

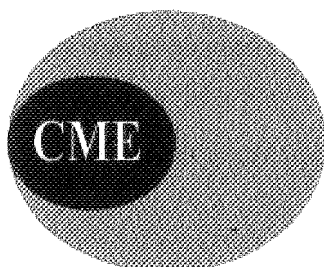
Working Paper Series 4/02

Resolving International Financial Crises – The Missing links

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April 2002**

Handelshøyskolen BI
Hovedbiblioteket

18 JUNI 2002



Centre for Monetary Economics

SERIE/HANDE

RESOLVING INTERNATIONAL FINANCIAL CRISES – THE MISSING LINKS

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1. Introduction

Over recent years, the debate on the international financial architecture has been intense. Several reform plans have been tabled. Some of these are “big ideas” requiring new, supra-national institutions – or at least an adaptation of existing institutions. In 1999, Fischer set out a blueprint for an International Lender of Last Resort, with the IMF as its centrepiece (Fischer 1999). One year later, Eatwell and Taylor (2000) proposed the creation of a International Regulatory Agency, to serve as financial sector rule-setter and supervisor at a global level. Last year, Krueger (2001) set out a plan for an International Bankruptcy Court – or Sovereign Debt Restructuring Mechanism (SDRM). All of these big ideas would require far-reaching institutional and statutory change.

In among these “big ideas” are several smaller ones, which mix and match some of the elements of the above models. For example, some have argued for a greater use of collective action clauses (CACs) in bond – and possibly other loan – contracts (Eichengreen and Portes (1995), Taylor (2002)). Others call for more intense dialogue between creditors and debtors in the run-up to and following crisis, perhaps by convening creditor committees (IIF (2002)). Others still have proposed some judicious mix of presumptive limits on official finance and the greater use of payments suspensions or standstills (Council on Foreign Relations (1999), Miller and Zhang (1999), Haldane and Kruger (2001), Kenen (2002)). These smaller ideas typically require less far-reaching reform.

These reform plans differ along a number of dimensions. Some would require statutory change (eg, the SDRM), while others are explicitly non-statutory in nature (eg, the Council on Foreign Relations). Some are explicitly aimed at countries facing solvency problems and therefore requiring a write-down of their debts (eg, the SDRM and CACs), whereas others would be used to help deal with both liquidity and solvency problems (eg, Kenen). Some require sweeping change to the international architecture which could take, at best, many years to put in place (eg, SDRM), while others represent incremental

progress from the current status quo and could therefore be implemented in short order (eg, Haldane/Kruger).

In this paper we seek to do four things. First, to establish whether some of the “big ideas”, by themselves, would be adequate in dealing with the crises seen over recent years. Second, to identify the “missing links” necessary to establish a robust architecture for dealing with such crises. Third, to argue that these missing links, once established, would take us 95% of the way towards achieving the aims of the big ideas. And fourth, to set out a plan of the crisis resolution framework, which nests both big and small ideas in an integrated fashion.

2. Comparing Two Reform Plans

To clarify some of the holes in the existing architecture, we compare and contrast two plans for architectural reform: one big idea – the SDRM; and one smaller one – Haldane/Kruger (hereafter HK). In the final section we discuss how these proposals can be integrated in a single crisis resolution framework.

On the face of it, these two reform plans have some similarities.¹ They share a common objective: the resolution of crises in a more orderly and equitable way than has been the case in the past. And some of the mechanisms they propose for achieving this goal are also common, in particular the need for a temporary suspension of payments or standstill. Standstills were recognised as one of the available tools for resolving crises in the IMFC Communique from Prague in 2000.² The SDRM and HK plans give this standstill idea some operational content.

The differences between the two reform plans are also, however, quite striking. Perhaps most fundamentally, the SDRM envisages a *statutory* standstill mechanism designed to

¹ Indeed, some have suggested the HK plan was an intellectual forerunner of the SDRM. For a discussion of academic antecedents to the SDRM, see Rogoff and Zettelmeyer (2002).

