
Official Policy Toward Crisis Resolution

This chapter examines the official policy statements that have outlined the G-7 and the IMF's intended approach to emerging-market financial crises. These statements address both sides of the official sector's policy: The first is the financial resources that the IMF, sometimes in conjunction with others, makes available to emerging-market economies willing to accept the IMF's policy conditions. The second is the treatment of private creditors' claims on the crisis country.

Before reviewing the evolution of policy, however, it is worth asking a basic question: Why issue policy statements outlining the official sector's intended approach? After all, one official-sector policy could be to avoid any such statements. Market participants and emerging economies could infer the official sector's response to future crises from its responses to previous crises. Even though writers—and perhaps readers—of G-7 and the International Monetary and Financial Committee (IMFC) communiqués certainly would welcome a policy of not issuing policy statements, such an approach is unrealistic. The official sector intervenes in the market by providing financial support to countries in distress, creating a corresponding need to outline the criteria that guide its decisions. In principle, clear policy statements could help the governments of emerging economies and private investors alike make more sensible economic and financial decisions.

The motivation for issuing a policy statement varies. Some statements try to reconcile the official sector's actual response to the most recent crisis with the existing policy. Others try to signal to investors and emerging economies alike that future crises will be handled differently than the

most recent one. Take two examples: After Mexico's bailout, many in the G-7 wanted to signal strongly that large bailouts should not always be expected. Conversely, after Russia's default, great care was taken to signal that official financing was still available to countries more committed to policy reforms.¹ Policy statements also have called for institutional changes to make future crises easier to resolve—changes in the way the IMF lends as well as in the legal terms used in sovereign debt contracts.

Two major themes emerge from this chapter. First, the constant restatement of policy toward emerging-market crises reflects the absence of a deep consensus within the G-7 and the official sector on the right way to respond to crises. The United States often has a different position than the United Kingdom, let alone continental Europeans. Indeed, the United Kingdom has often been closer to France and Germany than the United States.² Central banks, who have a seat at the G-7 but generally not on the IMF board, often have a different point of view than G-7 finance ministries.³ The finance ministries themselves are often uncomfortable with the decisions they made in the heat of the last crisis. Second, the official sector has been much more willing to say that it *intends* to adopt a new approach to crisis resolution than to actually adopt one. Calls for less IMF lending have not led to any reduction in IMF lending.

The official sector's policy toward emerging-market financial crises can be divided into four stages.

- Stage 1 was defined by the fallout from Mexico's bailout. It was marked by the 1995 Halifax G-7 communiqué, the 1996 Report of the G-10 Deputies on Sovereign Liquidity Crises, and the decision in 1997 to create an IMF facility to provide large amounts of financing for relatively short periods.
- Stage 2 was defined by the crises in Asia and Russia. The key policy themes are apparent in the reports the short-lived G-22 issued in the fall of 1998, but the resulting policy is best reflected in the G-7's proposals to reform the international financial architecture in the summer of 1999.
- Stage 3 was marked by a period of comparative calm in international financial markets, ongoing debates over how to implement the policy

1. The G-22's report, for example, emphasized that the principles laid out for debt restructurings were not "an agenda for addressing the problems currently being experienced in any emerging markets" (Group of 22 1998a, vi).

2. See "From Bail-out to Bail-in," *The Economist*, March 27, 1999, to get a flavor of the debate between the US and the European members of the G-7 during the tail end of the Clinton administration. See Rubin and Weisberg (2003, 24–25) for the G-7 debate over Mexico

3. The Bank of England and the Bank of Canada, for example, have supported tighter limits on IMF lending than their respective finance ministries.

outlined in 1999, and a push to reform the IMF's lending facilities. It culminated in the IMFC's adoption of the Prague framework in the fall of 2000.

- Stage 4 reflects the impact of the Bush administration and a new IMF management team led by Horst Köhler and Anne Krueger on the policy debate. This discussion centered around the development of an international bankruptcy regime and the need, at least in principle, to limit access to IMF financing. The April 2002 G-7 action plan offers the strongest statement of this policy approach.

This chapter discusses the forces that shaped each stage in the evolution of official policy.

Reaction to Mexico's Bailout

Mexico was the first of the "capital account" crises of the 1990s. Its payment difficulties stemmed from its short-term domestic dollar-linked debt (tesobonos), not long-term syndicated international bank loans. Just as the source of financial pressure differed, so did the official sector's policy response. The norm during the 1980s was to call together a committee of bankers to begin restructuring negotiations. Mexico did not summon the holders of tesobonos to the central bank to renegotiate their terms, in part because international bankers were no longer the only or necessarily the biggest players. Attempts to organize a voluntary exchange never went anywhere. Rather, the United States and the IMF provided Mexico with large loans to pay off maturing tesobonos. The size of the Mexican bailout broke new ground for both the United States—which used the exchange stabilization fund (ESF) to loan \$20 billion to Mexico—and the IMF—which offered more money (about \$18 billion) to Mexico than it had to any previous country.

Mexico was a success: It repaid the United States ahead of schedule, regained market access quickly, rebuilt the reserves it had blown defending an overvalued exchange rate peg, and generally pursued prudent macroeconomic policies. However, many in the G-7 were still uncomfortable.

- The US Treasury was uncomfortable making large bilateral loans to avoid financial meltdowns in emerging economies. The Clinton administration wanted to multilateralize the financing of crisis countries, which meant mobilizing new resources to augment the IMF's lending capacity.
- Many Europeans were uncomfortable with the size of the IMF's lending to Mexico and with the precedent of bailing out holders of traded securities. The Europeans worried that the IMF was being used to help

a US neighbor and to protect both the US investors who had bought tesobonos and the US banks that had lent to the Mexican banks to play the tesobono market. Many in Europe wanted to return to traditional lending limits and to signal that sovereign bonds and other traded securities would be restructured in future crises. Most US policymakers also supported work on bond restructuring: They defended the Mexican bailout as a pragmatic response to unique circumstances, not as a model for all future crises.

Consequently, a desire to make large IMF loans easier to provide coexisted alongside a sense that the official sector had done too much and private-sector investors too little in Mexico. These two sentiments informed the two major policy statements that emerged following Mexico's bailout: the G-7 communiqué at the Halifax Summit in the summer of 1995 and the 1996 report of the G-10 deputies on sovereign liquidity crises.

The Halifax communiqué emphasized the need to equip the official sector with new tools to manage the pressures that came with greater financial integration. It called for "adequate multilateral financial mechanisms" that could be "brought to bear on a scale and with the timeliness required to overcome the consequences of external shocks that may arise from the increased mobility of international capital" with conditionality "to quickly restore market confidence and access to private-sector money" (Group of Seven 1995, 5). The communiqué specifically suggested three reforms to expand the IMF's capacity to respond to Mexican-style crises:

- a new emergency financing mechanism to provide "high upfront access and faster procedures to access Fund resources" when IMF lending exceeded normal access levels. This led immediately to procedures to speed up IMF decision making and eventually to the creation of the supplemental reserve facility (SRF) in 1997.
- doubling the resources available through the backup credit line that the G-10 countries provide the IMF⁴
- an IMF quota review to increase the IMF's lending capacity. When the US Congress finally approved an increase in the US IMF quota in the fall of 1990, the IMF's resources increased by roughly 50 percent.

