
Recommendations for Reform

The international financial system is in far from robust health. Not because the institutional architecture of the international financial system has major gaps—the hardware of the international financial system is in better shape than is commonly assumed. The tools needed to respond to a wide range of crises by and large already exist, though there is always room for improvement. It is the software of the international financial system—the policies and practices that determine how the existing toolkit is used—that is in most need of an upgrade.

The rhetoric of many key policymakers sets a goal—limiting access to IMF financing over time—that would take the international community's most effective tool for financial fire fighting off the table. That is why limiting IMF lending has remained a long-term goal, conveniently ignored in actual crises. Even a country undergoing a debt restructuring may need access to significant IMF financing. A framework based on limits alone fails to provide real answers to the challenges posed by the sputtering, but still real, integration of emerging economies into the global financial system.

The biggest problem with the current framework is not the gap between what is said and what is done or that the posited goal of limits is unrealistic even as a long-term policy objective. Rather, it is that the current policy framework has precluded serious discussion of the best use of the IMF's ability to provide substantial emergency financing to a range of emerging economies. Claiming that substantial liquidity will not be provided in the future allows the custodians of the global financial order to avoid defining the circumstances when such liquidity provision is the right policy—and when it is the wrong policy.

This is unfortunate because the biggest policy challenge the international community confronts is not developing new tools for managing international financial crises but rather finding the best way of using the existing tools. The common image of vast flows of financial capital dwarfing a small IMF is true—if the IMF’s lending capacity is compared with financial flows into the United States. But this image is no longer accurate for emerging economies. The expansion of the IMF’s lending capacity in 1998 coincided with a fall in capital flows to emerging economies and a shift from current account deficits to current account surpluses in many of these economies. Capital flows started to recover in 2003 but remain well below their earlier peak.

The architecture for debt restructuring is also in decent shape. Even in the absence of an international bankruptcy regime, a sovereign enjoys effective protection from its external creditors while it develops its restructuring proposal. Debt exchanges provide a viable, if not always elegant, means of restructuring international bonds and other traded securities. The continued introduction of collective action clauses into bond contracts will only make the process more effective. Bank committees, official action, and moral suasion can help coordinate the rollover of cross-border bank credits. New money during the restructuring period comes from the IMF. That is not a bad thing: The IMF, at least in principle, can use the provision of new money both to shape the policies that a country pursues while in default and to push for the rapid development of a restructuring plan.

The current approach to crisis resolution has four major problems.

- The stated framework for policy—limiting IMF lending over time—has failed to produce consistent IMF lending decisions. If actual practice, not stated intent, defined policy, then the “rule” that best describes current access policy would be: provide larger quantities of financing to more heavily indebted countries to match their larger financing needs but, if possible, do so in fits and starts to avoid appearing to provide large amounts of financing. The IMF’s total lending to the major emerging economies now exceeds its total lending at the peak of the Asian, Russian, and Brazilian crises, but its loan portfolio is now in much more heavily indebted countries.¹

1. Between the end of 1996 and the end of 1998, IMF lending to a set of 12 crisis-prone emerging economies (the major users of IMF credit, and countries that went through a debt restructuring) increased by \$35.4 billion, growing from \$36.6 billion to \$72.0 billion. It then fell back to \$46.2 billion at the end of 2000. The IMF’s lending to these countries subsequently has increased by \$43.8 billion, growing to \$90.0 billion at the end of 2003. The average government debt ratio of the emerging economies that had borrowed heavily from the IMF, weighted by their share of the IMF’s lending portfolio, rose from 45.8 percent of GDP in 1998 to 89.6 percent GDP in 2002 (debt data are from Moody’s Investor Service 2003).

- The range of problems addressed by large-scale IMF lending has been expanded. Rather than providing large short-term financing in the face of a run, the IMF is now providing large medium-term—or perhaps long-term—loans to prevent large government debt loads from spiraling out of control. Mexico was able to repay most of its loan in two to three years; Turkey is scheduled to repay large chunks of its 2001–02 loan only in 2005–06 and is likely to need more time. The IMF also is effectively being called on to act as a lender of last resort to fragile, dollarized domestic banking systems. No effort has been made to explain whether these new uses of IMF financing are a necessary part of the world’s effort to help emerging economies adjust to an integrated global market.
- The IMF and the G-7 have not been willing, at least for large countries, to play an active role either in inducing a change in an unsustainable exchange rate regime or in helping a country through its debt restructuring. Rather, the IMF and the G-7 have preferred to dole out their funds in a series of programs that try to catalyze the voluntary restoration of market confidence. This strategy can work when conditions are right. In other cases, though, it simply helps the country dig itself into a deeper hole—and leaves the IMF unable to help when the country does confront its debt problems.
- Too much emphasis has been placed on international sovereign bonds relative to other potential sources of financial pressure and on protection from external litigation relative to other risks that arise in a sovereign debt restructuring. Too little attention, for example, has been placed on the risk of the decision to seek a restructuring triggering a bank run or other runs on nonsovereign claims. False expectations have been created that a better process for restructuring international sovereign bonds will reduce the need for IMF lending—and the need for an active IMF role in the debt restructuring process.

Avoiding crises altogether remains a worthwhile policy goal for emerging economies and the IMF. At the same time, efforts to prevent crises are unlikely ever to be completely successful. Emerging economies often finance themselves in ways that generate an ongoing risk of crisis, whether from dependence on short-maturity debt, on foreign-currency debt, on external debt, or all three. They typically lack the deep reservoirs of credibility that sometimes enable advanced economies to follow irresponsible economic policies for a time and then make the needed adjustments gradually, without facing a deep crisis. The IMF, the G-7, and others with a stake in the health of the global financial system should expect to continue to receive calls for help—and plan accordingly.

This chapter is divided into three sections. The first expands on our argument that the core “hardware” needed for crisis resolution is largely in

place. Ample room to use the existing tools better undermines the case for radical institutional reform. The second section develops our argument that weaknesses in the current “software” of crisis resolution impede effective crisis resolution. Hopes that the need for financial support to emerging economies will wither away over time are unrealistic, have masked a substantial transformation in the IMF’s role in the system, and have blocked a serious discussion of how IMF financing should be used to help emerging economies adjust to an integrated global market. The final section outlines our proposed framework for crisis resolution.²

“Hardware” Largely in Place

The hardware of the international financial system allows a wide range of responses to a range of crises. The toolkit has gaps, but they are relatively small.

The most important tool remains the IMF’s capacity to provide emerging economies with partial insurance against the risk of liquidity runs. Without the IMF, countries would have to hold more reserves, borrow much less, and impose more restrictions on domestic and external investors’ ability to move capital freely across borders—and likely still experience crises. The IMF’s institutionalized, multilateral lending capacity avoids the need to organize an ad hoc coalition of the financially willing each time a crisis occurs. In a world of sovereign states, international macroeconomic policy advice needs to be attached to a loan, not a threat.

IMF lending alone, though, is not enough. Debt restructurings will continue to be necessary, both to defer payments while a country takes steps to right itself and to clean up after it has fallen off the proverbial cliff. In the first instance, creditors need to give up only their right to be paid in full on the date their claim matures, not the right to be paid in full at a later date.³ In the latter case, the country’s debts must be reduced to match its reduced payments capacity. Depending on the circumstances, it may be necessary to restructure international sovereign bonds, cross-border bank lines, domestic sovereign debt, or even domestic deposits.

2. Eichengreen (2002), Fischer (2002), Kenen (2001), Eichengreen and Kletzer (2003), and Cohen and Portes (2004) have all put forward their own proposals for reforming the world’s approach to crisis resolution.

3. The right financial terms for a debt restructuring depend on the country’s circumstances. Neither Korea nor Ukraine had too much debt, only too much debt coming due at the end of 1997 and from 1998–2001, respectively. Consequently, a restructuring that extended maturities at a reasonable price worked in both cases. In contrast, Argentina’s attempt to solve its liquidity problems in 2001 through its expensive, voluntary megaswap failed. Argentina was taking on additional debt at high interest rates at a time when it could not afford to pay all of its existing debts.

Case for Partial IMF Liquidity Insurance

Our defense of the current hardware for crisis resolution hinges on our belief that the IMF should aim to provide partial, rather than full, liquidity insurance to emerging economies. The IMF exists to provide countries with some protection against the risk of running out of reserves. The IMF's insurance, though, is partial: It lacks the capacity to provide enough funds to let everyone who has lent to major emerging economies exit. This, though, is not a bad thing. Creditors should not be protected from the risk of all losses, and debtors with poor policies should not be protected from the risk of default. Of course, the capacity to provide partial insurance to a wide range of emerging economies implies the capacity to provide close to full insurance to those economies with relatively little debt and comparatively sound policies. That also is not something to condemn. Emerging economies with a history of responsible economic management ought to be rewarded with more protection than those with a history of profligacy.

Many analytic models of crisis resolution (box 9.1) postulate a world filled with liquidity runs on otherwise sound economies or a world where official rescue loans distort all incentives for sound borrowing and sound lending (moral hazard). These models often are critical of the effectiveness of partial bailouts, or partial bail-ins. They also tend to argue that the IMF either needs to be given a lending capability commensurate with a domestic lender of last resort or must lend only small sums to avoid moral hazard. Unfortunately, these models rarely assess potential real-world trade-offs. No IMF liquidity insurance means no moral hazard, but it also could transform manageable crises into economic disasters. Yet the risk of failing to nip runs and self-fulfilling crises of confidence in the bud has to be balanced with concerns that expectations of financial help will lead countries and their creditors to take risks that make future crises more likely.

Academic analysis that explicitly models crises in ways to avoid all or nothing conclusions suggests that partial IMF insurance can work. Protecting policymakers from the risk of a run leading to a catastrophic crisis before their investment in improved policies in times of stress pays off can encourage policymakers to pursue responsible policies rather than give up. Conditional IMF lending consequently may reduce, rather than increase, debtor moral hazard. Substantial, but not unlimited, official financing can convince creditors that default does not loom even if the most risk-averse among them want to leave (Corsetti, Guimaraes, and Roubini 2003). Partial bailouts—what the IMF calls catalytic financing—can work so long as the crisis country does not start from too weak a position.

Consequently, the risk of IMF moral hazard from IMF lending can be managed in better ways than denying all emerging economies any IMF insurance. Linking IMF lending to a country's willingness to make neces-

Box 9.1 Crisis prevention

It is hard to delve into crisis resolution without developing some sense of why crises happen in the first place. Our recommendations for crisis prevention are hardly radical. It is hard to top a list that includes less debt, less risky forms of borrowing, flexible exchange rates, well-regulated banking systems, early disclosure of financial weaknesses, and a long hard slog to build institutional and financial credibility through sustained implementation of sound fiscal and monetary policies. We emphasize four items:

- *Emerging economies that cannot borrow in ways that offer insulation against the risk of crises need to borrow less.* Few buffers against financial instability are better than long-term, fixed-rate, domestic currency-denominated debt. Such debt offers insurance against a refinancing crisis, an interest rate shock, and a depreciation in the real exchange rate. Emerging economies, though, often cannot borrow long-term in their own currency—whether because of their own lack of policy credibility or imperfections in global capital markets. Short-term debt emerges in equilibrium in part because investors have an interest in keeping countries with limited credibility on a short leash. Reducing debt levels usually yields dividends in two ways: Less debt is less debt, and the country's ability to borrow in less risky fashions goes up.
- *Pay particular attention to the systemic risks that the banking sector's foreign-currency liabilities create.* Countries have accumulated massive currency mismatches in two ways. Thai banks and finance companies built up an impressive currency mismatch by extensive external borrowing that was used to finance domestic foreign currency-denominated loans, even though most domestic deposits were in the local currency. Argentina's financial system built up an equally impressive currency mismatch by taking in domestic dollar deposits and making domestic dollar loans (in an economy with a small export sector). Insisting that the banks match foreign-

(box 9.1 continues next page)

sary (and often politically painful) policy changes limits the risk of the IMF weakening incentives for sound policies. East Asian countries in particular seem to have concluded that they would rather have immense war chests of foreign exchange reserves than run the risk of having to turn to the IMF again.

The partial nature of the IMF's insurance limits the risk of diluting creditors' incentives for sound risk management. To be sure, those who lent at short maturities and who knew when to get out will have incurred fewer losses than in a world with no IMF. But the IMF never lends enough to allow all creditors to get out, and private creditors have taken large losses in several crises.⁴ The roughly \$10 billion in net new financing the IMF provided Argentina in 2001 paled in comparison with the government of Argentina's roughly \$95 billion debt to private creditors, the Argentine bank-

4. The fact that IMF lending can finance the exit of short-term debt is one of many reasons why the IMF should be on the watch for countries that depend heavily on short-term debt—particularly if that debt is denominated in foreign currency. See Goldstein and Turner (2004) for an extensive discussion of why the IMF also should pay more attention to the currency structure of a country's debts.