² “...in certain extreme cases, a temporary payments suspension or standstill may be unavoidable.”

deal with sovereign *solvency* cases. By contrast, HK propose a *non-statutory* standstill mechanism designed to deal with both *solvency* and *liquidity* crises. These differences go to the heart of our concerns about the “missing links”.

To meet its stated goals, the SDRM would need to have the force of international law. That could only be established by international treaty or by a change in the IMF’s Articles of Agreement. Both would require changes in legislation in some national jurisdictions. The other key aspect of the SDRM is that it is designed only for those countries with an unsustainable debt load, which needs to be written-down in net present value terms. It would only be invoked in the so-called solvency cases.

These two features of the SDRM run together quite naturally. A legally-watertight mechanism would be useful in ensuring a comprehensive and smooth restructuring of international sovereign debts. It guards against the myriad creditor collective action problems typically associated with such an international debt restructuring. For example, it would prevent litigation by creditors against a defaulted sovereign debtor; and it would guard against the risk of some creditors holding-out from an agreed restructuring of debts (Krueger (2001, 2002)).

In both these respects, the SDRM model offers some advantages over CACs. It resolves some of the collective action problems otherwise associated with sovereign debt restructuring. This is sufficient to establish that the SDRM would be desirable as a means of dealing with certain types of crisis. The question is whether it is sufficient, or indeed even necessary in dealing with crises generally. The following sections argue that it is neither.

To establish these points, we focus on the two operational dimensions along which the SDRM and HK models differ. First, when to invoke a standstill – in liquidity or solvency cases? Second, how to invoke a standstill – using statutory or non-statutory means?

3. When to Invoke a Standstill?

The SDRM model is motivated, in part at least, by US corporate re-organisation law under Chapter 11. There are some clear points of tangency. For example, a stay on creditor litigation, a cram-down of creditors through majority restructuring provisions, and the provision of new monies with seniority during the stay (“debtor-in-possession” financing) are key features of both models.

Equally, however, there are some sharp differences between the two models. For example, under the SDRM, an *ex-ante* assessment of solvency is made before the mechanism is invoked. Indeed solvency, or at least unsustainability, is a precondition for SDRM activation. That is because the SDRM is only foreseen as being used for those cases requiring a write-down of debts – that is, the solvency cases.

This contrasts markedly with Chapter 11 procedures. Under Chapter 11, there is no *ex-ante* solvency assessment of the corporate. That assessment is only made after the standstill has been activated and a corrective plan put in place. *Ex-post*, Chapter 11 is used both for cases of corporate insolvency requiring liquidation of the firm, and for cases of corporate illiquidity where the firm is rehabilitated as a going-concern. Chapter 11 is designed for corporate *reorganisation*, rather than liquidation per se.

These Chapter 11 procedures make perfect sense when we begin to think about how the solvency or sustainability of a corporate is assessed. The solvency of a corporate depends on a comparison of the net present value of its liabilities and its assets. The liabilities in question will include future debt servicing costs. The assets will include future profits.

Several important consequences follow. First, any sustainability assessment will clearly be *probabilistic*; it will depend on the time-path of uncertain future variables. For example, the future path of liabilities will depend on macroeconomic outcomes for interest rates and growth; while the future path of profits will depend on actions taken by the firm. Both are very uncertain.

Second, following from this, sustainability is *conditional* on the outcome of actions taken by the firm (eg, on profits) and on macroeconomic outcomes (eg, debt servicing costs). Third, taking the first two statements together, a binary assessment of unsustainability is unlikely to be possible. Or, put differently, it is only for a small subset of cases that we will be able to say that a company is unsustainable or insolvent with probability one. Most corporates will lie somewhere along the liquidity/solvency spectrum rather than at the poles – what we might call operating in the “grey zone” between pure liquidity and pure insolvency.

