BAILING IN THE PRIVATE SECTOR: BURDEN SHARING IN INTERNATIONAL FINANCIAL CRISIS MANAGEMENT

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

Special Features

THE NATURE OF THE PROBLEM

The case of Mexico in the mid-1990s illustrates this problem. The Mexican government entered the crisis at the end of 1994 with some U.S.$28 billion in short-term, foreign-currency-indexed government obligations (*tesobonos*) set to mature, but only U.S.$6 billion in foreign reserves. Once confidence was lost, no investor had an incentive to make additional foreign exchange available. Had international assistance not been provided, Mexico almost certainly would have been forced to suspend redemption of these debts, inflicting significant losses on its creditors and risking damage to its creditworthiness. Instead, the government used its U.S. and International Monetary Fund (IMF) loans to retire its short-term, dollar-indexed debt obligations at full value as they matured.

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In the case of South Korea, the mechanism was more involved but the result was the same. Foreign creditors who had extended short-term loans to Korean banks attempted to withdraw their balances all at once. Those short-term credits far exceeded the government's foreign reserves. In the last two months of 1997, the Bank of Korea's reserves fell from U.S.$31 billion to U.S.$21 billion, with more than half the latter amount immobilized in the form of deposits with foreign branches of domestic banks.[1] Figures vary for the short-term foreign-currency obligations of the South Korean financial sector, but one seemingly reliable estimate puts them at about U.S.$26 billion in December 1997.[2] Had no official assistance arrived, the South Korean authorities would have been forced to declare a moratorium on foreign payments. Instead, the U.S. and IMF-led loan enabled the South Korean government to inject more credit into the banking system, deposit more reserves at overseas branches of Korean banks, and keep interest rates lower than otherwise would have been feasible, while paying back maturing foreign credits in full. The result was, in effect, to replace a significant share of those foreign credits with official funds.[3]

One justification for the South Korean package bandied about in Washington, DC, is that the Korean peninsula has too much geopolitical importance for South Korea's economy to be allowed to languish unaided. Similar arguments have been made about Indonesia, which sits astride some of the world's most important ocean-shipping lines. The South Korean and Indonesian precedents gave investors confidence that Russia, an "Indonesia with nukes," would receive similar assistance. This rhetoric may seem exaggerated, but in the wake of the IMF's Asian support programs, international bankers and others who poured money into Russia referred to positions in Russian treasury bills (GKOs) as the "moral-hazard play." There were sizable inflows of funds into Russia in the months following the Asian rescue packages. This was followed by financial difficulties, a crisis and an IMF rescue package in the summer of 1998.[4]

In practice, of course, not all investors were shielded from losses. In Mexico, the price of *tesobonos* tumbled before it became clear that the Mexican government would be able to retire them, and many investors who scrambled out of the market did so at a loss. In Mexico in 1994, and even more so in Asia in 1997, official support did not avert major declines in stock, bond and real estate prices, and investors in these markets incurred extensive losses. None of this, however, is to deny either the moral hazard problem or that present arrangements for handling crises are deficient, but rather to caution that one should not exaggerate the extent to which investors have been shielded.

The real dilemma is presented by bank creditors. Foreign funding of domestic banks in the form of deposits and deposit-like instruments is highly liquid. Deposits have a fixed face value. Banks are key to the stability of a country's payments and credit system. As a result, governments are understandably reluctant to contemplate any treatment of these claims that might threaten their position. These facts make it extremely difficult to write down foreign claims on domestic banks. It would be nice if foreign bank creditors could be made to "take a hit," that is, persuaded to reschedule and write down their claims. But so long as foreign bank creditors have the option to flee and bring down the banking system in their wake, governments will contemplate this option only *in extremis*.[5]

If the tendency for official support to shield creditors from losses—and to thereby encourage imprudent investor behavior—was not sufficient grounds for concern, there also is the question of whether international assistance as currently constituted can protect the recipients from serious damage. All too often, IMF-led rescues are ineffective in containing a panic because their resources are limited and are doled out drop by drop. Unlike a domestic lender of last resort, the IMF cannot print money, nor would its principal shareholders let it.[6] They are reluctant to do so because, unlike a government with regulatory powers dealing with a problem bank, the IMF has little ability to force corrective action on its members. Since the Fund lacks the other legal and supervisory powers of a government, it lacks the leverage to ensure that it will get its money back. Thus, the IMF is endowed with fewer resources, lends less freely and relies more heavily on continuing performance criteria when disbursing its funds. Similarly, the IMF hesitates to front load its disbursements, requiring evidence that policy reforms are being implemented before it releases each additional tranche of financing.[7]

For all these reasons, publicly committed support is generally less than meets the eye. The international community committed U.S.$57 billion to South Korea but released only U.S.$13.2 billion by the time the crisis there reached its height.[8] As a result, countries receiving international assistance and trying to avoid a debt moratorium, standstill or pause have to hike interest rates both to lure back foreign investors and to satisfy the Fund.