Box 9.1 (continued)

currency assets and liabilities is not enough to protect against a systemic crisis: The banks simply pass their currency risk on to their clients. Steps that discourage the banks from taking on foreign-currency deposits in the first place—like high reserve requirements on foreign currency-denominated bank liabilities—would reduce the banks' need to match their foreign-currency liabilities with domestic foreign-currency loans.

- *Don't stuff the banking system with government paper.* Emerging markets are subject to different risks than advanced economies and cannot simply imitate bank regulation in advanced economies. Bank regulation in advanced economies traditionally has assumed that the low yields on government bonds will deter the banks from doing little more than lending to the government. Consequently, banks usually don't have to hold any capital against the risk of default on their local-government debt portfolio. However, banks in emerging economies may need to be forced to hold significant capital against their holdings of local-government debt.
- *Flexible exchange rates.* Flexible exchange rates don't suddenly turn an emerging economy into an advanced economy. They typically don't allow—at least not yet—an emerging economy to adopt a countercyclical monetary policy, even if they do facilitate the real exchange rate adjustment that is part and parcel of being an emerging economy. Flexible exchange rates do tend to remind private borrowers of the risks associated with borrowing in a foreign currency—even if they also can create pressure on governments to issue domestic debt denominated in foreign currency to help manage exchange rate pressures. Flexible exchange rates certainly don't eliminate the risk of a crisis, as Brazil discovered. But it is also hard to imagine how Brazil could have managed the shock of 2002 without the ability to let its exchange rate adjust.

ing system's \$80 billion debt to its depositors, and the Argentine private sector's \$50 billion debt to its external creditors (box 9.2).

The evidence does not suggest that the amount of insurance the IMF has provided to emerging economies since 1995 has systematically distorted global capital flows. A world dominated by moral hazard should be marked by large credit flows into those emerging economies that potentially could draw on a large IMF loan. That is not the current pattern of capital flows. Emerging economies are now, in aggregate, running a substantial current account surplus and lending money to the industrial economies (Martin Wolf, "A Very Dangerous Game," *Financial Times*, October 1, 2003). Those emerging-market central banks now helping to finance the large US current account and fiscal deficits through the purchase of US Treasury bonds presumably are not doing so because they expect that the rest of the G-7 will bail out the United States.

The strongest case for moral hazard has come in those specific cases where creditors' sense of risk and reward was distorted by a perception that a country was too strategically important to the G-7 to be allowed to fail. Russia's creditors bet—inaccurately—that the G-7 would provide

Box 9.2 The Argentine debt restructuring process

In Argentina, the official sector has come close to abdicating its traditional role of negotiating an economic program with the debtor that outlines, in broad terms, the official sector's assessment of what the country and its creditors need to do to restore debt sustainability. The US Treasury believes the macroeconomic parameters of an IMF program interfere with private negotiations between a sovereign debtor and its creditors. Argentina's IMF program includes a primary surplus sufficient to allow Argentina to pay the international financial institutions and its "senior" domestic debt, but the final primary surplus target—the key macroeconomic content of a country's IMF program—is expected to emerge from Argentina's "negotiations" with its private creditors. This is a new and potentially risky approach to debt restructuring, which may not work as intended.¹

First, it requires an unprecedented degree of coordination among Argentina's private creditors. Argentina's creditors are more diverse than in other recent sovereign restructurings—German, Italian, and Japanese retail investors (or their representatives) are sitting at the table with international institutional investors, Argentine pension funds, and representatives of private Argentine investors who bought into Argentina's external debt. It will be hard for such diverse investors to negotiate both restructuring terms and the country's macroeconomic framework. In recent bond restructurings, the debtor has not negotiated restructuring terms, let alone macroeconomic policy, with its creditors, but rather launched an exchange offer after informal consultations with market participants. Argentine creditor representatives claim that the formation of an umbrella committee representing a significant fraction of the claims in default demonstrates their ability to resolve issues of creditor coordination. But forming a committee is not enough: The committee may split when real decisions have to be taken. Argentina's creditors may be able to agree among themselves that Argentina should offer more but be unable to agree on any concessions to offer Argentina.

Second, the absence of an IMF program that helps to define realistic expectations for either Argentina or its creditors is likely to reduce the chances of a successful exchange. Creditors are initially asking for 65 cents on the dollar. Market prices of around 30 cents on the dollar throughout 2003 and early 2004 probably provide a more realistic assessment of what the country may be able and willing to pay. But there remains a large gulf even between market prices and the government of Argentina's (2003) restructuring guidelines. The IMF program does not provide a benchmark that can help nudge the two sides toward a realistic agreement.

(box 9.2 continues next page)

Russia with unlimited insurance.⁵ Turkey's creditors certainly are aware of the country's strategic importance. This dilemma does not have an easy solution. Rules preventing the IMF from lending large sums would not eliminate the ability of the G-7 countries—acting collectively or individually—to bail out strategically important countries on their own.

Some have suggested that IMF-sanctioned standstills offer a good across-the-board substitute for IMF loans. We disagree. In the theoretically interesting, though practically rare, case of a pure run on a perfectly solvent entity, either a lender of last resort or a standstill stops the run:

5. See Rubin and Weisberg (2003) for an account of the decision not to augment or reprogram Russia's IMF loan to avoid a default in August 1998.

Box 9.2 *(continued)*

Third, the political economy of reform is likely to be harder, not easier, if a country has to negotiate its economic program with its private creditors. Any additional adjustment can easily be portrayed as serving the interest of Argentina's creditors, not the broader interest of sustaining Argentina's economic recovery. Argentina is, not surprisingly, resisting creditors' calls for formal "negotiations." A country that has told the IMF that a primary surplus above 3 percent is politically and socially unfeasible will find it difficult to commit to more fiscal adjustment after negotiations with its creditors. The chances of a successful exchange would have been greater if Argentina had followed the model used by other sovereigns: negotiate a realistic primary surplus target with the IMF, which sets a benchmark for an exchange offer, then consult with private creditors to develop restructuring terms that appeal to different creditor groups before launching a take-it-or-leave exchange.

Fourth, the absence of an agreed-upon macroeconomic framework leaves the official sector poorly positioned to offer carrots or use sticks to get the restructuring moving. Sticks include denying Argentina access to new IMF financing. Carrots include reduction of bilateral Paris Club claims to improve the debtor's cash flow, or even net new financing to the debtor. Such intervention is not simply official meddling. The official sector has more exposure to Argentina than either European retail investors or international institutional investors. It has much to lose if the restructuring terms Argentina offers to private creditors fail to add up, or if Argentina's restructuring proposal fails, leading to a protracted stalemate that eventually hinders Argentina's recovery.

It is certainly possible that Argentina will put forward an offer that attracts widespread participation and avoids a protracted stalemate. Argentina may find creative ways to close the gap between its Dubai offer and the current market value of its debt, whether by providing some upfront cash at the time of the deal, by recognizing some past due interest, or by deciding to run a larger primary balance. The IMF and the multilateral development banks (MDBs) could even decide to take a more active role in the restructuring process, perhaps by helping Argentina finance additional upfront cash payments in return for a commitment to additional fiscal adjustment. But the official sector's "hands off" approach is one of the reasons why the Argentine default already has dragged for over two and a half years without resolution and could drag even longer.

1. See also Truman (2004) for views similar to ours on the crucial role of the official sector in guiding the debt restructuring process.

Creditors run only because others may. In reality, though, creditors usually harbor doubts about the debtor's ability to make the adjustments needed to assure its long-run solvency as well as concerns that other creditors will pull their funds out. They would much rather be assured by the availability of a lender of last resort than be locked in through a standstill.

Moreover, the real world is far messier than the simple picture painted in most academic models of standstills. Stopping payments on some types of debt risks triggering other kinds of runs. Suspending payments on the sovereign's external debt, for example, risks triggering a bank run, a flight out of local assets, pressure on the currency, and corporate payment difficulties. The government could limit this risk by combining a sovereign

payments standstill with bank holidays and comprehensive capital controls.⁶ Both bank holidays and comprehensive controls risk turning the government's financial difficulties into an economywide payment problem. Indeed, few steps are more likely to deepen the economic contraction associated with a sovereign debt restructuring than a comprehensive bank holiday. Plus, anticipation of a bank holiday or capital controls will only strengthen incentives for domestic depositors and investors to run at the first sign of trouble, making crises more difficult to manage. For countries with low levels of debt that encounter liquidity difficulties, the risk of a broad standstill exceeds the risk associated with large-scale IMF lending.

There is no compelling empirical or theoretical case for taking the option of large-scale financing entirely off the table. At the same time, it does not make sense to provide all emerging economies with the same insurance against liquidity runs or to divorce liquidity support from policy changes. A country facing liquidity pressure may be liquid if its creditors don't run and illiquid if they do but also may be solvent if it changes its policies and insolvent if it does not. Countries with too much debt or with too little capacity to pull off the needed policy adjustments should not get the same kind of insurance as less indebted economies.

Successful rescue loans—with success defined as paying the loan back relatively quickly as well as the stabilization of the crisis country—generally have come from lending to countries with both reasonable debt loads and a political commitment to make the necessary policy changes. Mexico, Korea, and Brazil in 1998 all had high levels of short-term debt but relatively low overall debt levels, and all paid the IMF back relatively quickly. Countries with higher levels of debt—whether external or public debt—generally have *not* repaid the IMF as quickly.⁷ The IMF has done better when it tries to save a country with relatively low levels of debt from the full consequences of hanging on to a pegged exchange rate for too long than when it tries to save a country from the consequences of building up a large debt stock and only belatedly making the needed adjustments.

6. Such controls would limit the ability of the country's own citizens and foreign residents alike to trade local currency for foreign currency and also limit the ability of local banks and firms to obtain the foreign exchange needed to pay their international debts without authorization.

7. Chapter 4 systematically reviews the IMF's major lending commitments since Mexico. IMF programs failed (in part because of a failure to implement IMF programs) to avoid a sovereign default in Russia and to prevent systemic corporate default in Indonesia. Thailand's program was a mixed bag: Thailand avoided the bank run that devastated Indonesia but never regained the confidence of external bank creditors and had to run large current account surplus to repay its existing external debt. It is unrealistic—and undesirable—to expect the IMF to be able to avoid all mistakes. The IMF should take some risks. At the same time, .500 is a great batting average in baseball but probably not a good one for large-scale IMF lending.

Many are, understandably, uncomfortable with a process that in the end relies on the official sector's judgment—hopefully informed by sound analysis—to identify the countries that deserve large-scale IMF support to avoid a debt restructuring. But rules that insist the IMF lend the same amount to all crisis countries simply do not make sense. Neither a “never lend large sums” policy rule nor an “always lend large sums” policy rule works well across a range of crises. The first provides too little financing when a country without too much overall debt experiences temporary liquidity problems. Limiting the IMF to its current lending norm of 100 percent of quota in a year (and 300 percent over three years) assures that the IMF will not provide enough to matter, given private investors' ability to shift their financial assets out of a crisis country. The second provides too much financing when a heavily indebted country experiences trouble.⁸ A country with an external debt to GDP ratio of 60 percent should not expect the same treatment as one with 30 percent, even if both experience liquidity difficulties.⁹

The idea that the IMF should lend large sums only to countries that prequalify for such support with good policies has some conceptual appeal. However, the difficulties of prequalification should not be underestimated. Defining the right set of policies for prequalification is hard. Our understanding of the policies emerging economies need is still evolving: In 1998 Argentina was considered to be something of a model for other emerging economies.¹⁰ The countries sure to qualify for help are unlikely to need help and may never apply. Countries that do not qualify for help in advance may still be worth helping if their problems are correctable and if they are willing to commit to needed reforms.

