The International Financial Architecture: Old Issues and New Initiatives

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Abstract

Reform of the international financial architecture has made progress but has not dealt decisively with the need to involve private sector creditors in resolving debt-related crises. It has relied unduly on voluntary approaches combined with large-scale official financing. A comprehensive approach requires the use of temporary standstills to protect debtors against litigation. These can help to resolve ‘liquidity’ crises as well as ‘solvency’ crises. Proposals by Krueger (2001, 2002) provide a way to resolve the problem of a sovereign debtor with an unsustainable debt burden but offer no solution to problems involving private sector debt or to liquidity crises. They would also require an amendment to the Articles of Agreement of the International Monetary Fund, which could prove difficult. This paper proposes a less radical approach – adding rollover clauses and collective-action clauses to sovereign and private debt contracts, backed by strict
limits on IMF financing. It resembles, but goes further than, the contractual approach favoured by the US Treasury.

I. Introduction

The ongoing effort to reform the international financial system – what is now described as the international financial architecture – began shortly after the Mexican crisis of 1994–95, which was resolved with the aid of $50 billion in short-term credit from the International Monetary Fund (IMF) and US Treasury. The architecture exercise has gone through several phases focused on different issues, as the official community has sought to apply the lessons learned from the many crises that followed the Mexican crisis: the Asian crisis of 1997, the Russian crisis of 1998, the Brazilian and Ecuadorian crises of 1999, and, most recently, the Turkish and Argentinian crises of 2001–02. I have therefore described the architecture exercise as ‘reform on the run’ (Kenen 2001).

Descriptions and assessments of the architecture exercise usually distinguish between two goals: reducing the frequency of crises (crisis prevention); and reducing the costs of crises (crisis resolution). This review will do that too, although it will concentrate on crisis resolution. It should be noted, however, that the two efforts overlap. Measures to strengthen financial systems in emerging-market countries can perhaps reduce the frequency of crises but may also reduce their severity. The recent move towards more flexible exchange rates will likewise reduce the vulnerability of emerging-market countries to speculative attacks on their currencies, and Fischer (2001) is right to describe it as ‘the most important change in the international financial architecture during the past decade’. However, the move towards more flexible rates may also reduce the temptation of banks and firms to incur large amounts of foreign-currency debt and thus diminish their vulnerability to the devastating balance-sheet effects of large exchange-rate changes and the resulting implosion of domestic credit that was a chief cause of the sharp slump in domestic output that characterized the Asian crisis.¹

¹These balance-sheet effects were first emphasized by Calvo and Reinhart (2000) and Krugman (2000), drawing on previous work by Bernanke and Gertler (1995), which stressed the role of the ‘credit channel’ in transmitting the effects of monetary policy to the real economy. There is now a large literature on the balance-sheet effects of exchange rate changes; see, for example, Céspedes et al. (2002).
II. Crisis Prevention

Much has already been done about crisis prevention. The IMF has promulgated standards for the compilation and dissemination of economic and financial data, enabling market participants, as well as the Fund and other official institutions, to assess more readily the problems and prospects of individual countries. Standards and codes have also been drafted to aid in assessing the quality of national financial systems: Core Principles for Effective Banking Supervision prepared by the Basel Committee on Banking Supervision, Objectives and Principles of Securities Regulation prepared by the International Organization of Securities Commissions, Insurance Core Principles prepared by the International Association of Insurance Supervisors, and Principles of Corporate Governance prepared by the Organisation for Economic Cooperation and Development (OECD), as well as accounting and auditing standards and codes to foster transparency in the conduct of monetary and fiscal policies.

Some emerging-market countries have expressed reservations about the relevance of these standards to arrangements and conditions prevailing in their countries, because most of the standards describe ‘best practice’ and draw very heavily on the experience of the industrial countries. They have therefore insisted that compliance must be voluntary and have resisted attempts to devise official incentives or penalties aimed at promoting compliance. At one point, for example, the Basel Committee on Banking Supervision (2001) proposed that national supervisors require banks to hold larger amounts of capital against their loans to banks in countries that have not subscribed to the Basel Core Principles, but it was obliged to back off. Nevertheless, many countries have signed up for intensive reviews of their financial systems under the Financial Sector Assessment Program (FSAP) conducted by the IMF and the World Bank and, although the results remain confidential, they serve as the basis for summary assessments of those countries’ compliance with the relevant standards – the Reports on the Observance of Standards and Codes (ROSCs) – which appear on the IMF’s website and are thus available to private sector investors for use in judging country risk.

It is sometimes proposed that the IMF issue public warnings when economic and financial conditions suggest that a particular country is heading for a crisis. There are two objections. First, we do not have reliable ways of predicting crises. Much work has been done on models designed to forecast crises, and while they have helped us to highlight conditions that make for vulnerability, they are less successful in predicting the actual onset of crises. That is not surprising, as crises are often triggered by political shocks – the

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2For a review of recent work and major contribution, see Goldstein et al. (2000).
assassination of a presidential candidate in Mexico, the refusal of a Brazilian state governor to honour his state’s debts to the central government, or a furious quarrel between two Turkish politicians. Second, errors in forecasting crises could be costly. Predicting a crisis could trigger one that might not otherwise erupt. Failing to predict a crisis that did erupt thereafter could cause private investors to blame the Fund for the losses they then faced, putting the Fund under pressure to rescue the investors by bailing out the crisis country. The threat to issue a public warning could perhaps be useful. Long before the onset of the Thai crisis in 1997, the IMF sent confidential warnings to the Thai government, but those warnings were ignored. A threat by the Fund to go public might have caused the Thai government to sit up and take notice. The Fund cannot threaten to go public, however, unless it is willing to do so when its warnings are ignored, and that would still be risky for the reasons already given.