The communiqué noted that even an expanded IMF financing capacity "may not be sufficient in all cases" and coyly mentioned "other mechanisms that might usefully be considered in situations of crisis" (Group of Seven 1995, 5). The unwillingness to talk more explicitly about debt restructuring reflected both Mexico's delicate position in the early summer

4. The new arrangements to borrow (NAB) augmented the general arrangements to borrow (GAB).

of 1995 and a desire to avoid repeating the seemingly endless cycle of debt renegotiation that had marked the 1980s. It is striking, particularly in light of later communiqués, how little attention was placed on debt sustainability in defining the circumstances appropriate for exceptional levels of IMF financing. The communiqué instead emphasized the need to ward off contagion. Large-scale financing was justified for problems that could pose a “significant threat to the stability of the world’s increasingly integrated financial system” (Group of Seven 1995, 5).

The 1996 report of the G-10 deputies on sovereign liquidity crises—more commonly called the Rey Report—focused on the need to facilitate the restructuring of bonded debt, given that sufficient official financing might not be made available to resolve all crises.⁵ The deputies rejected calls, made most notably by Jeffrey Sachs (1995), for an international bankruptcy court. They instead drew on a recommendation Barry Eichengreen and Richard Portes made and encouraged market participants to include collective action clauses—contractual provisions that could facilitate a debt restructuring—in future sovereign bond contracts. The deputies assumed that the collective interest of bondholders in limiting the risk of holdout litigation would lead the market to adopt such provisions on its own: The report did call for the official sector to take steps to encourage the introduction of such clauses.⁶ Finally, the G-10 deputies suggested that the IMF should be prepared to lend into arrears on bonded debt. The IMF could signal its approval of a debtor country’s decision to seek a bond restructuring by continuing to lend even if the country was not paying on its bonded debt (the IMF had adopted a policy of lending into arrears on bank debt in the 1980s to put pressure on commercial banks to agree to restructure their syndicated bank loans).

Several aspects of the G-10 report are striking in light of the subsequent debate. The G-10 explored the role of a bond restructuring in resolving *sovereign liquidity* crises. The title of the report did not hint at the subsequent policy of emphasizing debt restructuring in cases closer to insolvency and IMF lending in true liquidity crises. Nor did the report hint at vulnerabilities stemming from the external borrowing of a country’s private banks and firms even though such vulnerabilities would give rise to the Asian crisis. Indeed, the report emphasized the need to exclude cross-border bank lending from a restructuring to facilitate commerce. Finally the report focused on the legal obstacles to restructuring international sovereign bonds, even though domestic tesobonos, not international bonds, had precipitated Mexico’s crisis. The G-10 report responded as much to the general shift in cross-border sovereign financing from syndicated bank loans to international bonds as to Mexico’s specific crisis.

5. The G-10 report is named after Belgian Deputy Central Bank Governor Jean-Jacques Rey, who chaired the deputies committee.

6. Peter Kenen (2001) has emphasized this weakness in the Rey Report.

In 1997, the IMF took up the G-7's 1995 call to create a facility better suited for the provision of unusually large amounts of IMF financing but for shorter terms. The United States and others argued that capital account crises could be resolved most efficiently by providing large amounts of financing—"Powell Doctrine" financing—to catalyze a quick turnaround in market confidence. The IMF did not agree to create a facility for crisis of confidence (the SRF) until 1997, but it makes sense to think of its creation as part of the official sector's overall response to Mexico. The IMF's normal access limits did not apply to the facility, but its other terms were more demanding: The country paid higher interest and had to repay faster than normal—after only two and a half years.

The debate over how to respond to emerging-market crises died down in early 1997. The communiqué of the 1997 G-7 summit in Denver is notable for how little attention it devoted to global finance. The G-7 heads of state and finance ministers, like most private forecasters, failed to anticipate the Asian financial crisis. Thailand's specific troubles were not a surprise, but the impact Thailand's crisis had on the broader region was. Given the importance of short-term bank lines in the Asian crisis, perhaps it is not surprising that central banks—and above all the Bank for International Settlements (BIS)—did far better than finance ministries at anticipating Asia's vulnerability (BIS 1997).

Reform of the International Financial Architecture

In 1995, Mexican-style crises seemed to be the exception, avoidable if countries recognized the need to avoid Mexico's policy mistakes. However, by the end of 1998, a number of major Asian emerging economies, Russia, and Brazil had experienced sharp crises. Official policy also needed to adapt to a world that seemed to be marked by a higher risk of crisis and to reflect the emergence of crises clearly stemming from excessive private-sector, rather than public-sector, external borrowing.

The official sector's response included an intensified push to provide the IMF with additional quota resources, an effort to specify more clearly when large-scale IMF support was appropriate, and a much stronger emphasis on obtaining financial contributions from the crisis country's private creditors.

When Is Large-Scale IMF Support Appropriate?

Once Russia's default and the long-term capital management (LTCM) crisis convinced the US Congress to agree to a quota increase, the need to define the circumstances when the IMF should mobilize its expanded lend-

ing capacity became more urgent. Four ideas had currency in G-7 circles. Large-scale support is appropriate in these circumstances:

- when a country is a victim of external contagion. Countries judged to have sound policies should be insulated from turbulence in global markets.
- if a country is not intervening heavily to defend a fixed exchange rate (Rubin 1999). Official support should be reserved for countries that have let their exchange rates float or that have an “institutionalized commitment” to exchange rate stability, such as a currency board or participation in the European exchange rate mechanism.⁷
- for illiquid but not insolvent countries
- only if private creditors are also contributing to crisis resolution. Those concerned about moral hazard wanted a “private” copayment to go with the official sector’s liquidity insurance to prevent such insurance from distorting market outcomes.

Of course, some argued that large-scale support was never appropriate and that the IMF should return to its traditional lending limits. However, the United States rejected such proposals outright, and other finance ministries also probably would have rejected them.

Policy statements consequently reflected, sometimes quite softly, a mix of the four ideas. For example, the Cologne statement echoed US Treasury Secretary Robert Rubin’s earlier calls for the IMF not to finance countries intervening heavily to defend fixed exchange rates. The G-7’s call for a contingent credit facility implicitly accepted the need to protect countries running sound policies from contagion.⁸

However, consensus was not possible either on the proposition that financing should be provided to illiquid but still solvent countries or on the proposition that official financing should always be linked with efforts to secure private-sector cofinancing. Many in Europe—and some in the United States—were uncomfortable with the suggestion that the private

7. Frankel (1999) provides a critique of the hypothesis that exchange rate regimes at the corner—namely a float and hard pegs like currency board or outright dollarization—are intrinsically more stable. Frankel does not dispute the correlation between countries with soft pegs and crises in the 1990s but argues that the reason why soft pegs were linked to a crisis is simply that most emerging economies had some form of soft peg at the time.