Faced with this uncertain outlook, Chapter 11 pursues a course of informed agnosticism. It calls for a temporary suspension of payments before any decision on solvency is made. This breathing space allows time for the corporate to be put in place alternative plans. The execution of these plans resolves some of the uncertainties about the company’s financial standing. Either the plans are sufficient to put the company back on the path to viability, in which case it emerges from Chapter 11 as a rehabilitated going-concern. Or the reorganisation plan still leaves the corporate unviable, in which case it is liquidated. Ex-post, the corporate’s problem can have been one of illiquidity or insolvency, given the ex-ante impossibility of making this judgement definitively. The standstill provides time for that judgement to be made.

4. Implications of the SDRM Model

Against this backdrop, consider now the operation of the SDRM, if it were simply to be glued onto the existing architecture. The SDRM is only invoked when an ex-ante assessment suggests that a write-down of debts is necessary – that is, when the probability of sovereign unsustainability is close to unity. In practice, this is likely to be a very narrow subset of countries. Sustainability is, if anything, even more uncertain in a sovereign than in a corporate context. In sovereign context, assets are future fiscal or current account surpluses (rather than profits). These depend, *inter alia*, on policy actions taken by the authorities. And these actions in turn depend not just on economic

factors but also on political ones. It is for this reason that some theorists have argued that sovereign default is fundamentally different than corporate default, reflecting willingness rather than ability to pay (Eaton and Gersovitz (1981)). This adds to the intrinsic uncertainty of a sovereign sustainability assessment. Other things equal, it would lead us to expect a greater number of countries (than companies) to be operating in the “grey zone” between pure illiquidity and pure solvency.

How would these grey-zone crises be dealt with? The SDRM is mute on this question; it is a piece of kit designed for a different set of crisis cases. So in the absence of other changes in the architecture, the grey-zone crises would need to be fixed using the existing architectural tools – namely, through some combination of official financing and policy adjustment. But this approach to tackling the grey zone crises is, we would argue, fraught with problems. It provides the wrong incentives to debtors, the official sector and private sector creditors. And it is unlikely to guard against the crises seen over recent years – for example, in Turkey and Argentina.

For countries in a grey-zone crisis, the existing system provides incentives to seek further official finance even when there is a very high probability of their debts needing to be restructured. Countries will almost always want to “gamble for resurrection” with cheap IMF money, rather than default and risk the political and economic repercussions. The existing system, with or without the SDRM, would do nothing to prevent such a gamble. We would expect the gamble to be repeated if it fails the first time, as countries in effect double-up their bets.

For the official community, the present system presents them with a time-consistency dilemma in dealing with grey-zone crises. Do we support a country that has a chance of avoiding default, even though the odds are strongly against a programme working? In the past, the official sector has been all too willing to give a country that chance, however slight. In other words, it has been complicit in supporting an approach of gambling for resurrection in the face of a grey-zone crisis. This is understandable given the membership-based governance structure of the IMF.

Finally, the existing approach to dealing with grey-zone crises also has potentially adverse incentives effects for the private sector. Bailing-out countries where the risk of unsustainability is high is more likely to result in official financing of private capital outflows. Why? Because creditors are most likely to bail-out of countries where they perceive the risk of a write-down to be high. So in grey-zone countries, we are most likely to see credit risk being transferred from the private to the public sectors.

These skewed incentives on the part of the official sector, private creditors and debtors are unlikely make for a favourable crisis-resolution framework. How would these adverse incentives manifest themselves?

First, we could expect to see a sequence of failed IMF programmes, as countries and the IMF gamble for resurrection – and the gamble fails. Second, we would expect to see these IMF programmes contain increasingly implausible assumptions, consistent with an ever-decreasing risk of the country reaching sustainability. Interestingly, there is empirical evidence from the IMF themselves to support this assertion. Systemic biases appear to exist in high-access IMF programme assumptions, if not in IMF programmes in general (Musso and Phillips (2000)).

