actual crises. A new framework for IMF lending is needed, one that focuses less on limits and more on defining the circumstances when IMF lending can play a constructive role in crisis resolution. The IMF needs a game plan that helps it do a better job of using its limited capacity to provide "liquidity insurance" to emerging economies, not a game plan for getting out of the business of providing liquidity insurance altogether.

Insisting that limits are around the corner has become a way to avoid carefully considering whether current lending decisions are setting precedents that should be emulated if other countries encountered similar problems. The new roles the IMF has assumed recently, including the use of the IMF to backstop domestic banks and the de facto use of the IMF to provide medium- and long-term financing to help Turkey cover large budget deficits, can not be dismissed as temporary aberrations. Attempts to ground IMF lending decisions, not on a desire to return to old lending norms but rather on an assessment of the country's debt sustainability, have not been significantly more successful. The recent trend has been for IMF lending programs to increase in size as countries' debt levels—and resulting financing needs in the absence of a debt restructuring—increase in size, despite the IMF's very real effort to improve the analytics behind its assessment of debt sustainability.[24] The IMF is paying more attention to debt sustainability than before: It is lending larger sums to countries that are substantially more indebted than before.

Second, a policy that in practice, though not in theory, provides every country with a large loan to try to avoid any debt restructuring is not the best way of using the substantial financing that the official sector provides to crisis countries. The IMF's initial response to crises in major emerging economies has generally been the same—a large IMF loan to try to avoid any restructuring—even though not all countries that get into trouble have the same chance of getting out of trouble. As one former policymaker noted, the standard response to a crisis is to provide liquidity and hope that the country truly just has a problem of "illiquidity." The IMF's organization as a credit cooperative, political pressure from the G-7, the impossibility of determining with certainty if any given level of debt is unsustainable with enough adjustment, and the consequences of demanding a restructuring result in pressure to give almost all countries the benefit of the doubt.

24. Debt sustainability involves more than just the size of a country's debt in relation to its economy—the average coupon on the debt, the amount of debt coming due in the near term, amount denominated in foreign currency, and the country's ability to deliver the adjustments it needs also matter. However, many of these variables tend to be correlated with the overall debt level. Countries with large debts tend to be able to borrow only at high rates and for a short period. Countries with large debts also tend to need to promise investors protection from exchange rate movements in order to attract funds. The difficulty in sustaining the political support for the effort required to pay also tends to increase as the amount of effort that is required increases.

Similar crises should be treated similarly, but not all crises should be treated the same way. Countries that get into trouble despite modest deficits and accumulated debts are better financial bets than those that get into trouble with larger debts and little proven ability to reduce their deficits. A policy that does not differentiate on the basis of an upfront judgment about a country's prospects is risky: Countries with more debt tend to need more money to have a reasonable chance of avoiding restructuring, yet even large sums may not be enough. If the rescue fails, the country literally has nothing left in reserve—it is in a deeper financial hole, with no further capacity to borrow from the IMF and fewer options to limit the trauma of the inevitable restructuring. Differentiation need not be based entirely on the size of IMF lending to crisis countries: The IMF also needs to insist that its financing be used to avoid a broader economic and financial collapse while the country seeks agreement with its creditors to restructure some of its debts.

Third, the IMF needs to be both tougher and more generous when a country's debt levels and policy track record suggest that there is a high risk that the traditional catalytic IMF lending won't work. Tough because the IMF should be willing to make an upfront judgment that a country won't be able to avoid a restructuring and thus be willing to refuse the country's request for help unless the country is willing to develop a credible plan to restructure its debts (and to change its exchange rate regime, if needed). More generous because the IMF should also be more willing to provide meaningful financial support to a country undergoing a restructuring. This is particularly true if the country, encouraged by the IMF, decides to restructure early on, before digging itself into a deeper hole. Restructuring a country's external debt carries the risk that the decision to seek a restructuring will prompt the crisis country's population to pull their savings out of the country's banks at the same time and trade their rubles, pesos, or baht for dollars en masse. A key argument of this book, in a nutshell, is that the signal of international support and money from an IMF loan can do far more to limit these risks than outright legal protection.

