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THE BAIL-IN PROBLEM: SYSTEMATIC GOALS, AD HOC MEANS

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ABSTRACT

The Bail-In Problem: Systematic Goals, Ad Hoc Means*

In this paper we analyse the recent efforts of the international financial institutions (IFIs) to limit the moral hazard created by their assistance to crisis countries. We question the wisdom of the case-by-case approach taken in Pakistan, Ecuador, Romania and Ukraine. We show that because default and restructuring are so painful and costly, it is simply not time consistent for the IFIs to plan to stand aside if the markets refuse to roll over maturing claims, restructure problem debts, or provide new money. Because these realities create an incentive to disburse even if investors fail to comply, the IFIs are then placed in the position of having to back down on their previous conditionality, which undermines their credibility. And since investors are aware of these facts, their behaviour is unlikely to be modified by the IFIs' less-than-credible statements of intent. Hence, this approach to 'bailing in the private sector' will not work. Fortunately, there is an alternative: introducing collective-action clauses into loan agreements. This, and not ad hoc efforts to bail in the private sector, is the forward-looking solution to the moral hazard problem.

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Submitted 7 March 2000

NON-TECHNICAL SUMMARY

In this paper we analyse recent efforts by the international financial institutions (IFIs) to limit the moral hazard created by their assistance to crisis countries. We question the wisdom of the case-by-case approach taken in Pakistan, Ecuador, Romania and Ukraine. We show that requiring countries seeking IMF assistance to first raise new money is unrealistic, given the reluctance of investors who do not already have a position in the crisis country to lend into highly uncertain conditions. Demanding that creditors roll over their maturing claims as a condition for multilateral assistance may be slightly more realistic, given incumbent investors' stake in the country, but still must overcome formidable collective action problems when the creditors are bondholders. Encouraging countries to suspend payments as a way of driving the bondholders to the bargaining table will be disastrous so long as there is no bargaining table to which they can be driven. The result will be formal declarations of default, the activation of cross-default and acceleration clauses, and an extended period of messy negotiation and lost capital-market access.

Given the fact that default and restructuring are so painful and costly, it is simply not time consistent for the IFIs to plan to stand aside if the markets refuse to roll over maturing claims, restructure problem debts, or provide new money. Because these realities create an incentive to disburse, even if investors fail to comply, the IFIs are then placed in the position of having to back down on their previous conditionality, which undermines their credibility. And since investors are aware of these facts, their behaviour is unlikely to be modified by the IFIs' less-than-credible statements of intent. The equilibrium in the game between the IFIs and the markets will remain fundamentally unchanged. This approach to 'bailing in the private sector' will not work.

Fortunately, there is an alternative: introducing collective-action clauses into loan agreements. Under present institutional arrangements, restructuring is unappealing except under the most extraordinary circumstances. Collective-action provisions would make it feasible to pursue this alternative. Debtors and creditors could decide when restructuring was desirable – it would no longer be necessary for the issue to be forced by the IFIs. Limited IMF lending into arrears to countries engaged in good-faith negotiations would become a feasible option. No longer would the only alternatives be paying off creditors in full with official funds or enduring a costly, extended interruption to market access. This, and not ad hoc efforts to bail in the private sector, is the forward-looking solution to the moral hazard problem.

The Bail-In Problem: Systematic Goals, Ad Hoc Means

Barry Eichengreen and Christof Rühl[1]
February 2000

I. Introduction

Moral hazard is increasingly seen as a problem in international financial markets, and private-sector burden sharing is increasingly seen as the solution. Investors must bear at least some of the costs of crises, the argument goes, if they are not to disregard the risks of lending. Ensuring that they do not escape all losses as a result of support provided by the international financial institutions (IFIs) — seeing that investors, rather than being "bailed out," are "bailed in" — is central to any strategy for limiting moral hazard. The failure of the IFIs to articulate a coherent approach to this problem thus provides ammunition to those who insist that they are part of the problem rather than part of the solution.

These are easy bromides on which to agree. Moving from bromides to policies is harder. There is no agreement about how the costs of a crisis should be shared among the parties, much less a mechanism for implementing that agreement. Some argue that investors already bear their fair share of the burden — witness, for example, the losses incurred by investors in Asian stock and bond markets in 1997 and following Russia's default in 1998.[2] They argue that attempts to

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[1] University of California at Berkeley and World Bank, respectively. None of the opinions expressed necessarily represent the official views of the World Bank, its Executive Directors, or any other official body. For comments and suggestions, we would like to thank, without implicating, Stijn Claessens, Stanley Fischer, Francesco Luna and Andriy Storozhuk. New developments in the negotiations surrounding the debts of some of the countries we consider are occurring as we write; this draft was completed in late-February 2000.