Why are governments so willing to put their economies through this wringer? Why in particular do they hesitate to suspend payments and negotiate agreements with the creditors to restructure debt? First, it would certainly discourage imprudent lending. Second, and more importantly from the domestic point of view, governments could avoid putting their economies through the wrenching deflationary consequences of the adjustments required for the maintenance of external debt service.[9]

Measures such as suspension of payments are shunned because governments and the international policy community regard the collateral damage as too severe. Countries that suspend payments and attempt to restructure find it difficult and costly to reach an agreement with their creditors. Their reputations are damaged, and they find it harder to borrow on international capital markets afterward.[10] However expedient the short-run policy, most governments regard the long-term consequences as insupportable.[11]

"Bailing in" the private sector, ensuring that private investors also take a hit, presupposes changes in institutional and contractual arrangements that make it palatable for governments to declare a moratorium and restructure their debts. It requires changes in the international financial architecture. These changes fall under two headings: *ex ante* measures (to be taken before the crisis), and *ex post* measures (to influence how it plays out).

Ex Ante Measures

Two classes of measures can be considered under this heading: discouragement of bank-to-bank lending and negotiation of international credit lines. The most direct way to avoid letting foreign creditors off completely is not to borrow from them in the first place. Short-term foreign credits, and particularly those taken by domestic banks, pose a special problem because they are easily liquidated, making it almost effortless for short-term creditors to scramble for the exits. These credits also pose a special problem because the institutions dependent on them are central to a country's financial stability.

The need to preserve the stability of the banking system makes it hard to impose a share of the adjustment burden on these creditors. For this reason, countries should discourage reliance on short-term foreign credits to the banking system in the first place. The Basle risk weights[12] for foreign bank lending should be raised and should be keyed to the source of a bank's funding and to the riskiness of the bank's investments. In markets where political pressure prevents capital from being written down, there is an argument for taxes or quantitative ceilings on short-term foreign funding. Where non-financial firms can do the borrowing and pass the proceeds on to financial intermediaries, there is an argument for the use of measures like those employed by Chile. Its government, while applying a tax to all capital inflows, structures that tax to fall most heavily on short-term inflows. If administered successfully, such measures would increase foreign portfolio investors' reliance on stocks, bonds and other long-term instruments, on which they would naturally suffer capital losses in the event of a financial crisis.

A second approach would be for governments to negotiate standby lines of credit. Foreign banks would agree to make these credit lines available in return for a commitment fee. Since foreign bank creditors would no longer be able to eliminate their exposure to the country in question, they would be more predisposed to negotiate a restructuring plan. From the standpoint of the borrowing countries, these credit lines would provide additional resources to insure against shocks to investor confidence. Both Argentina and Mexico have negotiated such agreements with foreign commercial banks despite neither country having an investment-grade sovereign credit rating. This strongly suggests that other countries could do the same.[13]

The main weakness of these arrangements is that the banks will be able to hedge their exposure. At the same time that they provide additional credits, they can contract to sell short government bills and bonds. In so doing, they can eliminate their exposure, and the country will have no additional financial resources to prop up its banking system or cope with other consequences of the crisis.

This constraint can be relaxed in part if the IMF and regional development banks supplement the contingent facility.[14] Like the commercial banks, these institutions could make credit lines available to governments in return for a commitment fee and an interest charge. They could take guidance on the pricing of the facility from the banks, charging the same fees and requiring the same collateral. This would be supplemented by the multilaterals only if a country qualified for a credit from the commercial banks. Thus, the conditionality would be negotiated *ex ante*, and the facility would be available only to countries that had taken reasonable steps to establish and preserve their creditworthiness.

This approach is limited in that the resources the IMF and other multilaterals can commit to such facilities are small relative to the resources of the market. Such a scheme could provide little insurance against financial shocks.

Ex Post Measures

The most important changes that could be made to facilitate orderly workouts of international debts are the incorporation of new clauses into loan contracts. This section considers bond and bank loans. It then discusses IMF lending into arrears and the establishment of standing committees of creditors.

Money-center banks (those of the United States, Western Europe and Japan) account for much international lending because they have well-developed capacities to gather information about foreign borrowers and have cultivated long-term client relationships, which provide leverage when it comes time to collect on loans.[15] That said, changes in technology and market organization suggest that securitized instruments (bonds and derivative instruments based upon the loans) will account for a growing portion of international lending over time. Improvements in information and communications technologies tend to undermine the informational advantage of banks. Advances in financial technology enable individual investors to unbundle and hedge credit and currency risks. The growth of mutual funds, pension funds, hedge funds and other collective investment vehicles creates a demand for securitized investments. Securitization has made great strides in the advanced-industrial countries, where observers speak with growing regularity of the shrinking market for banking services. One can confidently predict that bonds will account for a growing share of portfolio investments in emerging markets in years to come.

On balance, this technological revolution, which encourages international lending to flow through bond markets rather than banks, is probably a good thing. It reflects improvements in the information environment that render the market less dependent on banks as vehicles for surmounting informational obstacles, and it implies a more efficient allocation of resources. As a result of the decentralization of emerging-market debt, the major money-center banks become less vulnerable to international debt crises.