These three suggestions are not radical, but they are controversial. Lending new money to a country that has to seek a restructuring because, in part, it already has too much debt is counterintuitive. It still offers the best way to help cushion the blow to the domestic economy likely to result from decisive action by an emerging-market government to address its debt problem. A run on the currency that leads the country's exchange rate to overshoot or a run on the domestic banking system that leads the financial system to collapse can make the debt problem worse. Creditors need to make concessions, and the country needs to adjust its policies, but a cooperative win-win outcome is still possible if the country avoids a bigger fall in output, and its creditors avoid bigger losses. Of course, any steps to soften the blow of a restructuring could, at the margin, reduce a country's incentives for prudent policies. We think that this risk is manageable, though, and it is better to step in and help than run the risk that a crisis will end in an Argentine-style implosion and stalemate.

Structure of the Book

The details of a crisis matter, which is one reason this book is long. The mix of economic policy adjustments by the debtor country, official lending (bailouts), and commitments from private creditors (bail-ins) that is most likely to work depends on the nature of the crisis. Abstract discussions of either debt restructuring or IMF lending tend to oversimplify. But not every reader will want to read each and every chapter. Some will be more interested in the chapters that focus on the mechanics of debt restructuring; others will be more interested in the theory and practice of large-scale IMF lending. Each individual chapter can be read as a standalone essay on a particular topic, though the whole is also, we hope, more than just the sum of its parts. Our goal is to draw on both the growing body of experience with "21st century financial crises" and the analytical literature on crisis resolution to explore in some depth the choices the official sector faces in a crisis.

Chapter 2 examines the reasons many emerging-market economies have experienced financial crises in the last decade. A key theme in chapter 2 is that financial vulnerability stems from the interaction between ongoing budget and current account deficits, the way these ongoing deficits are financed, and the way the country has financed itself in the past. Chapter 3 focuses on academic models of the choices the IMF and other official creditors face once a crisis strikes. These analytical lenses inform the chapter's discussion of the arguments for and against payments standstills, the market failures that would arise in the absence of an international lender of last resort, the risk that an international lender of last resort could trigger moral hazard, and the case for—and against—partial bailouts.

Chapter 4 looks at the lessons that can be drawn from the actual experience in the last decade with bailouts and bail-ins. Rather than offering a chronological account of what happened in each case, the chapter is organized around the official sector's experience with different policy tools. Chapter 5 reviews the evolution of "official" G-7 and IMF policy. It highlights the reasons for shifts in policy as well as the private sector's reaction to official policy initiatives. Above all, it accesses whether the official sector has been able to send signals that were consistent with the policy decisions it took in subsequent crises.

Chapters 2 through 5 in some sense summarize and analyze the current state of play. Chapters 6 through 8 examine the difficult and still controversial open issues in the debate on crisis resolution—issues marked by the continued absence of consensus either within the official sector or among the official sector, crisis-prone countries, and market participants.

Chapter 6 examines in detail the options for providing emergency financing to countries facing shortages of foreign exchange as well as the challenges that arise when the country's private sector, not the government, is the initial source of the country's financial difficulties. Chapter 7 asks if sovereign debt restructurings could be made less disorderly and costly if claims against a sovereign could be ranked according to a more precise system of priorities, as well as the practical obstacles to establishing an enforceable priority structure.

Chapter 8 focuses on the case for creating a stronger legal basis for overcoming collective action problems in a sovereign debt restructuring. The key policy question is whether legal reform can reduce the economic disruption that can accompany a sovereign debt restructuring without upsetting the balance between the rights of creditors and of the debtor needed for the sovereign debt market to work.

Chapter 9 concludes with our critique of the current policy framework and our recommendations for reform. The debate on crisis resolution has two components. First, are the institutions needed to respond to a wide range of crises in place? Second, does the current policy framework match the available tools of crisis resolution to a country's specific problems? We argue that the institutions for crisis resolution, what we call the system's hardware, are in better shape than the current policy framework—the system's software.

Throughout the book, we make the case for a policy that recognizes that (1) there are enormous differences among different crises, and (2) different cases need to be addressed within an overall framework that provides some consistency and predictability to borrowing countries as well as to those who invest in emerging-market debt. One way to respond consistently to a range of crises is to provide all countries that get into trouble with a certain sum of money, appropriately scaled to reflect differences in economic size, to be used as the country sees fit. In our view, though, a policy that tries to treat all countries with similar problems in the same way is likely to be more effective. Making such a policy predictable, though, requires agreement on how to identify and respond to a range of crises.