[2] Conservative estimates put crisis-related losses since 1997 at $240 billion for equity investors, $60 billion for international banks, and $50 billion for other private foreign creditors (Haldane 1999).

impose additional losses on investors would render it less attractive to lend to developing countries, which already find it costly to access international capital markets. Creating a presumption that crisis countries will regularly restructure their obligations would only weaken the bonding role of debt. Extending the policy to Brady bonds and eurobonds would hinder efforts to create the clear seniority structure which is needed to support the international transfer of capital.

While the critics have a point, neither is it feasible to simply let the moral hazard problem fester. Hence, the IFIs have been groping toward a strategy for addressing it, most recently in their policies toward Pakistan, Ecuador, Romania and Ukraine. In all four cases, the focus of their efforts is bonds, not bank loans like those which created such problems in Thailand and Korea in 1997. It is sovereign debts, not private debts like those which were the problem in Indonesia. Focusing on bonds is appropriate insofar as the ongoing process of securitization makes them the wave of the future.[3] Focusing on sovereign debt is also appropriate insofar as

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[3] This is not to say that bank debt is unimportant, only that it is likely to be less important in the future than the past. In any case, it is not the focus of this paper, since it is not the focus of bail-in efforts in Pakistan, Ecuador, Romania and Ukraine. Courtesy of the crises in South Korea and Thailand (and the Latin American debt crisis of the 1980s), the international community now has considerable experience with this problem, the solution to which involves assembling representatives of the banks and negotiating their forbearance. Observers who question whether past "successes" can be repeated recommend the use of tax and regulatory policy to discourage resident banks and corporations from funding themselves via short-term loans from foreign banks in the first place. See the discussion in Eichengreen (1999a). Another suggestion (e.g. Buiter and Siebert 1999) is to require bank loan agreements to include clauses providing for a debt-rollover-with-penalty option. While we are sympathetic to this approach, we are also skeptical: unlike the collective action clauses in bond covenants discussed later in this paper, which actually exist in the real world (some 40 per cent of the international bonds issued by developing countries in the 1990s are subject to U.K. governing law and therefore contain at least limited collective-action provisions, as we explain below), debt-rollover-with-penalty options remain in the realm of theory; we have no practical experience with them.

mechanisms already exist for restructuring private debts (namely, domestic bankruptcy and insolvency procedures) through whose operation investors already take a "hit" when debt-servicing problems arise.[4] But implementation of the new strategy has been far from smooth, and considerable controversy has resulted.

Our assessment is that the IFIs' efforts to condition official assistance on "private sector participation" -- specifically, on the willingness of investors to roll over maturing loans, provide new money, or restructure existing debts -- have been less than a success. The reason is not hard to see. A new strategy built on statements of intent that does not also change the underlying payoffs will not be taken at face value. Because it is not credible, it will not change the strategies of market participants. Therefore it will not change the results of their interaction with the multilaterals and the debtor.

In addition, these ad hoc initiatives to "bail in the private sector" have not set the desired precedent. The countries involved are small and have only limited access to international financial markets. Disputes over their debts are unlikely to have systemic repercussions, which explains why they have been the subjects of these bail-in exercises in the first place. But this also means

[4] This is one of the few regularities to emerge from the debt crises of the 1990s: those with claims on the private sector (on nonfinancial corporations in particular) tend to incur more substantial losses as a result of a crisis. The problem is the tendency for governments to socialize these losses by taking over private-sector entities in distress and assuming their financial obligations. A further problem is the inadequacy of existing bankruptcy and insolvency procedures, which leads investors to scramble for collateral, thereby precipitating cascading defaults. But the corresponding solution is straightforward, namely, improving domestic bankruptcy procedures. This is a central element of the process of setting international financial standards (for prudential supervision, auditing and accounting practice, corporate governance and ***bankruptcy and insolvency codes***) in which the IFIs are taking the lead.

that any private sector burden sharing that takes place will not be precedent setting. This makes it unlikely to ameliorate moral hazard in international financial markets.