But like many good things, the securitization of emerging-market debt does not come without costs, such as additional problems at the renegotiation stage. Restructuring a sovereign bond issued in the United States (more precisely, under the legal provisions that govern bonds issued in that country) typically requires the unanimous consent of the bondholders, which can be a formidable hurdle. In the event of default, each bondholder has the right to sue the issuer, and no bondholder can be forced to agree to new terms by other bondholders.

Unlike syndicated bank loans, there are no sharing clauses requiring individual bondholders to share any amounts recovered with other bondholders, thereby discouraging recourse to lawsuits. There are no counterparts to the central banks and regulators who used their powers of moral suasion to encourage cooperative behavior by the members of commercial bank syndicates in the 1980s.[16] Nor do sovereign issuers have recourse to a bankruptcy filing, under which they would be protected from the threat of lawsuits and in the context of which terms could be imposed on minority creditors. Because agreement is difficult to reach, issuers are understandably reluctant to contemplate restructuring.

In the event that they do reach an agreement, "vultures" (offshore hedge funds or large individual investors) then have an incentive to purchase bonds from less patient investors and to threaten lawsuits designed to attach the debtor's assets. Wishing to avoid expensive and embarrassing litigation, the debtor may then feel compelled to buy them out at full price. Taken to the extreme, this scenario suggests that maverick creditors will buy up all the defaulted debt and litigate to prevent sovereign issuers from settling for less than 100 cents on the dollar. Restructuring that involves writing down principal and interest will then be impossible.

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

Fortunately, a solution is at hand, having been suggested two years ago by the G-10 (an organization of 11 central banks concerned with the world payments system) in its report, "Resolving Sovereign Liquidity Crises." G-10 deputies recommended making it easier to undertake negotiations by altering the provisions of loan contracts to include majority voting, sharing and non-acceleration clauses.[17] This would prevent maverick creditors from resorting to lawsuits and other means of obstructing settlements beneficial to the debtor and the vast majority of creditors alike. The addition of such clauses to bond contracts is the only practical way of creating an environment conducive to flexible restructuring negotiations. It is infinitely more realistic than advocating some form of supernational bankruptcy court empowered to cram settlement terms down investors' throats.

Some object that such provisions, by making it easier for developing countries to wriggle out of debt contracts, would only increase their borrowing costs.[18] For those who believe that moral hazard and other market imperfections cause governments to rely excessively on foreign borrowing, this is not entirely undesirable. Others question whether borrowing costs will in fact rise.[19] To be sure, majority voting, sharing and non-acceleration make it easier to renegotiate defaulted debts, but if this helps avoid a long deadlock and renders the majority of investors better off, there is no reason why they might shun bonds with these provisions. Small bondholders, who lack the resources to sue, might be better off if such clauses relieved them of the danger of a long period of unpaid interest and a sliding bond price as the government and maverick creditors fought their war of attrition. Institutional investors might be better off if, in the absence of this market-based solution, they came under pressure from their governments to cut a deal.

In the present context, the normal presumption that "if we see it, it must be optimal" is open to question. Those who argue that the prohibition on majority voting to restructure the terms of a loan is the market's way of strengthening the bonding role of debt are ignorant of the measure's history. In fact, the law was introduced not by proponents of the market but by individuals deeply suspicious of it. William O. Douglas championed the measure in the wake of the debt defaults of the early 1930s as one of a number of laws to protect small investors from victimization by securities houses. This peculiar history underscores that there is no reason to retain such archaic measures. So does the fact that bonds issued under the provisions of the laws of Great Britain, a country lacking the populist tradition of the United States, have more renegotiation-friendly provisions. There, individual bondholders are represented by a trustee and cannot sue individually.[20] British bonds also provide for the binding of all bondholders by a majority vote at a bondholders meeting.

According to the G-10 report, new provisions are to be introduced into debt instruments through a "market-led process." Governments are expected to trumpet the virtues of new clauses but otherwise to take no action, hoping the markets will see the light.

But if changes in contracts were so easily adopted, the markets would have done so already. That no progress has occurred in the intervening two years suggests that there are significant obstacles to market-driven reform. One such obstacle is the adverse signaling effect. If only some issuers include qualified majority-voting clauses in their loan agreements, creditors may suspect that those debtors expect to resort to restructuring in the future and that they are not fully committed to servicing the loan, a signal much like a bride or groom's request for a prenuptial agreement. As Mark Roe emphasizes, this allows inefficient arrangements, agreed to for historical reasons, to become locked in place.[21]

The G-10 report, perhaps in an attempt to look market friendly, says little about this dilemma. At one point it acknowledges the first-mover problem and suggests that official support for contractual innovation should be provided "as appropriate" but fails to elaborate. A more proactive approach is now required. The IMF should urge the adoption of majority-representation, sharing, non-acceleration and collective-representation clauses (provisions that specify who will negotiate on behalf of the bondholders) by all its members. It should recommend that members require all international bonds include such provisions as a condition for being admitted to domestic markets.

