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Bailing in the Private Sector

A particular concern of many critics of the existing international financial architecture is that official support has been used to bail out investors. In Mexico in 1995, South Korea in 1997, and Russia in 1998, official funds were used to repurchase and retire short-term debts. Having benefited from high interest rates while their money was in place, creditors were protected from losses when it came time to sell. The moral hazard thereby created provided an obvious incentive to engage in even less prudent lending, setting the stage for still larger crises and still larger bailouts. It would be better from a public-policy standpoint were international investors and banks in particular forced to ''take a hit.''

The Mexican crisis illustrates the problem. The Mexican government entered its crisis at the end of 1994 with some $28 billion of short-term government obligations indexed to foreign currency (*tesobonos*) about to mature but only $6 billion of international reserves. Once confidence was lost, no investor had an incentive to make available additional foreign exchange. Had international assistance not been provided, Mexico would have been forced to suspend redemption of these debts, risking significant damage to its creditworthiness. Instead, the government used its US and IMF loans to retire its *tesobonos* at full value as they matured.

In South Korea the mechanism was more complex but the result was the same. Foreign creditors who had extended short-term loans to South Korean banks attempted to withdraw their balances all at once. Those short-term credits far exceeded the government's international reserves. The Bank of Korea's reserves fell from $31 billion at end October 1997 to $21 billion at the end of December, with more than half of this latter amount immobilized as deposits with foreign branches of domestic banks (see IMF 1998a, box II.5). Figures vary for the short-term foreign-currency obligations of the South Korean financial sector, but one seemingly reliable estimate puts them at about $26 billion in December (Shin and Hahm 1998, table 1.7).[1] Had no official assistance arrived, the South Korean authorities would have been forced to declare a moratorium. Instead, the US- and IMF-led loan enabled the government to inject more credit into the banking system, deposit more reserves at overseas branches of South Korean banks, and keep interest rates lower than would have been possible otherwise, while maturing foreign credits were paid back in full. The result was to replace a significant share of those credits with official funds.[2]

The rationale for the South Korean package, in security circles at least, was that the Korean Peninsula is too important geopolitically for the South's economy to be left unaided. Similar arguments were made about Indonesia, which sits astride some of the world's most important ocean shipping lines. Russia being "Indonesia with nukes," the South Korean and Indonesian precedents gave investors confidence that Russia would receive similar assistance. This rhetoric may seem exaggerated, but the fact of the matter is that in the wake of the IMF's Asian support programs the international investors who poured money into Russia referred to positions in Russian GKOs (treasury bills) as the "moral-hazard play." There were sizable inflows into Russia in the months following the Asian rescue packages, followed by financial difficulties, a crisis, and a new IMF disbursement in the summer of 1998. As events transpired, the Russian government devalued and suspended service on most of its debts. But these actions came as a surprise to many investors, which is the point in the present context.

In practice, not all investors have been shielded from losses. In Mexico, *tesobono* prices tumbled before it became clear that the Mexican government would be able to retire them, and many investors who scrambled out of the market did so at a loss. In neither Mexico nor Asia did official support avert major declines in equity and real estate prices, and investors in these markets incurred extensive losses. None of this is to deny that existing arrangements for handling crises are deficient but to caution that

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1. South Korean financial institutions had foreign-currency denominated assets as well, because they were required to limit their open foreign-exchange positions. But because their loans were of longer maturity than their liabilities, there was still a liquidity problem that the central bank was in no position to address.

2. At that point, the number and exposure of the foreign bank creditors was reduced to the point where the South Korean authorities were able to negotiate a restructuring with their bank creditors, in which the latter agreed to a temporary delay in payments and then to the conversion of their short-term assets into longer-term instruments.

one should not exaggerate the extent to which investors have been shielded.

The real dilemma is that presented by bank creditors. Foreign funding of domestic banks in the form of deposits and deposit-like instruments is highly liquid. Deposits have a fixed face value. Banks being key to the stability of a country's payments and credit system, governments are reluctant to contemplate treatment of these claims that might threaten their provision. These facts make it extremely difficult to write down foreign claims on domestic banks. It would be nice if foreign bank creditors would agree to reschedule and write down their claims. But so long as they have the option of fleeing and bringing down the banking system in their wake, governments will contemplate this option only in extremes.[3]

The Need for Architectural Reform

If the tendency for official support to shield creditors from losses and to encourage imprudent investor behavior were not sufficient grounds for concern, there is also the question of whether international assistance as currently constituted can protect the recipients from serious damage. All too often, IMF-led rescues are ineffective in containing a panic because the Fund's resources are limited and doled out a drop at a time.[4] Because official support tends to be even less than meets the eye, countries receiving international assistance and trying to avoid a debt moratorium have to hike interest rates to both lure back foreign investors and satisfy the Fund.[5]

This raises the question of why governments are so willing to put their economies through the wringer. Why, in other words, do they hesitate to suspend payments and then negotiate with the creditors to restructure the debt? Doing so would certainly discourage imprudent lending. More important, governments could avoid putting their economies through

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3. Thus, the South Korean negotiations at the end of 1997 are often cited as examples of how international banks should be bailed in during crisis negotiations. Again, however, the fact of the matter is that so long as the South Korean government was reluctant to halt service on these and other external debts, the banks still had the option of exiting. The IMF, for its part, may have been reluctant to insist on haircuts for the banks for fear of inciting a rush out of other assets and other countries. In the end, the agreement reached with the government of South Korea did not impose significant capital losses on the banks, which only agreed to a delay of service payments and, eventually, to the conversion of their short-term claims into longer-term obligations.