III. Crisis Resolution

Less progress has been made on the second front – crisis resolution. Soon after the Mexican crisis, a working group was convened to distil the lessons learned from that crisis and seek better ways to cope with future crises. Its report (Group of 10 1996) was issued a full year before the Asian crisis and formally endorsed by the governments of the major industrial countries. Known as the Rey Report, after its Chairman, Jean-Jacques Rey of Belgium, it was the point of departure for much the subsequent architecture exercise. Although it did not rule out large-scale official financing for a crisis-stricken country, the strategy adopted in the Mexican case, it warned against using it frequently. The use of official financing to repay private sector claims, it said, is inconsistent with equitable burden-sharing and with the need to conserve official financial resources. Furthermore, routine recourse to large-scale financing would court moral hazard by insulating debtors from the costs of imprudent borrowing and insulating creditors from the costs of inadequate risk assessment.

3Fischer (2001) reports that three of the six country crises he discusses were on the Fund’s ‘radar screen’ well before they erupted (Thailand, Russia and Brazil) but three others were not (Mexico, Indonesia and Korea). He also admits to predicting ‘at least one crisis that didn’t happen’ but does not identify it.

4Another working group was convened after the Asian crisis and included officials from emerging-market countries. Its report (Group of 22 1998) was influenced by recent developments: the large role of private sector debt in the Asian crisis, Malaysia’s flirtation with capital controls, and the disruptive Russian default in August 1998. For these and other reasons, the report laid great stress on the desirability of ‘voluntary’ approaches to the resolution of debt problems. Its main findings and recommendations, however, resembled those of the Rey Report.

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The report rejected radical innovations, such as the proposal by Jeffrey Sachs (1995) for an international bankruptcy regime to meet the needs of sovereign debtors. It cited the legal and practical problems involved but also found fault with the implicit analogy between an insolvent country and an insolvent firm. I will return to this issue. The report also recognized, however, that the problems of dealing with sovereign debt, the key issue in the Mexican case, are more difficult than they were in the 1980s, when the debt problems of developing countries reflected their huge borrowings from foreign banks. Today, the debts of sovereign borrowers consist largely of bond issues, not bank loans, and many investors hold those bonds, including some without close links with the debtor countries. Nevertheless, the report concluded that debt workouts would be needed to avoid routine recourse to large-scale official financing. That, indeed, was its main message:

[It] is essential to maintain the basic principle that the terms and conditions of all debt contracts are to be met in full and that market discipline must be preserved. However, in exceptional cases, a temporary suspension of debt payments by the debtor may be unavoidable as a part of the process of crisis resolution and as a way of gaining time to put in place a credible adjustment program.

[Neither] debtor countries nor their creditors should expect to be insulated from adverse financial consequences by the provision of large-scale official financing in the event of a crisis. Markets are equipped, or should be equipped, to assess the risks involved in lending to sovereign borrowers and to set the prices and other terms of the instruments accordingly. There should be no presumption that any type of debt will be exempt from payments suspensions or restructurings in the event of a future sovereign liquidity crisis.

(Grupo de 10 1996)

The Rey Report, however, dealt mainly with sovereign debt, not private sector debt. In fact, it cautioned against interrupting the debt payments of the private sector. Trade credits and interbank credits, it said, are crucial links between a country and the world economy, and they should not be disrupted. Furthermore, a suspension of private debt payments might require the use of exchange controls, which could impair a country’s access to international capital markets and might induce market participants to rush for the exit before controls could be imposed.5

5The 1998 report took a different view: ‘it may be possible to suspend payments on some types of private sector debt, such as the foreign currency debts of banks, without imposing comprehensive capital controls. An announcement by the government without any binding enforcement mechanism may suffice to induce substantial compliance by most of the main private sector debtors’ (Grupo de 22 1998).
The Rey Report made two recommendations aimed at promoting the resolution of sovereign debt problems. First, it proposed the inclusion in bond documentation of so-called collective-action clauses. These govern the representation of creditors and curb the ability of dissident creditors to block a debt-restructuring agreement acceptable to the majority of creditors. Such clauses are included routinely in bonds issued under UK law but not in bonds issued under US law. In fact, US law requires that changes in the terms of payment of a bond issue be approved unanimously by the bondholders.6 Second, the report proposed that the IMF ‘lend into arrears’ to a crisis-stricken country — i.e. provide financing to a country that has halted its debt payments — if the Fund concludes that the country’s government is following appropriate policies and making a good-faith effort to reach agreement with its private creditors. Such lending, it said, would tell the creditors that the country’s policies deserve their support; it would also improve the country’s bargaining position by preventing dissident creditors from blocking the country’s access to IMF financing.