Finally, the current approach to private-sector burden sharing has a number of negative side effects. In some cases it has destroyed the rudimentary seniority structure that debtors and creditors have sought to create. In others it has substituted for impending debt-servicing problems the prospect of an even more severe crisis in the not-too distant future — it has traded bad today for worse tomorrow. And it has undermined the credibility of the IFIs by committing the International Monetary Fund and the World Bank to policies that are not credible or time consistent, and on which they are unlikely to follow through.

For all these reasons, we believe that the approach taken in these test cases is misguided. The IFIs would do better to devote less attention to ad hoc efforts to bail in captive investors in countries like Pakistan, Ecuador, Romania and Ukraine. They would do better to concentrate on a forward-looking solution of more general applicability. This means pressing for the introduction of renegotiation-friendly provisions (collective action clauses) into future loan contracts and using World Bank adjustment lending and IMF contingent finance to strengthen the incentives to move in that direction. The introduction of collective action clauses would change the payoffs in the game between the IFIs, investors, and the debtors. It would therefore change equilibrium strategies. Unlike the present approach, it would make it possible for the IMF and the World Bank to credibly commit to bailing in the private sector.

II. Burden Sharing in Principle

Efforts at achieving greater private-sector burden sharing are motivated by the perception that IMF programs starting with Mexico have let investors off the hook and are a source of moral hazard. In addition, because the Fund is almost always paid back, these payoffs are effectively transfers from the taxpayers in the crisis country to international investors. On both efficiency and equity grounds, then, the status quo is unacceptable.

Rules Versus Discretion. American and European officials have advocated contrasting approaches to the problem, the latter arguing for rules governing what investors will be bailed in under what circumstances, the former preferring the "constructive ambiguity" of a case-by-case approach. In the European view, the IMF Executive Board should agree to a set of formulas and procedures to be applied to emerging markets requiring assistance. It should articulate the circumstances under which debts would have to be restructured and/or new money provided by the markets as a condition for multilateral support. In the American view, no rules for bail-ins should be promulgated in advance. Each case should be considered on its merits, and procedures should be tailored to the particular circumstances.

The problem with rules is that investors will anticipate their application, with destabilizing consequences. If banks or bondholders regularly receive haircuts under a certain set of circumstances, they will have an incentive to scramble out of the market the day before, threatening to precipitate a crisis if they perceive even a remote possibility that those circumstances will obtain. A degree of constructive ambiguity is necessary, therefore, if bail-in procedures are not to be destabilizing.

The problem with the case-by-case approach, the Europeans counter, is that it is a source of uncertainty that will disrupt the market access of developing countries even in good times. If countries are required to impose losses on their creditors as a condition for receiving official assistance, potential creditors may be reluctant to lend in the first place. Insofar as a shadow is cast over countries' efforts to develop a well-defined seniority structure (since it now becomes possible for senior debt to be restructured along with junior debt), those with a preference for senior claims will no longer find emerging markets attractive.[5]

To date, the IMF has followed the case-by-case approach (IMF 1999a,b). Attempts to encourage private-sector burden sharing have taken two forms: writing down liabilities to private investors; and encouraging the markets to provide "new money" or roll over existing claims.[6] No rules have been promulgated for which debts should be written down as a condition for providing official finance, how they should be written down, or by how much they should be written down. Similarly, no general principles have been articulated regarding the circumstances under which investors should be required to provide new money as a condition for official assistance, how much they should contribute, or the terms on which they should contribute. In a sense, then, these four cases have been experiments with the American approach.

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[5] In addition, there is the feeling that the United States, as one country rather than a collection of continental neighbors, can move quickly to formulate a position on a particular case, as a result of which the Americans will dominate policy making under the case-by-case approach. The U.S. Treasury has the further advantage of proximity to the Fund, the Europeans argue, which positions it to influence policy in particular cases.

[6] To repeat what was said in the introduction, in focusing on Pakistan, Ecuador, Romania and Ukraine, we focus on problems of refinancing or writing down their bonds, which constitute the bulk of the debt in question. In previous cases (South Korea, Thailand), bank loans have instead been involved, which pose a different set of issues that we do not consider here.

New Money. Securing new money has been difficult. In the unsettled climate that surrounds a crisis, investors prefer to hold off extending additional credit until the uncertainty has been at least partially resolved. If there is even the possibility that the government lacks the willingness or capacity to pay, investors will be reluctant to increase their commitments, and the country's liquidity needs will have to be met by the IFIs. The latter can ask the markets to provide matching money, but given the option value of waiting, a positive response cannot be guaranteed.