Third, we would not expect any reflow of private capital in response to new IMF programmes. The traditional catalytic effect would be absent. Again, there is evidence from the IMF of this being the case in a number of recent capital account crises (Ghosh et al (2002)). Fourth, we would expect to see some debtors needing to undergo painful restructuring – more painful than if the bullet had been bitten sooner. Gambling for resurrection carries large potential benefits, but also commensurately larger costs for creditors, debtors and the official sector if the gamble fails and a larger debt load needs to be restructured. Finally, we would expect to see the IMF's loan book skewed towards a small number of big countries. A number of repeated programme failures would remain on the IMF's books. At present, the programmes in Turkey, Argentina and Brazil account for over 50% of the IMF's loan book.

All of these characteristics have been exhibited, in differing degrees, during the course of recent crises. In Russia, Indonesia, Argentina and Turkey we have seen a sequence of failed programmes. A number of these were founded on assumptions that, with hindsight, were systemically over-optimistic. That was particularly true of projections for the reflow of private capital. In all but the last of these cases, we have seen a painful and in some cases on-going debt restructuring.

The SDRM, had it existed back then, would arguably have done nothing to prevent this sequence of events in the countries in question. It would have helped in tidying-up the mess. But it would not have prevented this mess emerging in the first place. What would have done so? We would argue that there are two critical missing ingredients from a framework capable of averting these outcomes.

The first would be presumptive limits on the availability of IMF financing. Such access limits already exist for some IMF facilities – for example, IMF Stand-by Arrangements (SBA). But, in practice, these limits have largely been honoured in the breach. Moreover, some IMF facilities do not have limits on access – for example, the Supplemental Reserve Facility (SRF) introduced in 1987. As this is the primary IMF instrument for dealing with capital account crises, this means that in practice IMF lending faces relatively few constraints. This flexibility in IMF financing in turn fosters incentives to gamble for resurrection, even when the odds of success are short.

Placing presumptive limits on IMF facilities would help defuse these adverse incentives. It would provide incentives for debtors, creditors and the private sector to come up with alternative means of resolving grey zone crises. These solutions would not involve an increase in debt in situations where the odds were heavily in favour of the final solution requiring less debt. The limits would be “presumptive” because access above these limits would be permitted, but only in exceptional and well-defined circumstances – for example, in situations of grave systemic risk. Programme-approval procedures could be strengthened to reinforce the exceptional nature of access above the limits – for example,

by requiring approval by a super-majority of the IMF board (see Haldane and Kruger (2001)).

Such a system of limits plus escape clauses would then have many similarities with the framework used by many central banks in a monetary context. Monetary frameworks tend to combine fixed nominal targets (for example, an inflation target) with some flexibility (for example, escape clauses or bands for certain types of shocks). The resulting system has been interpreted by some as one of “constrained discretion”. It seeks to balance ex-ante incentives – the need to reign-in inflationary excesses – with ex-post flexibility – the need to respond adequately to offset the effects of adverse shocks (Barro and Gordon (1983)). Limits with escape clauses can be the optimal means of dealing with this ex-ante credibility/ex-post flexibility trade-off in a monetary context (Lohmann (1992)).

The exact same arguments apply in the design of a framework for crisis resolution. There is the same trade-off between ex-ante incentives – the need to reign-in financial excesses – and ex-post flexibility – the need to respond adequately to adverse shocks (Portes and Eichengreen (1995), Miller and Zhang (2000)). And the optimal framework is again likely to involve “constrained discretion”. Limits with escape clauses are one means of delivering such an outcome.

The second of the missing links are standstills. If IMF access limits are the incentive device for dealing with grey-zone crises, then standstills are the apparatus. They would reserve an identical role to the one they play under Chapter 11. They are a policy of informed agnosticism, allowing debtors a breathing space to resolve policy and macroeconomic uncertainties by putting in place corrective plans. Standstills are agnostic on whether the final outcome is a write-down of debt in net present value terms (a solvency crisis) or whether debt is unaffected in net present value terms (a liquidity crisis). In this sense, standstills are a man for all seasons.