The Fund adopted the second recommendation, but very little has been done to promote the wider use of collective-action clauses. Emerging-market countries have been reluctant to use them, fearing that they would thereby raise the cost of borrowing, and the official community has not pushed or pulled them to adopt the clauses. Only two of the G-7 countries, Canada and the UK, have led by example.7

IV. Groping Toward Private Sector Involvement

When the Asian crisis erupted in 1997, some of us expected the official community to follow the advice of the Rey Report by withholding large-scale official financing and thus forcing Thailand to suspend its debt payments. However, the relevant debt in this instance was interbank debt, not sovereign debt. Furthermore, there was concern that an interruption of debt payments would generate contagion — a flight by private creditors from other Asian

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6The federal statute requiring unanimity is the Trust Indenture Act, which deals only with corporate bonds. The same requirement is honoured by custom, however, in the documentation of sovereign bonds governed by New York law. On the form and functioning of collective-action clauses and the case for using them, see Eichengreen and Portes (1995).

7The fears of emerging-market countries may be unfounded. Eichengreen and Mody (2001) find that the use of collective-action clauses reduces the interest rates paid by creditworthy borrowers; the adverse effect of using them is borne mainly by high-risk borrowers. In a subsequent study, moreover, Becker et al. (2001) find that the use of those clauses reduces the interest rates paid by all borrowers, low-risk and high-risk alike, although some of the interest-rate savings are not statistically significant.
countries. Recall that the Thai crisis was seen, at first, as a ‘glitch’ that would not contaminate neighbouring countries. The strategy employed in the Thai case, however, was different from the one adopted in the Mexican case.

The core of the problem in the Mexican case was the large stock of short-term dollar-indexed government debt, the so-called *tesobonos*. Mexico did not have the foreign-exchange reserves required to redeem them, and it could not roll them over, as foreign investors knew that it could not redeem them.8 The amount of official financing for Mexico, though, was sufficiently large not only to redeem the *tesobonos* but also to rebuild Mexico’s reserves. In the Thai case, by contrast, the amount of official financing was smaller than the short-term foreign-currency debt owed by Thai banks – and that was also true in the Korean case. In this respect, indeed, the Mexican case was unique. It was the only case in which the IMF acted as a lender of last resort seeking to stem a creditor panic. It supplied enough financing to convince nervous creditors that they did not have to rush for the exit.

How, then, did the IMF expect to restore investor confidence in the Asian case? It conditioned its assistance on a very long list of wide-ranging economic and financial reforms – more than one hundred requirements in the Indonesian and Korean cases, some of them only remotely related to the immediate causes of those countries’ problems. It believed that swift implementation of the required reforms would lead to a rapid revival of investor confidence. This was a precarious strategy, because it assumed implicitly that crisis conditions would dissipate domestic political resistance to the ambitious reforms and would thus obviate the need for larger amounts of official financing.9 In the event, strong political resistance blocked the speedy adoption

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8 Mexico’s problem began earlier, when the assassination of Donaldo Colosio, presidential candidate of the ruling party, and the renewal of fighting in Chiapas sharply reduced capital inflows. As those inflows had financed Mexico’s large current-account deficit, Mexico began to lose reserves and did very little to stem the reserve loss. In December 1994, Mexico sought belatedly to devalue the peso but had insufficient reserves to defend the new exchange rate. Therefore, the peso was set free to float and depreciated steeply. At that point, Mexico’s currency crisis transformed itself into a debt crisis. The small size of its reserves and the effect of the depreciation on the peso cost of servicing the *tesobonos* cast doubt on Mexico’s ability to meet its short-term obligations.

9 For the Fund’s account and defence of its strategy, see Lane et al. (1999). Fischer (2001) also defends it but notes that the IMF paid a price for ‘trumpeting’ the seemingly large size of its programmes for the Asian countries. Although those programmes were more markedly front-loaded than usual, in no case was the first tranche of IMF financing larger than 50% of the total. The private sector, Fischer says, knew that the financing was tranched and conditional and also came to realize that the bilateral financing for Indonesia and Korea was meant to serve as a second line of defence. Unlike the bilateral financing for Mexico and Thailand (and the subsequent financing for Brazil), it was not disbursed *pari passu* with the Fund’s own financing but was reserved for contingencies that were not well defined.
of many financial-sector reforms and other reforms as well. Confidence was not restored, and the amounts of official financing proved therefore to be too small.

There was just one major attempt to involve the private sector in resolving the Asian crisis. When Korea had run down its reserves and used up the financing available initially from the IMF, the governments of the major industrial countries called on their own countries’ banks to roll over their claims on Korean banks. The banks agreed to do that and went on thereafter to convert their short-term claims into one-, two- and three-year bonds. This episode is frequently cited by those who believe that private creditors can be expected to assist voluntarily in resolving a debt-related crisis. There are, however, three objections to this interpretation of the Korean episode. First, the Korean government guaranteed the claims of the Korean banks. Second, the foreign banks did not volunteer; they were told to volunteer by their own countries’ governments and were warned that Korea would have to default if they did not volunteer. Third, the banks had already run down their claims on Korean banks when they were asked to roll them over and could therefore agree to roll over the rest of their claims.10