4. In chapter 7, I argue that this is inevitably the case and that schemes to change the international financial architecture by creating a ''true international lender of last resort'' are not feasible.

5. The international community committed $57 billion to Korea, for example, but released only $13.2 billion by the time the crisis there reached its height. Radelet and Sachs (1998b, 66-67).

the wrenching deflationary consequences of the adjustment required for the maintenance of external debt service.

The option is shunned because governments, and the international policy community as well, regard the collateral damage as too severe. Countries that suspend payments and attempt to restructure find it difficult and costly to reach an agreement with their creditors. Their reputations are damaged. They find it harder to borrow subsequently. In addition, there is the fear, well-founded or not, that a standstill or moratorium will unleash contagion to other countries and threaten the stability of the international system. However expedient the short-run policy, most governments and the IMF regard the long-term consequences as unsupportable.[6]

Thus, bailing in the private sector—ensuring that private investors take a hit—presupposes changes in institutional and contractual arrangements that make it palatable for governments to declare a moratorium and restructure their debts. It requires changes in the international financial architecture.

It is important to emphasize that there is unlikely to be a simple solution to this problem. A moratorium on repayment *should* be unattractive; otherwise, the sanctity of loan contracts would be jeopardized. Contracts and institutional arrangements are structured to make the suspension of debt service painful precisely in order to keep borrowers from walking away from their debts.[7] And there are good reasons why the IMF cannot be transformed into an international bankruptcy court with the power to cram down settlement terms.

Moreover, getting the banks to contribute new money to packages for crisis countries, or even to roll over maturing credits, is easier said than

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6. There are exceptions to the rule—in other words, governments that have overcome this reluctance to suspend payments and restructure: Mexico in 1982, South Africa in 1985, Brazil in 1987, Venezuela in 1988, and Russia in 1998. Several distinctive aspects of the Russian situation help to explain why it is the most recent addition to this list of exceptions. For one, the fact that Russia, unlike say Mexico and South Korea, did not show the resolve necessary to rein in its budget deficit suggested that providing official funds to retire the existing short-term debt would not solve the problem, because additional debt would soon have to be issued; thus, international support was halted. For another, the Russian government's failure to make headway on its fiscal problems suggested that capital-market access was in any case unlikely to be maintained, which eliminated the most important incentive to continue payments. Be that as it may, the aftermath of the Russian government's action, including a full-fledged depositor panic, capital flight, and the suspension of foreign-exchange trading, hardly reassures those worried that a government's unilateral suspension of payments could damage its creditworthiness and demoralize the markets.

7. By strengthening the ''bonding'' role of debt, this then reduces the cost of borrowing and encourages financial transactions. Without penalties for default, in other words, the credit market will not function. Lenders will not lend, and borrowers will not be able to borrow. This point is powerfully made in the international context by Bulow and Rogoff (1989).

done. There has been much glib talk about how the banks should somehow be compelled or required to contribute, without corresponding hard thought about how exactly this might be done. Banks extend short-maturity loans for good reasons, namely because they value the security and liquidity that short-term lending entails. While one can ask them to extend longer-term, less-liquid loans, absent other changes in policy and market conditions, they are unlikely to provide a compliant answer. One can ask them to contribute additional credit lines to supplement official resources, but, as in Brazil at the end of 1998, they will have an irresistible incentive to hold off and see how things develop. One can ask them to roll over their maturing loans, as in South Korea at the end of 1997, but even this is likely to succeed only when conditions are right—that is, when only a handful of creditors are involved, when there is essentially only one debtor with whom to negotiate (in South Korea, the government, which had already moved to guarantee the banks' foreign debts), and when there is a newly elected president with a reformist mandate. All these are reasons for questioning whether what was successfully done in South Korea can be done again.

Notwithstanding the difficulty of the problem, limited steps can be taken to more effectively bail in the private sector—to see that private investors do not get off scot-free. These fall under two headings: ex ante measures to be taken before the crisis, and ex post measures to influence how it plays out.

Ex Ante Measures

Two classes of measures can be considered under this heading: measures to discourage bank-to-bank lending and the extension of standby lines of credit. The first is likely to be more effective than the second.

Discouraging Short-Term Borrowing

The most direct way to avoid letting foreign creditors off scot-free is to not borrow from them in the first place. This is not meant sarcastically. Short-term inflows, and the short-term inflows into the banking system in particular, pose a special problem because they are so liquid, allowing those extending them to scramble for the exits. They pose a special problem because the institutions dependent on them are central to financial stability. The need to preserve the stability of the banking system thus makes it hard to impose on its creditors a share of the adjustment burden. This provides an argument for discouraging excessive reliance on short-term foreign credits to the banking system in the first place. It is an argument for raising the Basle risk weights for foreign bank lending and for keying those weights to the source of banks' funding as well as the riskiness of their investments. In markets where political pressure prevents capital from being written down, it is an argument for taxes or quantitative ceilings on short-term foreign funding. Where nonfinancial firms can do the borrowing and pass the proceeds on to financial intermediaries, it is an argument for using measures such as those employed by Chile, whose government, while applying a tax to all capital inflows, structured it so that it falls most heavily on short-term inflows. If administered successfully, such measures would increase foreign portfolio investors' reliance on stocks, bonds, and other long-term instruments, on which they would automatically suffer losses in the event of a financial crisis.[8]

Negotiating Standby Lines of Credit

A second approach would be for governments to negotiate standby lines of credit with commercial banks. Foreign banks would agree to make these credit lines available in return for a commitment fee. Because foreign bank creditors would no longer be able to eliminate their exposure to the country in question, proponents of this approach argue, they would be predisposed to negotiate a restructuring plan. In addition, from the standpoint of the borrowing countries, these credit lines would provide additional resources to insure against shocks to investor confidence. Both Argentina and Mexico have negotiated facilities with international banks that omit the no-adverse-material-change clause that typically permits commercial banks to back out of an agreement in the event of a crisis.[9] They have succeeded in doing so despite the fact that neither country enjoys an investment-grade sovereign credit rating. Their success in doing so suggests that at least some other countries could do the same.

