4

Crisis Resolution in the New Architecture

Since crises will occur periodically despite the best efforts at crisis prevention, the new architecture must provide suitable mechanisms for crisis resolution to deal with these occurrences. There is much less agreement in this area than in the area of crisis prevention because of differences on certain critical issues, especially the role of public international resources in managing crises, and the issue of moral hazard. Much depends on the extent to which the crisis is perceived to be caused by conscious pursuit of wrong policies or by pure contagion and also the extent to which it is likely to have systemic effects.

Those who view crises as being caused by investor panics, which can arise even when fundamentals are basically sound, emphasise the need for an international lender of last resort that can provide large amounts of liquidity to quell the panic and thus avoid unnecessary disruption of employment and output. Very different conclusions are drawn by those who believe that most crises are not caused purely by irrational investor panic. Loss of confidence may seem to be triggered by some random event, but it turns into a crisis only in situations when the country has become vulnerable on some fronts, for example because of imprudent build-up of short-term debt. This vulnerability reflects a deficiency in policies, or in the institutional framework, which needs correction. Providing international resources to 'bail out' countries in such situations only generates moral hazard, i.e. it encourages imprudent behaviour by both lenders and borrowers in future, making such crises more likely.[29] This 'principled' argument against large-scale international financing is re-inforced by the practical consideration that international public resources are in any case extremely scarce compared with the scale of resources which could move as a result of a change in market sentiment.

The new architecture discussions have sought to balance these conflicting views, and a consensus of sorts has emerged, but there are significant differences in perceptions on many issues. The general consensus can be summarised as follows:

- There is complete agreement on the need to encourage the development of efficient private financial markets, but there is also a consensus that the international community cannot leave crisis resolution entirely to private markets. This is because crisis situations often lead to temporary dislocations in which markets 'dry up'. They also lead to 'systemic effects' which can severely disrupt markets for an extended period. The existence of externalities makes crisis resolution an 'international public good' justifying the use of international resources.
- Crises impose an especially heavy burden on the poor in crisis-hit countries and this provides another justification for international financing as a means of promoting methods of crisis management which are less likely to hurt the poor.
- The danger of moral hazard associated with international public financing to

29 Many critics of the IMF have argued that the Mexican rescue package in 1995 was responsible for the neglect of risk on the part of lenders which generated an excessive flow of funds to East Asia in the years preceding the crisis.

help countries in crisis is real, but it can be met by appropriate design of conditionality. Some have argued for strong post-crisis conditionality to discourage reliance upon international resources, while others emphasise the need for pre-crisis conditionality which generates stronger incentives for taking preventive steps.

- Since public resources are scarce, crisis resolution strategies must place greater emphasis on 'involvement of the private sector'. Countries must be encouraged to look for private sector solutions as much as possible, both in anticipation of difficulties and also after problems have arisen. The conditionality associated with any international effort at crisis resolution should be tailored to achieve this end.
- Moral hazard considerations suggest that creditors should not be shielded from the consequences of imprudent lending and must therefore 'take a hair cut'. This is a form of involuntary private sector involvement.

Translating these general principles into specific mechanisms for crisis resolution which can be built into the new architecture poses several problems.

4.1 The Role of the IMF in Crisis Resolution

The IMF is the principal crisis manager in the international financial system and there is general agreement that it needs to be strengthened to perform this role effectively. Opinions differ however on how this objective is best achieved and, in particular, on whether the scale of Fund lending in future should be expanded, as most developing countries would argue, or whether it needs to be focused on more limited types of situations, as is being argued in many influential quarters.

a) Some recent innovations

Some important steps have been taken in recent years which provide the Fund with greater procedural flexibility and also with new instruments specifically designed to handle latter- day crises.

- The Emergency Financing Mechanism, introduced in 1996 after the Mexican crisis, enables the Fund to bypass its normal lengthy procedures and respond quickly in crisis situations. This is an important procedural innovation given the speed with which crises now explode.
- The Supplemental Reserve Facility (SRF), introduced in December 1997, enables the Fund to provide short-term financing in excess of normal access limits to meet the needs of countries hit by a sudden disruptive loss of market confidence. SRF assistance is provided in conjunction with a standby arrangement or Extended Financing Facility (EFF), but only when there is reasonable expectation that strong adjustment policies and adequate financing will result in an early correction of the balance of payments difficulties. Drawings under this facility involve a penal rate of interest (300 to 500 basis points above the normal rate) and are repayable within 18 months of the date of drawing which may be extended by one year.
- A new facility, the Contingency Credit Line (CCL) was introduced in April 1999 to provide advance assurance of finance from the Fund to well managed emerging market economies, wishing to protect themselves from possible future crises induced by contagion. The terms on which these funds are provided are the same as for the SRF but, unlike the SRF, which is negotiated in a post-crisis situation, the CCL is negotiated in advance of a crisis to provide assured access to resources in the event of a crisis. The CCL is not only a potential

instrument for crisis resolution, it also has a potential role in crisis prevention, since the existence of a CCL arrangement may increase market confidence in a country's ability to handle sudden problems. The facility has been established initially for a two year period and is scheduled to be reviewed in April 2000.

This is an impressive expansion of the Fund's armoury, but many issues related to the Fund's role in crises resolution remain unresolved.

b) The effectiveness of IMF adjustment programmes

The effectiveness of Fund programmes in dealing with contemporary crises came into question after East Asia and this is clearly one of the factors accounting for the erosion of support for the institution. As pointed out in Chapter 2, the primary objective of any strategy to handle a crisis of confidence must be to restore confidence so that capital flows return to normal levels but this is not easy to achieve in a short period of time. As the term 'market sentiment' implies, a great deal depends on psychological factors which are inherently difficult to influence.

In order to restore confidence, adjustment programmes must clearly address all the policy misalignments which may have directly provoked the crisis, or created the vulnerability which made the crisis possible (fiscal imbalances in some cases, or real exchange rate appreciation, or imprudent build up of short-term debt). Some of these weaknesses may not have been evident before the crisis, but once they surface after the crisis it becomes necessary to take corrective steps if confidence is to be restored.[30]

However, even a comprehensive programme of corrective policies cannot ensure successful adjustment if financing is inadequate. Even if all necessary corrective policies are adopted, there will be a time lag of at least a year, and possibly even two, before capital flows return to normal levels and until that happens, the financing gap can be very large. If a crisis-hit country which has taken all the corrective steps needed could finance most of the gap which arises in this interim phase, it could adjust relatively smoothly to the post-crisis situation with a minimum of pain, other than that which is involved in correcting policy deficiencies. However, if financing on the scale required is not available, the country has very few options. It can adopt severely restrictive policies to bring about a large current account improvement in the short term, which would protect the exchange rate at the cost of domestic output and employment levels, or it can allow the exchange rate to collapse and bring about the same turnaround through negative real balance effects, or it can introduce capital controls. Each of these options presents serious problems.