Despite its special features, the Korean episode also influenced official views about private sector involvement in crisis resolution. At the 2000 Bank-Fund meetings in Prague, the IMF’s International Monetary and Financial Committee (IMFC) issued a communiqué identifying three sorts of country cases:11

The Committee agrees that the operational framework for private sector involvement must rely as much as possible on market-oriented solutions and voluntary approaches. … In some cases, the combination of catalytic official financing and policy adjustment should allow the country to

10This importance of this point is stressed by Eichengreen (1999, 2000), Giannini (1999) and the IMF (2000a); see also Boorman and Allen (2000) and Roubini (2001), who suggest that the IMF might have sought to engineer an earlier rollover of interbank claims, not only in the Korean case but also the Thai case. The importance of the Korean government’s guarantee is emphasized by the IMF (2000b), which notes that the substitution of government-guaranteed debt for private sector debt had the effect, attractive to the banks, of reducing to zero the risk weighting of their claims on Korea. A few months later, foreign banks agreed to roll over their short-term claims on Brazilian banks without having the same incentives provided in the Korean case. Once again, however, they ran down their claims before rolling over the rest, and the public sector indicated clearly, if perhaps more gently, that it expected the banks to cooperate.

11The passage quoted here draws heavily on the text of the communiqué issued some months earlier by the finance ministers and central bank governors of the G-7 countries (G-7 2000); on the evolution of official views, see Kenen (2001) and Roubini (2001).
regain full market access quickly. ... In other cases, emphasis should be placed on encouraging voluntary approaches, as needed, to overcome creditor coordination problems. In yet other cases, the early restoration of full market access on terms consistent with medium-term external sustainability may be judged to be unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, may be warranted to provide for an adequately financed program and a viable medium-term payments profile. This includes the possibility that, in certain extreme cases, a temporary payments suspension or standstill may be unavoidable.

(IMF 2000c)

The first strategy is, of course, the one followed initially in the Asian case—with rather limited success. The second is the strategy followed belatedly in the Korean case. The third includes the approach discussed at length in the Rey Report—suspending debt payments to buy enough time to work out a restructuring of a country’s debt.

V. Rethinking Private Sector Involvement

The IMFC taxonomy seems sensible but has two defects. First, it ignores an important lesson taught by the Asian crisis: a combination of ‘catalytic official financing and policy adjustment’ may not restore confidence quickly. Second, it circumscribes the role of temporary standstills in the resolution of debt-related problems. A different taxonomy may be more appropriate.

The analytic literature on financial crises draws heavily on the familiar distinction between a liquidity crisis and a solvency crisis. The Rey Report and others have rightly expressed reservations about the applicability of that distinction to a sovereign state, because it is easier to identify conceptually an insolvent company than an insolvent country. An insolvent company has liabilities larger than the sum of its assets and the present value of its future earnings. An insolvent country is one that cannot pay its debts, not because it has insufficient assets but because it cannot mobilize the revenues required to service its debt without imposing great pain on its citizens, jeopardizing the survival of its government and impairing the social and political stability of the country itself. (The same point is sometimes made by distinguishing between a country’s willingness to pay and a company’s ability to pay, but that formulation has an unfortunate connotation. Willingness evokes wilfulness, and governments that default on their debts rarely do so wilfully. On the contrary, they do so very reluctantly. Opportunistic defaults are rare.)
It is also hard to distinguish clearly between a liquidity crisis and a solvency crisis, even in the case of a firm or bank. A liquidity crisis rarely occurs unless there are suspicions of insolvency, a point stressed by Tirole (2002). Furthermore, a liquidity crisis can turn quickly into a solvency crisis when an illiquid firm or bank must sell off long-term assets at bargain prices. It is still useful, however, to distinguish between a debt crisis that would not occur if creditors did not panic and the country involved was given the time to cope with its problems in an orderly way, and a debt crisis that cannot be resolved by any feasible change in a country’s policies or plausible change in its economic prospects – a large improvement, for example, in its terms of trade.

Why is this dichotomous distinction more useful than the tripartite distinction drawn in the IMFC communiqué? Because it suggests resort to rather different remedies. A country facing a creditor panic can perhaps resolve its problem with the aid of large-scale official financing – enough to buy time to make policy changes aimed at restoring investor confidence. However, it can also cope with a creditor panic by suspending its debt payments – those of the government itself or those of the private sector, whichever may be at issue in a particular case – and using the time bought by the suspension to calm down its creditors by altering its policies or, where appropriate, reaching an agreement to reschedule its debt. Suspensions need not be reserved for debt problems that require outright debt reduction. Furthermore, the intermediate case in the tripartite taxonomy, the one that it pairs with a voluntary approach aimed at creditor coordination, may be rather rare. The prototypical Korean example was not truly voluntary and cannot be readily reproduced. Finally, a suspension can buy the time needed for a thorough assessment of a country’s problem.

What should govern the choice between the two ways of dealing with a creditor panic – providing enough unconditional financing to allay creditors’ fears, so they will not rush for the exit, and shutting the exit itself by imposing a standstill? The first strategy, described hereafter as lender-of-last-resort financing, would perhaps be feasible in the international context if the supply of official financing was sufficiently elastic, but would have to be very elastic indeed. Fischer (2001) suggests that $100 billion, much of it up front, would have been needed to resolve the Korean crisis by lender-of-last-resort financing.