Collective-action and free-rider problems compound these difficulties. To be sure, new money, by allowing a country to surmount an otherwise disruptive liquidity crisis, can have a high rate of return.[7] But even if investors as a group are better off if they ante up additional funds, each investor may nonetheless prefer that others provide the new money needed to solve the problem. The share of private money will approach zero as collective-action problems grow more severe.

The IFIs could condition their disbursements on the markets first agreeing to provide new money.[8] Imagine that a costly default can be averted only if the markets and the multilaterals ante up, but the multilaterals announce that they will not contribute unless the markets do so first. Knowing that they will suffer the consequences of a costly default if they fail to organize a response, investors have an incentive to find a way around their collective-action problem. This,

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[7] In other words, in addition to earning interest, the new money may raise the value of pre-existing claims.

[8] There is now some experience with this approach, as we will see below.

it will be recalled, was the IFIs' strategy for encouraging concerted lending to crisis countries in the early 1980s.[9]

But this approach can be applied only to captive investors, like the banks that extended the loans that came to grief in the early 1980s. In the case of securitized debt, this strategy is impossible to implement once bonds are distributed on secondary markets, given the absence of mechanisms to encourage collective action by the creditors.

Moreover, default is costly for the country as well as its creditors and, by implication, for the IFIs that have the country's interests at heart. Given the difficulty of restructuring sovereign bond contracts, a default may result in an extended period during which all market access is lost. Since investors are aware of this fact, giving them veto power over multilateral disbursements arms them with an additional weapon to be used in their skirmish with the country.[10] Moreover, investors may doubt, with good reason, that the IFIs are really prepared to stand aside unless the markets ante up new money. They may believe that the multilaterals will offer assistance in the end whether the markets provide new money or not, in order to avoid even more costly disruptions. It follows that the new policy, predicated purely on statements of intent, is not credible and leaves the status quo unchanged.

It may have been this realization that led the IMF to its new policy of lending even when a country is in arrears on its bonds as well as its bank loans. Recent Executive Board decisions permit the Fund to lend to a country even when the latter is in arrears to private creditors, so long

[9] Boughton (2000) is a comprehensive account of these cases.

[10] The only options left to the debtor may then be full payment (the outcome that the bail-in strategy is designed to avoid) or a costly and extended interruption of market access during which neither private nor official funds are available, which would hardly be viewed as a desirable outcome by any of the parties concerned.

as it is making good faith efforts to negotiate and adjust.[11] The provision of official funds gives the country the essential liquidity it needs to survive the interruption of market access, and the fact that official funds are not conditioned on a prior agreement with investors may induce the latter to accept less than 100 cents on the dollar. Hence, IMF money that goes in the front door does not automatically go out the back door as payoffs to private investors. The moral hazard problem is lessened.

But is lending into arrears a feasible way of securing private sector participation? We think not. Debt restructuring is such a complex and messy process that this strategy is likely to result in extended negotiations and an unfeasibly large drain on the resources of the IFIs.

Restructuring. Substituting official funds for private funds is impractical and undesirable for an extended period.[12] The point of the bail-in exercise is to rely more on market discipline and less on official finance. This makes lending into arrears problematic if it is not possible to clear away the arrears and restore market access promptly. Both theory (the theory of incomplete contracts -- Hart 1995) and evidence (Suter 1992, Aggarwal 1996) suggest that an agreement to clear away arrears can be difficult to reach. The efforts of various crisis countries to avoid being declared in default and their resistance to multilateral pressure to go down the restructuring road are testament to their perception that the costs of restructuring are high.

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[11] Lending into sovereign arrears is something that the Fund has long done when a government is making a concerted effort to adjust and has shown good faith in its negotiations with the creditor community. The September 1998 decision by the Fund's Executive Board merely broadened the policy from bank loans to incorporate bonds and other nonbank credits.

[12] This is evident in the terms of the IMF Executive Board's decision to lend into arrears, which authorized the policy only under circumstances where the borrower is engaged in good-faith negotiations that are likely to clear away the overhang of nonperforming debt at a relatively early date.