Some of the criticism of the IMF's East Asia programmes needs to be re-examined in the light of these considerations. The Fund has been severely criticised for recommending tight fiscal policies and high interest rates in East Asia, even though the crisis was not caused by loose fiscal policy. But the original cause of the crisis is not strictly relevant. If a loss of confidence triggers a capital outflow, and if adequate finance is not available to cover the outflow, and capital controls are also to be avoided, then the country has to bring about a turnaround in the current account to accommodate the outflow. Restrictive fiscal policy can be viewed as a legitimate policy intervention aimed at improving the current account, albeit at the cost of economic contraction, in order to avoid a collapse in the exchange rate which would impose other costs.

The reason why this strategy did not

30 It is interesting to consider Feldstein's (1998) criticism of the IMF's Korea programme from this perspective. Feldstein argued that the Fund should have limited its conditionality to macro-economic issues relevant for restoring stability instead of expanding its conditionality to include larger issues of financial sector reform. This raises the issue whether reform of the financial sector was itself crucial for restoring confidence. It is difficult to pronounce definitively on this issue since the counterfactual cannot be tested, but the remarkable rebound of the Korean economy certainly suggests that some of the criticisms of the Fund programme were overdone.

succeed in East Asia, as pointed out by Lane *et al.* (1999), is that the financing provided in the Fund programmes was sufficient only on the assumption that they would succeed in restoring confidence and halt the capital outflow. When this did not happen, a currency collapse became unavoidable leading in turn to severely negative balance sheet effects which were highly disruptive. To be fair to the Fund, it should be recognised that although the Fund did not anticipate the currency collapse initially, it did recognise that meeting the original fiscal deficit targets in the face of the contractionary balance sheet effects generated by the exchange rate collapse would be excessively deflationary and the fiscal targets were greatly relaxed.[31] The economic contraction which occurred in East Asia therefore cannot be attributed directly to excessively tight fiscal targets as these were never actually implemented. It would be more correct to attribute it to over-optimism about the speed with which confidence would be restored once Fund programmes were in place, which led to inadequate provision of finance in support of the programme.

This raises some interesting questions. Did the Fund simply err in being over-optimistic about the speed at which confidence would return, or was it pushed into making an over-optimistic assessment against its better judgement because it knew that the resources available to it were limited in any case? In other words, did the lack of resources create a situation where there was too much reliance upon adjustment and too little upon financing? Did the Fund overstate the weaknesses in the financial system as an underlying explanation for the crisis and did this in turn deepen the crisis? To answer these questions, one has to speculate on what would have happened in a counterfactual situation and this is obviously not easy.

The high interest rate policies recommended by the Fund have also been criticised on the ground that they have severe negative effects on the real economy and also on the banking system where banks are weak. However, this must be weighed against the alternative of an uncontrolled exchange rate depreciation which also has negative balance sheet effects. The critical issue is whether a temporary increase in short-term rates actually helps to stabilise the currency by increasing the interest differential in favour of domestic assets. Furman and Stiglitz (1998) have argued that higher interest rates could actually have the opposite effect of increasing capital outflows if the negative effects on the real economy increases default risk, and if this effect is sufficiently strong to offset the incentive effect of the increased interest differential. However, the relative size of the two effects needs to be empirically verified before this point can be conceded in a particular case. The negative effect is obviously greater where the banking system suffers from a maturity mismatch and is undercapitalised and where corporations are highly leveraged.[32] Much also depends upon the period for which interest rates are hiked. It should be noted that interest rates in Korea and Thailand declined fairly quickly from the very high levels to which they were raised in the initial phase of crisis management.

The balance of evidence seems to suggest that an increase in short-term interest rates is an appropriate response when faced by a large capital outflow which cannot be financed. If this is combined with a reasonable adjustment programme there is a good chance that interest rates will decline reasonably quickly. The critical issue

31 The initial specification of fiscal targets calling for an improvement from the earlier position, which varied from a small fiscal surplus to small deficits, was justified by the Fund on the grounds that the fiscal position needed to be improved to meet the cost of bank restructuring. This is a valid argument, but the cost needed to be met over a period of time. In the short term there was a case for a more relaxed fiscal stance, had the negative balance sheet effects been correctly anticipated.

32 The development of efficient and liquid capital markets which lead to a greater reliance upon equity and upon bond markets for long-term debt, will obviously help to minimise the damage of high interest rates to the banking system. Countries having such markets have greater flexibility to use interest rates to manage crises.

is whether the adjustment programme will restore confidence and this is partly a function of the corrective policies introduced and partly also the volume of financing made available.

One way of avoiding high interest rates and yet containing capital outflows in the face of a crisis of confidence is by introducing capital controls. This was recommended by Krugman (1998) and it was the implicit alternative favoured by many of the critics of the Fund in East Asia. Capital controls appear to be an attractive option when a crisis is in full swing, but countries are extremely reluctant to resort to them because of the fear that it may undermine the possibility of a quick return to normalcy, especially as far as access to capital markets is concerned. Capital is likely to flow more freely to countries where investors have the assurance that they can exit whenever they wish; resort to capital controls violates this requirement. Indeed, if investors come to expect that controls may be imposed in times of difficulty, they are likely to exit in anticipation of a crisis. The possibility that controls may be used can therefore increase the instability of the system *ex ante*.

It is interesting to note that of the East Asian countries affected by the crisis, only Malaysia resorted to capital controls and then only of a limited nature, which were also quickly relaxed. There is no evidence that the intensity of the crisis was lower in Malaysia because of the use of capital controls nor its speed of recovery faster. It is true that Malaysia has not suffered in investor perceptions as much as some would have feared, but that may be due in large part to the limited nature of the controls and the early relaxation. Brazil, on the other hand, went out of its way to indicate that it would not resort to capital controls, precisely in order to retain investor confidence. The current consensus is that the imposition of generalised capital controls to handle crises of confidence may introduce more costs than benefits, though debt restructuring is an area which needs to be explored in certain situations. This is discussed in more detail later in this chapter.

c) Crisis management and the poor

Another difficulty in designing adjustment programmes relates to the impact on the poor who are in no way responsible for creating crises, but often suffer the most in the aftermath. The negative impact on the poor can also last well beyond the period when normalcy is restored because falls in real wages resulting from exchange rate depreciation may not be easily reversed.[33] Since one of the main arguments for providing international public financing in support of crisis management is that it can help mitigate the effect of a crisis upon the poor, there is a strong consensus that crisis management strategies supported by the Fund must pay special attention to the impact on the poor.

A minimal requirement is that adjustment programmes must not worsen the negative impact on the poor, which may already be substantial. If fiscal discipline requires a reduction in total real government expenditure this should be achieved while protecting those expenditures which are of particular importance for the poor. A reduction in total subsidies may be unavoidable, but the focus should be on cutting subsidies which are not effectively targeted, of which there are usually many, while preserving those subsidies which are effectively targeted at the poor. It is also necessary to protect expenditure on social services, especially health and education, which are not only important for the welfare of the poor but also affect their future earning capacity. Achieving these objectives is not easy because it means the cuts have to be deeper elsewhere, but this is a legitimate distributional objective of policy.