8. Some G-7 countries had reservations, but rather than opposing the idea they sought to make sure the bar to access contingent financing was kept high. In the end, no country ever applied for the contingent credit line (CCL) that the IMF created in 1999. Countries that might have qualified were concerned that the markets would interpret their decision to apply as a sign of a hidden weakness rather than of strength. The advantages of qualifying were not overwhelming. Countries that qualified for a contingent line did not get automatic access to financing, and most countries believed—correctly—that they would be able to obtain access to crisis financing through traditional facilities. The IMF eliminated the CCL in 2003.

creditors of illiquid but not insolvent countries would be bailed out in full. They believed that private creditors should be asked to agree to roll over short-term claims, stretch out the maturity of their claims, or otherwise contribute financially to the resolution of liquidity problems as well as solvency crises. But US policymakers were equally uncomfortable with European efforts to rule out the provision of large-scale financing in liquidity cases in the absence of a corresponding financial commitment from private creditors. They argued that in practice, it was often difficult to arrange a private contribution without taking coercive steps that might fuel a broader panic—a panic that could well push the country into insolvency.

Policy statements therefore had to find ways of bridging the gap between the United States' desire to maintain the option of providing large IMF rescue loans and the European desire to tie the amount of official financing more closely to financial commitments from private creditors. For example, the Cologne statement emphasized the need to find ways, if possible, for private creditors to contribute to crisis financing but also clearly left open the option of providing large IMF loans—so long as the country was not intervening heavily to defend a given exchange rate.

Private-Sector Involvement

Birmingham G-7 Communiqué: Summer 1998

The call for greater involvement of private creditors emerged out of a sense—most notable in the statements of US Treasury Secretary Robert Rubin—that private lenders had lent to Asian borrowers (typically banks and private firms) without thoroughly assessing the risks associated with their lending (Rubin and Weisberg 2003, 257–58). Moreover, Korea's inter-bank rollover arrangement provided a model for how private creditors could contribute constructively to resolving emerging-market financial crises, though it was not clear if this model was replicable.⁹ "Catalytic financing" from the IMF and the G-7 had played a smaller role in the resolution of the Asian crisis than in Mexico, and the restructuring of the debt Asian banks and firms owed to external creditors had played a bigger role.

The Birmingham communiqué in the spring of 1998 signaled the official sector's continued willingness to look to private creditors for crisis financing. "Ensuring that the private sector takes responsibility for its lending decisions" was one of the five areas where the Birmingham communiqué indicated action was needed to strengthen the architecture of the global financial system (Group of Seven 1998a, 3).

We also need approaches to ensure that the private sector is involved in crisis resolution, and bears the cost as well as the rewards of its lending decisions. . . . There

9. Chapter 4 provided the details of the treatment of external claims on Korean, Thai, and Indonesian banks; Thai finance companies; and Indonesian firms.

will always be pressure in the event of a crisis to act quickly to stabilize the situation. We need to find ways in which this can be done without implicitly insuring debts to the private sector (Group of Seven 1998a, 18–19).

It was not clear, however, how calls for “all exposed institutions in the private sector” to “bear some costs” would be implemented, other than by IMF lending to countries that are in arrears on their debt to private creditors after a payments standstill (Group of Seven 1998a, 19).

G-22 Report: Fall 1998

The G-22 brought major emerging economies together with the G-7 countries to discuss, among other topics, crisis resolution. The resulting report (Group of 22 1998a) was only partially successful. Much of it did little more than broaden the consensus that supported the core conclusions of the G-10 deputies report (Group of 10 1996). It did, however, add calls for strengthened national bankruptcy regimes and improved deposit insurance to limit “domestic” sources of moral hazard to the G-10’s focus on bond restructuring.

The core of the G-22 report built on the Rey Report’s call for the IMF to signal its willingness to lend into arrears on bonded debt and on the G-7’s suggestion that IMF lending in the context of a standstill might help stabilize a crisis country without letting private investors off the hook. The G-22 consequently laid out a model for crisis resolution where a restructuring of the debt a country owed to its private creditors, rather than IMF financing, provided the bulk of crisis financing. The IMF’s primary role in this framework was to develop the macroeconomic policies the country would adopt during the restructuring. By lending to support those policies, it also would implicitly signal that the debtor’s decision to seek a restructuring reflected the lack of realistic alternatives. However, the G-22 did not outline the criteria that the IMF would use to determine that there was no reasonable alternative other than a debt restructuring. The overarching assumption was that debt-restructuring cases would be “exceptional” and that catalytic financing and adjustment would remain the norm.

In retrospect, the G-22 report is also notable for its optimistic belief—one typical of the late 1990s—that financial innovation could solve most problems. The G-22 called for legal innovation to improve sovereign debt contracts. It called for greater use of private contingent credit facilities—facilities that let a country buy in advance the right to borrow from a group of private banks during a liquidity crisis. It called for innovative financial contracts that would provide a greater degree of risk sharing between the country and its creditors, such as bonds with payments linked to the oil price or to GDP growth. Unfortunately, the official sector’s call for financial innovation came at a time of financial retrenchment in the private sector. No G-22 country that used New York law for its sovereign bonds subsequently decided to use clauses. The market for bonds with a

higher degree of risk sharing never developed. The number of countries with contingent credit facilities slowly sank from three to zero: Indonesia drew on its credit lines in its 1997 and 1998 crises; Mexico drew on its facility in 1998 to the displeasure of its creditors; and Argentina, after renewing its facility in 1999 with the help of an enhancement from the Inter-American Development Bank, drew on the remainder of its facility just before defaulting in late 2001. Well before Argentina, though, the banks concluded that they had initially underpriced these facilities, and the market for such facilities dried up.

Cologne G-7 Communiqué: Summer 1999

The Cologne communiqué responded to the challenge set out in the Birmingham communiqué. It set out a framework that outlined how the official sector intended to involve the private sector in crisis resolution.

The principles in the Cologne framework accurately described the trade-offs those in the official sector acutely felt. However, because the principles that were to guide official policy were in tension, they offered relatively little concrete guidance to market participants. Official action should neither “undermine the obligation of countries to meet their debts in full and on time” nor undermine the principle that “market discipline will only work if creditors bear the consequences of the risk that they take.” The official sector would balance the contribution “reducing net debt payments to the private sector” could make toward meeting a country’s immediate financing needs against the impact that measures to reduce payments could have on “the country’s own ability to attract new private capital flows, as well as the potential impact on other countries.” One principle, however, was not balanced by an offsetting principle. It indicated, “No one category of private creditors should be regarded as inherently privileged relative to others in a similar position. When both are material, claims of bondholders should not be viewed as senior to claims of banks” (Group of Seven 1999, 45a–d). While this statement lagged behind the Paris Club’s decision to ask Pakistan to seek a comparable restructuring of its eurobonds, it accurately foreshadowed the official sector’s subsequent willingness to force Ecuador to seek a restructuring of its bonded debt.