The crux of the matter is thus the very great difficulty of restructuring sovereign debts under prevailing institutional arrangements.[13] Most emerging market bonds are bearer bonds; not only are they widely disbursed, but their owners are not registered with the debtor, the underwriter, or anyone else. This can make it difficult for a government to get in touch with its bondholders to avoid a formal declaration of default, the activation of acceleration and cross-default clauses and the initiation of legal action, which will then close off other avenues of credit market access.

Moreover, American-style instruments, governed by New York law, typically require the unanimous consent of the bondholders to the terms of a restructuring. Many US-style bonds do not even provide for a bondholder assembly, precluding any effort to modify payment terms (and other bondholder rights) without the consent of each and every bondholder.[14] This contrasts with bonds governed by UK law, which typically include provisions enabling the holders of debt securities to call a bondholder assembly empowered to pass extraordinary resolutions addressing issues relating to the settlement of defaults or other modifications to the original bond covenant subject to the consent of bondholders holding a clear majority of the outstanding principal.[15] Such resolutions are binding on all bondholders so long as the requisite majority has agreed. American-style bonds generally contain no prohibition on legal action by dissident bondholders, exposing

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[13] The discussion here draws on Eichengreen and Mody 2000.

[14] Although there are exceptions. Some US-style bonds also provide for amendments, even to payment terms, with the approval of a qualified majority of bondholders.

[15] Typically 75 per cent. Some covenants provide for lowering the necessary quorum to 25 per cent if 75 per cent of the bondholders cannot be reached.

those seeking to restructure to lawsuits from "vultures" seeking to hold up the restructuring process.[16]

Collective Action Clauses. This brings us to the other approach to encouraging private sector burden sharing: amending loan contracts to include sharing, majority voting, and collective-representation clauses so as to make restructuring a viable option. Majority voting and sharing clauses would discourage maverick creditors from resorting to lawsuits and erecting other obstacles to a settlement beneficial to the debtor and the majority of creditors. Clauses specifying who represents the bondholders and making provision for a bondholders committee or meeting would allow orderly solutions to be reached.[17]

Such modifications of loan contracts would solve, or at least greatly ameliorate, many of the problems identified above. The restructuring of problem debts could be left to the consenting adults involved. Greater reliance on the markets is after all the purpose of the bail-in exercise. Countries that attach a high value to the maintenance of market access would be free to take the extreme measures needed to keep current on their debts, while restructuring would now be viable for countries without the same capacity to adjust and which therefore attach priority to obtaining an immediate reduction in debt-servicing costs. Countries that value a well-defined seniority

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[16] UK bonds governed by Trustee Deed Agreements, but not those involving fiscal agents, generally prohibit individual bondholders from initiating litigation. The power to do so is vested with the trustee, acting on the instruction of creditors holding a specified fraction, typically, at least 25 per cent of the principal, who is required to distribute any funds recovered in proportion to the principal amount.

[17] This was suggested in 1996 by the G-10 in its post-Mexico report (G10 1996) and echoed in a series of recent G-22 and G-7 reports and declarations. The G-7 then placed the issue on its work program for reforming the international financial system with the goal of reaching a consensus by the Cologne Summit in June of 1999. Two recent discussions of the operation of such provisions are Yanni (1999) and Drage and Mann (1999).

structure could choose to restructure junior debts while leaving senior debts untouched. Asking for new money even where it was not needed as an alternative to haircuts, which under present arrangements can be impossibly difficult to administer and which are unattractive even to the borrower, could be avoided because it would now be feasible to restructure instead. Limited IMF lending into arrears would become feasible if renegotiation-friendly provisions in loan contracts could be used to avert a major financial drain and extended loss of market access.

There are two objections to this approach. First, adding collective-action clauses to new loan agreements would not solve the problems created by the existing stock of bonds. The average term to maturity of international bonds is on the order of five years, but some have as long as 20 years to run. However, new provisions could be added to existing loans through a voluntary exchange of old bonds for new ones. Some bondholders might resist, but the IFIs could help the debtors buy them out by providing concessionary finance for such operations.

The second objection is that renegotiation-friendly provisions would make it too easy for countries to walk away from their debts. Collective-action clauses would weaken the bonding role of debt. They would create moral hazard. They would disrupt credit-market access and raise borrowing costs. On the other hand, provision for orderly restructurings would make emerging-market issues more attractive by minimizing acrimonious disputes, unproductive negotiations, and extended periods when no service was paid and growth was depressed by a suffocating debt overhang.[18] In theory, the impact on spreads cuts both ways.