To be sure, this is no panacea. Private placements would not be affected. New provisions could be added to existing loans only through a voluntary exchange of old bonds for new ones. Not only might some bondholders resist, but any one country that attempted to be the first to carry out the exchange might be seen as signaling its imminent default and thereby precipitate a crisis. For all these reasons, the incorporation of sharing, majority-voting and non-acceleration provisions into bond covenants will be slow.

SHORT-TERM BANK-TO-BANK LENDING

Short-term credits extended by one bank to another represent a more difficult case. Since interbank loans are not governed by formal contracts, renegotiation cannot be eased by altering contractual provisions. Some commentators have suggested that this can be avoided if countries adopt laws limiting the terms and conditions under which short-term loans to their banks might be repatriated. Robert Litan and others recommend that countries enact legislation imposing an automatic reduction in the principal of all foreign-currency loans that are not rolled over during a crisis in the affected country.[22] Foreign creditors still could get out, but only at a loss of 10 percent or 20 percent. The prospect of that loss would strengthen their incentive to remain in the market, address their collective problems and restructure the debt.

But if this legislation is only passed when the crisis strikes, such initiatives have no advantage vis-à-vis current arrangements. Nothing now prevents countries from freezing or writing down foreign loans to their banks as Russia did on August 17, 1998. In any case, governments' own behavior suggests that they fear that action to freeze bank claims would provoke flight by other foreign and domestic creditors, forcing the imposition of across-the-board exchange controls.[23] They regard this as too damaging to their reputations for financial probity and to their countries' ability to borrow.

If such legislation should be adopted in advance of any crisis, then the measure is likely to be much more demoralizing to lenders than the addition of majority-voting clauses to bond covenants. Even if new clauses are added to bond covenants, the decision to halt interest payments still will be in the hands of the individual corporate, financial or governmental borrower. The write down of principal will be determined on a case-by-case basis in bilateral negotiations between the debtor and its creditors. In contrast, the obligatory "haircut" for foreign bank creditors would apply across the board. Foreign creditors would be especially alarmed if, as is likely, the circumstances under which the new law was triggered were left to the government's discretion. If the trigger was the announcement of an IMF program, as some authors recommend, the smallest hint that a government was exploring the possibility of obtaining help from the Fund would provoke flight by its foreign bank creditors, precisely the outcome that the measure was intended to prevent.

More generally, foreign bank creditors, worried that a mandatory haircut is in the offing, will be tempted to flee at the first sign of trouble. Once the provision is actually triggered, of course they will have an incentive to stay in, but imagine their incentive to get out before the trigger is pulled. This perverse effect has the potential to transform small crises into big ones. There also is the familiar "after you, Alphonse" problem, where no country will want to be first to impose such legislation for fear it would signal its concern of an impending crisis.[24] Finally, foreign banks are likely to respond to the measure by channeling their lending through the offshore branches of the debtor's banks. Creditors would then dispute the applicability of the developing-country law and appeal to their own courts in an effort to attach the assets of those offshore branches. For all these reasons, the best way of dealing with the special problems created by short-term bank-to-bank lending is to discourage excessive reliance on this form of funding in the first place.

Institutional Solutions

IMF policy through most of the 1980s was to lend to a country that had fallen into arrears on its external debts only after it had reached an agreement in principle with creditors. Initially, the notion was that lending into arrears, by softening the consequences of default, might tempt governments to pursue more reckless financial policies. Later the thinking was that the Fund should provide assistance only if commercial banks contributed their fair share by providing the financing needed to clear away arrears.[25] The debt crisis of the 1980s, a protracted affair, raised doubts about this approach. The banks, their balance sheet positions strengthening as they drew down their Latin American exposure, hardened their positions over time. Rather than the IMF using this policy as a lever to encourage burden sharing by the banks, the banks realized that they could use it as a club in their battle with governments. If countries refused to settle on favorable terms, the banks could veto new IMF money in addition to denying their own.

Consequently, in the late 1980s, in a departure from past practice, the IMF contributed to the pool of money used to retire nonperforming bank debts and replace them with Brady bonds.[26] Since 1989 the Fund has had a de facto policy of providing support for a member's adjustment efforts after the emergence of arrears and before an agreement had been reached between the debtor and its creditors, so long as the country in question was engaged in good-faith negotiations and serious adjustment efforts. Lending into arrears can provide working capital for an economy that is making an adjustment effort and—analogous to the "debtor-in-possession" financing provided under U.S. corporate bankruptcy procedures—avert unnecessary damage to the economy. Insofar as collective-action problems (exacerbated by rules requiring the unanimous assent of creditors to the terms of any restructuring plan) render negotiations between governments and their creditors unacceptably protracted, IMF support to a country in arrears can help bring creditors to the bargaining table.[27] To the extent that sovereign debtors and the international community generally see the temporary suspension of payments, followed by negotiations to restructure, too difficult and costly to pursue, it may then be desirable for the IMF to tip the balance, opening up debtor-creditor negotiations as a viable alternative to regular IMF rescues.