Above all, the IMF's major shareholders are not prepared to live by such a constraining set of rules. They are under too much pressure to give countries a chance to right themselves. Turkey and Brazil (particularly in 2001–02) would not have prequalified for IMF protection under any reasonable scheme, but it is hard to believe that the G-7 would be willing to

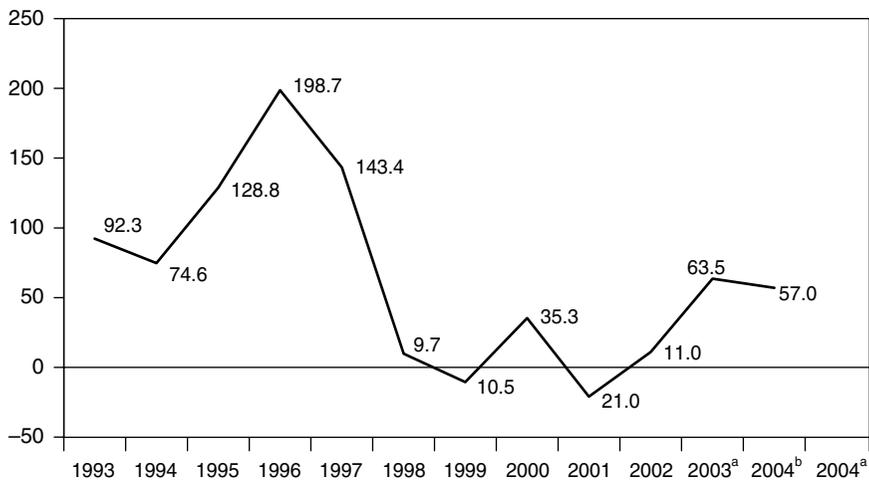
8. Ortiz (2002) recommended that the IMF provide any country willing to make needed policy changes with a large IMF loan to help avoid a payments interruption. This would provide the country and its creditors with more certainty about the IMF's policy response, in part because Ortiz would not link such financing to efforts to convince private creditors to maintain their exposure.

9. Manasse, Roubini, and Schimmpfenning (2003) found that emerging economies are at risk of default at substantially lower levels of debt than more advanced economies. European economies are not at risk of default with debt-to-GDP ratios of 60 percent, but most emerging economies are. Debt-to-GDP ratios of above 50 percent are sufficient to significantly increase the risk of default.

10. Argentina lacked many of the vulnerabilities of the Asian-crisis countries: Foreign banks participated heavily in its domestic financial system, the banking system was generally thought to be well-regulated, Argentina's accounts were transparent, and a currency board allegedly assured consistency between its peg and its monetary policy.

Figure 9.1 Net private debt flows to emerging markets, 1993–2004

billions of dollars



a. Estimated.

b. Forecast.

Source: Data from Institute of International Finance (various years).

stand entirely aside and let each of these countries sink or swim without any international support. No country is too big to fail, but some are likely too big or too important not to help.

Does the IMF Have the Resources It Needs?

Going into the Asian crisis, the IMF's total lending capacity was substantially smaller than the annual sum international investors lent to emerging economies.¹¹ The IMF's maximum lending capacity is now between \$190 billion and \$200 billion, relative to between \$130 billion and \$140 billion in 1997. Net private lending to emerging economies has picked up from the low levels of 2001 and 2002, but even with the current modest resurgence, capital flows have not returned to their 1997 levels. The estimated \$64 billion in net private debt flows to emerging economies in 2003 was both well above the 1998–2002 average of \$5 billion and well below the 1995–97 average of \$157 billion (IIF 2004) (see figure 9.1). This is not to say that capital flows cannot now overwhelm IMF lending—they clearly can. But right now this risk often stems more from the capability of do-

11. See IIF (2004) and IMF (1998). Net private credit is the sum of bank lending and other credit flows—largely bonds. The IIF estimates that the emerging economies in its data set owed \$562 billion to commercial banks, \$856 to “other private creditors” (mostly bond holders), and \$732 billion to official creditors (multilateral and bilateral) at the end of 2003.

mestic investors in emerging economies to move their savings offshore in mass than from the risk of international investors suddenly withdrawing their financing from emerging economies.

The IMF currently has the resources it needs to put enough money on the table to make a difference in most emerging-market crises. That, however, does not mean that the IMF's funds will never need to be augmented. The present pattern of global capital flows will not persist forever. As the world economy grows, as global trade continues to expand, and as some of the \$500 billion in capital now flowing to the United States to finance its current account deficit starts flowing to emerging economies, the case for expanding the IMF's lending capacity will need to be reassessed. Over the medium to long term, IMF resources may need to be expanded to parallel the growth of world trade and international financial flows and the greater integration of the global economy.

The Restructuring Architecture

Three sets of concerns motivate sovereign debt theorists. Some argue that the core objective of a sovereign debt contract must be to sustain incentives for payment by penalizing sovereigns who default. Some worry more about the risk of debt contracts obstructing a helpful restructuring in the event of unexpected economic shocks, including shocks that originate in changes in capital markets' willingness to finance countries. Some others argue that the real issue is how best to discourage international investors from fueling emerging-market governments' own intrinsic biases toward deficits and overborrowing.

All three concerns are important. The expectation that payment terms can be altered too easily will inhibit lending, reduce capital flows, and increase borrowing costs. Yet a preemptive restructuring that avoids a certain default—or a restructuring that lets a country with unsustainable debts that has stopped payments get out of default in an orderly manner—can be in the interest of both the debtor and its creditors. It is particularly important that countries that can borrow only at high costs borrow for the right reasons. Yet steps to make borrowing harder and more expensive to deter future overborrowing do not help countries that already have too much debt.

Many who look at the sovereign debt market—from all three points of view—worry about the absence of any formal institutions for sovereign debt restructuring. Emerging-market sovereigns borrow at spreads that imply a significant probability of default, spreads similar to those for high-yield corporate bonds. Yet it seems, at least superficially, that the sovereign debt market lacks the institutional infrastructure—namely a bankruptcy regime—that make the high-yield corporate bond market work. Many New York-law sovereign bond contracts even lack provi-

sions outlining an obvious process for changing the bond's payment terms. Unlike in the 19th century, standing committees of creditors are not sitting around ready to represent creditors in a sovereign restructuring.

It is important, though, not to overstate the impact of the absence of formal institutions for sovereign debt restructuring. Sovereign debtors who default on their external debt do not have to worry about the threat of liquidation, fear that their international reserves will be seized (if they take some basic precautions), or risk losing control of their domestic assets. Neither the absence of a treaty setting up an international bankruptcy regime for sovereigns nor the absence of contractual provisions spelling out how to do change a bond's payment terms has been an insurmountable obstacle to a restructuring. Multi-instrument exchange offers provide the basic technology to coordinate the restructuring of international sovereign bonds and other traded securities. Bondholders pragmatically have preferred to trade instruments that risk not being paid for new instruments that will be paid, regardless of unenforceable contractual provisions promising that a bond would never be restructured.

This is not to say that the growing use of collective action clauses that allow a supermajority of creditors to vote to amend a bond's financial terms—or the use of the “aggregating” superclauses in Uruguay's bonds—would not make sovereign bond restructurings smoother. The absence of provisions that spell out explicitly how to change a bond's payment terms often pushes a financially distressed government to use less transparent means, notably the amendment of a bond's nonfinancial terms, to herd bondholders into an exchange. Other reforms—like a code of conduct that focuses narrowly on the disclosure of the debtor's overall restructuring plan at an early stage—could strengthen the existing bond restructuring process. But these innovations would make exchange offers work better, not radically transform the existing restructuring process.

Sovereign debt theorists have overstated the role that collective action clauses play, either in creating incentives for sovereigns to honor their debts or in creating obstacles to an efficient debt restructuring. The postulated world of expensive and difficult restructurings without clauses and of quick and painless restructuring with clauses does not match the existing experience. If the absence of clauses assured virtue, Ecuador would be a model debtor. If the absence of clauses blocked any and all restructurings, Ecuador would still be in default. There is no evidence either that the presence of collective action clauses makes sovereign default an attractive option or that the absence of collective action clauses will prevent a sovereign from eventually reaching agreement with its creditors. The case for clauses is far more modest: The introduction of clauses could facilitate a cooperative restructuring in the face of adverse shocks with minimal risk of encouraging opportunistic defaults.

Criticism of the IMF's proposed sovereign debt restructuring mechanism (SDRM) also ran ahead of the relatively modest proposal that IMF

management ultimately embraced.¹² The IMF bears primary responsibility for this confusion. It started by making a case for replicating Chapter 11 of the US bankruptcy code, even though many of the problems that Chapter 11 addresses in the corporate context are not problems in the sovereign context. The IMF never was able to separate its less ambitious final proposal from its sweeping initial framing of the problem. But if one sets aside the rhetoric and looks at the details, the proposed SDRM would have created a restructuring process that resembled the aggregated vote in Uruguay's new bonds far more than the court-supervised restructuring of Chapter 11 of the US bankruptcy code.

The absence of formal institutions for a debt restructuring traditionally has not been a major concern to creditors. But Argentina's prolonged default is leading creditors to lament the absence of many of the protections corporate creditors in advanced economies take for granted—protections that push a corporate creditor to put a restructuring offer on the table rather than remain in prolonged default. The solution here, though, is not to lift the informal protections that have made sovereign restructuring possible in the absence of an international bankruptcy regime. Letting creditors litigate to seize a sovereign's reserves after a default would create even stronger incentives for a sovereign to default only after running down all its reserves. In the absence of a sovereign bankruptcy regime that clearly defines the seniority of different claims on a sovereign, a creditor rushing to grab any remaining assets of the debtor would be destructive. Rather, the solution is for the IMF, backed by the G-7, to be willing to do more early on to help a country through its restructuring. The IMF should provide real money and real guidance in a real effort to avoid prolonged default.

Financial crises, though, are not caused exclusively, or even predominantly, by difficulties in making payments on a sovereign's international bonds, and crisis resolution requires more than the capacity to restructure a sovereign's international bonds. The debt restructuring architecture also needs to make it possible to restructure:

- **cross-border bank lines.** Modern risk management techniques lead international banks to limit their own risks by quickly pulling their funds out of countries at risk of crises. In the process, they have pushed more risk onto emerging economies. The withdrawal of cross-border bank credit has been a bigger source of financial pressure in most major crises than payments on international bonds.

12. The final IMF management proposal (IMF April 2003) provided the debtor with the option of seeking to convince its creditors to vote in favor of a stay on litigation and let the debtor—if it got the support of a creditors' committee—petition a dispute settlement board to block disruptive litigation before a formal vote. The IMF's December 2002 proposal resembled Uruguay's aggregating clauses more closely: It did not offer the debtor the option of calling a vote on a stay or the right to petition the dispute settlement board.

- **domestic sovereign debt.** Domestic debt often has a much shorter maturity than international sovereign bonds and thus can roll off faster. Most sovereigns have substantial capacity to restructure their own domestic debt if they need to, whether by unilateral decree or by putting pressure on domestic financial institutions to accept—voluntarily—altered terms.
- **domestic deposits.** Most countries avoid a domestic bank run by extending an outright government guarantee to the domestic banking system, giving banks government bonds to avoid losses, and by using the central bank to supply the banks with domestic currency. In extremis, though, domestic bank deposits will need to be restructured—whether through deposit freezes, mandatory “pesification” (forced currency conversion), or a mandatory exchange of deposits for longer-term bonds.

We don’t think institutional change is required to be able to restructure any of these claims. Experience suggests that short-term bank lines can be rescheduled in a crisis. The informal institutions—and some of the people—that helped the big international banks survive the 1980s debt crisis remain available to help coordinate the rollover of the bank claims. The contractual provisions in domestic sovereign debt contracts have not created obstacles to recent domestic debt restructurings.

The case for institutional change here parallels that for putting collective action clauses in international bonds: Institutional change is not necessary for a restructuring but might make the existing process work better. The undeniable success in Korea has been difficult to replicate when a country is not almost out of reserves. Turkey’s efforts to encourage banks to maintain their exposure in 2001 were a miserable failure. In many ways, the machinery for coordinating the rollover of bank claims in a crisis is rustier than that for restructuring traded securities.

One solution to this problem is for the official sector to insist more forcefully that the country obtain an agreement with its bank creditors to roll over their claims and to be prepared to tolerate arrears on these debts if the creditor banks do not agree. Another approach would be to modify the terms of cross-border interbank contracts to give the crisis country’s central bank the right to unilaterally extend the maturity of these credits in a crisis. This is a modification of earlier proposals for rollover options (Buiter and Siebert 1999, Kenen 2001). The initial advocates of rollover options put an emphasis on making the use of such options universal in order to provide a broad “contractual” standstill in a crisis. That seeks too much. But the contractual option to defer payments into external interbank claims could be used to perform a more limited but still crucial function: providing time for the government, the borrowing banks, and the creditor banks to negotiate a formal rescheduling. Such options would

replicate contractually what now is achieved informally (often with official intervention) in a successful rollover arrangement.