The main weakness of these arrangements is that the banks will be able to hedge their exposures. At the same time they provide additional credits, they can draw down their other exposure to the country or sell short government bills and bonds. Taken to an extreme, this ''dynamic-hedging'' argument suggests the country will have no additional financial resources for propping up its banking system and coping with the other consequences of a crisis.

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8. The first three words of this last sentence are an important caveat, one that is addressed in the final part of chapter 4.

9. The Argentine facility is illustrative. Its contingent repurchase facility with 13 commercial banks provides for $7 billion in standby credits (the equivalent of about 10 percent of bank deposits), while Mexico's arrangement with 31 banks provides for $2.5 billion. Under the provisions of the former, the Argentine Central Bank can swap Argentine government securities for US dollars up to the specified ceiling, at an effective interest rate of LIBOR plus 205 basis points. The commitment fee is 33 basis points. Loan length is two to five years, depending on the commercial bank involved.

Recent evidence casts at least some doubt on the extreme version of the story. Mexico drew on its contingent credit line in September 1998 when it was about to expire and it became evident that the banks were reluctant to renew it. One is led to ask why, if dynamic hedging is so easy and efficient, the banks were so reluctant to renew their credit lines. The answer must be that there are costs of dynamic hedging, in response to which the banks anticipated being able to hedge their exposures less than fully. But the other side of the same coin is that the banks, finding it difficult or costly to hedge their exposure, will be reluctant to extend standby lines of credit to countries with a serious prospect of drawing on them.

Thus, while commercial credit lines are not a bad idea, they are likely to be available only to a select few countries with relatively strong policies, and the amount of money they actually make available may be less than meets the eye. For both reasons, then, the burden will necessarily fall on ex post measures.

Ex Post Measures

The most important changes that can be made to bail in the private sector after the fact are the incorporation of new clauses into loan contracts. This section considers the cases of bonds and bank loans in turn. It then discusses IMF lending into arrears and the establishment of standing committees of creditors.

New Provisions in Loan Contracts

International banks account for so much lending to emerging markets because they have well-developed capacities to gather information about foreign borrowers and have developed long-term relationships with their clients, which provide leverage when it comes time to collect on loans.[10] That said, changes in technology and market organization suggest that securitized instruments (bonds and derivative instruments based upon them) will account for a growing fraction of international lending over time. Improvements in information and communications technologies tend to undermine the informational advantage of banks. Advances in financial technology enable individual investors to unbundle and hedge credit and currency risks. Securitization has made considerable strides in the advanced industrial countries, where observers regularly speak of the

10. Some observers would add that because banks are critical to financial stability, they can count on the support of the United States and other creditor-country governments in the event of debt-servicing difficulties.

shrinking market for banking services. Even if they have not already, one can uncontroversially predict that bonds will account for a growing share of portfolio investments in emerging markets in years to come.

This technological revolution encouraging international lending to flow through bond markets rather than banks is surely a good thing on balance. Insofar as it reflects improvements in the information environment that render the market less dependent on banks as vehicles for surmounting informational obstacles, it implies a more efficient allocation of resources. And insofar as emerging-market debt becomes less concentrated in the hands of the major money-center banks, it leaves the latter less crisis prone.

But like many good things, the securitization of emerging-market debt does not come without costs. Securitization means a significant increase in the number of creditors, small creditors in particular, aggravating collective-action problems.[11] Restructuring a sovereign bond issued in the United States (or under the legal provisions that govern bonds issued in that country) typically requires the unanimous consent of the bondholders, which can be a formidable hurdle. No bondholder can be forced to agree to new terms by other bondholders, and each bondholder can sue the issuer. A successful lawsuit could trigger cross-default clauses in the country's other external instruments, in turn activating acceleration clauses requiring that debt to be immediately repaid. Unlike syndicated bank loans, bonds lack sharing clauses that require individual creditors to share any amounts recovered with other bondholders and thereby discouraging recourse to lawsuits. There are no counterparts to the central banks and regulators that used their powers of moral suasion to encourage cooperative behavior by the members of commercial bank syndicates in the 1980s.[12] Neither do sovereign issuers have recourse to a bankruptcy filing, under which they would be protected from the threat of lawsuits and in the context of which terms could be imposed on minority creditors.

Agreement being difficult to reach, issuers are understandably reluctant to contemplate restructuring. And in the event they do, ''vultures'' (offshore hedge funds or large individual investors) then have an incentive to purchase bonds from less patient investors and to threaten lawsuits against the debtor. Wishing to avoid expensive and embarrassing litiga-

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11. Stein's (1989) finding that bank creditors are more likely than bondholders to support corporate debt workouts negotiated in the shadow of the court is consistent with this implication. Miller and Zhang (1997) provide some theoretical and numerical evidence designed to show that this is precisely the consequence of the switch from bank to bond finance.