Cologne also laid out a comprehensive set of options for “involving” private creditors. The list of options extended well beyond lending into arrears. It included steps the official sector could take when it wanted both to “involve” private creditors *and* to help the country avoid the disruption of a formal default. Some proposed options were quite soft: a road show to explain the program, efforts to “seek” (not to obtain) voluntary commitments of support, and a commitment to raise new funds from private markets. The G-7 indicated that no single option was right for all cases, rather “the appropriate role for private creditors, if any, and the policy approaches needed to induce private creditors to play this role will

vary depending on the circumstances of the case (Group of Seven 1999, 46). But Cologne also provided private markets with hints to help them assess when a given option was most likely. The right approach would depend on “the country’s underlying capacity to pay,” “its access to the markets,” and “the nature of outstanding debt instruments.” The words “liquidity” and “solvency” were never explicitly used, but the framework clearly reflected the United States’ basic belief that different approaches should be used in liquidity than in solvency cases. Sovereign arrears and extensive controls on private payments, for example, were appropriate in the event of insolvency but risky in the event of illiquidity.

Cologne balanced a clear desire to find a way for private creditors to play a greater role in resolving all crises with an unwillingness to pre-commit to any given approach to securing private financial commitments. The United States neither wanted to rule out the large loan used successfully in Mexico nor signal that large bailouts without any bail-ins would be the norm. The United States neither wanted to rule out a decision to seek an interbank rollover as in Korea nor signal that an effort to call the banks would be a component of all future IMF programs. Secretary Rubin did not want to make statements that would not stand up to the strain of an actual crisis (Rubin and Weisberg 2003). Cologne consequently can be criticized for keeping all options on the table. However, it did try to lay out the principles and considerations to guide the G-7 in responding to a specific crisis.

The Debate Fractures

Cologne did not end the debate on how to respond to crises. Rather, the debate veered in several directions.

The United States pushed to “operationalize” the Cologne framework by spelling out in more detail how the IMF should apply Cologne’s broad principles. G-7 calls for the IMF to “put strong emphasis on medium-term financial sustainability” (Group of Seven 2000, annex 2) reflected concerns that the IMF was paying too much attention to implementing a rule requiring that 80 percent of debts coming due during the period of the IMF program be restructured and not enough attention to the impact of the restructuring terms on the crisis country’s financial health.¹⁰ The G-7 also called for the IMF to do more to implement the Paris Club principle of comparability of treatment. The United States’ emphasis on cases where

10. For example, in 1998 and 1999, Ukraine’s restructuring terms had deferred payment on 80 percent of the debt coming due, but payments had only been deferred by a year, and the restructuring carried an implied interest rate of nearly 20 percent. Retroactive application of the 80/20 rule also led the IMF to impose a requirement that Romania raise 80 percent of the amount Romania paid to retire a large eurobond just before its IMF program. Both episodes are covered in more detail in chapter 4.

there was a consensus that a restructuring was necessary—Ecuador being the prime example—also reflected a desire to avoid “relitigating” the broad debate on the need to link all IMF lending to efforts to involve private creditors.

The IMF staff argued that Cologne fell short of providing the IMF with the policy guidance it needed to develop a workable framework. In particular, it failed to spell out how decisions about IMF lending should be linked to the decision about whether, and how, to obtain crisis financing from private creditors. The IMF’s proposed framework highlighted two possible approaches toward crisis resolution. The first approach focused on the ability of “strong adjustment programs and Fund support” to catalyze “private-sector involvement.” Here, the Fund staff implicitly adopted a loose definition of private-sector involvement: So long as the private creditors and investors decided to return to the crisis country at a later date, they were “involved,” even if they were pulling out funds at the time of the crisis. The second approach focused on the need to take “concerted” action to secure private-sector involvement, whether a concerted interbank rollover or a bond restructuring. Catalyzing the future return of private creditors was appropriate when “financing needs were relatively small”—Fundspeak for a country that did not need much money—or when financing needs were large but the country has “good prospects for regaining market access in the near future” (IMF September 2000a). Concerted action was needed when an early restoration of market access was judged to be unrealistic or when the country’s debt burden was unsustainable.

The IMF’s framework implicitly lumped Korea—where a concerted rollover arrangement for interbank credits had helped to resolve what in retrospect was primarily a problem of illiquidity—with Russia, where unilateral default and subsequent restructuring resulted in a different kind of concerted restructuring. The IMF’s willingness to combine these two kinds of restructurings reflected the IMF staff’s belief that the opportunity to work cooperatively with creditors on a restructuring that avoided default would be increasingly rare.¹¹ Korea was a rare exception, not a model for future crises. The real choice was more between a large IMF bailout and a highly disruptive default, a default that would likely need to be accompanied by “additional measures”—a euphemism for capital controls—to contain capital outflows (IMF September 2000a). While Cologne sought to expand the set of possible policy options by highlighting the wide range of steps that might be taken to involve private creditors, the IMF’s proposed framework sought to pare down the list of policy options to only two.

The IMF, above all, hoped to find a way to limit G-7 carping about the provision of large rescue packages. To the IMF, it often seemed that the G-7 consensus was to call on the IMF to find a way to help the country

11. This skepticism is found, for example, in the IMF’s July 2002 paper discussing possible reforms to IMF lending facilities (IMF July 2002a).

and to avoid bailing out any creditors—and then to criticize it for failing to do the impossible.

Others in the official sector were more interested in asking whether the IMF should be in the bailout business at all. For example, a paper from the Bank of England and the Bank of Canada—circulated in private early in 2000 and then posted in public—called for sharply scaling back IMF lending and relying on officially sanctioned payments standstills to solve liquidity crises (Haldane and Kruger 2001). The debate this paper triggered is worth examining because the rules the Bank of England and Bank of Canada proposed offered a clear alternative to the constrained discretion the United States advocated.

Advocates of rules argued that without a rule limiting official financing, the official sector would always be pushed to lend more than optimal in the heat of a crisis. They also noted that even large loans had proven ineffective in some cases. The United States—joined by the IMF staff—argued that standstills were too blunt a tool to address liquidity crises. The stabilizing standstill postulated in theory was likely to be highly destabilizing in practice. Stopping a run on the sovereign's external debt by suspending sovereign payments—or even by suspending payments on cross-border interbank credit lines—is fairly easy to do. However, stopping payments risks triggering both cross-border contagion and additional runs inside the crisis country, as a suspension of sovereign or cross-border payments can lead to a rush to take funds out of domestic banks and move them abroad. Stopping the broader run requires a much more comprehensive suspension of currency convertibility. This debate is fleshed out in chapter 6.