5. How to Invoke a Standstill?

Under this alternative model, standstills would play a more substantive role than under the SDRM, helping deal with both liquidity and solvency crises. But how, in practice, would standstills operate? Who would call them? Would they have a statutory basis? And what role would the official sector play?

The responsibility for calling a standstill can only, and should only, reside squarely with the debtor. The official sector can, however, influence in important ways debtor incentives to activate and maintain a standstill, through decisions about official lending. In particular, the IMF currently has the capacity to lend to countries which have temporarily suspended payments to their debtors, through so-called “lending-into-arrears”. Lending-into-arrears is a non-statutory means of helping countries tackle liquidity crises, by providing financial support to countries seeking the breathing space of a standstill.

To be eligible for IMF lending-into-arrears, a debtor in principle need only comply with two conditions: first, it needs to be adhering to IMF programme parameters; and second, it needs to be acting in “good faith” with private creditors. Arguably, both conditions would benefit from some sharpening.

The current programme parameters for lending-into-arrears lack clarity. This acts as a strong disincentive to countries contemplating the suspension of payments. Debtors are uncertain whether they are likely to be complying with programme conditions – and hence uncertain whether the IMF will be willing to stand behind them if they stop payments. This lack of clarity is also costly for creditor. For example, in a situation of sovereign default, it is unclear how an IMF programme strikes the appropriate balance between official financing, debtor adjustment and the haircut taken by private creditors. Since the first two help determine the third, this is an area of particular concern to creditors. This was evident at the time of the IMF’s lending-into-arrears to Ecuador in 2000.

The “good faith” condition which attaches to lending-into-arrears is important in protecting creditors’ interests, but also lacks operational content as currently defined. Lending-into-arrears needs a more concrete set of good faith guidelines. For example, it could require transparency of policy information by the debtor; consultation between the debtor and all of its creditors; and it could provide for the seniority of new private finance extended after the suspension of payments. These good faith conditions would then act like surrogate work-out principles, the like of which have been proposed by other bodies (eg, Council on Foreign Relations (2000)). They would help ensure the debtor played fair during the period of the payments suspension.

Would IMF lending-into-arrears, augmented in the ways outlined above, take us far enough, or would statutory change also be necessary? To address this question, it is worth recalling the four primary advantages of the SDRM. These are to protect creditors’ interests during the standstill; to provide for the seniority of private monies extended during the standstill (“debtor-in-possession”); to guard against litigation by creditors against the debtor; and to mitigate the risk of hold-out creditors disrupting a debt restructuring agreement (Krueger (2001)).

The protection of creditors’ interests and the provision of new IMF monies could be explicitly accommodated under an augmented lending-into-arrears policy by the IMF. These features of the architecture do not need a statutory basis. It is more a question of providing the right set of incentives to debtors and creditors to do the right thing. Augmented lending-into-arrears could provide such incentives.

That leaves litigation and hold-out risk by creditors. A statutory framework such as the SDRM would rule out these risks *de jure*. But it is worth assessing whether a well-designed non-statutory framework could do the same thing *de facto*. And, indeed, it is interesting to assess how great these risks are in the first place.

Litigation risk is an ever-present for a defaulted sovereign. Of the 70 sovereigns that have defaulted since 1975, around 20 have faced litigation. But the risk is easily overstated. In very few of these cases has litigation been widespread or successful. The norm has been unsuccessful or small-scale payouts to a narrow subset of “rogue” creditors. The recent Elliot Associates versus Peru case is not thought by most informed observers to have altered fundamentally that dynamic. And the intrinsic difficulty of attaching sovereign assets makes it unlikely that dynamic will much alter in the future.