It can also be argued that adjustment strategies should go beyond avoiding negative impacts and actually make a positive contribution through programmes specifically aimed at increasing income levels of the poor and other

33 Real wages in Mexico had not recovered to the pre-crisis level of 1994 even by 1998.

vulnerable groups who are adversely affected by the unemployment caused by a crisis. An important problem in implementing this approach is that the effectiveness of these programmes cannot be taken for granted. International experience suggests that leakages to non-target groups can be very large unless the programmes are very carefully designed and efficiently implemented, and that this is very difficult to achieve in the short period that is relevant for crisis management. Expansion of existing programmes, which have a tested delivery capability, may be more effective than the creation of new programmes.

While recognising the importance of protecting the living standards of the poor as far as possible, it must also be recognised that country authorities, as well as international organisations, will face practical problems if adjustment programmes are overloaded with too many social objectives. This can distract attention from the immediate task of crisis management and possibly also politicise the design of adjustment programmes. Yet delay in implementing adjustment can sometimes cause more damage to the poor by prolonging and deepening the crisis. Where poverty alleviation objectives have not been built into the existing strategy, and there are not enough well functioning poverty alleviation schemes, it will be difficult to incorporate new programmes into adjustment programmes, at least in the short run. However where such programmes already exist, it is much easier to strengthen them. This is clearly an important area for IMF-World Bank collaboration, with the Bank helping to formulate appropriate criteria for Fund programmes which would ensure that the pro-poor components of expenditures in the government budget are not reduced. The Bank can also directly finance social sector programmes as part of its own development lending, but this would be part of a longer-term strategy.

d) The Contingency Credit Line: last resort lending

The recently introduced Contingency Credit Line (CCL) responds to a long standing demand of the developing countries for an international 'lender of last resort' facility which should be available for well-managed countries to deal with crises caused by irrational panic or by contagion from problems elsewhere.[34] The Fund Board had discussed the need for a 'short-term financing facility' of this type in 1994 (before the Mexican crisis), but agreement could not be reached on the conditionality to be associated with such drawings, since there was obvious moral hazard if access was unconditional.

The CCL deals with the moral hazard problem by prescribing extensive pre-qualification requirements while also keeping open the possibility of post-crisis conditionality (see Box 1). As a result, the facility is much more circumscribed than advocates for last resort financing typically have in mind.

- The pre-qualification requirements may deny the facility to countries which do not have any apparent problems, if the Fund finds that their policies are likely to lead to a balance of payments problem in future. Access can also be denied on the ground that the country is not taking sufficient preventive action in the form of a credible programme to upgrade regulatory and supervisory standards in the financial sector.
- Prequalification does not ensure automatic access to financing because post-crisis conditionality may be imposed at the time of the activation review before resources can be drawn. The need for such conditionality arises because external circumstances may have

34 The G-24 Ministers in their meeting in Madrid in October 1994 had urged the Fund 'to expedite its work on the establishment of a new, short-term, and fast disbursing facility aimed at assisting member countries to deal with large private capital outflows arising out of sudden market speculation not generated by fundamental disequilibria or similar factors beyond their control.

Box 1

Conditionality associated with the new CCL

Pre-qualifying conditionality

Four pre-qualifying conditions have to be met by countries seeking access to the Contingency Credit Line facility.

- ❖ The Fund must be convinced that the country's policies would not on their own lead to a balance of payments problem.
- ❖ The country's policies, broadly defined, should also have been positively assessed at the last Article IV consultations and subsequently. A positive assessment in this context includes the country's adherence to 'relevant internationally accepted standards' including the SDDS, the Basle Core Principles, the code of transparency in fiscal policy, the code of transparency in monetary and financial policy and such other standards as may be agreed in future. This implies that substantial action towards financial sector reform of the type recommended for crisis prevention is a pre-condition for CCL access.
- ❖ The country should be maintaining 'constructive relations' with private creditors, with a view to facilitating appropriate involvement of the private sector. It should also have made satisfactory progress in limiting vulnerability through management of the level and structure of its external debt. In this context the Fund will consider initiatives taken in the area of debtor-creditor discussions, creation of private contingency lines, introduction of call options in debt instruments, and action taken to allow modification of international bond contracts.
- ❖ Finally, the country must have submitted a satisfactory financial programme, including a quantified framework which it 'stands ready to adjust as needed'.

Post-crisis conditionality

Approval of a CCL programme does not provide automatic access to the approved amount on the occurrence of a crisis. The country can draw up to 5 per cent of quota immediately upon approval of the CCL (or at any time thereafter), but the remaining amount will be made available in the event of a crisis subject to an 'activation review'. At this stage the Fund would determine :

- ❖ Whether the financing need is of the type for which the CCL was intended (i.e. caused by disruption of capital flows due to development in other countries);
- ❖ Whether the financial programme submitted when requesting the CCL has been observed; and also whether the country is committed to adjusting its policies to deal with any real economic impact that my follow from the contagion.

Based on the findings of the activation review, the Fund would determine the amount of the CCL to be released immediately and the phasing of the rest of the amount, as well as any related conditionality which may be additional to what was agreed at the time of approval.

changed since the CCL was negotiated, making the earlier agreed macro-economic programme insufficient.[35] The crisis could also reveal new internal weaknesses which were not evident earlier, but which surface because of the crisis. The state of the banking system is an obvious area where the extent of weakness may turn out to be much larger once a crisis arises and where strong corrective action may therefore be needed.

The need to negotiate conditionality after the

35 External developments strong enough to generate contagion effects via investor confidence are usually also strong enough to generate real effects via trade; these effects call for adjustment action.

crisis makes the CCL more like the negotiation of a normal Fund programme whereas the whole idea of providing advance assurance of finance was the ability to draw resources without having to negotiate in the midst of a crisis. However, it can be argued that the possibility of introducing post-crisis conditionality makes it possible to avoid having to negotiate frequent adjustments of the economic programme agreed at the pre-qualification stage to reflect changing circumstances. Besides, negotiation of additional conditionality at the activation stage may be much easier than for an entirely new programme, since there would be a presumption of shared perspectives on policy built into the CCL programme itself.

No country has opted for the CCL thus far. While this may simply reflect that fact that financial markets have calmed down, reducing the perceived need for such a facility, there is also reason to believe that the pre-qualification requirements are too stringent. Countries in a strong position are unlikely to be willing to subject themselves to stringent pre-qualification scrutiny. Countries in a weak position are likely to fear that seeking a CCL arrangement may be viewed as a negative signal by markets and may actually trigger a crisis. These issues will no doubt be considered when the facility is reviewed in April 2000.

e) The adequacy of resources with the IMF

The adequacy of the IMF's resources remains a controversial issue. The SRF and the CCL facilities enable the Fund to provide crisis-hit countries with financing beyond the normal access limits, but the resources available with the Fund are not sufficient to enable it to meet the total demand that may arise if there are crises in a few major countries. The latest quota increase, which provided an additional $65 billion of usable resources, may be sufficient to meet the normal requirements of developing countries for Fund financing but it is much less than what would be needed if the Fund has to deal with crises in several countries.