The call to let standstills replace large-scale official lending failed to attract the support of most European finance ministries, let alone the United States. Yet many European governments that did not want to make standstills the standard response to crisis resolution wanted another rule: The IMF should make sure that the private sector was “always” involved in crisis resolution. The underlying logic of this position was simple: the larger the amount of official financing, the larger the need to take action to limit the associated distortion. Most healthcare plans include a small payment for each visit to the doctor to discourage overuse of medical facilities. IMF lending is a form of “insurance” and could distort incentives for sound risk assessment by private creditors if not matched by some sort of private-sector “copayment.” Two suggestions were put forward to provide substance to this rule. One emphasized that large-scale official financing always should be accompanied by commitments on the part of some private creditor groups not to pull their funds out. The other put less emphasis on obtaining matching commitments from private creditors and instead argued that IMF programs should always leave a financing gap that the country would be expected to work with its private creditors to fill.

The United States was unwilling to accept either suggestion. A rule tying IMF financing to confidence-destroying steps to lock in (some) pri-

vate creditors would make it harder for countries to regain the confidence of private investors and creditors.¹² Rather than being reassured by the news that a country was approaching the IMF for help, creditors would worry that they would be locked in and so would run faster. In the domestic context, the lender of last resort rarely conditions its liquidity support on the imposition of a partial bank holiday. A commitment not to meet all of a country's financing needs risked systematically underfinancing IMF programs.¹³ A domestic lender of last resort can stop runs, because it promises to provide enough financing to let any depositor leave: This promise, in turn, means that few depositors want to leave.¹⁴ Inside the US Treasury, there was a strong belief that the United States' willingness to provide a very large loan had been one of the keys to the success of Mexico's bailout. A principle of the "Rubin doctrine of international finance" that Treasury staff gave Robert Rubin at his departure was: "Money is no substitute for strong policy, but there are times when it is more costly to provide too little money than to provide too much" (Rubin and Weisberg 2003, 251).

IMF Reform

During his tenure as Treasury Secretary, Lawrence Summers put particular emphasis on reforming the IMF's lending facilities. His proposed reforms did not seek to change dramatically the way the IMF lends to emerging economies. Rather, Summers called on the IMF to reform its lending facilities to reflect its core financial fire fighting mission.

Summers suggested that the IMF phase out facilities that provided longer-term financing to emerging-market economies and rely on three core facilities: standby arrangements for countries that did not face capital account crises, the SRF for capital account crises, and the CCL to protect countries with sound policies from the risk of contagion. Summers also proposed raising the charge on all IMF lending, making the lending terms of the CCL more attractive to encourage countries to apply for it

12. Chapter 6 examines the conditions when steps to lock in some creditors might be combined with official financing to encourage other creditors and investors to maintain their exposure to the crisis country. Official financing can, in some circumstances, complement a debt restructuring.

13. The proposal to leave part of the country's financing need for private creditors to fill assumed that financing "gaps" could be determined with a high degree of precision. This can be questioned. A lot of judgment goes into estimating the size of the gap, since the gap depends on the estimated rollover rate on maturing financial claims as well as the scale of capital outflows by private creditors and investors. IMF programs always project a gap equal to the IMF's lending in order to show a fully financed program, but the financing gap forecast has a large margin of error.

14. See Jeanne and Wyplosz (2001) for an analytical formalization of this idea.

and introducing an expectation that IMF loans should be paid in advance, if possible. Not all of these reforms were adopted, but the IMF generally did move in the direction Summers suggested. For example, the IMF board decided to impose a surcharge that increased along with the size of a country's IMF loan.

Summers' proposals echoed, albeit very softly, some of the calls of the Meltzer Commission (IFIAC 2000),¹⁵ though his reforms were no doubt intended in part to ward off calls for more radical change. However, Summers' proposed reforms also left the IMF with substantial flexibility. The SRF was clearly intended to be the main vehicle for providing large IMF loans, but nothing formally prevented the IMF from providing large loans on more generous standby terms.

Prague Framework

By the fall of 2000 it was clear that these debates had run their course. Agreement to radically change policy was not possible. At the fall 2000 IMFC meeting, a synthesis of the IMF's proposed framework and previous G-7 statements provided the basis for a new compromise policy. The Prague framework suggests three possible responses to crises:

- "In some cases, the combination of catalytic official financing and policy adjustment should allow the country to regain full market access quickly." Think Mexico. But that statement also indicated that Mexican-style responses also should not be the norm: "Reliance on the catalytic approach at high levels of access presumes substantial justification, both in terms of its likely effectiveness and the risks of alternative approaches."
- "In other cases emphasis should be placed on encouraging voluntary approaches, as needed, to overcome creditor coordination problems." Think Korea or Brazil—countries that sought to monitor the rollover of interbank claims (and in Korea's case, stretch out maturities) as they undertook policy changes.
- "In yet other cases, the early restoration of full market access . . . may be judged unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, may be warranted. . . . this includes the possibility that, in certain extreme cases, a

15. Peter Kenen (2001) summarized the Meltzer Commission's recommendations succinctly: "The Meltzer Report recommends that the IMF transform itself into an ILOLR [international lender of last resort]. It should limit itself to making very short-term loans, base its lending decisions exclusively on preconditions aimed chiefly at appraising the soundness of its member countries' banks, and do little else." The proposed term structure for IMF loans—120 days with one rollover—was particularly unrealistic.

temporary payments suspension or standstill may be unavoidable.” (IMF September 2000b, 22). Think Ecuador and Ukraine.

While Prague did articulate the range of responses available to the official sector, like previous statements, it offered relatively little guidance to market participants seeking to know where the official sector would draw the line between those crisis best addressed through catalytic and probably large-scale official financing, perhaps supplemented by efforts to coordinate some groups of private creditors, and those crises best addressed through a debt restructuring.¹⁶

Prague effectively ended the debate on trying to “involve private creditors” in crisis resolution. The basic policy dilemma that ran throughout this debate was never really resolved. It was easy to see how private creditors could be coerced into providing crisis financing if the official sector made obtaining private financing its primary objective. It was hard to see how the steps required to assure the provision of crisis financing from private creditors who, left on their own, were inclined to cut and run, could be reconciled with the official sector’s other objectives. The official sector’s primary goal was always to limit the economic impact of the crisis, not to involve private creditors—and key players believed that there often was a trade-off between these two objectives.

Views of Emerging Economies and Private Sector

The debate on private-sector involvement primarily was a debate among the G-7 and G-10 over the appropriate use of the funds they provided the IMF. Particularly after the G-22’s demise, emerging economies often felt excluded from the debate.