12. To be sure, a nonnegligible fraction of foreign bonds are held by commercial banks. And pension funds, mutual funds, and insurance companies are also subject to regulatory oversight, if not always with the same intensity as banks. But institutional investors as a group hold only a fraction of the bonds outstanding, in contrast to the earlier situation with syndicated bank loans, rendering moral suasion less effective.

tion, the debtor may then feel compelled to buy them out at full price. Taken to the extreme, this suggests that maverick creditors will buy up all the defaulted debt and litigate to prevent sovereign issuers from settling for less than 100 cents on the dollar. Restructuring that involves writing down principal and interest will then be impossible.

One need not subscribe to this extreme version of the argument to see that the provisions governing the issuance of sovereign bonds greatly complicate renegotiation and restructuring.[13] It is hardly a mystery that under present arrangements, governments are reluctant to go this route.

Fortunately, a solution is at hand, having been suggested in 1996 by the G-10 in its report, *Resolving Sovereign Liquidity Crises*, and having been echoed in recent G-22 and G-7 declarations.[14] Nearly three years ago, G-10 deputies recommended making it easier to undertake negotiations by altering the provisions of loan contracts to include majority-voting, sharing, and nonacceleration clauses.[15] This would discourage maverick investors from resorting to lawsuits and other ways of obstructing settlements beneficial to the debtor and the vast majority of creditors. To their recommendations one might add the idea of minimum thresholds for creditor lawsuits, requiring that a certain minimum percentage of creditors, say 10 or 25 percent, would be required for legal action to be taken against the creditor.[16] The addition of such clauses to bond contracts is the only practical way of creating an environment conducive to flexible restructuring negotiations. It is infinitely more realistic than advocating some kind of supranational bankruptcy court empowered to cram down settlement terms.

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13. Evidence against the extreme view can be drawn from four recent cases where countries succeeded in restructuring their sovereign bonds through unilateral exchange offers: Costa Rica in 1985, Nigeria in 1988, Guatemala in 1989, and Panama in 1993. In all these cases, the vast majority of bondholders, typically more than 90 percent, exchanged their old debt obligations for new ones rather than selling out to vultures (Pinon-Farah 1996). It can be questioned whether these cases are representative, however, since the terms of the exchange implied little reduction of interest or principal, only a grace period, longer maturities, and unbunching of payments.

14. These documents are G-10 (1996), G-22 (1998c), and G-7 (1998), respectively.

15. In the case of most international bonds, 10 to 25 percent of the bondholders (more precisely, those holding 10 to 25 percent of the principal) can vote to require immediate repayment of all principal and interest due in the event of default. In contrast, syndicated bank loans typically require 50 percent of creditors to vote for acceleration. This therefore raises the danger that even when a majority of bondholders prefer an orderly workout that will maximize the value of their claims, an impatient minority can trigger the clause requiring immediate repayment. The debtor would then have to reschedule not only interest payments and amounts due to be paid into a sinking fund but all principal as well.

16. Note the parallel with the minimum percentages that already exist for activating acceleration clauses.

A further advantage of these changes is that they would make it easier for governments to obtain forbearance from their creditors before the fact—to get them to roll over maturing loans instead of forcing a disruptive default. Under present circumstances, if a government seeks to induce foreign bondholders to convert their maturing securities into longer-term bonds by halting (or modifying) repayment of the old obligations, it runs the risk of investor lawsuits. This is the problem with the strategy attempted by the IMF to bail in private investors in Ukraine, where it told the government that it would violate a condition of its Fund program if it repaid investors in a maturing bond issue. Although some three-quarters of bondholders reportedly agreed to convert their maturing bonds into longer-term eurobonds, a minority threatened lawsuits capable of triggering cross-default and acceleration clauses. New contractual provisions would ameliorate this problem.

Some object that such provisions, by making it easier for developing countries to wriggle out of debt contracts, would increase borrowing costs (Institute of International Finance 1996). For those who believe that moral hazard and other market imperfections cause governments to rely excessively on foreign borrowing, this is not undesirable. In practice, however, there are grounds to question whether borrowing costs will in fact rise.[17] Majority voting, sharing, and nonacceleration may make it easier to renegotiate defaulted debts, but if this permits a long deadlock to be avoided and renders the majority of investors better off, there is no reason why they should shun bonds with these features. Small bondholders, who lack the resources to sue, would be rendered better off if such clauses averted a long period when interest was not paid and bond prices were depressed while the government and maverick creditors fought their war of attrition. Institutional investors might be better off if in the absence of this market-based solution they came under pressure from their governments to cut a deal.

It is important to understand that the normal presumption that ''if we see it, it must be optimal'' is questionable in the present context. Those who argue that the prohibition on majority voting to restructure the terms of a loan is the market's way of strengthening the bonding role of debt are ignorant of the measure's history. The law was introduced not by a market-driven process but by individuals deeply suspicious of the market. William O. Douglas championed it in the wake of the debt defaults of the early 1930s as one of a number of laws to protect small investors from

17. At this point, there is little evidence of whether or not this is the case. While the Hong Kong Airport Authority is frequently invoked as an example of a borrower that has issued bonds with these provisions without obviously elevating its borrowing costs, it is not a fully sovereign entity, rendering it a special case. A more systematic analysis of the pricing of bonds issued under the UK and US models (with and without the relevant provisions) is clearly called for.

victimization by securities houses. This peculiar history underscores that there is no necessary reason to retain these archaic measures. So does the fact that bonds issued under the provisions of the laws of the United Kingdom, a country lacking this one's populist tradition, have provisions more friendly to renegotiation. There, bondholders are represented by a trustee and cannot sue individually.[18] British bonds also provide for the binding of all bondholders by a majority vote at a bondholders meeting.