Even if it were deemed important, contractual devices could well have an important, complementary role to play in guarding against litigation risk during the period of a non-statutory standstill. The introduction of sharing clauses in sovereign debt would serve to mitigate litigation incentives among rogue creditors, as the proceeds of any successful action need then to be shared across all creditors. These clauses were common in syndicated loans issued during the 1980s, but are not typically included in bonds. The retraction of waivers of sovereign immunity in sovereign debt instruments would be a second contractual means of achieving the same end. These contractual clauses would serve as useful underpinning to non-statutory standstills.

On hold-out creditor risk, history again offers some encouragement. Recent sovereign debt restructurings in Pakistan, Ukraine and Ecuador all resulted in only a very small set of hold-out creditors – typically, less than 1%. As with litigation, the incentives of most creditors are heavily skewed towards accepting the agreement of the majority, given the costs and uncertainties involved in being in the minority. Contractual clauses also again have a potentially important complementary role to play. For example, majority restructuring agreements, common under English law, provide an explicit contractual means of guarding against the “tyranny of the minority” (Buchheit et al (2002)). Exit consents provide an (implicit) contractual means of achieving a potentially similar end.

Against this backdrop, it could plausibly be argued that a framework of non-statutory standstills would take us 95% of the way towards achieving the same objectives as a statutory framework. Given the practical costs involved in the statutory approach – an

international treaty or a change in the IMF's Articles of Agreement – they sound like a reasonable compromise.

6. The Crisis Resolution Framework

Figure 1 attempts to bring together some of the architectural ideas discussed above, in the context of a single, integrated framework for crisis-resolution. The framework can be thought to comprise three phases. A country in crisis might move through these phases chronologically. Alternatively, the phases could be thought to apply to countries which are at different points along the liquidity-solvency spectrum.

The IMF has the facility to lend through all three phases. But this lending is subject to an aggregate presumptive limit. This limit serves as one of the key incentive devices to debtors and creditors, to resolve their payments problems expeditiously and voluntarily. It also improves the predictability of the overall framework and mitigates the risk of time-inconsistency problems for the official sector.

The first crisis resolution phase would involve conventional IMF programming. It would require no change to the existing architecture. The IMF provides last-resort financing to a country facing payments problems, with associated conditionality. This is intended to have a catalytic effect on private sector capital flows. This might by itself be sufficient to resolve a great many crises, especially those towards the pure liquidity end of the spectrum.

In the middle phase, there is a role for non-statutory standstills. These are supported by the official sector through lending-into-arrears, with its accompanying conditionality. Inter alia, lending-into-arrears conditionality helps protect creditors' interests. The standstill allows the debtor breathing space to put in place remedial policy measures, on the basis of which an ex-post assessment can be made of sovereign sustainability.

That assessment would determine where a country moves next. One route would see the sovereign rehabilitated onto a sustainable payments path in the third phase. Ex-post, the crisis has been a liquidity crisis. Another route would see the sovereign needing to write-down its debts with private creditors in the third phase. Ex-post, the crisis has been a solvency crisis. In this event, a debt restructuring is required. This could be facilitated by the use of clauses in debt contracts (the contractual approach) or indeed by the SDRM (the statutory approach) were it to exist. Note that both of these approaches potentially have a role to play in dealing with certain types of crisis. They are a potentially desirable feature of any crisis-resolution framework. These mechanisms are not, however, strictly necessary for the crisis resolution framework. And they are most certainly not sufficient for the operation of this framework.

Sufficient conditions for an orderly framework for crisis resolution are presumptive limits on the one hand, and an orderly mechanism for non-statutory standstills on the other. These are really two sides of the same coin. One provides the incentives to avoid the excessive accumulation of debt; the other, the apparatus for managing-down that debt. Currently, we have neither mechanism. They are the “missing links” in the international architecture. Lofty goals or big ideas for redesign of the international architecture should not lose sight of this basic fact.