Many major emerging economies—Brazil, Argentina, and Mexico in particular—wanted the debate to go away. They believed that the core problem in the international financial system was the collapse of private capital flows to emerging economies after 1998, not the difficulty in getting private creditors to contribute to crisis financing. In their view, talk of “involving private creditors” inhibited the resumption of capital flows. They did not believe that concerns about moral hazard warranted restricting the IMF’s ability to be able to provide Mexican-style liquidity support. Some Asian emerging economies had a more positive view of efforts to “involve” private creditors. They believed that international banks and market speculators shared responsibility for Asia’s financial difficulties and that painful

16. Despite its limitations, the Prague framework did say far more about the options available to the IMF in a crisis than the IMFC had been willing to say. Back in 1998, the whole topic was considered too sensitive to discuss clearly. The IMFC could only agree to call on the IMF “to study further the use of market-based mechanisms to cope with the risk of sudden changes in investor sentiment” (IMF October 1998, 3).

policy adjustments inside Asia should be matched by efforts to rope in the Asian economies' private creditors. Korea in particular believed the active role the G-7 had played in encouraging banks to roll over their exposure was central to the successful resolution of its financial difficulties.

The private financial community's views also varied. In general, the private sector—or at least the Institute for International Finance (IIF), which claimed to speak on behalf of the private financial community—welcomed large “catalytic” financial packages. The IIF also lauded the rollover arrangements in Korea and Brazil as examples of the success possible when the official sector collaborated with private creditors.¹⁷

However, an important minority in the private sector believed that large-scale official financing was distorting the market and that the uncertainty official intervention created offset any benefits (Porzecanski 2002). Large official packages let short-term creditors—often banks—exit. But they do not allow long-term investors, like bondholders, to get out. No doubt, long-term creditors, like the crisis country's citizens, benefit if the rescue works. The country avoids a broad default, and the market value of the country's bonds recovers. However, long-term creditors can be left worse off if an IMF rescue fails to resolve the crisis, as the need to pay back preferred creditors like the IMF can reduce the resources available for other creditors. Critics of large rescue loans often argue that such loans bail out the bond market, but in reality—as argued in chapter 4—they typically do far more to bail out international banks and other short-term investors.

The largest differences between the official sector and private creditors, though, arose over the restructuring of international sovereign bonds (Gopinath 1999; “When Lenders Should Be Losers,” *The Economist*, March 27, 1999). Some in the markets believed that bonds, and in particular the Brady bonds that emerged from the 1980s debt crisis, should be “preferred” instruments and insulated from restructuring. The 1996 call for collective action clauses by the G-10 deputies signaled that the official sector did not share this belief, but their call for clauses hardly attracted the attention of most in the market.¹⁸ Nor, for that matter, did Asia's crisis.

17. In some ways, central banks, some of which also functioned as bank supervisors, were more uncomfortable with these arrangements than the major international banks. Once a large private bank decided to maintain its exposure, it had a self-interest in encouraging other banks to do so as well. Bank supervisors worried about the risk of encouraging the major international banks to roll over their exposure to a country that subsequently was unable to pay, exposing the banks they supervised to substantial losses.

18. The IIF—the leading group of private creditors—issued a report of its own in 1996 arguing against the G-10 deputies' call for the use of collective action clauses in international sovereign bonds. It subsequently softened its position and only opposed efforts to force the markets to adopt collective action clauses. It is clear, though, that the IIF did not do much to encourage voluntary change either. It did not, for example, highlight that many dollar-denominated bonds in the major indices were governed by English law and therefore already had clauses.

Asian governments had not issued many international sovereign bonds before their crisis and paid the bonds that they had issued.

The bond restructuring debate heated up only in 1999, after three events combined to grab the market's attention. First, many major institutional investors held Russia's defaulted London Club debt, which had been securitized and traded like a bond. Second, the Paris Club asked Pakistan in early 1999 to seek to restructure its bonds by the end of 1999 (one of its bonds matured in December 1999). Third, Ecuador decided in the fall of 1999 not to make payments on some of its external bonds, in part because the official sector made it clear that Ecuador's bonds would have to be part of the broader financial restructuring the country clearly needed. Since Ecuador's bonds—unlike Pakistan's—were in the leading index of emerging-market debt, Ecuador's default had a particularly strong impact on the market.¹⁹

Two basic responses emerged from the markets. Some objected to the very idea of a coercive bond restructuring. Voluntary exchanges at market rates were fine, but the IMF should not condition its lending on a bond restructuring—and the Paris Club should not link the restructuring of debts owed to Paris Club creditors on a “comparable” restructuring by bondholders.²⁰ Such linkages were described as “forcing a country to default.” The most dire warnings from the private sector have aged every bit as poorly as certain official policy statements: Claims that any restructuring of sovereign bonds would destroy the market are difficult to square with the sustained rally in emerging-market debt from 1999 to 2003.²¹ Others accepted that bonds would need to be restructured but argued that the process of restructuring left much to be desired. This seemed to echo the official sector's own long-standing interest in improving the bond re-

19. See Currie (1998), Brainard (1999), Caplen (2000), and Hubbard (2000) for accounts of these bond restructurings, written largely from the point of view of investors in emerging-market debt securities. An unnamed emerging-market banker was quoted by Currie as stating, “A sovereign Eurobond default now could be cataclysmic,” though he also noted that this was, in part, because of unsettled market conditions after Russia's default.

20. IIF (1999a, 5–6) publicly argued that “private investors and creditors . . . do not seek to be bailed out by the official sector” and “no category of private financing, including Eurobonds and Brady bonds, should be automatically exempt from restructuring.” However, the IIF also argued vehemently against restructuring Ecuador's bonds (particularly its Brady bonds), even though Chase Research noted that Ecuador's 1999 interest bill was 12 percent of GDP at a time when Ecuador lacked market access. See Dallara (1999) and IIF (1999b).

21. These returns were all the more impressive considering that one of the largest issuers of sovereign bonds—Argentina—defaulted on its international bonds at the end of 2001. New bond issuance slowed following Russia's London Club restructuring and Ecuador's restructuring—but it is not obvious that this was a bad thing, given the rising levels of indebtedness in many emerging-market sovereigns. See IMF (October 2003) for a more extensive discussion of current debt levels in emerging economies.

structuring process. However, the convergence was more apparent than real. The official sector worried about the risk of holdout litigation. Market participants were concerned with another set of issues: the debtor's ability to pick and choose whom to pay (and not to pay), and the debtor's apparent preference to avoid negotiating directly with a committee of bondholders and instead to rely on their investment bank advisers to set the terms for a unilateral exchange offer.²²

Chapters 7 and 8 take up the details of the restructuring process. It is worth noting, though, that responding to private-sector complaints posed a dilemma for the official sector. On one hand, many in the markets argued that the official sector had been too involved in cases like Pakistan and Ecuador and that it was wrong for the IMF to condition its program on a bond restructuring. On the other hand, addressing bondholder concerns about the way countries like Ecuador and Russia went about their restructuring would have required the IMF to become more involved in the restructuring process. For example, Ecuador's initial decision to pay its uncollateralized Brady bonds, not to pay its collateralized Brady bonds, and to seek to withhold its eurobonds from the restructuring went down poorly with international investors. While the decision to exclude the eurobonds was reversed after holders of Brady bonds threatened legal action, Ecuador's actions left a bitter taste in the mouths of most bondholders. However, avoiding this mistake would have required the IMF to go beyond indicating that Ecuador needed to restructure if it wanted access to official financing and to start giving concrete advice on the right way to go about a restructuring.