Make no mistake, the right to defer payments unilaterally is a much more profound change in a contract than the ability to amend a contract's financial terms through a supermajority vote. A three-month rollover option makes the shortest possible maturity of any cross-border bank credit three months and turns a three-month credit into a six-month credit. Such options will be costly and will reduce cross-border interbank lending—not a bad thing, given its risks. They certainly won't emerge voluntarily from market pressures: They will be introduced only as a result of coordinated regulatory pressure.¹³ On balance, the gains of a more defined institutional framework for the renegotiation of bank claims outweigh the risk of giving banks strong incentives to reduce their exposure before the rollover options are invoked.

The current international financial system does lack tools to solve one problem: how to restructure sovereign debt held by domestic banks without triggering a domestic bank run. Unfortunately, there are no easy solutions. Advanced economies have solved the bank run problem by using the government's financial strength to protect small depositors from losses—an option that is not available to many overindebted emerging economies. One potential solution—transferring the responsibility for bailing out, supervising, and regulating the banking systems of emerging economies to a global regulator—is simply not politically feasible (Tarullo 2001). All feasible solutions are second best. The IMF already is paying more attention to the health of the banking systems of many emerging economies—a form of shadow supervision. We think it also should be more willing to help—in appropriate ways—back the domestic banking systems of sovereign debtors going through a restructuring.

Problems with Crisis Resolution “Software”

Calls for Limits Fail to Produce Consistent Lending Decisions

The current framework for deciding which countries should receive IMF liquidity insurance is not working. The G-7's stated policy goal is to limit

13. The practical obstacles to the introduction of rollover options are immense. It would be necessary to define what constitutes a cross-border creditor, to determine if such provisions need to be included in cross-border credits to finance companies or even private firms as well as to banks, and to decide if such options need to be included in cross-border bank credits among banks located in advanced economies or just in credit extended to counterparties in emerging economies. Putting the options only in credits to emerging economies requires a consensus definition of an emerging economy and risks introducing a regulatory discontinuity in the market. Putting the options in all cross-border credits would be simpler, though putting such provisions into credits among banks in the world's financial centers would generate strong resistance.

access to the IMF's traditional norms, with rare exceptions that do not need to be spelled out. Apart from Uruguay, actual lending decisions have been much closer to the policy advocated by Guillermo Ortiz, governor of the Bank of Mexico: Always provide large amounts of liquidity to try to avoid a coercive debt restructuring. Statements from both the G-7 and the International Monetary and Financial Committee (IMFC) indicate that large-scale lending should not go to countries with unsustainable debts. Yet the recent recipients of large IMF loans typically have substantially higher levels of debt than the past recipients. Current policy can be summed up, with apologies to St. Augustine, as "give me virtue but not right now."

The expectation that it will be easier to refuse in the future is not realistic: Recent large-scale lending is not just a near-term necessity created by the difficulties of weaning a fragile world off the lax lending standards of an earlier era. The pressures that led to lending to Argentina, Turkey, Uruguay, and Brazil are real and reflect the emergence of difficulties that stem from the need to finance these countries' growing stocks of debt. Larger stocks of debt will tend to lead, *ceteris paribus*, to the need to make larger loans to give traditional catalytic financing a chance. For all the talk of limits, more IMF money has been made available relative to crisis countries' GDP in recent crisis cases than in Mexico, Asia, or Russia. These large loans are likely to tie up a substantial portion of the IMF's lending capacity for a long time, since several are unlikely to be repaid quickly.¹⁴ (See table 9.1.)

Recent lending decisions have broadened the IMF's role in responding to emerging-market crises almost as significantly as the Clinton administration's decision to encourage the IMF to act as a surrogate lender of last resort in Mexico in 1995. The IMF is increasingly providing medium- to long-term financing to a country that is undertaking a medium- to long-term program of fiscal adjustment, in part by sometimes financing large fiscal deficits. The IMF also has gone beyond helping countries manage a collapse of external confidence; it is now helping both to backstop domestic banking systems and to finance domestic budget deficits. Yet no effort has been made to define whether the IMF should expect to assume these roles in other crises.

This is unfortunate. After the IMF was stretched in new directions in Mexico, the United States and the rest of the G-7 developed a theory of when the new use of the IMF was appropriate, created new facilities adapted to this kind of lending, and set about expanding the resources available to the IMF so that it could play this role in future crises. No com-

14. The IMF has lent over \$50 billion—roughly 25 percent of its overall lending capacity—to Turkey and Brazil. Argentina has indicated that it will not start repaying the \$15.5 billion it owes the IMF until 2014 (it has offered to pay the IMF interest in the interim). Recent IMF analysis suggests that Turkey, Brazil, and Uruguay could have difficulty repaying the IMF in full when their current loans come due (IMF April 2004). Should either Turkey or Brazil slip back into crisis, the IMF's overall financial position would start to look rather precarious.

Table 9.1 IMF lending limits compared with actual lending
(billions of dollars)

Country	Current limit		Proposed limit		Actual program		
	One year (100 percent)	Cumulative (300 percent)	One year (300 percent)	Cumulative (500 percent)	One year	Cumu- lative	Peak
Mexico	2.6	7.9	7.9	13.1	13.1	18.0	13.1
Thailand	0.8	2.3	2.3	3.9	2.8	3.9	3.7
Indonesia	2.0	6.1	6.1	10.2	5.0	11.3	11.3
Korea	1.1	3.2	3.2	5.4	18.9	20.8	19.4
Brazil (1998)	3.1	9.2	9.2	15.3	11.1	18.4	13.4
Russia	8.1	24.4	24.4	40.6	5.1	15.1	5.1
Argentina (September 2001)	2.8	8.3	8.3	13.8	12.7	22.1	12.7
Brazil (2001)	3.9	11.7	11.7	19.5	10.2	15.6	14.6
Brazil (2002)	3.9	11.7	11.7	19.5	22.1	29.3	22.1
Brazil (combined)	3.9	11.7	11.7	19.5	10.2	35.1	30.1
Uruguay	0.4	1.2	1.2	1.9	1.7	2.7	2.2
Turkey (2001)	1.3	4.0	4.0	6.6	11.9	20.7	16.2
Turkey (2002)	1.3	4.0	4.0	6.6	13.7	17.6	14.8
Turkey (combined)	1.3	4.0	4.0	6.6	11.9	33.8	23.1

Note: Korea's quota was unusually small and Russia's was unusually large. Turkey 2002 and Brazil 2002 partially refinanced the country's existing IMF exposure; net disbursements were smaller. Mexico, Thailand, Indonesia, Korea, Brazil 1998, and Russia are in pre-1998 quotas—current quotas would be larger.

Source: International Monetary Fund, www.imf/external/fin.htm, and authors' calculations.

parable effort has been made to articulate how the new uses of the IMF in countries like Turkey and Uruguay fit into a broader policy framework or whether the IMF's response to these crises should be repeated if other countries encounter similar problems.

Assessing Recent Bailouts

While the dossiers for Argentina, Turkey, Uruguay, and Brazil will not be closed until these countries repay their IMF loans, it is not too early to start asking whether the IMF should provide a similar response should other countries encounter similar trouble. Our general answer is no: The official sector's response to recent emerging-market crises should not be institutionalized. However, one important qualification is needed to this argument. The approach adopted in Uruguay—pushing the country to float early on, closing some banks and freezing some deposits while backing all remaining deposits with a credible guarantee, and restructuring the sovereign's external debt—has promise, even if we don't think Uruguay's debt levels were low enough for that approach to have made sense in this specific instance.

Argentina, of course, is the easiest case to criticize. The decision to augment the IMF's \$15 billion loan to Argentina with another \$8 billion loan

in late summer 2001 to avoid devaluation and default was an obvious mistake (Mussa 2002b). The small augmentation of summer 2001 had no chance of working, leaving the IMF with additional exposure when Argentina collapsed and damaging the IMF's credibility inside Argentina by signaling continued IMF support for policies that failed. In our judgment, Argentina clearly had passed the point of no return and should have received additional support only if it were willing to change its exchange rate regime and initiate a needed coercive debt restructuring. Indeed, both the initial decision to lend Argentina \$15 billion in January 2001 and the decision to keep lending even as Argentina missed its not terribly demanding fiscal targets in the spring of 2001 can be questioned.

No option available to Argentina in 2000 could have avoided a significant fall in output. Recognizing reality and letting the exchange rate adjust was always going to be painful. Argentina's overvalued exchange rate had masked its true debt burden. Moreover, the Argentines were not willing to make a draconian shift in policy in late 2000. Since Argentina had approached the IMF when the central bank still had substantial reserves and the government still had the ability to draw on the banking system's own liquidity to tide the government through a rough patch, the IMF's leverage was limited. Argentina almost certainly would have rejected IMF advice to act preemptively, let the peso float, and initiate a debt restructuring. Argentines committed to convertibility would have harshly criticized the IMF for the subsequent crisis. Still, the IMF should have tried more actively to initiate a shift in policies. Forcing Argentina to rely solely on its own resources to defend the currency board would have forced Argentina to abandon the currency board more quickly.

Argentina instead ended up receiving a significant loan to support an attempt to avoid both any exchange rate adjustment and meaningful debt reduction but nothing to support a transition to a sustainable real exchange rate and a more sustainable debt profile. A better policy would have used the IMF's lending capacity to limit the negative fallout from exiting the currency board and from the unavoidable debt restructuring. Such a plan would have used the IMF's funds—plus any of Argentina's own remaining reserves—to avoid a bank run and to limit the overshooting of the peso. Any plan would have needed to include the following:

- *a strategy to avoid—or contain—a domestic bank run.* The chances of creating a credible backstop would have been far higher if Argentina moved quickly. At the end of 2000, Argentina held \$25 billion in reserves; the banks themselves held another \$5 billion in liquid reserves in offshore accounts. Plus Argentina had substantial capacity to borrow from the IMF. Argentina could have assembled a headline package almost equal in size to \$50 billion in domestic, dollar-denominated deposits.¹⁵ Cross-border bank debt would have needed to be restruc-

15. Data from Lagos (2002) and authors' calculations.

tured, à la Korea. IMF lending also would have been available to intervene to avoid excessive exchange rate overshooting.

- *a strategy to restructure the banking sector's private lending portfolio.* Many domestic borrowers could not absorb the higher real burden on their dollar debt that would follow devaluation, and some form of across-the-board relief for small domestic borrowers was unavoidable. Unless the government planned to pass such losses onto depositors, it needed to pick up most of the tab for such relief.¹⁶
- *a strategy for restructuring the government's own debt.* Government debt held by Argentine banks would have needed to be treated differently than that held by external investors and the Argentine pension funds in order to avoid adding to the banking sector's weakness. Indeed, the need to compensate the banks for the losses on their private lending portfolio implied the need to take on new debt even as the government was seeking relief from its existing creditors.
- *a strategy for paying the debt that emerges from Argentina's restructuring.* Any restructuring obviously needed to be matched with domestic fiscal adjustments to enable Argentina to meet its new payments commitments. The scale and diversity of Argentina's existing debts—and the need to take on new debt as part of the banking sector's restructuring—increases the importance of clearly defining the amount of adjustment that Argentina is able to undertake, so that both Argentina and all its creditors have a clear sense of the amount of payments that Argentina can sustain.

There is no guarantee that such a policy would have produced a better outcome. But the fact that the economic collapse that accompanied Argentina's eventual default and devaluation was much deeper than necessary to bring Argentina's external accounts into some semblance of balance, which suggests that it is at least conceptually possible that an alternative policy path might have produced a smaller fall in output.

The IMF certainly would be in a stronger position to set the policy framework for the debt restructuring if it had not exhausted both its credibility and its lending capacity in 2001 trying to support the currency board. Because of its large exposure at the time of the default, the IMF has been forced to link its conditionality in 2002 and 2003 to loans that did

16. Many of the banking system's larger borrowers, notably Argentina's utilities, also would have encountered trouble. Letting the utilities continue to index their prices to the dollar would have been politically untenable (and economically unwise) after a devaluation, and a change in the utilities' pricing structure would have had to have been accompanied by a parallel negotiated restructuring of their external and domestic debts. Hopefully, these interlinked negotiations could have been completed without degenerating into the current impasse, but all parties would have had to show real flexibility.

nothing more than prevent Argentina from falling into arrears to the IMF (and other IFIs, whose lending is contingent on an IMF program). The IMF ended up settling for a program that failed to set a fiscal policy path that could guide the subsequent debt restructuring, or assure the country's overall ability to repay the IMF.¹⁷ In theory, the absence of agreement on a fiscal adjustment path lets the bondholders negotiate directly with Argentina the amount of additional adjustment it needs to undertake to reach a settlement with its external creditors. In practice, failing to define the amount of adjustment needed to pay all of Argentina's creditors probably just increases the probability that Argentina will not be able to reach agreement with its external creditors. It is also not obvious why Argentina's bondholders—who are only one of the many sets of creditors with a claim on Argentina's fiscal effort—should be the ultimate arbitrators of Argentina's fiscal adjustment.