According to the G-10's 1996 report, new provisions can be introduced into debt instruments through a ''market-led process.'' Governments are to trumpet the virtues of new clauses but to otherwise take no action. They are to hope that the markets would see the light.

But if changes in contracts were so easily adopted, the markets would have done so already. That no progress has in fact occurred suggests that there are significant obstacles to market-driven reform. One is the adverse signaling effect. If only some issuers include qualified-majority-voting clauses in their loan agreements, creditors may suspect that those debtors anticipate having to restructure in the not-too-distant future. The clause will be regarded as a negative signal that the borrower is less than fully committed to servicing the loan, much like a bridegroom's request for a prenuptial agreement. As Mark Roe emphasizes, this can allow inefficient arrangements, put in place for historical reasons long past, to become locked in.[19]

The G-10 report, perhaps in a desire to look market friendly, said little about this dilemma. At one point it acknowledged the first-mover problem and suggested that official support for contractual innovation should be provided ''as appropriate,'' but it failed to elaborate. The G-22 and G-7 reports reluctantly acknowledge this fact but again fail to commit to specific action. The G-22 recommends that unnamed governments, but presumably those of the United States and the other major creditor countries, ''examine'' the use of such clauses in their own sovereign bond issues. The G-7 recommends that its members ''consider'' them. They need to do more than examine and consider. Without the introduction of actual legislation and regulations in the creditor countries, progress on this front is unlikely.

One way of pushing it ahead would be for the IMF to urge its members to add majority-voting, sharing, nonacceleration, minimum-legal-threshold, and collective-representation clauses (where these last provisions make provision for an indenture trustee to represent and coordinate the bondholders) to all international bonds as a condition for their being admitted to domestic markets. It should provide an incentive for countries

18. Although a specified minority holding a fifth to a quarter of principal can require the trustee to do so on their behalf.

19. This path-dependence argument is a theme of Roe (1987).

to do so by indicating that it is prepared to lend at more attractive interest rates to countries that issue debt securities featuring these provisions. US and UK regulators, for their part, could make the admission of international bonds to their markets a function of whether those bonds contain the relevant sharing, majority-voting, minimum-legal-threshold, and collective-representation provisions.

To be sure, this is no panacea. Private placements would not be affected. New provisions could be added to existing loans only through a voluntary exchange of old bonds for new ones. Not only might some bondholders resist, but any one country that attempted to be the first to carry out the exchange might be seen as signaling that it was contemplating imminent default and precipitate a crisis.

All this means the incorporation of sharing, majority-voting, nonacceleration, and minimum-legal-threshold provisions into bond covenants will be slow. But slow progress is better than no progress.

New Provisions for Bank Credits

Short-term credits extended by one bank to another are a more difficult case. Because interbank loans are not governed by formal contracts, renegotiation cannot be eased by altering contractual provisions. Some commentators have suggested that this can be gotten around if countries adopt laws limiting the terms and conditions under which short-term loans to their banks can be repatriated. Robert Litan and his coauthors urge countries to enact legislation imposing an automatic reduction of the principal of all foreign-currency loans extended to banks in their countries that are not rolled over in the event of a crisis (see Litan et al. 1998). Foreign creditors could get still out, but only at a loss. The prospect of that loss would strengthen their incentive to stick around, to address their collective-action problem, and to restructure the debt.

If this legislation is only passed when the crisis strikes, such initiatives have no advantage vis-à-vis current arrangements. Nothing now prevents countries from freezing or writing down foreign loans to their banks, as Russia did. In any case, governments' own behavior suggests that they fear that freezing bank claims would provoke flight out of other assets by foreign and domestic investors, forcing the imposition of across-the-board exchange controls.[20] They regard this as too damaging to their reputations for financial probity and to their countries' ability to borrow.

If the idea is that such legislation should be adopted in advance of a crisis, then the measure is likely to be much more demoralizing to lenders

20. Indeed, the Russian action freezing foreign credits on 17 August 1998 dried up all credit to the Russian financial system, provoked widespread capital flight, and forced the government to halt all foreign-exchange trading several times in the final week of August.

than the addition of majority-voting clauses to bond covenants. If new clauses are added to bond covenants, the decision to halt interest payments will still be in the hands of the individual corporate, financial, or governmental borrower. The write-down of principal will be determined on a case-by-case basis in negotiations between the debtor and its creditors. In contrast, the obligatory haircut for foreign bank creditors would apply across the board. Foreign creditors would be especially alarmed if, as is likely, the circumstances under which the new law was triggered were left to the government's discretion. If the trigger were the announcement of an IMF program, on the other hand, the merest hint that a government was exploring the possibility of obtaining help from the Fund would provoke flight by its foreign bank creditors, precisely the outcome that the measure was intended to avert. More generally, foreign bank creditors worried about a mandatory haircut will be tempted to flee at the first sign of trouble. Once the provision is triggered, of course, they will have an incentive to stay in, but imagine their incentive to get out before the trigger is pulled. This perverse effect has the potential to transform small crises into big ones. Then there is the familiar "after you, Alphonse" problem: no country will want to be first to pass such legislation for fear of signaling that it is worried about an impending crisis. Finally, foreign banks are likely to respond to the measure by channeling their lending through the offshore branches of the debtor's banks. Creditors would then dispute the applicability of the developing-country law and appeal to their own courts in the effort to attach the assets of those offshore branches.