12This point is stressed by Roubini (2001), although he endorses the intermediate approach favoured by the official community – restoring creditor confidence by ‘catalytic financing and policy adjustment’ rather than one of the polar solutions – suspending debt payments or providing large-scale financing. See also Lindner (2001), who uses a game-theoretic model to show that a suspension can be an optimal response to a creditor panic and that, in the context of his model, it is a sub-optimal response to a solvency crisis. (This last result, however, derives from his assumption that the amount obtained by each creditor depends only on the realized state of nature and is unaffected by the character of the insolvency regime.)
financing alone. That is nearly twice the sum actually committed to Korea in 1997 and more than six times the sum actually disbursed by the IMF during the first three months of the Korean program.

Furthermore, three risks attach to lender-of-last resort financing. First, the size of the 'financing gap' in a capital-account crisis is itself dependent on the amount of financing provided, because the amount of financing can affect the size of the capital outflow. If, then, the amount of financing is too finely calculated, it may prove to be too small. Second, the IMF would find it hard to provide unconditional financing to one member country, based only on the Fund's belief that the country faces a pure creditor panic, while insisting on conventional conditionality when another country asks for IMF financing. (It must be remembered, moreover, that the basic rationale for conditionality is the Fund's need to be sure that it will be repaid; unlike a domestic lender of last resort, it cannot readily insist that a country applying for help furnish conventional forms of collateral.) Finally, a commitment by the Fund to provide lender-of-last-resort financing would expose it gravely to the risk of error – treating too many countries' problems as pure creditor panics when they were really symptomatic of serious flaws in the countries' policies or financial systems.

Combined with perennial worries about moral hazard, the three risks attached to lender-of-last-resort financing have led a number of observers to suggest that strict limits be imposed on the supply of official financing, and they have led a small but growing number of observers to recognize the corresponding need for the more frequent use of standstills, not only in the 'extreme' case cited by IMFC, where a standstill would serve as a time-buying prelude to a debt restructuring, but also in the case of a creditor panic, where a standstill can serve as proper alternative to lender-of-last-resort financing.13

A country halting its debt payments, those of the government or private sector, runs the risk of litigation. It is therefore unrealistic to advocate the more frequent use of standstills without asking how a crisis-stricken country can fend off litigation. This brings us to the proposals launched by Anne Krueger, First Deputy Managing Director of the IMF. They are meant to deal with the third type of problem listed in the IMFC communiqué: the case of a government having an unsustainable debt burden. It bears a resemblance to the proposal by Jeffery Sachs for an international bankruptcy regime but has

13The need for strict limits on the supply of official financing was stressed by the task force convened by the Council on Foreign Relations (1999); the case for combining strict limits with standstills was set out analytically by Miller and Zhang (2000) and argued persuasively by Haldane and Kruger (2001). Although Fischer (2000) has retreated from his earlier view that the IMF can act as a lender of last resort, his recent endorsement of standstills (Fischer 2001) is couched in the context of his belief that a new regime is needed to facilitate debt restructuring. His views resemble those of Krueger (2001), discussed below.
been given a different name – the Sovereign Debt Restructuring Mechanism (SDRM) – and would not require the creation of a wholly new institution.14

There are now two versions of the plan for an SDRM. The first was outlined briefly in a speech by Krueger (2001) late last year and was described more fully in a memorandum prepared for the Fund’s Executive Board (IMF 2002a). The second was outlined four months later in another speech by Krueger (2002) and was described more fully in another memorandum (IMF 2002b).

VI. The First Krueger Plan

Krueger’s initial speech listed seven steps for involving private sector creditors in the resolution of a sovereign debt problem:

1 A government believing that it has an unsustainable debt burden would ask the IMF to confirm the government’s own assessment.
2 If the IMF did that, it would authorize a standstill – a suspension of debt payments and stay of litigation – and could prolong the standstill and stay of litigation if the debtor country was seen to be negotiating in good faith with its private creditors.
3 The government would then impose exchange controls to protect its official reserves from capital flight, and the stay of litigation would be made to cover the country’s private sector debtors who could not make debt payments due to the exchange controls.
4 Interim financing for the country would be elicited from private lenders by assigning seniority to their new claims. There was no mention in the speech of interim financing by the IMF, which was an unfortunate omission, as it led one to wonder whether the Fund meant to rescind its present policy – lending into arrears during a debt suspension.
5 The debtor country’s government and its private creditors would negotiate a restructuring of the government’s own debt; the IMF would not impose the terms of the restructuring. The speech, however, said nothing about Fund ratification of those terms – its right to satisfy itself that the terms gave reasonable promise of restoring debt sustainability.
6 An independent tribunal would be created to adjudicate disputes between the debtor and its private creditors, as well as disputes between creditors; there might be disagreements, for example, about the valuation.

14For a plan based on a new institution and more closely analogous to a conventional bankruptcy regime, see Schwarcz (2000). For a survey of earlier plans, see Rogoff and Zettelmeyer (2002).
of various claims and about equitable treatment across classes of creditors.

7 Dissident creditors would be bound in by majority voting, just as they would be under bond covenants containing collective-action clauses.