A New Administration, a New Policy?

A series of changes occurred in 2001. The Bush administration replaced the Clinton administration. Stanley Fischer retired from the IMF, and Anne Krueger joined Horst Köhler at the top of the IMF. This completed the turnover of the team that had gone through Mexico and Asia together.

This section examines the subsequent effort to forge a new policy toward financial crises. The first part focuses on the Bush administration's policy statements. The second discusses how the Bush administration's

22. The private sector is far from homogenous. The "buy" side—the institutional investors that are the main purchasers of emerging-market securities in the United States—doubted that the major "sell" side—investment banks that advised emerging markets on new issuance and debt exchanges—would adequately represent the "buy" side's interest. The fact that many large US commercial banks active in the 1980s debt restructuring had become, over time, the largest players on the "sell" side of the bond market (JP Morgan, Citibank through Salomon) only heightened "buy side" suspicions.

new policy preferences were reflected in the G-7 and the IMF's policy statements.²³

US Policy Statements

Many in the Bush administration's economic policy team came into office believing that official action to "stabilize" emerging-market crises—like other forms of government intervention in private markets—was a mistake.²⁴ The best way to limit the risk of official action distorting private markets was to limit official lending, not to offset IMF loans with steps to lock in certain groups of private creditors. John Taylor (2001a, 4) put it simply: "In order to reduce bailouts of private investors it is necessary to limit the use of official resources, especially in cases where debt sustainability is in question." He qualified this statement by noting that any change needed to be gradual, but the clear emphasis was on "[moving] in the direction of less reliance on large official finance packages." US Treasury Secretary O'Neill emphasized that the risk of contagion should not be overstated in order to provide a rationale for official intervention (O'Neill 2001). The Bush administration also signaled that it would refrain from trying to coordinate the behavior of private creditors. Active participation by the US government in Korean-style rollover arrangements repeatedly was ruled out (Taylor 2001a and 2001b).

The Bush administration's unwillingness to articulate a "framework" that laid out how the official sector should respond to a range of crises was indicative of its deeper differences with the Clinton administration. Crises in Mexico, Asia, and Russia had led the Clinton administration's foreign economic policy team to conclude that the US government could not stand by if a financial crisis threatened a major ally or threatened to trigger widespread financial chaos. The United States, the rest of the G-7, and the IMF would need to be involved in finding constructive solutions. Moreover, the Clinton administration believed that official intervention

23. Between 1996 and September 1998, the IMF increased its outstanding credit by \$31 billion in response to the crises in Asia, Russia, and Brazil. Since September 2000, the IMF has increased its outstanding credit by \$49 billion in response to crises in Turkey and a series of Latin American economies. IMF loans to Turkey, Argentina, Brazil, and Uruguay, as discussed in chapter 4, were all quite large in relation to these countries' GDP.

24. Suskind (2004, 173) noted, "Many conservative economists, including Larry Lindsey [the head of the National Economic Council] felt the international lending of the Clinton era had placed too much of taxpayers money at risk and done more harm than good . . . the Rubin and Summers gravy train, they felt, had created a moral hazard problem, a situation in which developing countries were encouraged to make bad decisions because they knew the IMF would bail them out." The position of President George W. Bush is a little less clear. As governor of Texas, he strongly supported the 1995 loan to Mexico. Suskind reports that President Bush supported the decision to lend to Argentina in the summer of 2001 but has not delivered a major policy speech outlining his approach to the IMF.

could at times correct for private market failures. International institutions were needed to stabilize the international economy, just as domestic institutions—like a central bank able to supply emergency liquidity—were needed to stabilize the domestic economy. The policy challenge was how best to limit the risk of inevitable official intervention distorting global capital flows.

The Bush Treasury's emphasis on limiting official involvement contributed to its other policy initiative: the development of new institutions for sovereign debt restructuring. Changing sovereign debt contracts—or the adoption of a new international treaty to create a sovereign bankruptcy regime by statute—would enable a country to address its financial problems directly with its creditors, with minimum official involvement. Taylor (2001a, 4) noted: "The official sector should not encourage countries to default on their debts, though we recognize that restructurings can and will happen in certain cases. . . . It is therefore important to develop some kind of international insolvency mechanisms to ensure that if and when restructuring occurs, it does so in an orderly matter that treats creditors fairly, *reducing the scope for arbitrary, unpredictable official action.*" This topic is covered in depth in chapter 8. It is nonetheless worth noting that Taylor based his case for an international bankruptcy mechanism on the need to reduce the distortions official action created, not on the need to eliminate the market failures from the uncoordinated actions of private creditors.

The Bush Treasury's rhetorical emphasis on limits, however, was hard to square with the Bush administration's decision to support large augmentations to the financial support packages provided to Argentina and Turkey in 2001 and its support for large new programs for Brazil and Uruguay.²⁵ The Bush administration put forward a number of arguments to demonstrate how these large loans were consistent with its stated policy of limiting access to IMF financing. The need to change market expectations meant that limits needed to be introduced gradually. Opposition to any IMF quota increase would limit, over time, the IMF's overall lending capacity. A policy of not providing bilateral support further limited available official financing.

These arguments, though, did not stand serious scrutiny. The 1998 quota increase had expanded the IMF's lending capacity to roughly \$200 billion, reducing the need for supplemental lending from bilateral creditors. IMF programs to Turkey and Uruguay were larger in relation to GDP than the combined sums the IMF and the United States provided to Mexico. The

25. The Bush administration joined with others in the G-7 to insist that a substantial fraction of IMF lending to Argentina, Turkey, and Brazil be provided on SRF terms. However, the Bush administration and the G-7 were more effective at insisting that the IMF use the SRF than they were at insisting that the IMF lend only to countries that had a realistic chance of repaying a large loan quickly. Argentina, Turkey, and Brazil all were not in a position to repay their SRF loans when they came due, and new longer-term standby loans were provided to refinance the initial SRF loan.

IMF alone provided more money to Brazil in 2002 and 2003 than the IMF and a group of bilateral lenders provided in 1998 and 1999. The Bush administration also was unable to avoid bilateral lending. It used the ESF for a very short-term bridge loan to Uruguay. If Turkey would allow the United States to use its territory to invade Iraq, the United States was willing to dip into the ESF to provide a loan to Turkey, which would “bridge” not to an IMF program but to a formal congressional approval of a loan guarantee.²⁶

G-7 and IMF Policy Statements

The G-7 and the IMFC policy statements in 2001 were forgettable. In April 2002, though, the Bush administration convinced the G-7 to issue a one-page action plan outlining a new approach to emerging-market financial crises. The action plan focused heavily on the need to introduce collective action clauses into debt contracts. But it also indicated that “we [the G-7] are prepared to *limit* official lending to normal access levels except when circumstances justify an exception.” In case anyone missed the message, the statement went on to conclude: “It is becoming clearer that official sector support is being *limited*. *Limiting* official sector lending and developing private sector lending are essential parts of our action plan” (Group of 7 2002).