The G-10's 1996 report acknowledged that lending into arrears was a way for the IMF to expedite restructuring.[28] While the Fund has not made lending into arrears standard policy, it seems prepared to move further in this direction.[29]

The risk is that creditors might sue in an effort to attach the proceeds of the loan. While private debtors can seek shelter in the bankruptcy court from a creditor lawsuit, sovereign debtors have no such recourse. If the creditors are commercial banks, they will be subject to moral suasion by their central banks and regulators and are unlikely to seek to attach IMF assets in this way.[30] But if they are bondholders, as will increasingly become the case as securitization proceeds, the danger is greater. The fear, if not yet the reality of lawsuits, is real.

Perhaps IMF balances could be transferred from the Fund's accounts to the central bank in question, and the courts would recognize the central bank as a legally separate entity from the government and therefore not responsible for the latter's debts.[31] Perhaps attempts to attach the proceeds of the loan before it is disbursed would be rejected by the courts on the grounds that its Articles of Agreement make the

IMF itself immune from legal process.[32] Perhaps the courts could be swayed by a brief filed by a creditor-country government arguing against attaching IMF resources. Perhaps the creditors, knowing that they would have to do battle not only with the debtor but also the U.S. government and the IMF, might be reluctant to throw down the gauntlet. That there have been no attempts so far to attach Fund disbursements is consistent with this view.

That said, what will happen is uncertain. This has prompted discussion of Article VIII.2(b) of the Fund's Articles of Agreement, which allows countries to apply exchange controls in response to balance-of-payments problems without violating their obligations to the IMF. Should it be amended to give official status to a country's standstill of payments and shelter the government and any IMF resources lent into arrears, from legal action? The article would have to be given an authoritative reinterpretation by the Fund's executive directors, or more likely, be amended with the consent of countries commanding 80 percent of the Fund's voting power. Only then could it be expanded to give countries' sanction to a standstill on external debt.

Realistically, it is unlikely that the requisite majority would agree to vest such considerable powers in the hands of an international organization.[33] Not only would market participants oppose empowering the Fund to interfere so extensively in private debt contracts, but the Fund is not seen as possessing the impartiality and detachment necessary of a bankruptcy judge. Among other conflicts of interest, the Fund might itself have made loans to the country. The idea of amending Article VIII.2(b) to empower the Fund to declare a standstill would be rejected as soon as it was considered on Capitol Hill.[34]

Fortunately, more practical alternatives exist. One is a limited amendment to the Fund's Articles of Agreement in which its members agree to give immunity in their national courts to the Fund's own disbursements and transactions. It is not obvious why, in order to achieve this limited goal, Article VIII.2(b) should have to be amended to give the Fund the power to halt all legal action against a government. A complementary approach would be for countries to amend their own sovereign immunity laws to allow their courts to stay attempts to attach sovereign assets. In the United States and United Kingdom, creditors are already prevented from attaching certain sovereign assets even when the sovereign has waived its immunity. It would be desirable to clarify these provisions and for other countries to emulate them.

COMMITTEES OF CREDITORS

A final change in the international financial architecture to facilitate orderly workouts and help bail in the private sector would be to create standing committees of creditors. Restructuring negotiations are most difficult and protracted when information is least complete. Where the preferences and capacities of all parties are common information, agreement should come immediately.[35] The more asymmetric the information environment, the more likely debtors and creditors are to fight a lengthy war of attrition. Establishing a standing committee of representatives from the various classes of creditors—bondholders, banks and other institutional investors—that meets regularly with borrowers would open lines of communication and help overcome information problems.

Moreover, the existence of a standing creditors' committee would reduce transaction costs in times of crisis. Currently, when a crisis erupts and debt service is halted, negotiations cannot proceed until the time-consuming process of identifying creditors is completed. The existence of a standing committee in continuous contact with its constituents would ease this difficulty. The debtor must next decide with whom to negotiate—that is, who speaks for the creditors. The existence of a standing committee would answer this question in advance. Finally there is the need to gain the assent of a majority of creditors to the restructuring plan and to buy out those who refuse. The existence of a standing committee within which various classes of creditors regularly interact would create peer pressure for agreement and facilitate the extension of any required side payments.

The difficulties created by the absence of such committees are evident in the recent experiences of South Korea and Russia. In South Korea, the difficulty in the last week of 1997 was to get the banks to roll over their maturing short-term loans, accept a delay in making interest payments and agree in principle to convert short-term credits into long-term loans. The South Korean government and the banks were just barely able to reach such an agreement. Only with the help of Citibank Vice-Chairman Bill Rhodes' Rolodex were the relevant bankers located, pulled from their Christmas dinners and thrust into negotiations.[36] Russia's experience in August 1998, which followed its suspension of payments the previous week, similarly illustrates the confusion that can arise when no committee of creditors exists.[37] First, the Russian authorities met with a small group of Russian and foreign banks to discuss the formation of a creditors' committee. Then it was decided that the committee would be formed only after the authorities had somehow managed to draw up a full list of creditors. This was followed by a variety of disagreements over the composition of the creditors' club.