The two omissions mentioned in this summary were addressed by the Fund’s memorandum (IMF 2002a). First, it said that a country applying for a standstill would have to be implementing or actively negotiating a Fund-supported programme. In that case, of course, it would receive interim financing from the Fund and would not be wholly dependent on new private lending. Second, it said that ‘some form of Fund endorsement of the terms of the restructuring would probably be necessary’. Otherwise, it warned, the country might still bear an unsustainable debt burden and need future Fund financing. It did not explain, however, what would happen if the Fund refused to endorse the terms of a restructuring – what it could do to force the parties back to the bargaining table. Nor would it authorize the Fund to involve itself ex ante by providing a framework for the negotiations between the debtor government and its private creditors. Having said the country’s existing debt burden is unsustainable, the Fund should be prepared to say what level of debt would be sustainable. At the very least, it should be prepared to warn a debtor government not to expect future Fund financing if it agrees to a restructuring that does not come close to achieving medium-term sustainability. Otherwise, the bargain between the parties may merely defer the government’s problem rather than resolve it. That has happened before. In 2001, for example, Argentina engineered a debt exchange that lengthened the maturity of its existing debt but greatly raised the interest cost of servicing that debt.

The Fund’s memorandum, however, flagged two other problems. Crucial aspects of the plans outlined by Krueger in her first and second speeches – the legalization of standstills and stays of litigation, and the use of majority voting to bind in dissident creditors – require an amendment to the Fund’s Articles of Agreement (its constitution), and an amendment cannot take effect until it is approved by three-fifths of the Fund’s member governments having 85% of the total voting power. That means that the US Congress must approve it, because the USA has more than 15% of the total voting power. The Fund’s memorandum also noted that there might be concerns about the independence of the Fund’s Executive Board – its ability to render objective judgements. ‘Not only will the Fund be a creditor – with the power to provide additional financing in the future – but Executive Directors will also be representing the interest of [the] Fund shareholders, who are also creditors.’ It was for this reason that Krueger proposed the creation of a new tribunal to adjudicate disputes. For the same reason, however, many outside observers have said that
the plan outlined by Krueger in her first speech would give the Fund too large a role in resolving debt-related problems.

VII. The US Treasury’s Contractual Approach

Although Fischer (2001) reports that Paul O’Neill, the US Secretary of the Treasury, agreed with Horst Köhler, the Managing Director of the IMF, on the need to develop an international bankruptcy regime, the US response to Krueger’s first speech was not encouraging. Appearing before the Joint Economic Committee of the Congress, John Taylor, Undersecretary of the Treasury for International Affairs, expressed concern about the large role of the IMF in the first version of the SDRM and suggested a different ‘decentralized’ approach – one that would foster debtor and creditor ownership of the process by relying chiefly on collective-action clauses (Taylor 2002a).

Taylor described that approach more fully in a subsequent speech (Taylor 2002b). Sovereign borrowers and their private sector creditors, he said, would adopt a package of new clauses. A majority-action clause would be used to bind in all creditors once an agreement had been reached between the debtor country and the creditors’ representative. A procedural clause would define how creditors would be represented, would require the debtor to provide the creditors’ representative with the necessary data and would give the creditors’ representative the exclusive right to initiate litigation if instructed to do that by a specified fraction of the creditors.15 A third clause would provide for a short ‘cooling off’ period to give the creditors time to choose their representative; it would permit a deferral of debt payments and bar litigation during the ‘cooling off’ period. These three clauses, Taylor said, could be put into bank debt as well as bonded debt but would be invoked on an instrument-by-instrument basis, not across the board.16

How would governments be induced to include this package of clauses in their own debt instruments? Taylor (2000b) suggested two possibilities:

First, the official sector could require that these clauses be used by any country that has, or is seeking, an IMF program. Second, the official

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15This provision would appear to provide the debtor with a stay of litigation, but the protection would be precarious if the specified fraction was low; in that case, a minority of creditors could, at any time, instruct the creditors’ representative to initiate litigation.

16There might then be many creditor classes, each with its own representative, and votes would be taken by each class, not by all creditors jointly. If inconsistencies arose across creditor classes or jurisdictions, they would be resolved by arbitration under rules included in all of the relevant debt instruments. In this respect, the US proposal differs from the second version of the SDRM plan, described below.
sector could provide some financial enhancement, such as slightly lower charges on IMF borrowing for countries that include these clauses in their debt. Such an enhancement would be especially useful to encourage borrowers to swap existing debt for debt with the new clauses.

**VIII. The Second Krueger Plan**

Responding to reservations like those expressed by Taylor and to more vigorous private sector criticism, Krueger (2002) proposed a different plan for an SDRM. It would still require an amendment to the Articles of Agreement to provide a uniform legal basis for collective action by a country’s creditors and to solve the debtors’ own collective-action problem; if left to decide individually whether to adopt a package of clause like the one favoured by Taylor, each country might wait until others had done so. The amendment, however, would not confer new powers on the IMF. The debtor and its creditors would take the key decisions. The Fund might still have to start the process by putting a stay in place, because it would take time to organize the creditors and verify their claims, but the prolongation of a stay beyond, say, three months, would have to be approved by a super-majority of all the country’s creditors, not by each creditor class. Furthermore, to elicit new private financing, a super-majority of all creditors could be given the power to subordinate the existing claims of the country’s creditors. Finally, a super-majority of all creditors would be required to approve a debt-restructuring agreement. Their decision, however, would be informed by the Fund’s views about the sustainability of the reduced debt burden. If the terms of the agreement fell short of that objective, ‘the Fund would be compelled to withhold further financing, creating pressure for another restructuring further down the road’ (Krueger 2002).