However, this statement only widened the gap between the G-7’s tough rhetoric and its actual lending decisions. Indeed, flights of fancy all around marked the spring of 2002. The G-7 was indulging in calls for limits on IMF lending even as it was backing large loans to Uruguay and Brazil, and the IMF was indulging in calls for a new treaty setting out bankruptcy law long after it was clear that key G-7 countries were not on board.

One indication that the G-7 was not prepared, in reality, to reduce access levels came at the IMF board meeting. The IMF staff suggested a range of procedural hurdles to the provision of exceptional levels of access. However, none of the proposals that had real bite—such as amending the IMF articles to require a supermajority rather than a majority of

26. The Bush administration argued that its use of the ESF has been consistent with its policy of avoiding bilateral financing for financial crises, since Uruguay’s loan was paid back almost immediately and since bilateral financing was offered to Turkey only to deal with the specific economic costs Turkey would incur as a result of a war in Iraq. The US offer to provide Turkey with a \$6 billion grant (which could be used in part to help cover the cost of a guarantee for a larger amount of low-interest rate loans) died when the Turkish parliament voted against authorizing the use of Turkish territory for military operations against Iraq. However, in September 2003 the United States and Turkey reached agreement in principle to use \$1 billion from the United States to back a more modest but still substantial \$8.5 billion low-interest rate loan to Turkey. As of July 2004, Turkey has not drawn on this loan, but it still clearly ended the policy of saying “no” to bilateral money. The Clinton administration had initially proposed bailing out Mexico with a loan guarantee as well. It only turned to the ESF after Republicans in Congress decided to oppose the loan guarantee.

the board to support large loans, requiring the activation of the NAB for part of the program's financing, or charging IMF members a surcharge to compensate the IMF for the financial risks associated with large loans—generated widespread support among the IMF's key member countries.²⁷ In the end, the IMF board agreed only on the need for relatively minor changes to improve the IMF's internal information flow and risk assessment along with automatic *ex post* evaluation of large IMF programs.²⁸

The IMF also developed a new—and long overdue—template for debt sustainability analysis that tried to address some of the analytical weaknesses that had tended to make previous sustainability assessments too optimistic. However, it was becoming increasingly clear that improved debt sustainability analysis alone would not make it any easier to determine who should get access to large IMF loans. Better stress testing did not suddenly allow debt sustainability analysis to determine, mechanically, the right size for an IMF loan or help the IMF assess whether a crisis country will be able to maintain the policy adjustments needed to keep its debt levels from rising. Improved analysis coincided with an increase in the IMF's exposure to countries with both large debt levels and risky debt profiles.

The fall 2002 IMFC communiqué started the process of bringing official policy statements closer in line with reality. Rather than calling for limits that the international community was not prepared to implement, this communiqué called only for more “clearly defined criteria” to justify exceptional access and “strengthened procedures” to help the IMF board assess the risks associated with large-scale lending (IMF September 2002a).²⁹ The April 2003 G-7 statement also adopted a more sober tone. It called only for “greater discipline in the provision of official finance” (Group of Seven 2003a).

Conclusions

The official sector's core challenge has been how best to adapt to the changes in private international capital markets that developed in the early 1990s. The official sector's policy should be judged on both how

27. Drawing on the NAB requires the approval of 80 percent of the NAB's contributors, so requiring NAB's activation would make large-scale lending more difficult. The CFR Task Force Report (1999) suggested that the IMF provide exceptional financing only in the event of “systemic” crises and that NAB finance all such lending.

28. Specifically, the IMF staff needs to provide the board with rigorous debt sustainability analysis and a formal assessment of the risks to the IMF's financial position. See IMF (July 2002a) and IMF (January 2003b).

29. The 2003 decision to push the SRF's repayment expectations and repayment obligations back—full repayment is required after three rather than two and a half years—offers additional evidence of the G-7's growing realism.

well it responded to developments in the market and how well its efforts to signal its policy provided useful signals to private markets.

The official sector's record on providing emerging-economy borrowers and their creditors with advance warning of policy change is mixed.

- Halifax (1995) accurately signaled the G-7's desire to expand the IMF's lending capacity, in part to avoid institutionalizing heavy reliance on US bilateral financing. This was reflected in the leading role the IMF took in Asia.
- Birmingham (1998) underscored a new focus on finding ways to respond to crises that did not "insure" payment of private claims—a shift apparent in the subsequent work of both the G-7 and G-22. In the end, the effort to find ways to convince private creditors to provide crisis financing alongside the IMF floundered on the difficulties inherent in roping in creditors without insisting the country take coercive steps—like threatening default—that ran the risk of triggering a broader crisis.
- Cologne (1999) foreshadowed the official sector's willingness to insist that sovereign bonds would need to be restructured. However, its signal that official financing should not be used to support pegged exchange rates was a bit at odds with the subsequent provision of significant support to Turkey, while the country maintained a pegged currency regime.
- Prague (2000) never explicitly indicated how severe a country's problems needed to be to rule out an approach based on catalytic financing. Nonetheless, its suggestion that "exceptionally" large financial support require particularly strong justification is hard to square with subsequent decisions in Turkey, and Argentina. Both received significant amounts of official support to avoid a debt restructuring despite doubts about their solvency.
- If Argentina and Turkey are hard to square with the spirit of Prague, they are even harder to square with the spirit of calls for new limits. Neither the Bush administration nor the G-7 has backed talk of limits with a real willingness to scale back official financing.

In many ways, the biggest surprise is how well official policy statements in 1995 and 1996 charted out the official sector's subsequent policy course. Mexico demonstrated that the combination of modern financial technology, capital account liberalization, and the issuance of short-term debt could combine to generate very large capital outflows. This has proven true time and time again. Policy weaknesses sometimes overlooked in good times can give rise to fears that lead to large outflows when the mood shifts. The G-7 and other stewards of global financial

order responded by developing the IMF's capacity to lend larger sums to the crisis country to help prevent a devastating collapse. This required expanding the resources available to the IMF. At the same time, the stewards of global financial order have sought to make some types of debt easier to restructure, whether out of a desire to develop an alternative to large bailouts or out of recognition that even rescues comparable in size to the loan given to Mexico will not always be sufficient to avoid a debt restructuring. The G-10 started calling for collective action clauses in 1996, though little happened until the Bush administration made the introduction of collective action clauses an overarching policy priority.

Yet the basic approach to emerging-market crises laid out in 1995 and 1996 also continues to be a source of deep discomfort. The Clinton administration did not believe that it was credible for the official sector to step aside and let the country and its creditors sort out the crisis without any official-sector involvement. Instead, Clinton-era policymakers sought to find ways to limit the risk of official action distorting market incentives. The Bush administration believed this framework implied too active a role for the official sector. However, the Bush administration's stated long-term intention to limit official financing—an intention the G-7 has endorsed—has not resulted in any reduction in the amount of money the G-7 wants the IMF to put on the table in actual crises.