Turkey has received more money relative to its GDP from the IMF than Mexico received from the IMF and the US Treasury combined in 1995, despite having a substantially higher debt-to-GDP ratio than Mexico. Turkey's loan is being used in a different way than Mexico's: Turkey's IMF loan is covering a medium- to long-term, rather than a short-term, financing need.

Turkey encountered trouble at the end of 2000 when its crawling currency peg—part of an IMF-supported program to end Turkey's chronic inflation—came under pressure. The decision to provide Turkey with additional funds to bolster this peg at the end of 2000 was a mistake. Neither Turkey's government finances nor its banking system were strong enough to withstand the rigors of a peg. The peg, perversely, was creating incentives for Turkey's banking system to take on risky foreign-currency debt to finance the government—increasing Turkey's financial vulnerabilities.

Moving more quickly to a float would not have avoided Turkey's subsequent government debt crisis. The vast bulk of Turkey's \$24 billion IMF credit line was disbursed after Turkey let its exchange rate float and allowed the central bank to help finance the government's large ongoing budget deficits without printing money. Consequently, the core issue raised by Turkey is the wisdom of using IMF financing to finance (indirectly) large fiscal deficits, not the wisdom of supporting pegged exchange rates. In theory, IMF help in the early stages of Turkey's fiscal adjustment program will enable Turkey to obtain the credibility needed to borrow at a lower rate in the future—the high real interest rates that led

17. The required primary surplus in Argentina's current IMF program covers interest payments to the IFIs and Argentina's "senior" domestic creditors. Argentina also has agreed to increase its primary balance to cover additional payments that emerge from its external debt restructuring. Consequently, the IMF delegated the negotiation of the final parameters of Argentina's IMF program to Argentina's bondholders.

to large fiscal deficits in 2001 and 2002 will come down over time, lowering Turkey's future borrowing need.¹⁸

Turkey had a true need for external financing to support this kind of program of fiscal adjustment, since the initial budget deficits exceeded what could be financed domestically. But it also needed medium-term external financing to support a slow process of fiscal consolidation at a high debt level, not short-term lending. The probability that private markets will provide the funds needed to cover Turkey's ongoing budget and current account deficits *and* the additional funds needed to repay the IMF \$9 billion in 2005 and over \$10 billion in 2006 is close to nil.¹⁹

Large-scale IMF lending to Turkey, to date, has warded off outright default and economic collapse, domestic confidence in Turkey's finances is currently strong, and it is certainly possible that Turkey will ultimately be able to repay the IMF. However, we still do not believe providing long-term financing to support a long-term fiscal consolidation program is an appropriate use of large-scale IMF financing. Judged solely on its economic and financial merits, Turkey's debt had reached a level where its IMF program should have been designed around a debt restructuring. Turkey would not have needed to move immediately to outright debt reduction: Its willingness to run a significant primary surplus would have allowed it to pay positive real interest rates on its existing debt stock, just not real interest rates of 20 to 30 percent. Turkey needed to call on its domestic banking system to trade their short-term treasury bills for longer-term debt that carried positive real interest rates. This would have required a corresponding restructuring of the short-term international bank lines that local banks had used to finance some of their bets on Turkish government debt.

This approach would be risky: Even a restructuring backed with an IMF loan can trigger a run and the potential outflows in the event of a deposit run that dwarfed the available financing. An IMF-supported domestic debt restructuring could well have produced a worse outcome than the

18. Turkey could only finance budget deficits in excess of 15 percent of GDP in 2001 and 2002 by tapping its domestic markets for new lending and then drawing on the IMF loan to provide additional new financing. Turkey's stock of government debt consequently increased substantially between 2000 and 2003. However, after rising dramatically in 2001, Turkey's debt-to-GDP ratio fell in both 2002 and 2003. Turkey's fiscal adjustment and the resumption of GDP growth both helped, but Turkey also benefited significantly from the fall in the dollar. Turkey's foreign-currency debt is largely denominated in dollars, while its economy is oriented more toward Europe. Unfortunately, many of the factors that helped Turkey in 2002 and 2003 would reverse in a crisis.

19. Turkey has received net new funds from the IMF every year since 2000. Turkey has yet to prove it can finance itself without obtaining additional official financing, let alone show that it can start to make net payments to the IMF. In late 2003, Turkey obtained a bilateral \$8.5 billion guaranteed loan from the US government. Turkey has yet to draw on this loan guarantee, in part because it would commit Turkey to supporting US policy in Iraq.

approach the IMF and the G-7 actually adopted. No one should maintain that a policy of restricting IMF lending—or even a policy of restricting IMF lending to countries with large debts and large budget deficits—will be costless.

We are not so naïve as to think that lending to Turkey has been determined solely on its economic and financial merits. Turkey's commitment to democracy, strategic location, aspirations to join Europe, and long-standing alliance with the United States do give it unique geostrategic importance. However, in cases where the G-7's strategic interests require cutting a country a lot of slack, the G-7 countries themselves, not the IMF, should supply the bulk of crisis financing.

Why does this matter? After all, the G-7 countries supply most of the IMF's financing anyway. There are two reasons. First, the IMF's economic and financial credibility is eroded if its decisions are not based primarily on economic and financial criteria. Lending to Turkey through the IMF, an institution designed to treat all of its members similarly, creates an expectation that the IMF should provide less strategically important countries with similar financial problems a comparable loan. The IMF would need to be substantially expanded to be in position to comfortably lend more than 10 percent of a country's GDP for an extended period to every emerging economy with a nominal budget deficit of 15 percent of GDP and debt-to-GDP ratio of over 80 percent. Second, G-7 countries are better equipped to manage the risk that Turkey ultimately won't be able to repay on the original terms or that Turkey will eventually fall into an Argentine-style default. The IMF's funds are supposed to "revolve" and therefore to be lent and repaid quickly—not tied down in cases like Turkey.

The IMF's approach in *Uruguay* differed from that adopted in other recent cases. Uruguay combined large-scale support to stop a bank run with a maturity-extending restructuring of its sovereign debt.²⁰ A large loan from the IMF allowed the central bank to act as a lender of last resort in dollars to the banking system and therefore avoid both a domestic and external bank holiday after Argentina's own bank holiday had catalyzed a run out of Uruguay's banking system. After the run subsided, the government's own debt was restructured through a maturity-extending bond exchange. Creditors who lent to the government of Uruguay were bailed in even as the banking system was bailed out.

Uruguay is a small country, and while the IMF's loan was very large in relation to Uruguay's size, it is not large on an absolute scale. However, Uruguay is important because it raises two issues that we believe are central to defining the role the IMF should play in the future. First should the IMF provide the funds to let a central bank act as a domestic lender of last resort? Second, should it do so on a scale comparable to Uruguay when the government itself is highly indebted?

20. This is true of both precrisis and postcrisis debt-to-GDP ratios.

Our answer to the first question is a qualified yes. Avoiding a domestic bank holiday and the associated economic collapse by providing the central bank the reserves it needs to stop a domestic run can be an appropriate use of the IMF's financial capacity as the country deals with its banking crisis. The strategy of combining a restructuring that locks in those creditors that lent to the sovereign and IMF lending to augment the country's reserves so a domestic run does not undermine the sovereign restructuring can make a lot of sense.

Our answer to the second question is no. Unless the IMF is expanded, it cannot consistently lend all of its members 15 percent of their GDP to allow their central banks to act as a full lender of last resort in dollars. Uruguay could obtain such a large loan only because its economy is small, so even 15 percent of GDP was not a large absolute sum. Lending a comparable sum to Argentina, which also had a heavily dollarized banking system, would have meant lending it around \$40 billion just to back the banking system—and even this sum would have fallen short of backing all bank deposits. Moreover, even if the IMF's resources were expanded so it could provide all major emerging economies loans of a comparable size, Uruguay's debt levels themselves were too high to warrant such large-scale support. Given Uruguay's high debt burden and its deep economic slump, Uruguay should have sought a bigger haircut from its creditors rather than just pushing out the maturity of its debt at precrisis interest rates during its restructuring. As in Argentina, postponing a haircut may cause greater damage than taking the bitter pill sooner.²¹

Brazil is the most difficult recent case. It received much more money from the IMF in 2001–03 than it received from the IMF and its bilateral creditors combined in 1998–99, despite entering into its current crisis with substantially more debt than in 1998–99. That is one reason why Brazil has been unable to repay the IMF as rapidly.

Brazil combines important strengths and major weaknesses. While Brazil's fiscal and external debt levels in 2002 were comparable to Argentina's before its crisis, Brazil's fundamentals were otherwise stronger than Argentina's. Brazil has run a primary surplus of 3.5 percent of GDP since the 1999 crisis, and President Luiz Inacio Lula da Silva, seeing the abyss of Argentina, decided to increase the primary surplus above 4 percent of GDP. The depreciation of the real that occurred in the course of 2002 also had brought Brazil's current account into balance. Unlike Argentina in 2000 and 2001, an overvalued currency did not understate

21. Reducing the amount of financing available and a deeper debt restructuring almost certainly would have implied a broader restructuring of domestic and external deposits than what took place. We would have tried to keep demand deposits unfrozen by backing them with a smaller bailout loan but would have frozen and then rescheduled time deposits—including those held by Argentines.

Brazil's debt burden.²² Brazil's domestic banking system was not dollarized, so a fall in the real did not translate into debt problems for a wide range of domestic borrowers.

These strengths, the inherent risk of a domestic debt restructuring, and the likely disruption to both Brazil and the world if Brazil were to fail all combine to make the current IMF program a reasonable, though risky, bet. We think it would have been appropriate, though—given the scale of the IMF's commitment—for Brazil's external bank creditors to also have made a serious commitment to maintain their exposure.

A number of important financial weaknesses offset Brazil's strengths. Brazil's government debt is heavily indexed to short-term interest rates, so high domestic interest rates increase the government's borrowing needs and choke economic growth. Brazil never rebuilt the reserves it lost defending its exchange rate in 1998, and it lost more reserves during 2002. Reserves are now starting to rise again, but net reserves remain low for an economy of Brazil's size, particularly given Brazil's stock of short-term external debt (mostly owed by private banks and firms) and the government's stock of domestic dollar-linked debt (Credit Suisse First Boston 2003). All this combines to create an underlying dependence on borrowed reserves from the IMF.

Brazil's current government has made a real commitment to fiscal adjustment and is taking advantage of favorable financial conditions to rebuild its reserves and reduce its dollar-linked debt stock. There is hope for renewed growth in 2004—though not for quick repayment of the IMF. Brazil certainly deserves every chance to succeed.

However, should growth disappoint, fiscal adjustment slip, or international investors' willingness to look for yields wane, another crisis cannot be ruled out after 2004.²³ The emergence of new financial pressures would force both Brazil and the IMF to face a difficult choice. Would Brazil's remaining reserves—and the capacity to borrow from the IMF embedded in Brazil's current "precautionary" program—be better used to support a debt restructuring, or should both be deployed in yet another "catalytic" attempt to avoid a restructuring? Moving too fast risks forcing a country to undergo the pain of an avoidable debt restructuring, but moving too

22. However, Brazil's practice of reporting its net rather than its gross public-sector debt does understate its debt burden.

23. Growth is expected to recover in 2004, and Brazil's relatively limited external financing needs can be addressed by the recently augmented IMF program and the resources that are still available in the original \$30 billion program (Brazil met all conditions to draw additional funds from the IMF at the end of 2003 but opted not to). However, the IMF's capacity to provide still more financing to help meet large external financing needs in 2005 and thereafter is limited. As a share of Brazil's GDP, the IMF's current exposure to Brazil is not anywhere near as large as it is to Uruguay or Turkey; however, as a share of the IMF's portfolio, Brazil already looms large.

slowly risks making a necessary debt restructuring more painful and disruptive. Brazil cannot continue to emerge from each crisis with higher debts and lower reserves. Brazil's government needs to deliver on its commitment to reduce Brazil's debt level over time to be in a position to continue to obtain IMF help to augment its low levels of reserves. Otherwise, a debt restructuring may become unavoidable.

Crisis Management Is Harder When Debt Stocks Are Larger

The policy dilemmas created when emerging economies with large debts encounter difficulties are real, particularly if the emerging economy's banking system is a major creditor of the sovereign. Larger debts usually translate directly or indirectly into larger needs for emergency financing. This dilemma has no easy solutions. Upping the amount the IMF lends to countries with larger debts increases the odds of success, but at some point this ceases to be a realistic policy. If the size of the IMF's insurance policy grew in relation to the size of a country's problems, IMF lending would give rise to moral hazard. Plus, lending to a country whose starting point calls into question its capacity to take on additional debt is risky, even if the IMF lends on a preferred basis.