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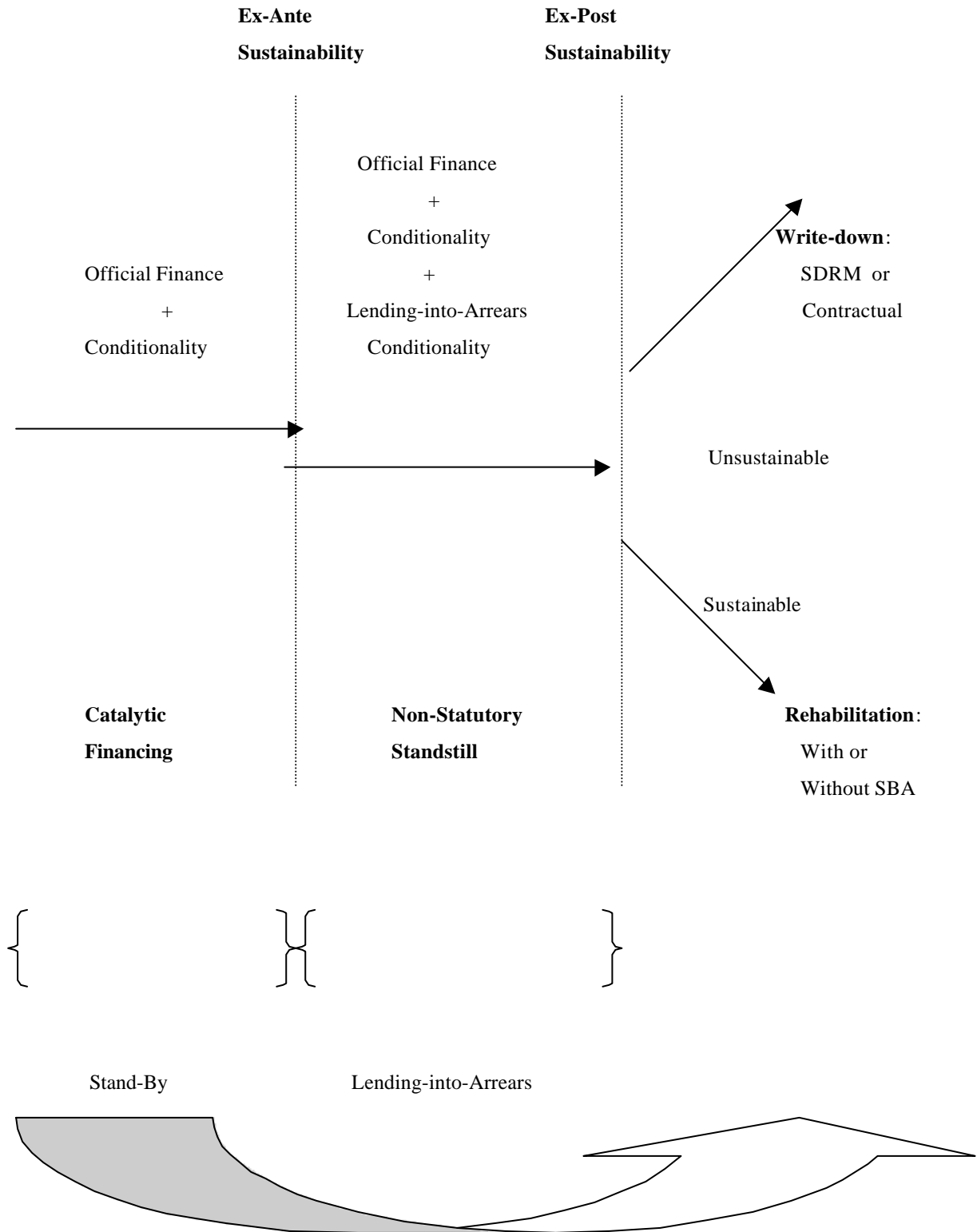
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Figure 1: Crisis Resolution Framework



Presumptive Limit