Central banks acting as lenders of last resort do not face resource constraints because they can create the money needed. Keynes' original vision of the Fund envisaged giving the institution the flexibility to create 'bancor' but that idea was still-born then and would find little support today. Fischer (1999) has argued that the Fund can perform the role of an international lender of last resort even though it cannot create liquidity, and also may not be able to provide all the necessary financing from its own resources, as long as it can 'arrange' finance from other resources. This is the approach that has been followed thus far. In all the major crises of the 1990s the resources of the Fund had to be supplemented by financing from other bilateral and multilateral sources (see Table 3). However there are practical difficulties with this approach as is evident from the East Asian experience.

At first sight, the Fund's efforts at 'arranging' financing can be said to be impressive because it was able to mobilise a total of $117 billion for East Asia from different sources in a very short period. The reality is much less impressive because the bilateral contributions for Korea and Indonesia, which were almost half of the total package for these countries, were only a 'second-stage back up' with considerable uncertainty about the circumstances under which they would become available. If the bilateral contributions for Korea and Indonesia are excluded, the total volume of resources mobilised for East Asia was only $ 76 billion, compared with $ 49 billion (including the US contribution which was unambiguously available) for Mexico in 1995. A comparable figure for the three East Asian countries, using GDP as the scaling factor, would be close to $200 billion![36] As pointed out earlier, inadequate financing may have been a factor

36 This is of course a very crude comparison as GDP may not be the appropriate scaling factor, but it does suggest that the resources made available for East Asia were much smaller than for Mexico and this may be part of the reason why the programmes failed to restore confidence.

Table 3 Composition of Recent Rescue Packages ($ billion)

	IMF	World Bank	Regional Development Bank	Bilateral	Total
Mexico 1995	17.7	-	-	31.1[1]	48.8
Thailand 1997	4.0	1.5	1.2	10.5	17.2
Indonesia 1997	11.2	5.5	4.5	21.1	42.3
Korea 1997	21.1	10.0	4.2	23.1	58.4
Russia 1998[2]	15.1	6.0	-	1.5	22.6
Brazil 1998	18.1	4.5	4.5	14.5[3]	41.6

The rescue packages for each country represent resources available over differing periods for each case.

1 Comprises US$20 billion from the USA, US$1.1 billion from Canada and a US$10 billion credit line from the BIS.

2 Conditional commitments through end 1999. Of these US$1.5 shown under bilateral consists of Japanese support co-financing the World Bank.

3 From industrial countries including direct assistance from Japan and from others through BIS.

explaining the depth of the crises in East Asia, but there was no way the Fund could have quickly mobilised a larger volume of resources given its own resource constraints and the difficulty in raising bilateral financing.

The use of World Bank and Asian Development Bank (ADB) resources as part of the crisis management package also needs to be reconsidered. It can perhaps be justified in the specific circumstances of the East Asian crisis because no other source was available at the time, but this does not mean it should be accepted as a regular feature of the new architecture. Direct involvement in crisis lending operations only distracts these organisations from their primary function, which is to provide long-term development finance; this distraction is particularly undesirable in an environment where the flow of such lending has been declining in real terms over the past decade. The World Bank should, of course, be free to negotiate adjustment lending operations for crisis-hit countries as part of implementing structural reforms or creating social safety nets in the post-crisis phase, but this should be a separate activity with no compulsion to disburse funds in the very short time needed for a crisis resolution package.[37] A more logical role for the Bank in crisis resolution is in the post-crisis recovery phase, when it could use its guarantee facilities to help countries to regain access to commercial markets earlier than might happen otherwise.[38]

The options available to empower the Fund to provide larger volumes of finance in crisis situations are limited. One would be through a larger expansion in quotas. However, this increases the Fund's general financing capability and it could be argued that this is not the best way to provide for the large but sporadic financing requirements associated with severe crises. An alternative approach would be to give the Fund assured access to special borrowing facilities which can be automatically triggered for use in crisis management situations. The GAB and the NAB provide such back-up at present, amounting to a total of $38 billion, but use of

37 Structural adjustment lending requires time to design an appropriate policy framework and this process should not be hurried to fit within the very short timeframe appropriate for crisis management.

38 This is entirely appropriate where market access is needed by the government. However when it is the private sector which needs to regain access, the requirement that governments should counter-guarantee the Bank's guarantee is not entirely appropriate. Ideally the World Bank should be able to extend guarantees to the private sector on the basis of credit assessment and suitable pricing.

these resources requires the specific consent of the contributing countries in each case; each contributing country has a veto on the use of its resources for each particular purpose. What is needed are pre-arranged lines of credit which can be drawn upon to finance SRF and CCL programmes approved by the Fund Board if the Fund's own resources prove inadequate. These lines could be co-ordinated by the BIS and provided by the central banks of the industrialised, and also the major developing, countries which are members of the BIS on an appropriate burden-sharing basis. If it becomes necessary to access resources from the World Bank or the relevant regional development bank, this should be in the form of bridge finance to the Fund, which can be repaid by the Fund in a short time.

A more radical approach to solving the Fund's resources problem outlined in Ahluwalia (1999) would be to amend the Fund's Articles to allow the Fund to issue SDRs to itself, for use in lender of last resort operations, subject to a cumulative limit on the total volume of SDRs that could be created by the Fund for this purpose. The limit could be determined by an 85 per cent majority, as is the case for a general allocation of SDRs and should be set fairly high at, say, SDR 100 billion. The Fund could then finance SRF or CCL operations through this mechanism. These SDRs, on repayment by the borrower, would not be available for general use by the Fund but should be credited back to the Fund's SDR limit to be available only in another crisis situation. This arrangement has several advantages. Unlike a general allocation of SDRs, it would not amount to a permanent increase in unconditional liquidity available to all countries. The liquidity would be injected into the system only in the context of lender of last resort programmes when it would be linked with appropriate conditionality and it would be extinguished on repurchase. Since any programme using these resources would have to be approved by the Board, the additional liquidity involved would be subject to substantial support from the G-7 countries, though not necessarily from all of them.[39]

Unless some initiative along these lines is taken, the Fund's ability to manage large crises will continue to be dependent upon its ability to mobilise individual country contributions. This has obvious disadvantages.

- ❖ The size and even content of the programme will be affected by the political climate in contributing countries at that particular time. This creates a sense of discrimination because some rescue packages will be seen to receive bilateral support more easily than others (for example the generous US support to Mexico in 1995 compared with the more limited support to East Asia). There is also the danger that the Fund's conditionalities may be seen to be tailored to the specific expectations of bilateral donors as alleged by Feldstein (1998) in the case of Korea.
- ❖ The Fund may feel under pressure to rationalise under-funded programmes against its own better judgement. There is a real danger of making over-optimistic assumptions about the speed at which confidence can be restored or the ease with which fresh private investment can be attracted. When these optimistic assumptions do not materialise, there is a danger that the programme itself may be discredited, making recovery that much more difficult.