To be sure, these arrangements will grow more complex with the shift from bank to bond finance. That shift will increase the number of interested parties and vest additional power in the hands of a class of creditors less likely to be influenced by the moral suasion of their central banks. But it will erode the effectiveness of Rhodes' Rolodex even more dramatically. What was possible in South Korea will not be possible again. Standing committees will become essential.

In fact, standing committees of creditors were precisely the channel for disseminating information and for organizing negotiations the last time bond financing was important, from the late nineteenth century through World War II.[38] At first, ad-hoc bondholders' committees were formed in response to each interruption in debt-service payments. Predictably, these committees had trouble establishing contact with a majority of bondholders and opening lines of communication with foreign debtors. In Great Britain, the leading creditor country of the era, the situation was regularized in 1868 by the creation of the Corporation of Foreign Bondholders. Composed initially of representatives of banking firms and brokerage houses, its governing body was expanded in 1898 to include several individual bondholders and a representative of the London Chamber of Commerce. The Council became the recognized spokesman for bondholders and their representatives in negotiations, working closely with the underwriting banks and the London Stock Exchange. The same evolution occurred elsewhere with the establishment of standing bondholders' committees in Paris, Amsterdam and Berlin before World War I and in the United States in the 1930s. These committees fell into disuse after World War II, first because the international capital market was slow to recover from the debt crisis of the 1930s and later because syndicated bank loans superseded bond finance. Now, bond financing has returned, and creditors have become more numerous and heterogeneous than when international lending was the domain of bank syndicates.

In the wake of the Mexican crisis, Rory Macmillan, Richard Portes and I resuscitated the idea of creditors' committees.[39] To date, however, the investor community has been reluctant to act. It fears that the existence of standing committees would make it too easy for debtors to initiate restructuring negotiations, making it too tempting for them to suspend debt payments. In the creditors' narrow self-interests, it is better that no one is there to pick up the phone.

For policymakers wishing to create a viable alternative to large-scale bailouts of nations in crisis, and for whom the difficulties of debtor-creditor negotiations render moratoria and restructuring unacceptably difficult and painful, standing committees of creditors are desirable precisely because they make it easier for debtors to initiate negotiations. Their formation is important for creating a viable alternative to ever-more-costly bailouts and disastrous Russian-style defaults, neither of which is an acceptable option.

The creation of such committees would require that the governments of the Group of Seven industrialized nations, their central banks and the IMF use moral suasion and lobbying. In fact, there would be nothing unprecedented about their involvement. The Corporation of Foreign Bondholders received a parliamentary charter and other forms of official support. Its U.S. equivalent, the Foreign Bondholders Protective Council, was formed only with the encouragement and support of the U.S. State Department.[40] The government support for such organizations is a precedent that should be followed.

Markets Need Institutional Support

Bailing in the private sector requires changes in institutional and contractual arrangements to make it economically acceptable for governments to negotiate an orderly restructuring of their debts. For those who regard ever-larger IMF bailouts as undesirable because of their escalating cost and the moral hazard they create, but who also acknowledge that governments regard the costs of a unilateral moratorium as too severe under present arrangements, this is the only feasible alternative.

It is important to emphasize that there is not likely to be a simple and wholly satisfactory solution to this problem. A moratorium on debt repayments *should* be unattractive; otherwise, the sanctity of loan contracts would be jeopardized. Contracts and institutional arrangements are structured to make the suspension of debt service painful precisely to keep borrowers from walking away from their debts. Were this too easy, the capital market would not function at all. Moreover, it is unrealistic to imagine the creation of an international bankruptcy court with the power to force settlement terms upon debtors and creditors. There also are good reasons why the IMF cannot be transformed into a true international lender of last resort.

Notwithstanding these difficulties, constructive steps are available. The most important of these include limiting banks' short-term foreign-currency-denominated borrowing (if necessary, by placing a holding-period tax on all portfolio capital inflows), adding sharing clauses to loan contracts, establishing creditors' committees, entertaining the possibility of IMF lending into arrears and amending sovereign immunity laws. History shows that the market left to its own devices cannot provide a perfect solution to international debt problems any more than the market can efficiently provide for the liquidation and reorganization of financially distressed domestic companies in the absence of an insolvency law. To operate efficiently in the present context, markets need governments and international organizations to provide institutional support. ■

NOTES

This article draws on the author's forthcoming book, *Toward a New International Financial Architecture:A Practical Post-Asia Agenda* (Institute for International Economics, 1999.)