However, not upping the size of the financing in the face of potentially bigger financing needs also is risky. Lending 10 percent of GDP to a country with a debt-to-GDP ratio of 30 percent brings more effective financial force to bear than lending 10 percent of GDP to a country with a debt-to-GDP ratio of 60, 70, or 80 percent.²⁴ The IMF may put enough money on the table to tie down a large share of the IMF's lending capacity, but not large enough to catalyze a clear change in market sentiment.

Neither the IMF nor its major shareholders have acquitted themselves well in the face of these dilemmas. They often have dithered rather than confronted difficult problems with decisive actions. Pressure to show progress toward the stated goal of limiting IMF lending has manifested itself in efforts to minimize the size of the IMF's initial loan. But if the initial amount is not enough, the IMF's typical response—Argentina, Turkey, and Uruguay are all examples—has been to lend more money.²⁵ The overall impact of drizzling out lending decisions over time may just be to di-

24. The combination of an IMF loan and US bilateral lending provided a commitment equal to 10 percent of Mexico's precrisis GDP, a little under one-third of Mexico's precrisis government debt of 31 percent. Turkey received an IMF commitment equal to 12 percent of its precrisis GDP, but that was only about one-fifth of its precrisis government debt to GDP ratio of close to 60 percent.

25. Uruguay's 2002 loan was augmented thrice, Turkey's 2000 loan was augmented twice and then superseded by a new, even bigger, loan in 2002. This new loan effectively was a third augmentation. The bilateral loan that Turkey recently received from the United States can be considered a fourth augmentation.

minish the chances of the initial IMF loan, the augmented second loan, or even a third loan catalyzing the desired change in market conditions.

The core tenet of the “Powell doctrine” of financing—to use a phrase popularized by former US Treasury Secretary Lawrence Summers—is that the chances of official intervention catalyzing a decisive shift in market sentiment increases if the full size of the official sector’s commitment is put on the table from the beginning—even if disbursements are tranching to encourage adherence to policy commitments. We would add a corollary after Argentina: The chances of a debt restructuring being completed without a deep economic and financial collapse goes up if decisive action is taken early on. The country can use both its own reserves and its capacity to borrow from the IMF to prevent the restructuring from triggering a catastrophic collapse in confidence.

It’s Not Just the Bond Market, Stupid!²⁶

To paraphrase basketball legend Bill Walton, it is important not to confuse activity with results. The price at which two international investors are willing to exchange a long-term emerging-market bond provides a visible sign of financial distress and an easy source of stories for the financial press. Wild swings in market prices matter a lot to those holding the bonds but don’t always correspond to wild flows in and out of the crisis country. It is a lot harder to get real-time data on changes in banks’ exposure loans, even though changes in bank exposure correlate far more closely with changes in the country’s reserves. Don’t get us wrong: A sustained fall in secondary-market prices usually augurs real trouble. But movements in the market price of bonds don’t always mean movements of funds out of the country or don’t necessarily put direct pressure on the country’s reserves.

The problem with the current debate on bond restructuring is not the content of most of the proposed reforms. Many existing bond contracts do make it too easy for a minority of creditors to hold out and try to get a better deal than everyone else. The problem is that too much attention has been devoted to solving what has been, to date, a relatively small problem—siphoning attention away from other, often more important, problems.

Long-term sovereign bonds simply have not been the most common cause of international liquidity crises. Mexico, Russia, Turkey, and Brazil all turned to the IMF because of prospective difficulties in making payments on their domestic sovereign debt, not their international sovereign

26. The motto for former President Clinton’s 1992 campaign was “It’s the economy, stupid.” The Clinton administration’s economic policy went on to emphasize how the bond market would rally with deficit reduction, lowering interest rates across the board.

bonds.²⁷ The rolloff of short-term cross-border bank claims was a bigger source of stress in Asia, Turkey, Brazil, and even Argentina than an inability to refinance maturing international bonds. The crises in Argentina and Uruguay demonstrated how residents' willingness to shift from dollar-denominated bank deposits (local assets) to dollars and dollar assets abroad (foreign assets) can put enormous pressure on a country's reserves. Argentina, which will be remembered as the international bond crisis par excellence, lost more reserves in 2001 trying to halt a bank run than making payments on its maturing international bonds.²⁸ Bonds have played a bigger role in some smaller crises, but even here, the country typically confronts far more intractable problems than those posed by the absence of provisions that could limit the risk of holdouts from a sovereign bond restructuring.

The focus on bonds has deflected attention away from the risks posed by the rolloff of external bank lines, even though short-term bank lending is often a bigger problem than long-term bonds. Neither the IMF nor the G-7 seem to have seriously considered making a real commitment by the banks to maintain their exposure a part of Brazil's recent rescue package. The focus on legal obstacles to an external bond restructuring also has diverted attention from the economic and financial obstacles to a domestic sovereign debt restructuring. This is unfortunate. The domestic sovereign debt of many indebted emerging economies is growing faster than their external sovereign debt.²⁹ The success of future debt restructurings will likely hinge far more on finding ways to restructure domestic as well as external debt without triggering a domestic bank run than on finding ways to limit bondholder litigation.

The most promising approaches to limiting the risk of a debt restructuring triggering a bank run and a generalized flight from domestic assets require redefining how the IMF is used, not a new IMF—it is more a change in the IMF's software than a change in the system's hardware. Debt held by the banks often cannot be exempted from any restructuring, but it can be restructured on terms that lower its interest rate without necessarily reducing its face value. If the IMF has not already exhausted its

27. Mexico, Russia, Brazil (1998 and 2002), and Turkey faced difficulties because of the sovereign's domestic debt, not international bonds. The Asian-crisis countries faced difficulties because of a rolloff of cross-border bank loans to private creditors. The rolloff of bank loans was also an important factor in Brazil and Turkey; see Truman (2002, 341–46).

28. Estimating principal payments to external bondholders is not straightforward, given the large domestic holdings of the government of Argentina's international sovereign bonds. The government of Argentina estimated that roughly \$6 billion was coming due on externally held bonds in 2001, and nearly all of this rolled off. This compares with the \$24 billion that fled from the Argentine banking system in 2001 (authors' calculations and data from the government of Argentina and the Argentine central bank).

29. Many emerging-market economies also have less external debt than they seem to, since their domestic banks are major buyers of the governments' international bonds.

lending capacity helping the country avoid any restructuring, such a restructuring can be combined with IMF support to help convince most domestic depositors not to run (in part by demonstrating that the financing is available for some to exit). In some cases, though, this won't work. Domestic deposits will have to be frozen and depositors will have to absorb losses—either directly by an upfront haircut or indirectly by taxing domestic residents to pay off depositors over time.³⁰

Of course, if emerging economies managed their public finances more prudently, they would have less need to stuff their domestic banking systems with government debt, and the debt that the banks do hold will be less risky. It would help if domestic bank regulation did not encourage domestic banks to lend to their own government. But heavily indebted sovereigns are unlikely to suddenly start regulating the banking system to protect against a sovereign default. The temptation in a crisis is always to do the opposite: to loosen bank regulation to make it attractive for the domestic banks to provide the government with the emergency financing—a form of gambling for resurrection.

IMF's Vital Role in a Debt Restructuring

The Bush administration's top economic policymakers came into office promising not to play an active role in the resolution of emerging-market crises. Their initial policy statements suggested that they would not only limit IMF lending but also let the market find its own way through a sovereign debt restructuring (Taylor 2001a, Suskind 2004). Neither the rest of the Bush administration nor the rest of the G-7 ever fully embraced this laissez-faire approach to crisis resolution. When forced to choose between letting a country slip into crisis without making any effort to help and providing a large loan, the Bush administration and other G-7 governments consistently have decided that a large loan is the lesser of two evils. Turkey, Brazil, and Argentina's 2001 augmentation are all cases in point.

However, an aversion to helping a country define a coherent strategy for a coercive debt restructuring, especially when combined with the IMF's institutional reluctance to declare a country's chosen exchange rate regime untenable,³¹ still can have perverse and destructive results. As

30. See chapter 7 for a discussion of challenges created when the banking system's financial assets are claims on the government and Hoelscher and Quintyn (2003) for a comprehensive survey of systemic banking crises.

31. The IMF's Articles of Agreement give each member country the right to select their own exchange rate regime. However, the IMF is under no obligation to provide financial support to back a country's chosen exchange rate regime or even to back draconian adjustment plans designed to save the country's chosen exchange rate regime. Recent experience—Turkey and Argentina—shows that even currency boards can become unsustainable.

Argentina ran down its reserves and its capacity to borrow from the IMF even as it failed to meet its policy commitments, the probability of avoiding a complete meltdown sharply decreased. The G-7 and the IMF worried more about the risk of being implicated in the decision to abandon the currency board and to seek a coercive restructuring than about the risks of failing to support Argentina at the peak of its crisis. This was a serious mistake in Argentina and will be a mistake in other cases.

The IMF—backed by the G-7—should play an active, coordinating role rather than a hands-off role in the resolution of emerging-market debt crises. This implies helping the country develop a strategy to prevent the secondary runs triggered by the restructuring from cascading out of control and backing that strategy with new money. It also means working to make sure that all the steps required to resolve a complex crisis—the restructuring of the country’s domestic debts, its international debt held by private creditors, and its debts to other governments plus the country’s own policy efforts—combine to form a coherent whole.³² Putting collective action clauses into all international sovereign bond contracts won’t reduce the need for the IMF to play these active roles.

The IMF’s financial exposure means that it will never be an entirely disinterested party in a sovereign restructuring. But there is no completely disinterested party with the leverage needed to play some of the supervisory roles a bankruptcy judge plays during the restructuring of a domestic firm. As the representative of the largest economies, the IMF has interests that go beyond assuring its own repayment. This gives it the authority to take action to help stabilize the international financial system. Only the IMF combines the leverage that comes from the ability to provide new money with the ability to act decisively to help define a distressed sovereign debtor’s overall program for financial rehabilitation (IMF January 2003b). It is hard to imagine that a country’s dispersed creditors could come together quickly and agree both to provide new financing and to link that financing to a macroeconomic policy path that would help guide the subsequent debt restructuring—particularly since the interest of different sets of creditors are not congruent.

Moving from Problems to Solutions

The core challenge of crisis resolution is not creating brand new institutions to manage international financial crises.

32. New lending from the IMF and the MDBs to refinance their existing exposure can also be thought of as a form of a restructuring.

Updated Framework for Crisis Resolution

The G-7's basic framework for crisis resolution needs to be updated to better match the existing tools of crisis resolution to the particular challenges that different crisis countries face. Many of the following principles are not new. Taken together, however, they would imply a significant change in the way the official sector handles many emerging-market crises.

Be Willing to Distinguish Between Countries and Make Hard Judgments Early On

Despite all the difficulties in distinguishing between illiquidity and insolvency—as illiquidity can be a leading indicator of insolvency—any viable framework needs to differentiate between different cases and treat different crises differently. Sorting crises into different categories is intrinsically difficult. But key decisions still need to be made upfront.

Any approach to crisis resolution should start with an assessment of the country's debt, the structure of its debt, its exchange rate regime, and more difficult, the country's forward-looking capacity to adjust its policies. Countries with too much debt coming due tomorrow, but not too much overall debt, need time to make the adjustments that will assure their solvency and allow them to regain market credibility. Countries with too much overall debt relative to their ability to increase their payments capacity—not just too much debt coming due tomorrow—need to find the best way of reducing their debt. Countries that fall in the middle need something in the middle—often maturity-extending restructurings that keep coupons low but avoid outright debt reduction. Countries with unsustainable exchange rate regimes—even a currency board—should not receive large-scale IMF financing unless they are willing to change their exchange rate regime.

Link Financing to Appropriate Policy Adjustments

Even countries whose difficulties stem more from “too much short-term debt in relation to their reserves” than from “too much overall debt relative to their long-term capacity to pay” typically need to make some policy adjustments. Pure illiquidity is rare: Cases where an illiquid country is solvent if it makes appropriate—and doable—adjustments are far more common. Even Mexico, the quintessential liquidity case, would not have remained solvent for long if it had continued to run large current account deficits as a result of an overvalued exchange rate. Moreover, IMF bailouts are partial, not total: The country still needs to demonstrate to its private creditors and its own citizens that it is taking steps to improve its creditworthiness. Countries with “too much debt relative to their long-term capacity to pay” need to take steps to increase their payments capacity even as they seek relief from their creditors. Successful crisis reso-

lution always combines appropriate policy changes with a credible plan to deal with the debtor's short- and long-term financing needs.