The inadequacy of resources with the Fund will also lead to calls for regional financing arrange-

39 The report of the Council on Foreign Relations (1999) makes a similar suggestion for financing lending by the Fund in the context of systemic crises. However its proposal is for a general increase in SDRs which does not require amendment, with an agreement that industrialised countries would contribute their SDRs to a pool which could be used by the Fund to supplement its own resources. However this lending would be parallel to Fund lending and the credit risk would be borne by the countries, and not by the Fund.

ments such as the Asian Monetary Fund which was mooted by Japan at the time of the Asian crisis. Co-operative arrangements with Central Banks in the same region providing each other with limited lines of credit are a normal phenomenon but any mechanism for providing large volumes of assistance in crisis situations would have to involve some adjustment programme. How this aspect would have been handled in the context of the Asian Monetary Fund was never explicitly spelt out, but the broad approach appeared to be to provide a pool of resources which would be made available for crisis-hit countries in the region 'in parallel' with a Fund programme and therefore based on Fund conditionality.[40]

Such regional financing arrangements are clearly a departure from the principle of multilateralism. They may seem to be justified in situations where the Fund does not have all the resources that may be needed, but countries which share a special regional interest are willing to provide additional resources to deal with crises in their region. However such arrangements will certainly create differences in the degree of financing available in different situations, and inevitably also differences in the degree of conditionality applied in different cases.

f) The alternative view: A smaller role for the IMF

Whereas developing countries typically call for a larger role for the IMF to deal with the very large financial needs which can arise in crisis situations, there is an alternative view that countries will never be sufficiently motivated to take the necessary preventive actions unless they are encouraged to believe that they are on their own. This is essentially the moral hazard argument, which calls for a reduction of the scale of Fund lending, especially in situations where there is no systemic threat to the system. This is the approach adopted by the Task Force on the International Financial Architecture sponsored by the Council on Foreign Relations (1999) and, in a more extreme form, by the Meltzer Commission appointed by the US Congress.

The Task Force report recommends that the Fund should make a distinction between 'country crises' which do not threaten the functioning of the international monetary system or the performance of the world economy, and 'systemic crises' which are defined as multi-country crises where private markets often dry up and where failure to interfere would threaten the performance of the world economy. For country crises, the Task Force has recommended that the Fund should reduce its potential involvement and adhere strictly to its present access limits of 100 per cent of quota annually and 300 per cent cumulatively. This would rule out SRF type financing in a country crisis, however severe, if it did not threaten the performance of the world economy.

In the case of systemic crises, large-scale lending is acceptable, but the Fund should distinguish between cases where the country's problems are of its own making and those where problems have arisen because of developments beyond the country's control. In the former case, Fund assistance should be offered with strong conditionality and should be funded only through NAB/GAB, so that it would require a special majority of the creditor countries funding the programme to agree to the arrangement. Where the country is judged to be suffering for no fault of its own, it should be financed from a new 'contagion facility' which should replace the SRF and CCL. Unlike the CCL, there would be no pre-qualification and also no Fund programme or conditionality. It is proposed that the new facility would be funded by a special one-time allocation of SDRs in which all countries would contribute their share to a common pool from which lending would take place. Use of the facility would also require a super majority of

40 It was never clear whether the requirement of parallel financing required only that a Fund programme should be in place, or whether all the conditionalities specified by the Fund would also be specified in the parallel programme.

Box 2

Meltzer Commission (majority) recommendations for restructuring and downsizing the IMF

The recommendations regarding the Fund supported by the majority of the Commission are :

a. Surveillance is important but it need not be extended to OECD countries as their performance is reviewed extensively in OECD and BIS.

b. The long-term financing windows supporting policy reform (e.g. the EFF and ESAF) should be closed and shifted to the World Bank and the regional development banks. (This is not just a locational shift to avoid duplication but also implies a scaling down of these flows since the World Bank is expected to narrow its focus to only the poorest countries).

c. The Fund should limit itself to performing a quasi-lender of last resort function providing short-term assistance to 'solvent emerging economies' facing liquidity crises. It should not expect to lend to industrialised countries which can rely on their own central banks.

d. Fund financing should be very short term (120 days with a maximum of one rollover) and there should be a penalty rate related to the sovereign yield paid by the country in the week prior to the IMF application to provide incentives to shift to private financing as soon as possible.

e. There should be no detailed policy conditionality involving prolonged negotiations. Assistance should be provided promptly without conditionality but only to countries deemed eligible on the basis of pre-qualification. The emphasis on pre-qualification reflects the view advanced in Calomiris and Meltzer (1998) that it would strengthen incentives for taking preventive action and thus reduce moral hazard.

f. The only criteria for pre-qualification are the prudential standards in the financial sector, including capital adequacy of banks, the existence of market discipline on financial institutions and especially freedom of entry for foreign financial institutions.

g . The only post-crisis requirement is that Fund assistance should not support 'irresponsible budgetary policies'. (It is not clear how this condition can be fulfilled except through conditionality.)

Several members of the Commission – C. Fred Bergsten, Richard Huber, Jerome Levinson and Esteban Edward Torres – have submitted notes of dissent criticising the majority view. They acknowledge that the Report has some constructive proposals and agree with the need to refocus the Fund and delineate its responsibilities more clearly vis-à-vis the World Bank. However they have stated that 'some of the central proposals are fundamentally flawed and/or unsubstantiated. They rest on misinterpretations of history and faulty analysis [and] would greatly increase the risk of global instability'.

the creditor countries and the loans would be 'in association with the Fund', i.e. the donor countries will bear the credit risk.

Some of the recommendations of the Task Force are clearly innovative. Recognising the distinction between a systemic crisis and a country specific crisis and providing a special SDR-based mechanism to provide finance in support of systemic crises would certainly strengthen the capacity of the Fund to act as a true lender of last resort. Differentiating between countries experiencing crises due to policy mistakes and those hit by contagion, with lower conditionality in the latter case, is also an important step forward. However, the proposal to restrict Fund lending to normal access limits in the case of country crises may be too restrictive. It seems to be based on the presumption that if there is no systemic threat to the world economy there is no need for large-scale Fund lending. This approach can be questioned on several grounds.

❖ The distinction between a country crisis and a systemic crisis may be difficult to make since a crisis in an individual emerging market country, if not properly handled, could snowball into a larger crisis affecting other countries.

- ❖ Even if the crisis is caused by internal policy weaknesses, it cannot be solved solely by corrective policy since the crisis-hit country may not be able to regain normal access to markets for some time, even after it has made all necessary policy corrections. This means it will have a very large short-term financing need until such time as confidence is restored. Refusal to provide financing in such situations will force the country into a severe contractionary phase which involves unnecessary cost. This could be avoided through Fund financing and as long as the financing is short term, at penal rates, and is associated with appropriate policy conditionalities, there should be no fear of moral hazard.
- ❖ Finally the burden of an excessive contraction because of inadequate financing falls very heavily on the poor; allowing larger than normal access can surely be justified on this ground.