[1] International Monetary Fund, *International Capital Markets* (Washington, DC: International Monetary Fund, 1998): Box II.5.
[2] Inseok Shin and Joon-Ho Hahm, "The Korean Crisis—Causes and Resolution," unpublished manuscript, Korea Development Institute (July 1998): Table 1.7. South Korean financial institutions had foreign-currency denominated assets as well, since they were required to limit their open foreign exchange positions. But since their loans were of longer maturity than their liabilities, there was still the possibility of a very serious liquidity problem that the central bank was in no position to address.
[3] At that time, foreign bank creditors' exposure was reduced to the point where the South Korean authorities were able to negotiate a restructuring with their bank creditors, in which the latter agreed to a temporary delay in payments and then to the conversion of their short-term assets into longer-term instruments.
[4] As events transpired, the IMF and the leading industrial countries refused to provide further funding in the middle of August 1998. The Russian government responded by devaluing the ruble and suspending service on most of its debts. These actions, however, came as a surprise to many investors, which is the point in the present discussion.
[5] The South Korean negotiations at the end of 1997 are often cited as examples of how international banks should be "bailed in" during crisis negotiations. However, as long as the South Korean government was reluctant to halt service on these and other external debts, the banks still had the option to exit. Thus, the agreement reached with the government of South Korea did not impose significant capital losses on the banks, which only agreed to a delay of service payments, and later, to the conversion of their short-term claims into longer-term obligations.
[6] Anna J. Schwartz, "G-7 Countries at Halifax Summit Repeat the Mexican Myth," Communiqué of the Shadow Open Market Committee (September 10-11, 1995).
[7] Unavoidably, the Fund must tranche its assistance rather than following Walter Bagehot's classic advice for a central bank acting as a lender of last resort, namely to lend freely at a penalty rate. This, then, is the main problem with Alan Meltzer's otherwise sound advice that the IMF should act more like a true lender of last resort by lending at a penalty rate. See "Asian Problems and the IMF," testimony prepared for the Joint Economic Committee, U.S. Congress, February 24, 1998. That it will not be able to lend *freely* at a penalty rate suggests that lending at higher interest rates in order to limit moral hazard will not suffice to redress the crisis problem.
[8] Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies,

Prospects," *Brookings Papers on Economic Activity* 1 (1998): 66-67.
[9] For clear statements of these two arguments from authors with otherwise very different perspectives, see Alan Meltzer, "Asian Problems and the IMF," Testimony Prepared for the Joint Economic Committee, U.S. Congress, February 24, 1998, and Radelet and Sachs, (1998): 66-67.
[10] In addition, there is the fear that a standstill or moratorium will unleash contagion to other countries and threaten the stability of the international system.
[11] There are exceptions, of course. These include Mexico in 1982, South Africa in 1985, Brazil in 1987, Venezuela in 1988 and Russia in 1998. Several distinctive aspects of the Russian situation help to explain the unusual outcome in this case. First, Russia, unlike Mexico or South Korea, did not show the resolve necessary to rein in its budget deficit, which suggested that providing official funds to retire the existing short-term debt would not solve the problem, since additional debt would soon have to be issued. Second, the government's failure to make headway on its fiscal problems suggested that capital market access was in any case unlikely to be restored soon. The aftermath of the Russian government's action, including full-fledged depositor panic, capital flight and the suspension of foreign-exchange trading, supports concerns that a government's unilateral suspension of payments would damage its creditworthiness and deeply demoralize markets.
[12] Developed-nation bank regulators have agreed that commercial banks working in the international sphere should have a minimum 8 percent ratio of capital to outstanding liabilities. That percentage, however, is risk-weighted with regard to the capital held, with riskier assets being discounted versus safer assets.
[13] Argentina's contingent repurchase facility with 13 commercial banks provides for U.S.$7 billion in standby credits, while Mexico's arrangement with 31 banks provides for U.S.$2.5 billion. Under the provisions of the former, the Argentine Central Bank can swap Argentine government securities for U.S. dollars up to the specified ceiling, at an effective interest rate of the London Interbank Offered Rate (LIBOR) plus 205 basis points. The commitment fee is 33 basis points. Loan length is two to five years, depending on the commercial bank involved. These agreements omit the "no adverse material change" clause that would otherwise permit the banks to back out of their agreement in the event of a crisis.
[14] A similar idea is developed by Michael Gavin and Ricardo Hausmann, "A Contingent Facility to Promote Financial Stability and Strengthen Market Discipline," unpublished manuscript, Office of the Chief Economist, Inter-American Development Bank (1998).
[15] Some observers would add that because banks are critical to financial stability, they can count on the support of the United States and other creditor-country governments in the event of debt-servicing difficulties.
[16] To be sure, a non-negligible fraction of foreign bonds are held by commercial banks. Pension funds, mutual funds and insurance companies also are subject to regulatory oversight, if not to the same degree as banks. Even taken together, institutional investors as a group hold only a fraction of the bonds outstanding. This is in contrast to the earlier situation with syndicated bank loans and therefore means that moral suasion is likely to be less effective.
[17] In the case of most international bonds, 10 percent to 25 percent of the bondholders (actually, those holding 10 percent to 25 percent of the principal) can vote to require immediate repayment of all principal and interest due in the event of default. In contrast, syndicated bank loans typically require 50 percent of creditors to vote for acceleration. This thus raises the danger that even when a majority of bondholders prefer an orderly workout that will maximize the value of their claims, an impatient minority can trigger the clause requiring immediate repayment. The debtor would then have to reschedule not only interest payments and amounts due to be paid into a sinking fund but all principal as well.