Matching Financial Response to the Crisis

The three responses described below are meant to suggest that different types of financial crises in emerging economies will be resolved in different ways, just as different private-debt problems require different techniques for resolution. They should not be taken literally: there is no international lender of last resort, any bailout will be partial, and there is no perfect sovereign analogue to a Chapter 11.

- *Lender of last resort–style financing for sovereigns.* A central bank typically can supply a solvent (or potentially solvent) bank with an unlimited credit line to stop the run. The best the IMF can do is to provide enough financing to prevent immediate collapse, if some external creditors leave and some domestic residents shift their funds abroad. Financing from a surrogate lender of last resort to avoid any debt restructuring should be reserved for countries that can reasonably be expected to regain market access and repay the IMF quickly, so the IMF is not financing a permanent withdrawal in private financing. These countries typically have moderate levels of public and external debt, flexible exchange rates, and a (somewhat belated) political commitment to reform. Mexico is an example.
- *Out-of-court sovereign debt reorganizations.* A maturity-extending rescheduling of a country's external debts at sustainable interest rates (i.e., precrisis rates) is roughly analogous to an out-of-court corporate reorganization. Such reorganizations allow the firm and its creditors to avoid the cost of Chapter 11 reorganization or outright liquidation. There is a parallel for a country: Its external debts can be rescheduled to buy time for reforms that may avoid the need for deep debt reduction. This approach suits a country that may need financing for several years, while it shows that it can get its act together. Ukraine is an example.
- *Sovereign de facto "Chapter 11s" that provide significant debt reduction.* Sovereign debt reduction takes place outside the formal protections of a bankruptcy regime, in part because the difficulty in taking legal action against a sovereign has mitigated the need for formal protection. Some sovereigns, though, dig themselves into such a deep hole that getting out requires deep debt reduction. The country needs to adjust so that it no longer needs to take on new debt, and all creditors have to take large losses: There is no "given time, losses may be avoided" option. Argentina is a good example.

The lines between these responses often are a bit blurry. Korea comes closer to being a pure liquidity crisis than most after it let its exchange rate adjust, yet the approach adopted in Korea straddled the line between lender-of-last-resort financing and an out-of-court rescheduling.³³ The line between an out-of-court maturity-extending rescheduling and a sovereign Chapter 11 debt reduction also can blur. Many countries will be reluctant to seek outright debt reduction (or even a low interest rate on debt that is rescheduled for a very long time) until they give the combination of stretching out maturities and adjustment a chance to work. Uruguay is a case in point.

Large-Scale IMF Lending Can Usefully Complement a Coercive Debt Restructuring

Official financing can help limit the risk of a restructuring triggering a total panic—inherently a bad outcome—whether by helping to finance intervention to prevent extreme overshooting in the exchange rate or by helping to backstop the banking system.³⁴ Financial support from the IMF can help avoid steps like closing the capital account or freezing domestic bank deposits that risk expanding and deepening the crisis. In a sense, providing financing to stop a domestic run—either on the banks or the currency—while a country is seeking to push out the maturities of its external debt (bonds but external bank loans too) is analogous to restructuring the large creditors of a bank during a bank resolution while paying small depositors in full.

Large-scale lending is appropriate even in some debt reduction cases. Right now defaulting on private debt usually means losing access to significant official support as well, thus encouraging countries with too much debt to hold on for too long. One of the advantages of providing IMF debtor-in-possession (DIP) financing is that it gives the IMF leverage to define a sensible course for macroeconomic policies during the restructuring. Since the IMF is the entity best positioned to help the crisis country coordinate the different components of a complex restructuring, the IMF—backed by the G-7—needs to play an active role in crisis resolution. The disaster in Argentina shows the consequences of the G-7 and IMF's un-

33. Many firms can be insolvent (like some Korean banks and corporations) even if the government and the country as a whole are solvent. The country's aggregate capacity to generate foreign exchange may exceed its aggregate external debt service even if some major firms cannot cover their debts. Of course, if the government bails out insolvent banks and firms, it may put its own solvency at risk.

34. For example, Argentina's central bank intervened to support the peso after Argentina's default and devaluation in order to prevent an already depreciated peso from overshooting further. One year later, it was buying, not selling, dollars after the exchange rate had stabilized.

willingness to lead, manage, and use their leverage to resolve a complex crisis quickly.

Preserve IMF's De Facto Seniority

The IMF can neither finance countries like Mexico or Brazil nor take bold steps to limit the fallout from a debt restructuring without the informal priority currently given to repaying the IMF. Reducing this informal seniority would severely impair the IMF's ability to deal with crises. The IMF, though, does need to be more cognizant of the risk of a failed bailout leaving both itself and the country's long-term creditors worse off. Financing the rolloff of junior debt with senior debt before a default means a larger haircut for the country's remaining junior creditors and slow repayment of the country's senior creditors.

Don't Let Cross-Border Bank Credits Off the Hook Too Easily

More crisis countries should be encouraged to seek a monitored rollover arrangement for cross-border bank exposure, and such arrangements should be put in place well before a country is entirely out of reserves. At times, the short-term creditors of a crisis country will need to refrain from exercising their option to exit in order to give the country a better chance of emerging from its crisis. Institutional innovations like rollover options could help. But contractual innovations are not a precondition for moving more aggressively to limit the rolloff of cross-border bank credit.

Monitored commitments from the banks to roll over their claims work only if it is clear that low rollover rates will have consequences. For example, the IMF could condition its willingness to continue financing on a high participation rate in such a rollover and make a low rate a trigger to negotiate replacing the rollover arrangement with a maturity-extending rescheduling. Official pressure to encourage private creditors to roll over their short-term debts—so-called moral suasion—also should not be taken entirely off the table. In cases where lender of last resort-style financing is either impossible or undesirable and where failure to agree on a rollover that avoids default could have systemic consequences, the official sector should be willing to do everything that it can to generate a good outcome. Korea is a prime example.

Be Willing to Finance a Domestic Lender of Last Resort That Helps Backstop the Local Banking System

Few events can be as disruptive to a country's social, political, and economic fabric as the widespread collapse of the domestic banking system. Access to international reserves can help a country with a dollarized financial system avoid a deposit freeze. It also can reduce the pressure on the exchange rate associated with the central bank's provision of domestic currency in the event of a run out of local-currency deposits.

However, the IMF should support domestic lenders of last resort only in countries that are performing some form of triage during a banking run and crisis to make sure that the funds provided by the IMF are used to support the right banks. The central bank of the crisis country should not be providing liquidity to its domestic banks without also taking offsetting steps to restructure and clean up the banking system. Some banks may need to be shut down and their deposits either paid off or transferred to other banks. The equity investors in other banks may need to put up additional capital in return for liquidity support. In some cases, the needed triage may even require rescheduling some deposits while backing others in full (as in Uruguay).

No matter how the IMF resources are used, the IMF lends to a country's government, and the government retains ultimate responsibility for repayment. The IMF can finance a domestic lender of last resort if the country's government is short on international reserves but not overly indebted. Such governments have the capacity to repay all their existing debts as well as the additional debt that they are taking on in a crisis to finance a domestic lender of last resort. We are willing to go one step further and use the IMF's lending capacity to support the banking system of a country that is engaged in an early restructuring of its own debt (as in Uruguay). Here the IMF is lending largely on the strength of the priority traditionally accorded to the IMF. But the government's ultimate solvency—and capacity to repay the IMF—hinges on its ability to restructure its debt as well.

Recognize More Explicitly the IMF's Role in a Wide Range of Crises

Central bank reserves serve many functions. They back the country's domestic currency. They provide foreign currency that the central bank can lend to the domestic banking system, whether to meet demands stemming from the rolloff of external bank lines (Thailand, Indonesia, Korea, Brazil, and Turkey) or a domestic deposit run (Argentina and Uruguay). They can be sold to mop up the domestic currency that the central bank is lending to a troubled banking system (Indonesia) or a troubled government (Russia). They can be sold in the market to meet a surge in demand for foreign exchange from private firms that are having difficulty refinancing their external debt (Indonesia and Brazil). They can be lent to the country's government when it is having difficulty paying its maturing foreign currency-denominated debt (Mexico) or can be sold in the market to fund the central bank's local-currency lending to a government that is running budget deficits (Turkey).

Reserves borrowed from the IMF can be used in all these ways as well, so the IMF has a role in the resolution of a broad range of crises. The basic criteria for IMF lending, though, don't change. The IMF needs to be comfortable with how the country is using the reserves it borrows from the IMF (or how borrowing from the IMF allows the country to put more of

its own reserves to use). The IMF also needs to be confident that the country will be in a position to repay the IMF relatively quickly. There is no intrinsic problem with lending the central bank's reserves to the government in the event of a run on the banking system or on the government's debt. Reserves are not just held to prevent a run on the local currency. But the bar for on-lending the reserves the central banks borrow from the IMF to finance ongoing budget deficits should be very high—as such financing needs are rarely short-term.

Lay Out a More Realistic IMF Access Policy

No one wants to bite the bullet and take the political heat associated with acknowledging that current access limits are no longer the actual norms for IMF lending to major emerging economies. No emerging economy that is part of the G-20 has been limited to 100 percent of quota in a year and 300 percent of quota over three years since Mexico.³⁵ These limits are so far below what a major emerging economy facing capital account pressures needs that they no longer help to assess what a reasonable amount of financial support should be. Setting higher limits for a new IMF crisis facility tailored to address the needs of major emerging economies that face higher demands for reserves during the process of financial integration (so-called capital account crises) would provide more useful guidance for the IMF. Tighter limits could be maintained for other types of lending, including concessional lending.

Specific suggestions include

- setting limits on the IMF's crisis response facility at 300 percent of quota in the first year and no more than 500 percent of quota over three years. The precise limits can be debated. The 300/500 percent limit is within the ballpark of many recent IMF programs but well below the levels of access recently granted to Turkey and Brazil. Countries should expect that they will have to repay the loan when it comes due, not just refinance it—though the option of refinancing can never be taken off the table. Realistically, countries may need a bit longer to repay than the three years provided by the IMF's current facility for large-scale lending (the supplemental reserve facility).
- authorizing the IMF to lend up to 300 percent of quota in a year/500 percent of quota over three years to countries that are engaged in an external debt restructuring. The IMF should be able to provide a significant amount of sovereign DIP financing both to countries seeking to extend the maturities of their external debt and to those seeking

35. The G-20 brings together the G-7 countries, the country holding the presidency of the European Union, and a set of the largest emerging economies to discuss global economic policy issues. Membership in the G-20 is thus a proxy for economic and financial importance. For the details on current IMF facilities, see www.imf.org/external/wp/exv/facts/howlend.htm.

debt reduction. Of course, the actual amount of financing will depend on the merits of each case: Not every country that needs a debt restructuring should receive the upper limit for DIP financing. In cases with modest capital-account pressures, the standard 100/300 percent quota should be enough.

- Providing an opt-out that allows the IMF to lend more than 300/500 percent of quota in lender of last resort-type responses to a few rare cases. The option of exceeding the new, higher limits cannot be entirely taken away, but there should be a very strong presumption that the IMF would exceed these new limits only in a very small set of cases. If access norms for emerging economies are increased, exceptional should really mean exceptional. Lending above this higher access limit should be given only to countries that can repay on time and in full; the need to refinance exceptional access should be considered *prima facie* evidence of failure. The IMF managing director should be expected to personally testify that in his or her judgment, the crisis country will be in a position to repay in full after three years and should provide documentation supporting that assessment both to the IMF Board and the public.
- The IMF's policy framework should neither deny support to small countries just because they are small and have limited "systemic" importance nor assure that all large countries that are potentially "systemic" receive support. The potential to prevent a financial crisis from cascading through the domestic economy and generating catastrophic falls in output is sufficient to justify official intervention even in the absence of a high risk of contagion. Conversely, lending large amounts to a systemically important country that has unsustainable debts is a poor use of official resources—it is better to build a firewall around the crisis country. Larger countries are likely to receive the benefit of the doubt more often than small countries, but there should be "constructive ambiguity" about how much extra help a country's size will generate.

Don't Rely on the IMF to Save Countries That Are Too Strategically Important to Fail

If the G-7 countries want to let a country of particular political or strategic importance avoid the risks of a debt restructuring, even though its debt levels suggest it is not a good candidate for an IMF bailout, the G-7 countries—either individually or collectively—should provide the additional medium-term financing the country needs. The logic is simple: The IMF is a universal institution that needs to respond similarly to countries with similar financial problems. If the G-7 wants to give a politically important country a special break, it should do so on its own dime. The IMF would presumably continue to define the country's economic plan and

lend in smaller quantities. This limits the risk of the IMF's own lending capacity being tied down in long-term commitments to a few favored countries. The United States' recent willingness to provide an \$8.5 billion bilateral loan to Turkey is a good first step in this direction, even if it came only after the IMF exposed itself excessively.