For all these reasons, the best way of dealing with the special problem created by short-term bank-to-bank lending is to discourage excessive reliance on this form of funding in the first place.

IMF Lending into Arrears

IMF policy through most of the 1980s was to lend to countries that had fallen into arrears on their external debts only after they had reached an agreement in principle with their creditors. The notion was that the Fund should provide assistance only if the banks contributed to burden sharing by at least clearing away the country's arrears.[21] Eventually, however, experience with the debt crisis raised doubts about this approach. The banks, their balance sheets strengthening as they drew down their Latin American exposure, hardened their positions. Rather than the policy providing the IMF with a lever to encourage burden sharing by the banks, the banks realized that they could use it as a club in their battle with governments. If countries refused to settle on favorable terms, the banks

21. The traditional IMF position on lending into arrears was stated in an Executive Board decision in 1970 (see Cline 1996).

could veto new IMF money in addition to denying their own, a fact that the banks learned to use to their advantage.

In the late 1980s, in a departure from past practice, the IMF therefore contributed to the pool of money used to retire nonperforming bank debts and replace them with Brady bonds. Since 1989 the Fund has had a de facto policy of providing support for a member's adjustment effort after the emergence of arrears but before an agreement had been reached between the debtor and its creditors, so long as the country in question was engaged in good-faith negotiations and making a serious effort to adjust. In more than three dozen instances the IMF has lent in support of adjustment programs before a member has cleared away its arrears to commercial banks. Lending into arrears can provide working capital for an economy that is making an adjustment effort and—analogous to the debtor-in-possession financing provided under US corporate bankruptcy procedures—avert unnecessary damage to its economy. Insofar as collective-action problems, exacerbated by rules requiring the unanimous assent of creditors to the terms of any restructuring plan, render negotiations between governments and their creditors excessively protracted, IMF support to a country in arrears can help to bring creditors to the bargaining table.[22] Insofar as sovereign debtors and the international community generally see the temporary suspension of payments, followed by negotiations to restructure, as too difficult and costly to pursue, it may then be desirable for the IMF to tip the balance in this way, opening up debtor-creditor negotiations as a viable alternative to regular IMF rescues.

The G-10's 1996 report acknowledged that lending into arrears was a way for the IMF to expedite restructuring and asked the Fund to consider extending the policy from commercial bank loans to bonded debts (G-10 1996).[23] The IMF's Executive Board subsequently agreed that it will consider doing so ''under carefully designed conditions and on a case-by-case basis,'' so long as that lending was essential to the member's adjustment program and it was making a good-faith effort to negotiate a settlement

22. Goldstein (1996) argues that the Fund's lending into arrears was critical for driving commercial bank creditors to the negotiating table in the late 1980s and finally clearing away the Latin American debt crisis.

23. Spokesmen for the creditors responded that lending into arrears may have been appropriate in the 1980s, when the existence of a generalized debt crisis justified the provision of public-sector enhancements to support debt reduction arrangements, but that it is not warranted in ''normalized'' capital-market conditions (Institute of International Finance 1996). Recent experience casts doubt on this contention on two grounds: first, even normalized conditions can quickly become abnormal; and second, even if debt problems are limited in geographical scope, the provision of the equivalent of debtor-in-possession financing by the IMF may be important for preventing the kind of complete economic breakdown that can set the stage for the contagious spread of the crisis and can help to expedite a negotiated agreement to restructure.

(Camdessus 1998a).[24] And the G-7 now has urged the Fund "to move ahead, under carefully designed conditions and on a case by case basis" (notice the pattern), in implementing the policy (G-7 1998, 4).

Its feasibility has yet to be established. In particular, there is the risk that creditors might sue in an effort to attach the proceeds of the loan. While private debtors can seek shelter from a lawsuit in the bankruptcy court, sovereign debtors have no such recourse. If the creditors are commercial banks, they will be subject to moral suasion by their central banks and regulators and are unlikely to seek to attach IMF assets in this way.[25] But if they are bondholders, as will increasingly become the case as securitization proceeds, the danger is greater. The fear if not yet the reality of lawsuits is real.

Perhaps IMF balances could be transferred from the Fund's accounts to the central bank in question and the courts would recognize the central bank as a legally separate entity from the government and therefore not deem it responsible for the latter's debts.[26] Perhaps attempts to attach loan proceeds before the Fund has disbursed them would be rejected by the courts on the grounds that Article IX.8(I) of its Articles of Agreement makes the IMF immune from legal process.[27] Perhaps the courts could be swayed by a brief filed by a creditor-country government arguing against attaching IMF resources. Perhaps the creditors, knowing that they would have to do battle with the US government and the IMF, would be reluctant to throw down the gauntlet.[28]

That said, what will happen is uncertain. This has prompted discussions of whether Article VIII.2(b) of the Fund's Articles of Agreement should be amended to give official status to a country's standstill of payments and to shelter its government and any IMF resources lent into arrears from legal action. Article VIII.2(b) allows countries to apply exchange controls in response to balance of payments problems without violating

24. See also the comments of IMF Managing Director Michel Camdessus at his joint press conference with Philippe Maystadt, chairman of the Interim Committee, at IMF Headquarters, 16 April 1998, http://www.imf.org/external/np/tr/1998/TR980416.htm.