[18] Institute of International Finance, *Resolving Sovereign Financial Crises* (Washington, DC: Institute of International Finance, 1996).

[19] At this point, there seems little evidence either way. The Hong Kong Airport Authority is frequently cited as an example of a borrower that has issued bonds with these provisions without obviously elevating its borrowing costs, but it is not a fully sovereign entity, rendering it a special case. A more systematic analysis of the pricing of bonds issued under the British and American models (with and without the relevant provisions) is necessary.

[20] However, a specified minority representing a fifth to a quarter of the principal can require the trustee to do so on their behalf.

[21] This path-dependence argument is one of Roe's themes. See "The Voting Prohibition in Bond Workouts," *Yale Law Journal* 97 (1987): 232-280.

[22] Robert Litan, et al., "Statement of the Shadow Financial Regulatory Committee on International Monetary Fund Assistance and International Crises," Statement 145 (Shadow Financial Regulatory Committee, 1998).

[23] Indeed, the market reaction to the Russian action dried up all foreign credit to the Russian financial system, provoked widespread capital flight and forced the government to halt all foreign exchange trading several times during the last week of August, 1998.

[24] Again, this is not necessarily welfare reducing when there exist other distortions such as implicit guarantees that encourage excessive bank-to-bank lending. The caveat to this point is that a policy or law discouraging bank-to-bank lending can still be welfare reducing if it more than offsets the initial distortion (in this case, the moral hazard of the implicit guarantee) and eliminates all interbank lending, where at least some bank-to-bank lending plays an economically useful role.

[25] The traditional IMF position on lending into arrears was stated in an executive board decision in 1970. See William R. Cline, "Crisis Management in Emerging Capital Markets," in Peter B. Kenen (ed.) *From Halifax to Lyons: What Has Been Done About Crisis Management? Essays in International Finance* 200, Princeton University (October 1996).

[26] Brady bonds are consolidated, restructured debt obligations of developing countries sponsored by the United States. The bonds use U.S. Treasury obligations as part of the collateral.

[27] Morris Goldstein, "Avoiding Future Mexicos: A Post-Halifax Scorecard on Crisis Prevention and Management," *From Halifax to Lyons: What Has Been Done About Crisis Management? Essays in International Finance* 200, Princeton University (October 1996): 56-72, argues that the Fund's lending into arrears was critical in driving commercial bank creditors to the negotiating table in the second half of the 1980s and finally clearing away the Latin American debt crisis.

[28] "Resolving Sovereign Liquidity Crises," Group of Ten (1996).

[29] See for example the comments of IMF Managing Director Michel Camdessus at his joint press conference with Philippe Maystadt, chairman of the interim committee, at IMF headquarters, April 16, 1998, [http://www.imf.org/external/np/tr/1998/TR980416.htm].

[30] During the debt crisis of the 1980s, when the principal creditors were international banks, lawsuits were consequently rare (except for precautionary suits filed merely to protect against expiration of the statute of limitations).

[31] When not waived, central bank reserves enjoy sovereign immunity in the major financial centers, most notably the United States and the United Kingdom.

[32] This is so under the provisions of Article IX.8(I). In addition, the Fund's articles require it to deal only with members through their treasuries, central banks and fiscal authorities. Thus, it could argue that it cannot deal directly with a court-appointed receiver or with the creditors' fiscal agent.

[33] In any case, member countries would have to pass domestic legislation ensuring that this measure had effect in their domestic courts.
[34] One need only recall congressional resistance to the dispute-panel provisions of the World Trade Organization agreement.
[35] Or it should come virtually immediately. This is a basic premise of bankruptcy theory: in a world of complete information and absent transactions costs, there is no need for a bankruptcy code or bankruptcy court, since debtors and creditors would be able to instantaneously adjust their contracts to any unanticipated contingencies.
[36] Peter Lee, "Korea Stares into the Abyss," *Euromoney* (March 1998): 32-37. Rhodes is a veteran of the debt crisis of the 1980s.
[37] Reuters, "Russia, Western Banks to Form Creditors Club," Monday, August 24, 1998, 8:25 a.m., [http://biz.yahoo.com/finance/980824/russia_ban_1.html].
[38] Barry Eichengreen and Richard Portes, "After the Deluge: Default, Negotiation, and Readjustment During the Interwar Years," in Barry Eichengreen and Peter H. Lindert, eds., *The International Debt Crisis in Historical Perspective* (Cambridge, MA: MIT Press, 1989), 12-47.
[39] Rory Macmillan, "New Lease on Life for Bondholder Councils," *Financial Times*, August 15, 1995, 11, and Barry Eichengreen and Richard Portes, *Crisis? What Crisis? Orderly Work-outs for Sovereign Debtors*, Centre for Economic Policy Research, London (1996).
[40] See Eichengreen and Portes (1989).

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