The Task Force's proposal to eliminate both pre-qualification and conditionality in the case of countries affected by a systemic crisis through no fault of their own will be welcomed by potential beneficiaries since it appears to move towards Bagehot's classical description of a lender of last resort, lending freely but at a penal rate. However, it is not clear how eligibility under this facility will be determined. Since CCL type pre-qualification is explicitly excluded, there will have to be much greater reliance upon pre-crisis surveillance to certify the quality of a country's macro-management, but even so, this would have to be combined with a specific assessment of whether country policies subsequent to last surveillance review might have been at fault. The recommendations that there should be no Fund programme associated with such lending is somewhat surprising. Even if a country is hit by contagion 'for no fault of its own' in a systemic crisis, such a crisis is likely to generate real effects and it is surely necessary to adjust to these effects. Cushioning the impact of contagion, without ensuring that countries make the minimal adjustments needed to deal with the real shocks associated with the crisis, does not seem well-advised.

The Meltzer Commission has suggested a much more drastic downsizing of the Fund, restricting it to act only as a 'quasi-lender of last resort' and that too with a very narrow mandate. The detailed recommendations regarding the Fund are summarised in Box 2. Several Commissioners have expressed serious reservations with the majority view and have submitted dissenting notes.

The Commission's majority recommendations would restrict the Fund only to providing short-term finance to meet liquidity crises. The traditional role of providing finance to help countries deal with conventional balance of payments problems arising out of a deterioration in the current account is effectively eliminated, presumably because of the belief that all such financing needs can, and should, be met from the markets. This may be feasible for the relatively small number of developing and transition economies which have access to private markets, but the majority of countries do not have such access. Besides, countries which have access to financial markets can easily lose it in times of difficulty. The Fund's traditional role of providing medium-term balance of payments financing under standby arrangements is therefore still needed. Indeed, many recent successful stabilisation efforts, e.g. Mexico, Uruguay, Turkey, the Philippines and Argentina, would not have been possible under the Meltzer Commission proposals. The case for longer-term EFF financing from the Fund also remains strong as long as developing countries have to phase in adjustments over a longer period and cannot access capital markets. It is interesting to note that the Task Force of the Council on Foreign Relations did not question the need for these facilities, but only recommended that the normal access limits should not be exceeded except in a systemic

crisis. The Meltzer Commission goes much further and recommends elimination of these windows entirely.

The Commission's conception of the lender of last resort role is also excessively restrictive. Limiting the term of financing to 120 days, with a maximum of one rollover, may not be appropriate for any liquidity crises. Only Korea in 1998 would have found such financing to be adequate and Korea was clearly a case of exceptionally successful adjustment. One can easily envisage liquidity crises which require a more prolonged period of recovery and restricting Fund financing to a very short period would easily reduce the credibility of the Fund's intervention and jeopardise the chances of restoring confidence. The longer period provided in the SRF/CCL (18 months with a one-year extension if needed) allows more reasonable time for investor perceptions to improve. One can understand the concern to minimise the period for which such resources are used, but this is adequately met by the penalty rate which is applicable.

The proposal to abandon conditionality and replace it by pre-qualification is also impractical. In any case, such pre-qualification could not be based solely on the status of the financial sector as the Commission has recommended. Policy failures in other areas, e.g. fiscal imbalances or poor exchange rate policies, can also lead to crises and it would be odd to ignore such problems when pre-qualifying countries for assistance. The difficulties in devising a discipline for pre-qualification have been discussed earlier in this chapter, in the context of the CCL, and it is not clear how these difficulties can be overcome except by replicating CCL procedures. Although the Commission recommends the abandonment of conditionality, it also specifies that the Fund should not lend in support of irresponsible budgetary policies; this clearly implies fiscal conditionality – a contradiction that is left unexplained.

It would also be difficult to insist that countries which do not meet pre-qualification requirements should be denied finance even if they are willing to undertake appropriate corrective steps after a crisis has occurred. Such denial could precipitate a contractionary spiral followed by an unduly delayed recovery during which the poor would suffer heavily. The costs involved in this option are surely too large compared with the intangible gains of stronger incentives to take precautionary action. The traditional approach of providing financing based on post-crisis conditionality therefore has to be kept open. The argument that a shift to prequalification increases the incentive to take precautionary action is valid, but this is at best an argument for introducing an optional window, based on pre-qualification, which provides easier access to finance in the event of a crisis. This is precisely what the CCL was expected to achieve and we need to see how it work in practice.

Other ways of encouraging countries to take preventive action can also be explored. One way would be to introduce discriminatory pricing for Fund assistance based on the quality of preventive action. Fund surveillance could be used to classify countries into different categories based on prudential criteria and countries in lower ranked categories (i.e. higher risk) could be made to pay a penalty rate for Fund financing. If this country classification is also made public, it would have an impact on market perceptions and affect the rate of interest at which countries can borrow in normal times. Higher rated countries should be able to borrow at finer rates which should increase the incentive to strengthen preventive steps.

To summarise, the role of the Fund in crisis resolution remains a subject on which there are conflicting perceptions. Developing countries, focusing on the potential instability of private financial markets and their tendency to 'dry up' in times of difficulty, typically emphasise the need for the Fund to play the role of lender of last resort. There is general agreement that some sort of lender of last resort is needed and also that the Fund is the logical institution to play that role. However, there is not enough agreement on

what exactly the role implies. Developing countries generally want a Fund with larger resources at its disposal which can intervene decisively in times of crises, with appropriate conditionality ensuring that resources are well spent. Sceptics, mainly in industrialised countries, question the desirability of large-scale financing on the grounds that it provides a soft option, discouraging developing countries from taking adequate protective action and encouraging private lenders to expect bail-outs. Much of this scepticism seems to be based on an exaggerated notion of the efficiency of financial markets and also on an inadequate appreciation of the stabilising role that can be played by the Fund in many situations. Nevertheless there is agreement even among sceptics that the Fund must be able to intervene decisively when faced by a systemic crisis and this agreement is an important outcome of the architecture discussions. The consensus on this point needs to be broadened to allow the Fund to play a stabilising role even in individual country crises. It should be possible to do this in a manner that does not create moral hazard or encourage excessive dependence on Fund assistance.