25. During the debt crisis of the 1980s, when the principal creditors were international banks, lawsuits were consequently rare (except for precautionary suits filed to protect against expiration of the statute of limitations). However, when Argentina defaulted on some of its bonds in 1986, three bondholders sued successfully in US courts. And when Panama defaulted in 1987, at least one bondholder pressed a lawsuit.

26. When it is not waived, central bank reserves enjoy sovereign immunity in the major financial centers, notably the United States and the United Kingdom.

27. In addition, the Fund's articles require it to deal with members only through their treasuries, central banks, and fiscal authorities. Thus, it could argue that it cannot deal directly with a court-appointed receiver or with the creditors' fiscal agent.

28. That there have been no attempts to date to attach Fund disbursements is consistent with this view.

their obligations to the IMF. That article would have to be given an authoritative reinterpretation by the Fund's executive directors or more likely be amended with the consent of countries commanding 80 percent of the Fund's voting power for it to give sanction to a standstill on external debt as opposed to the imposition of exchange controls.

It is unlikely that the requisite majority would agree to vest such powers in the hands of an international organization. Not only would market participants oppose empowering the Fund to interfere so extensively with private debt contracts, but the Fund would not be seen as possessing the impartiality and detachment of a bankruptcy judge. Among other things, it might have made loans to the country itself. Clearly, any proposal to amend Article VIII.2(b) to empower the Fund to declare a standstill would be rejected as soon as it was considered on Capitol Hill.

Fortunately, there exist alternatives. One is a limited amendment to the Fund's Articles of Agreement in which its members agree to give immunity in their national courts to the Fund's own disbursements and transactions. This could be done by each IMF member country in a manner consistent with national legal traditions and precedents without requiring domestic prerogatives to be ceded to an international entity. Another would be for countries to amend their own sovereign immunities laws to allow their courts to stay attempts to attach sovereign assets (Hurlock 1995). In the United States and United Kingdom, creditors are already prevented from attaching certain sovereign assets even when the sovereign has waived its immunity, as is commonly the practice when governments float international bonds. It would be desirable for these countries to clarify these provisions and for other countries to emulate them.

Standing Committees of Creditors

A final change in the international architecture to bail in the private sector would be to create standing committees of creditors. Restructuring negotiations are most difficult and protracted when information is least complete. Where the preferences and capacities of all parties are common information, agreement should be immediate.[29] The more asymmetric the information environment, the more likely are debtors and creditors to fight a lengthy war of attrition. Establishing a standing committee of representatives of the various classes of creditors—bondholders, banks, hedge funds, and the like—would open lines of communication and help to overcome information problems.

29. This is a basic premise of bankruptcy theory: in a world of complete information and absent transactions costs, there is no need for a bankruptcy code or bankruptcy court, because debtors and creditors will be able to instantaneously adjust their contracts to any unanticipated contingencies.

A standing creditors' committee would thus reduce transactions costs in times of crisis. When a crisis erupts and debt service is halted, negotiations cannot proceed until the creditors have been identified, which is time-consuming when the process starts from scratch. The existence of a representative committee in continuous contact with its constituents would ease this difficulty. Next, the debtor must decide with whom to negotiate—that is, who speaks for the creditors? The existence of a standing committee would provide the answer to this question in advance. Finally, there is the need to gain the assent of a majority of creditors to the restructuring plan and to buy out those who refuse. The existence of a standing committee on which various classes of creditors interact would create peer pressure for agreement and facilitate the extension of any required side payments. This last point is important: these committees would offer only nonbinding recommendations to the bondholders, who would then have the right to accept them or reject them. They would play much the same role as bank advisory committees in the syndicated-bank debt crisis of the 1980s.

The difficulties created by the absence of these committees are apparent in recent experience. In South Korea, for example, the problem in the last week of 1997 was to get the banks to roll over their maturing short-term loans, to accept a delay in interest payments, and to agree to the principle of converting those short-term credits into long-term loans. The South Korean government and the banks reached that agreement by the skin of their teeth. With the help of Bill Rhodes's Rolodex, the relevant bankers were located, pulled from their Christmas dinners, and thrust into negotiations.[30] The existence of a committee infrastructure would have considerably eased the process. Russia's experience in August 1998 following its suspension of payments similarly illustrates the confusion that can arise when there exists no committee of creditors (Reuters 1998). First, the Russian authorities met with a small group of Russian and foreign banks to discuss the formation of a creditors' committee. Next, it was decided that the committee would be formed only after the authorities had somehow managed to draw up a full list of creditors. Finally, there were disagreements over the composition of the creditors' club, with hedge funds complaining that they had been denied a seat at the bargaining table.

To be sure, these arrangements will grow more complex with the shift from bank to bond finance. That shift will increase the number of interested parties and vest additional power in the hands of a class of creditors less susceptible to moral suasion by their central banks. But it will erode the effectiveness of Rhodes's Rolodex even more dramatically. Standing committees will become essential.

30. Or so the situation is described by Lee (1998). Rhodes is the vice chairman of Citibank and a veteran of the debt crisis of the 1980s.