There is as yet no agreement within the Fund’s Executive Board on the best way to proceed. Here is how Krueger summed up the Board’s two days of discussion of the initial Fund-based SDRM plan, the intermediate SDRM plan outlined in Krueger’s second speech, and the contractual approach proposed by the US Treasury:

Many Directors believed that … intermediate options could help address concerns about significantly extending the Fund’s powers in a statutory approach, although it was recognized that the difficulties … would still be significant. Some Directors, however, expressed a strong preference for a contractual approach not requiring an Amendment of the Fund’s Articles, and cautioned against any mechanism that would imply the
creation of an international judicial body to oversee the restructuring process, either within or outside the Fund. Some other Directors saw considerable merit in a statutory approach that would grant the Fund additional legal authority to make key decisions in the operation of the restructuring mechanism … In this vein, several Directors cautioned against requiring the approval by a qualified majority of creditors of the activation of the stay, and suggested that a decision on activation by the debtor in consultation with the Fund would be more practical and effective.

(IMF 2002c)

I, too, have reservations about this last feature of the intermediate and contractual approaches. I also have strong reservations about the innovation introduced in the second SDRM plan – the pooling of disparate creditor claims to define the single super-majority required to prolong a stay and approve a final restructuring agreement. It would pose difficult practical problems, because it would require a comparable valuation of bank loans, bonds and other claims. More importantly, it would create a strong presumption that a country facing a serious debt problem should restructure its whole foreign debt – bank loans as well as bonds – and might create a strong presumption that it should also restructure its domestic debt.¹⁷

Note further that the second SDRM plan does not answer a legitimate objection to the first. Both plans would impair the rights of existing creditors by imposing majority voting on those who currently hold debt instruments requiring their unanimous consent to any change in the terms of payment.

In short, the Fund’s second plan is not better than the first. It is a rather awkward effort to move matters forward by combining features of the Fund’s first plan with the US Treasury’s contractual approach; and there may be a better way to do that – a plan that would retain a key role for the Fund without changing its Articles of Agreement.

It should be recognized, moreover, that all three plans reviewed here fall short of resolving the problem encountered during the Asian crisis, which involved the liquidation of short-term foreign claims on Asian banks and firms, rather than claims on the Asian governments. Recall a point made earlier. Suspensions of debt payments and stays of litigation may be required by all debt-related crises, not merely those requiring

¹⁷This issue was raised by Krueger in both of her speeches and by the Fund memoranda. It poses very complex problems, especially when a country’s domestic banks hold large amounts of government debt.
restructurings of sovereign debt. The proposal made below would meet that need.

IX. A Comprehensive Contractual Approach

Taylor’s proposals provide a starting point but should be strongly reinforced by taking these two steps:

1. including collective-action clauses in all standardized debt contracts, those of the private sector as well as those of the government
2. including a 90-day rollover option in all standardized debt contracts and requiring debtors to exercise that option in the event of a formal finding by their country’s government that their country faces a financial emergency.

One could, of course, exclude debt contracts involving small amounts of debt, and it might be sufficient to limit the coverage of private sector debt to debts denominated in foreign currency. By including private sector debt, one might obviate the need to impose exchange controls. By writing the rollover option into individual debt contracts, one would forestall litigation. Having agreed to a contract containing the rollover option, whether by making a loan or buying a bond to which the option was attached, a creditor would have agreed to the terms and conditions under which the option would be exercised and have no cause to seek legal redress if it were actually exercised.

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18 Under the initial SDRM plan, private sector debtors could be made to suspend their debt payments if their country’s government imposed exchange controls, and it was suggested that they be protected from litigation if that should happen. Under that plan, however, a government could not impose exchange controls and expect the IMF to protect its private sector debtors by sanctioning a stay of litigation unless the country faced a sovereign debt problem.

19 Buiter and Sibert (1999) suggested a similar device, which they described as a universal debt rollover option with penalty (UDROP), and Lindner (2001) has modelled it formally. Under their plan, however, the option would be exercised at the discretion of the individual debtor, not under orders from the debtor country’s government. The implications of this difference are discussed in Kenen (2001). The penalty payment to creditors built into the Buiter–Sibert plan is meant to prevent individual debtors from abusing the rollover option, and it would not serve that purpose under the variant proposed here. Ways to prevent abuse by the government are suggested below.

20 It should be noted, however, that a mere suspension of debt payments by the private sector, not backed by exchange controls, might not furnish full protection for a country’s currency. It would not prevent a private sector debtor from buying foreign currency before the end of the 90-day rollover period, so as to anticipate the need to resume debt payments after the end of the period.
There are two ways to minimize abuse of the rollover option:

1 allowing the option to be exercised once, and only once, during the life of any debt contract, no matter how long the original or remaining maturity of the debt involved, and
2 including in the framework legislation a clause requiring the government to obtain a finding of fact from the IMF, endorsing the government’s judgement that the debtor country does indeed face a financial emergency justifying the exercise of the rollover option.