4.2 Private Sector Involvement

The need to involve the private sector in crisis resolution has received a great deal of attention in the discussion on the new architecture. This is partly because public resources are scarce and crisis resolution strategies must use them carefully; it is also the result of the belief that private sector solutions introduce the right incentives for good behaviour while avoiding the moral hazard usually associated with provision of public resources. Action in this area is now viewed as a relevant factor in determining a country's eligibility to receive financial support in the event of a crisis, thus linking the availability of public resources ex post to the strength of efforts made to involve the private sector ex ante.

a. Contingent credit arrangements

The simplest way of involving the private sector in crisis resolution is to negotiate contingency credit arrangements with commercial banks of the type negotiated by Argentina ($6.2 billion), Mexico ($3.0 billion), Indonesia ($1.5 billion) and several others. The potential borrower pays an upfront commitment fee (in effect an insurance premium) to obtain assured access to finance if needed. The extent to which these arrangements provide net additional finance in crisis situations has been questioned on the grounds that banks offering contingent credit lines may, in the event of a crisis, decide to reduce their exposure through other windows. When Mexico tried to draw on its credit line in September 1998, the banks first tried to discourage the drawing, arguing that it was not really needed, and subsequently threatened that it would only force them to offload other Mexican debt. Yields on Mexican paper did go up immediately after the drawing, but they settled down again quite quickly.[41]

The concern about the absence of additionality in these arrangements is probably exaggerated, but it is not entirely misplaced. The net additionality could be less than it seems if, in the build-up to a crisis, when the banks perceive that the risk of a crisis has increased, they engage in dynamic rebalancing of their exposure by reducing their existing exposure to a greater extent than they would have done in the absence of a contingent credit commitment. However the process itself provides useful market signals which should prompt countries to take corrective action.

A more serious limitation of such arrangements is that the total volume of finance available through them is likely to be limited as is evident from the numbers cited above. Large-scale reliance on these facilities is also likely to lead to pricing arrangements which would reflect

41 Part of the problem in the Mexican case was disagreement about the circumstances in which the lines would be drawn. The banks' understanding was that the lines would be drawn only if alternative financing was not available and not because changes in market conditions regarding interest rates made the contingency line attractive. The interest rate built into the credit lines was only 100 basis points above Libor, and market condition had widened the spread considerably.

the risks involved. Banks are unlikely to agree to pricing arrangements which fix the spread at the time of disbursement, or, if they do, it is likely to be at the cost of much higher upfront fees which reflect the probability of a crisis occurring. The pricing arrangements are also likely to be structured in a way which discourages the borrower from using the arrangement except in real difficulty by fixing the spread at a high enough level.

b. Borrowing to build reserves

An alternative to contingency credit arrangements is a strategy of borrowing to build reserves to levels which would strengthen investor confidence and thereby reduce the probability of a crisis. Higher levels of reserves provide more comfort than a contingency arrangement because reserves are more visible and can also be more freely used when needed. Developing countries integrating with international financial markets definitely need to shift from traditional norms for determining the desired levels of reserves which typically focus on current account variables (for example in terms of 'months of imports') and focus instead on broader concepts of liquidity requirements which include consideration of pressures which could arise from the capital account. The maturity structure of debt is an obvious consideration in this context.

The choice between negotiating contingency credit and borrowing to build reserves has to be made on the basis of relative costs. The cost of borrowing to build reserves is essentially the difference between the interest rate paid on longer-term borrowing and the interest rate earned on reserves which are typically invested in lower-yielding liquid securities. The cost of contingency credit lines is the upfront fee, plus the interest rate that would have to be paid in the event the line is drawn. It is possible that the contingent credit arrangement may be the cheaper option, especially if the need for drawing on the facility is likely to arise only sporadically, and then for a relatively short period, but this depends critically upon the mechanisms used for determining the commitment fee and the interest rate charged at disbursement. In practice, countries would be well advised to follow a mix of both approaches.

c) Call options in inter-bank lines of credit

Another method of obtaining advance access to liquidity is through embedding call options in inter bank lines of credit which allow the borrowing bank to extend maturities under specified conditions. The trigger that would activate the option needs to be clearly defined and exercise of the option could involve a penal interest rate. Since call options have to be negotiated by the banks as a form of insurance against possible illiquidity, the willingness of the banks to negotiate such arrangements obviously depends upon the pricing. It is relevant to ask whether it should be left to the banks to decide on whether to build in such options on the basis of their own assessment of liquidity risk, or whether there should be some regulatory compulsion or incentive to use these instruments. The latter approach has some merit.

4.3 Debt Restructuring and Crisis Resolution

Restructuring of debt payments is a potentially important mechanism for crisis resolution, especially in circumstances where large debt repayments are due and new financing is suddenly withdrawn. Markets view an interruption in debt service payments very negatively, and for very good reasons, and official opinion has generally mirrored this view. However, in certain circumstances, debt restructuring may be the lesser of two evils. The parallel with bankruptcy laws is relevant. Bankruptcy laws are based on the premise that the value of a firm as a going concern is greater than the value of its assets in liquidation. In order to avoid a grab race for assets which pushes a firm into liquidation, firms facing liquidity problems are allowed to obtain temporary respite from recovery action by creditors to give the debtor time to find the finance needed or seek a voluntary restructuring of debt. This may yield an outcome which is more favourable for both debtors and creditors, especially when

the problem is one of liquidity and not solvency.

The need for a similar mechanism to permit an orderly restructuring of international debt, in a manner seen to be fair to both debtors and creditors, has been articulated on several occasions since the Latin American debt crisis.[42] The case for debt restructuring is obviously strongest when the problem is essentially one of liquidity. Restructuring in such cases enables the country to repay its restructured obligations in a relatively short time. Lenders can even be compensated by a higher interest rate on restructured obligations, and the country could return relatively quickly to the international market to raise new finance.[43] Where solvency is involved, a debt restructuring alone may not suffice and it may need to be accompanied by a partial write off. This is clearly more painful, and countries placed in such situations may not regain access for some time, but that is not an inappropriate outcome and certainly sends the right signals for the future. However, even in such cases, it may be better to attempt a debt restructuring with a partial write-off in an orderly fashion rather than allow the crisis to spin out of control with a creditor grab race.

a) The official consensus on debt restructuring

The official consensus on the role of restructuring of private sector debt in crisis resolution has evolved considerably over the past two years with a growing acceptance in official quarters that it has an important role, especially because imprudent lenders must bear some of the cost of restructuring. The current state of the consensus can be summarised as follows:

- ❖ Since even a temporary suspension of debt service has a high cost and undermines confidence in markets, countries should make the strongest possible efforts to meet the terms and conditions of all contracts.
- ❖ However, a temporary suspension of payments can be considered when it is clear, based on consultations with the Fund and other international financial institutions, that even with appropriately strong policy instruments the country will experience an exceptionally severe financial and balance of payments crisis.
- ❖ Unilateral action must be avoided and countries must seek co-operative and voluntary solutions with their creditors. (This is clearly an implicit criticism of the unilateral Russian default.)
- ❖ No category of lenders should be regarded as privileged relative to others. The claims of bond holders must therefore be subject to restructuring in the same way as claims of commercial banks.
- ❖ The Fund should be able to lend into arrears, including arrears on bond holder claims, provided the country is seen to be seriously engaged in negotiations to restructure the debt.
- ❖ It is appropriate that imprudent lenders bear some costs in the resolution of financial crises.

It is important to note that the consensus does not envisage creating any formal institutional mechanism for debt restructuring in crisis resolution situations. In particular, it does not empower the Fund to provide any legal sanction on a standstill on payments, as was suggested by Sachs (1998). However it does give the Fund a critical role in certifying that the pre-conditions exist which justify debt restruc-

42 For a more detailed review of issues see UNCTAD (1998). Raffer (1990) suggested an international treaty establishing an international bankruptcy court for sovereign debt. Other suggestions have focused on less structured arrangements which involve the Fund in various ways as part of the restructuring process, for example Eichengreen and Portes (1995) and Sachs (1998).