Graphical Presentation of Our Proposed Approach to Crisis Resolution

We are not calling for a tiered, graduated response that moves slowly through the full range of options, first giving adjustment and moderate amounts of financing a chance, then moving to some form of voluntary maturity-extending restructuring supported by a bit more money, and then letting a country move to outright debt reduction without the benefit of official support or any plan negotiated with the IMF. That is what did not work in Argentina. We are calling for a greater willingness by the IMF and its major shareholders to challenge a country's exchange rate regime—even a currency board—when it is unsustainable, a greater willingness to decide from the get go that a debt restructuring is part of the solution, and a greater willingness to put money on the table to limit the risk of the restructuring triggering a broader collapse of confidence.

Figure 9.2 illustrates how we think our proposed framework would work and highlights where we think the application of this framework would have implied significant changes in the international community's response to crises. Our proposed framework starts with an assessment of where a country stands on a spectrum from solvent but potentially illiquid to totally insolvent. The country's position on this scale would define both the amount of IMF lending and the country's approach toward its private creditors. Access can be *normal* (100 percent of quota in a year/300 percent overall), *large* for the appropriate capital account crises (300/500 percent), or *exceptional* (greater than 500 percent). Private financing may be obtained by fully *voluntary or catalytic* means, by *semi-coercive* steps to bail in creditors, like a maturity-extending debt restructuring, or by *fully coercive* steps like outright default or debt reduction. This simplifies the presentation, though it also compresses a broader spectrum of options into three boxes.

The top part of this 3x3 matrix shows how past crises were actually addressed; the bottom part shows how we believe they should have been addressed. Argentina, Uruguay, and Turkey, in our view, should have received large, not exceptional, financial packages, and this financing should have been used to limit the risks associated with a coercive debt restructuring, not to avoid any debt restructuring (unless the G-7 stepped in with junior bilateral financing). If a country like Ecuador could develop a coherent approach to its crisis, in principle it could have received additional financing to soften the impact of its restructuring. Brazil in 2001–02 poses the most difficult case. Its debt levels put it outside the bounds of a typical liquidity case. But its flexible exchange rate regime and its

Figure 9.2 Matrix formulation of crisis resolution approach

a. Actual crisis resolution

		Private financing		
		Voluntary/soft (catalytic)	Debt rescheduling (semi-coercive)	Debt reduction (after default)
Official financing	Exceptional financing (>500 percent)	1 Mexico Turkey Brazil (1999) Brazil (2000) Argentina	2 Uruguay Korea	3
	Large financing for capital account crises (300/500 percent)	4	5 Thailand Indonesia	6 Russia
	Normal financing (100/300 percent)	7 Romania	8 Pakistan Ukraine	9 Ecuador

b. Proposed new framework

		Private financing		
		Voluntary/soft (catalytic)	Debt rescheduling (semi-coercive)	Debt reduction (after default)
Official financing	Exceptional financing (>500 percent)	1 Mexico Brazil (1999) ^a	2	3
	Large financing for capital account crises (300/500 percent)	4	5 Korea ^b Thailand Indonesia Brazil 2002 Turkey Uruguay	6 Russia Argentina Ecuador
	Normal financing (100/300 percent)	7 Romania	8 Pakistan Ukraine	9

- a. Allowance would be made for exceptional financing (i.e., above 500 percent) from bilateral junior loans in cases where a G-7 member considered the debtor to be strategically important.
- b. Korea could have been handled as a large financing case if it had had a more reasonable quota. Its program was exceptional in size only because the quota was so small.

record-running significant primary surplus may just be enough to make a case for large or even exceptional financing in the absence of a restructuring of the government's own debt. We would have buttressed IMF lending with a concerted attempt to bail in cross-border interbank creditors.

Can the IMF Act Differently Without Institutional Reform?

An obvious criticism of our proposals is that we want the IMF to act differently but are not proposing any institutional changes that would create incentives for the IMF to act differently. The IMF sometimes may get too close to some of its members, and it has an institutional bias as a credit cooperative against pushing one of its members to do something that it does not want to do. The G-7 countries, both individually and collectively, like to be seen as trying to help rather than hurt major emerging economies and geostrategic friends and allies: The biases of the IMF's largest shareholders may also be reflected in IMF lending decisions. To return to our initial analogy, it may be hard to change the IMF's software—its lending decisions—without changing its own institutional hardware—its governance structure. Our response to the “you cannot teach an old dog new tricks” argument is three-fold.

First, a lot of proposed institutional reforms would gum up IMF decision making without necessarily generating the desired results. For example, requiring a supermajority vote to approve large-scale financing would make it more difficult for the IMF to lend large sums to risky countries. But supermajority voting also would tend to create an institutional bias against making *any* difficult decisions. We want the IMF to be more willing to make a range of difficult decisions, including the decision to link the availability of IMF financing to a country's willingness to initiate a debt restructuring.

Second, reforms that would insulate the IMF from political pressures from the G-7—such as proposals to make the IMF's Executive Board more independent of the G-7—go in the wrong direction.³⁶ The world is not ready for a powerful independent supranational organization divorced from national political control. IMF programs are far too invasive and embody far too many judgments about the content of good economic policy to be left purely to the technocrats. The G-7 countries need to think more systematically about the role that they want the IMF to play in the world's financial system and need to take ownership of their decisions to support large IMF loans. The IMF is not going to be more willing than its major financial contributors to make hard calls.

Third, ideas do matter. Too often, IMF financial support and a debt restructuring are presented as diametrically opposed choices. If large

36. See, for example, the proposal for an “independent and accountable IMF” in De Gregorio et al. (1999).

amounts of IMF financing make sense, a debt restructuring does not. If a debt restructuring makes sense, large IMF financing does not. Believers in lender of last resort-style financing fear that an intermediate option—out-of-court restructuring—will take Mexican-style lender-of-last-resort financing entirely off the table. Proponents of payments suspensions and debt restructurings often believe these are attractive options precisely because they would reduce the distortions introduced by IMF lending. The notion that the IMF should take a more active role—including an active financial role—in guiding a country through a debt restructuring is one that encounters substantial resistance.

There is something counterintuitive about lending potentially significant sums of new money to countries that need to seek a debt restructuring, in part because the country may already have too much debt. We think it makes sense in some cases because a country is a lot more than just the sovereign. The government of the crisis country may be at high risk of insolvency and may need both long-term financing and serious adjustments to get itself out of a deep hole. But that does not necessarily mean that there are no liquidity needs elsewhere in the economy.

Conclusion

The selection of Rodrigo Rato as the new IMF managing director is sure to focus attention—at least briefly—on the IMF's health and the state of the international financial architecture. Such an examination is needed. The IMF has quietly taken on new roles in the resolution of crises, and it is time to ask which of these roles the IMF should, and should not, be performing.

As former IMF Chief Economist Michael Mussa has suggested—paraphrasing Watergate's Deep Throat—the way to find the core issues facing the IMF is “to follow the money.” A quick look at the IMF's balance sheet at the end of 2003—the \$28 billion outstanding loan to Brazil, the \$24 billion outstanding loan to Turkey, the \$15 billion loan to Argentina, and the \$10 billion loan to Indonesia—should leave little doubt that the IMF remains heavily invested in the business of providing emergency liquidity to increase the foreign exchange reserves of major emerging-market economies. Indonesia's outstanding debt to the IMF is evidence that not all large IMF loans will be repaid quickly, a lesson that Argentina is sure to reinforce. The debate over returning to the IMF's traditional lending limits was settled in practice when the Bush administration made its peace with large-scale lending in Argentina, Uruguay, Brazil, and Turkey and when the Europeans decided they wanted the IMF to lend to Brazil in the summer of 2002.

The IMF has the ability to lend quite significant quantities of money to all but the largest emerging economies, whether to help meet external

debt payments that the country cannot refinance in the market, to finance a budget deficit that can no longer be financed domestically, or to prevent a restructuring from triggering a run on the banks and the currency. The IMF is big enough to matter but not so big as to guarantee that a program it backs will be a success.

This makes it all the more important to develop a sensible policy for determining who gets access to the IMF's liquidity insurance. Such a policy needs to treat countries with different problems and different debt levels differently. Liquidity insurance that saves countries with little debt from the risk of a correctable policy error—like blowing reserves defending an exchange rate peg—forcing a costly restructuring that could result in an Argentine-style meltdown is one thing. Liquidity insurance that tries to save a country that borrowed too much, built up too much debt, and now must dig itself out of a deep hole from any restructuring is quite another.

It is unrealistic to think that protection from external litigation offers a true substitute for large IMF support packages or that a better process for restructuring sovereign bonds will allow the IMF to disengage from the sovereign debt restructuring process. Bond clauses—or even the full legal protection from a statutory bankruptcy regime—should not be expected to do more than make it easier for a sovereign to avoid holdouts. They won't suddenly make it possible for the official sector to say no to requests for help or transform the management of financial crises in emerging economies. The shift from long-term bank loans to long-term bonds has not caused the wave of financial distress many emerging economies have experienced over the past 10 years. Crises are every bit as much a product of the withdrawal of short-term bank claims, the speed with which international investors can move in and out of local markets, and the sudden shifts in local residents' willingness to hold local financial assets. Provisions allowing the amendment of a bond's financial terms won't stop a cross-border bank run or be of much help if a restructuring triggers a wild rush out of the local banks or the local currency. We like bond clauses, but they are no substitute for an active IMF role in the resolution of debt crises.

Predicting future crises can be a fool's errand. But it is not a stretch to say that the IMF is likely to be forced to confront more crises of domestic confidence. Domestic debt levels in many emerging economies—not just Brazil and Turkey—are already high and often on an upward trend, and in many countries, local banks and other domestic investors hold a large share of the country's "international" bonds. Growing domestic debts often imply larger annual financing needs, both to cover budget deficits and to refinance existing debts. At some point the domestic creditors of a major emerging economy may be unwilling to continue to provide their government the financing it needs at a price it can afford.

Our core recommendation is that the decision to lend large sums always be combined with another, equally important, decision: Should the IMF's

financial force be used to help a country avoid any debt restructuring or to support a debt restructuring? The logic of large packages and soft or no bail-ins when the problem is one of illiquidity versus comprehensive standstills and deep debt reduction when the problem is one of insolvency leaves many sensible options off the table. Some crises are too deep to qualify as pure liquidity cases but are not so severe as to justify a comprehensive standstill, immediate debt reduction, and all the associated economic disruption. There is room to use large IMF programs to complement a coercive debt restructuring. IMF financing can help to convince the country's other creditors and investors not to run even as the country goes about a restructuring, and the leverage that comes from provision of new money can be deployed to limit the risk of prolonged default. Even a country that gets into trouble because it has too much debt often needs more money—borrowed international reserves—along with better policies to help it get through its crisis.

Some believe that the new managing director should not focus on crisis resolution, particularly after the IMF's proposal for a new bankruptcy regime was shot down. Rather, they argue that Rato should focus on institutional reforms: increasing the representation of emerging economies at the IMF, increasing the amount of resources the IMF has available to lend, spinning off the IMF's "surveillance" from its crisis lending to strengthen crisis prevention, or even changing the IMF's own internal governance to reduce its major shareholders' influence over specific lending decisions. Many of these ideas are worth discussing, though a quest for political independence is unlikely to go further than did calls for a new international sovereign bankruptcy regime. The IMF needs to focus above all on what can and should be done to manage crises more effectively even in the absence of institutional change.

In a world where financial integration, volatile capital flows, and less than fully sound and credible economic policies make financial crises an ever-present risk, the core issue facing the IMF remains the resolution of balance-of-payments crises. Strong leadership at the top of the IMF is essential. The IMF should be accountable to its shareholders, but it should not hide behind them. Rather, it should use the persuasion power and the vast analytical tools of the institution to convince its shareholders on how best to respond to each crisis. It would help, though, if the G-7 countries that provide most of the IMF's funds were willing to go beyond the stale calls for the IMF to return to its traditional lending norms (calls forgotten in a crisis) and instead start to discuss the set of problems that they believe should—and should not—be addressed by large or even exceptionally large amounts of IMF lending. The IMF may need more financial resources in the medium term, but it needs even more urgently to decide how best to use its current resources. The IMF's existing lending capacity—along with the existing set of debt restructuring tools—offers substantial scope for creative policymaking.