One sometimes hears the objection that experience with corporate debt workouts suggests that committees of creditors can be quickly constituted when the time comes. The Institute of International Finance cites the case of AeroMexico as an example of how negotiations can be concluded swiftly in the absence of a bondholders' committee (Institute of International Finance 1996). In fact, the situation for corporate bonds is different from that affecting sovereign debts. Most corporate bonds are issued in the United States through an indenture trustee. The indenture trustee is responsible for acting as a communications center to coordinate the bondholders. It must communicate with the bondholders and follow the instructions given by a majority. The trustee is the bondholders' representative in negotiations with the debtor and the court. However, the Trust Indenture Act of 1939 exempts securities issued by foreign governments, their subdivisions, and municipalities. Sovereign bonds are typically issued through a fiscal agent rather than an indenture trustee. The fiscal agent has a much more limited role, and its obligations are mainly to the issuer, not the bondholders. Its responsibilities do not extend to acting as a communications center or attempting to coordinate the bondholders (Macmillan 1997, 9-10).

History supports the argument: standing committees were precisely the channel for disseminating information and organizing negotiations when bond finance was last important, from the late nineteenth century through World War II (Eichengreen and Portes 1989). At first, ad hoc bondholders' committees were formed in response to each interruption in debt service payments. Predictably, these committees had trouble establishing contact with the bondholders and opening lines of communication with foreign debtors. In Great Britain, the leading national creditor of the era, the situation was regularized in 1868 by the creation of the Corporation of Foreign Bondholders. Composed initially of representatives of banking firms and brokerage houses, its governing body, the Council, was expanded in 1898 to include several individual bondholders and a representative of the London Chamber of Commerce. The Council became the recognized spokesman for the bondholders and their representative in negotiations, working closely with the underwriting banks and the London Stock Exchange. The same evolution occurred elsewhere with the establishment of standing bondholders committees in Paris, Amsterdam, and Berlin before World War I and in the United States in the 1930s. These committees fell into disuse after World War II because the international capital market was slow to recover from the debt crisis of the 1930s and then because bond finance was superseded by syndicated bank loans. Now, however, bonds are back, and the creditors are more numerous and heterogeneous than when international lending was the domain of bank syndicates.

The idea of creditors' committees was resuscitated in the wake of the Mexican crisis by Rory Macmillan and by Richard Portes and myself

(Macmillan 1995; Eichengreen and Portes 1995). Macmillan suggests the creation of two such committees, a resurrected Foreign Bondholders Protective Council to represent and coordinate the holders of government bonds issued under New York law and submitting to New York courts and a resurrected Corporation of Foreign Bondholders to represent and coordinate holders of government bonds issued under English law. Because the vast majority of bonds are subject to either New York or English courts and law, two councils would go a long way toward solving the problem. When problems arose with the debts of a particular country and negotiations had to be commenced, these committees, working separately or jointly, would be in a position to appoint a subcommittee to undertake the task.

To date, however, the investor community has been reluctant to act. It fears that standing committees would make it too easy for debtors to initiate restructuring negotiations, making it too tempting for them to suspend debt payments. It is better, in the self-interested view of the creditors, for there to be no one at the other end of the line to pick up the phone.

The interests of the international policy community are different. For those seeking to create a viable alternative to large-scale bailouts of crisis countries and for whom the difficulties of debtor-creditor negotiations render moratoriums and restructuring unacceptably difficult and painful, standing committees are desirable precisely because they make it easier for debtors to initiate negotiations. Their formation is important for creating a viable alternative to ever-more-costly bailouts and disastrous Russian-style defaults, neither of which is acceptable.

The creation of such committees would require moral suasion and lobbying by G-7 governments, central banks, and the IMF to overcome the markets' reluctance. There would be nothing unprecedented about their involvement. The Corporation of Foreign Bondholders received a parliamentary charter and other forms of official support. Its US equivalent, the Foreign Bondholders Protective Council, was formed with the encouragement and support of the US State Department (Eichengreen and Portes 1989). These are precedents that should be followed.

Some have suggested that such a committee, possibly with rotating membership, could also interface with the IMF and other official bodies. In practice, this would create more problems than it solved. For one thing, because membership on the committee would be selective, some in the markets might feel that other participants were getting preferential treatment from the IMF. And insofar as the problem of information asymmetries arises in negotiations between the lenders and the borrowers, it is with the debtor that the creditors' representatives most urgently need to interact. If the IMF were negotiating the extension of financial assistance while the debtors and creditors were at the same time attempting to restructure outstanding debts, there might be occasion for exceptional discussions among the three parties, but it is not obvious why regular meetings between the creditors' committee and the official sector would be essential. And to the extent that there is a need for the Fund and the financial community to exchange information in a time of crisis, this can be done more simply, by asking the central bank or national treasury in each of the creditor countries to identify a representative of their financial community.

It is important to be clear on what these committees can and cannot achieve. By creating a vehicle for exchanging information and a venue for negotiations, they can ease the process of restructuring defaulted debts, which is essential to create a viable alternative to ever-bigger bailouts. That process will remain difficult—as it must to prevent borrowers from walking away from their debts—but not as difficult as now. What the creation of committees cannot do, except under unusual circumstances, is to get the creditors to exercise collective forbearance and roll over their short-term credits as a way of averting default. It would be nice, as Jeffrey Sachs and Steven Radelet advocate, if a ''committee of large-bank creditors [could] be set up . . . and proceed to negotiate directly'' with governments with pressing debt service problems (Sachs and Radelet 1998). But the unfortunate fact is that collective forbearance will be difficult to arrange. The main role of creditors' committees will be to facilitate restructuring after the fact.

This means that the most important measures to bail in the private sector are, first, policies to prevent governments, banks, and firms from relying on short-term foreign credits in the first place, and, second, new provisions in loan contracts to ease the restructuring negotiations in which creditors' committees will engage.