A government could also look to the IMF to set the parameters for the negotiation of a debt restructuring when a restructuring is required for the country to achieve debt sustainability. The Fund could take on both of these tasks without an amendment to its Articles of Agreement.21

Let me conclude by anticipating four questions:

Would the proliferation of rollover options induce foreign creditors to run at the first sign of trouble? It could perhaps have that effect – but creditors run pretty quickly now. The same problem would arise, moreover, under any plan that might be seen to result in a debt restructuring. It is, in any case, hard to arrange a quasi-voluntary standstill or rollover of the Korean type before foreign creditors have run down their claims substantially, so rollover clauses are not likely to make matters worse.

Would a 90-day rollover option buy enough time for a country to seek a durable solution to a debt-related problem? It may be sufficient to cope with a creditor panic even when, as in the Korean case, a 90-day rollover had to be replaced by a long-term rescheduling of interbank claims. It may not be sufficient to cope with the problems of a government burdened by excessive debt, because it could take many months to negotiate the restructuring of that debt. It may therefore be necessary to include in sovereign bonds and bank debt a clause authorizing a super-majority of a sovereign’s creditors to extend the initial rollover for additional 90-day periods.22

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21There is, of course, the risk that private sector borrowers will want to avoid exposing themselves to the mandated rollover option and will try to do that by using offshore affiliates for their foreign borrowing. To repatriate the proceeds of that borrowing, however, a parent firm would have to enter into loan agreements with its offshore affiliates and would have to include the rollover option in those agreements. If they had thereafter to exercise the options, their affiliates might be unable to honour their own obligations when they fell due. On these and related issues, see Buiter and Sibert (1999).

22In effect, the initial 90-day rollover would serve as the short ‘cooling off’ period mentioned by Taylor (2002b), but the risk of subsequent litigation might be greater under his proposals (see footnote 15).
What can be done to encourage countries to include collective-action clauses and rollover options in the relevant debt contracts? In my recent book (Kenen 2001), I suggested that countries that do that should enjoy more liberal access to the IMF, but that is the wrong way to go, because the main purpose of the proposal, like that of the Krueger and Taylor plans, is to reduce the need for large-scale official financing. It would therefore be better to go in the opposite direction. Countries that do not adopt the necessary legislation should suffer a reduction in their access to Fund credit. After, say, a five-year period, governments that had not begun to include collective-action clauses and 90-day rollover options in their own debt instruments and had not required their use by private sector debtors should suffer a gradual cut in their cumulative access to IMF credit (the conventional ceiling is currently set at 300% of a country’s Fund quota), and they should be denied any access whatsoever to the Supplemental Reserve Facility – the window opened by the Fund to furnish large-scale financing.23

As collective-action clauses and rollover options can be added only to new debt instruments, not existing instruments, would it take too much time to build them into the whole stock of emerging-market debt? Not a long time in the case of private sector debt, as much of the stock of private emerging-market debt is of relatively short maturity. Somewhat longer in the case of sovereign debt, but there are ways to deal with that problem in the interim. Although the payment terms of bond issued under New York law cannot be amended without the unanimous consent of the holders, other provisions of those bond covenants, such as waivers of sovereign immunity, can be amended or excised by a majority of the bondholders. Ecuador used this strategy effectively to discourage dissident bondholders from demanding the full payment of their existing claims rather than accepting a bond exchange. Those who agreed to exit from Ecuador’s old bonds and take up the new bonds were asked to consent to certain ‘disfiguring amendments’ to the terms of the old bonds.24 These so-called exit consents cannot, of course, produce a standstill – the task of the mandatory rollover option – but can be used again

23As cumulative access limits are set by the Executive Board, a tightening would not require a change in the Articles of Agreement, see IMF, Selected Decisions and Documents (26th issue, December 2001).

24On the legal foundations for using exit consents, see Buchheit and Mitu Gulati (2000); on their future use as an interim substitute for collective-action clauses, see Kumar and Miller (2001). For an ingenious two-step scheme, see Bartholomew et al. (2002), who suggest that exit consents be used to consolidate existing bond issues into uniform ‘interim debt claims’ having collective-action clauses, with a view to converting the interim claims into new long-term bonds. However, it would be imprudent to rely indefinitely on exit consents. Investors might soon insist that new bond covenants be drafted to preclude their use.
to cover for the absence of collective-action clauses until those clauses have been added to the entire stock of debt.

There is one more reason, however, for adopting the comprehensive contractual approach suggested here. It could take a few years to amend the Fund’s Articles of Agreement in the manner required by either version of the Krueger plan. Even the modified version is apt to encounter opposition from the private sector, may not win support from the US Treasury, and may also be opposed by some emerging-market countries, which were worried about the Fund’s first plan and have even stronger reasons for being worried about the second. The US Treasury’s approach, however, may not afford adequate protection for sovereign debtors and, like both of the Fund’s plans, fails to address the full range of debt-related problems. A more comprehensive contractual approach may be the most expeditious second-best way to go.

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