43 The restructuring of Korean commercial bank debt in January 1998 clearly belongs in this category as Korea was able to access the market five months later in May 1998.

turing as an exceptional measure. The Fund is not to act as an arbiter determining the terms of restructuring – that must be left to voluntary negotiations – but it is empowered to provide finance to support countries that are undertaking strong adjustment programmes but are unable to make debt service payments, provided that the country is 'seriously' engaged in negotiations with its creditors. This does imply some endorsement of the reasonableness of the debt restructuring position of the crisis-hit country but the implicit endorsement does not have any legal sanction.

The ability to 'lend into arrears' frees the Fund from becoming hostage to unco-operative creditors unwilling to bear any share of the burden. This is an important area of flexibility in view of the recognition that imprudent lenders must bear some costs. However, this does not mean that the Fund is authorised to provide the full amount of financing needed. Fund financing in such situations is at best equivalent to providing working capital to keep the economy going while the country negotiates with its creditors, a negotiation in which the country has a strong incentive to reach a successful conclusion since that determines restoration of normal market access.

The official acceptance of restructuring of private sector debt as an instrument of crisis resolution and the endorsement of 'hair cuts' for creditors in certain circumstances has raised some concern in private sector circles. The Institute of International Finance (1999), for example, has warned that insisting upon debt restructuring as an essential ingredient in crisis resolution may discourage the resumption of private flows in the post-crisis situation. It is argued that one of the reasons for the success of the Mexican package in 1995 was the liberal use of official finance to restore market confidence and the speed of Mexico's subsequent recovery, with its unexpectedly early repayment of all official finance, amply vindicated this strategy. This experience is contrasted with the prolonged debt restructuring attempted in the 1980s which led to a long period of loss of access to capital markets. However, as the recent Korean experience suggests, debt restructuring can be undertaken with an early return to markets. Admittedly Korea's case was exceptional – the problem was clearly one of liquidity and the conversion of commercial debt into sovereign debt was a feasible package because of Korea's strong fiscal situation. Korea's strong adjustment programme enabled a quick recovery once rescheduling was in place.[44]

The private sector has also expressed concern that mechanical insistence on debt restructuring in all crisis situations on moral hazard grounds can have destabilising consequences. Creditors will have an incentive to exit at the first sign of difficulty and this could in fact precipitate a crisis. For the same reasons, countries may hesitate to approach the Fund at an early stage, which is normally recommended, because the approach to the Fund may trigger a flight of creditors if there is a presumption of forced 'hair cuts'. This is clearly an area where some constructive ambiguity is desirable.

b) Extending debt restructuring to bond holders

Fairness requires that if debt restructuring is necessary it should also be extended to maturing bonds but this poses several problems. Renegotiation of commercial bank debt is relatively easy to arrange because the number of creditors is limited and the regulatory authorities in creditor countries can encourage the banks to co-operate. In contrast, renegotiation of bond terms is beset with problems, especially for US-style bonds, which are the instruments most commonly used. Negotiations are difficult to

44 There were also a number of special factors which made the negotiations relatively easy. The creditors were a handful of international banks which had lent to Korean banks and the debt restructuring was facilitated by the conversion of Korean bank debt to Korean government bonds. Such a conversion would have been difficult to justify had the debt been private sector debt and in the absence of government backing of rescheduled debt payments, agreement of creditors may have been more difficult to secure.

organise because bond holders are dispersed and they are also not amenable to encouragement from regulatory authorities. US-style bonds also require unanimity for renegotiating bond terms. These problems can be reduced if future bond contracts are modified to include various provisions, which already exist in UK-style bonds, and which would make renegotiation much easier. These include collective representation clauses which would allow such negotiations to be conducted with designated trustees; qualified majority voting clauses which overcome the problem of unanimous consent; clauses for minimum requirement for legal action; clauses requiring equal sharing of repayment realisations with other creditors in order to remove the incentive for small groups of bond holders to insist on full repayment; and non-acceleration clauses to avoid bond holders seeking to exit at the first sign of trouble or default elsewhere.

Such clauses could be easily introduced into sovereign bonds and quasi-sovereign bonds. They could also be made mandatory for bonds issued by commercial banks which would give debtor countries an opportunity to renegotiate bond contracts if a serious crisis forces some resort to restructuring. There is perhaps less need to introduce such changes in private corporate bonds since it is not practical for the government to trigger such negotiations and have them conducted by the debtors who would be numerous.

Developing countries have been reluctant to introduce such clauses unilaterally because of the fear that they would be viewed negatively by the markets and lead to higher pricing. The post-Mexico G-10 Report, which first recommended modification of bond contracts, had indicated that industrialised countries may be willing to give the lead by introducing such covenants in their own instruments. This has not happened so far and is unlikely. However, even if the industrialised countries do not take action in this area, developing countries may be well advised to introduce the changes on their own. The fears of a negative market reaction may be exaggerated since the risk of a financial crisis is a real risk and is presumably built into the pricing of existing bond contracts. As long as modification in bond contracts does not generate moral hazard and encourage countries to resort to restructuring lightly, it could be argued that it may even improve bond pricing because it ensures an orderly restructuring of debt in the event of a crisis; this is surely better for creditors than the disorderly process which would result otherwise.

c) Controls on other capital outflows

An issue which has not received sufficient attention in the context of debt restructuring is whether, in a crisis situation where debt restructuring is initiated, countries should also impose controls on other capital outflows, at least during the period when the negotiations are taking place. Unless this is done situations may arise where creditors are prevented from taking their money out, while residents, and even other foreign investors, remain free to exit through the open capital account, thus exacerbating the currency crisis. Raising domestic interest rates is one of the ways of discouraging such outflows but, as pointed out earlier, this has its limitations.

The G-7 Finance Ministers (1999) have recognised that in exceptional circumstances countries may need to resort to capital or exchange controls as part of crisis resolution. However there is no agreement on what precise circumstances would justify such a step, nor what should be the coverage of these controls. The IMF has an important role in crisis resolution, but it has yet to evolve a set of rules, or even guidelines, which might help to define best practice in this area. As noted earlier, there is an understandable reluctance to give the Fund any mandate for approving capital controls of any kind, but there is a clear need to evolve a consensus on this issue as it would help create shared expectations about what constitutes a reasonable approach.

To summarise, the new architecture dis-

cussions have made some progress in defining a possible framework for debt restructuring as an instrument for crisis resolution, giving the IMF a limited role in certifying the preconditions in which such restructuring is appropriate and also in providing financial assistance for adjustment programmes associated with debt restructuring. However, it must be recognised that standstills on debt payments cannot be a 'first resort' instrument. They cannot therefore be used to halt a crisis in its early stages – other instruments have to be used for that purpose – but they cannot be invoked as a last line of defence to prevent a crisis from spiralling completely out of control.