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[18] As *The Economist* put it in a leader, "the prospect of an orderly renegotiation rather than a messy default might actually make some bonds more attractive" (*Economist* 1999, p.21).

The empirics of collective-action clauses have been analyzed by Eichengreen and Mody (2000), who compare the spreads on otherwise equivalent bonds issued under U.S. and UK law (where the latter typically contain the relevant contractual provisions but the former do not). The results do not indicate a large impact on borrowing costs. But this negligible overall impact disguises very different effects on borrowers with worse and better credit ratings. Collective-action provisions reduce the cost of borrowing for the most credit-worthy issuers, for whom default is unthinkable except in extremis, but who benefit from being able to avail themselves of an orderly restructuring when those exceptional circumstances obtain. For less credit-worthy issuers, in contrast, there is evidence of higher spreads. We conjecture that for less credit-worthy borrowers the advantages of provisions facilitating orderly restructuring are offset by the moral hazard and additional default risk associated with the presence of renegotiation-friendly loan provisions.

These results do not support the dire consequences of including collective-action clauses suggested by some market participants. Moreover, the differential effects suggest that collective-action clauses should become more attractive as emerging markets improve their credit worthiness. If the goal of reforming the international financial architecture is to strengthen market discipline by encouraging investors to more generously reward more credit-worthy borrowers and penalize less credit-worthy ones, then the more widespread adoption of collective-action clauses, which would reduce borrowing costs for the more credit worthy while raising them for their less credit-worthy counterparts, would seem to be a step in the right direction.

III. Burden sharing in practice

To date, efforts to encourage private-sector burden sharing have attempted to involve the private sector in re-financing or rolling over existing obligations on an ad hoc basis. The obligations have been bonds; the debtors have been sovereigns. The four test cases have been Pakistan, Ecuador, Romania and Ukraine.

Figures 1 and 2 summarize the debt situation in these countries using national accounts and Bank for International Settlements data.[19] Debt and debt service have been on the rise in all four countries. There has been a decline in the relative importance of long-term debt, with the possible exception of Pakistan, although multilateral finance has risen, in both absolute and relative terms, thereby filling the gap.[20] The growing importance of claims on the private sector is evident in all four countries.[21]

Notwithstanding these similarities, these four countries had fundamentally different problems when they became the subjects of the IFI's efforts to encourage private sector participation. Ecuador and Pakistan were experiencing very serious economic and political crises, creating reasons to doubt they had the capacity to service their heavy inheritance of debts. Both

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[19] BIS data often paint a more accurate picture of the capital account than national balance-of-payments sources.

[20] Where debt to private creditors is only a minuscule proportion of the total. Prior to the Asian crisis, this had been accompanied by a growing importance of both claims on the private sector (Figure 1) and lending from official sources (Figure 2). Both declined following the crisis though this decline was generally less pronounced for the share of private creditors. Interesting, bilateral creditors cut their lending in all four countries well before the onset of the Asian crisis. Thereafter, the share of private creditors falls everywhere except for Romania. This shift is confirmed by the subsequent rise in the share of public- and publicly-guaranteed debt in total long-term debt, a ratio which was in decline prior to the crisis.

[21] Although this trend was interrupted in 1999, when secondary markets became difficult to access and bail-in requirements began to bite.

countries subsequently defaulted on their international obligations. Pakistan incurred sanctions as a result of its nuclear tests and a loss of investor confidence as a result of its military coup, while Ecuador has suffered a very severe recession and continuing political unrest, including a short-lived military takeover. Ukraine and Romania, in contrast, have relatively light debt loads, as is typical of the transition economies, but sharp repayment peaks that will create liquidity problems unless their maturing debts are rolled forward. Romania has managed to meet its obligations to date, while Ukraine is in the process of restructuring.

As this diversity of circumstances makes clear, it would be difficult for even the most ambitious international financial architect to design a single procedure suitable to all of them. Yet despite the differences in initial conditions, the case-by-case approach to dealing with their problems has followed a broadly similar pattern and encountered similar problems in all four instances.

Ecuador. Ecuador is the most high profile of the four test cases because it was the first to formally default on its international debt. Ecuador's external obligations are dominated by debt to private creditors (see the top-right panel of Figure 2). Almost half of the total foreign sovereign debt of $13 billion is in Brady bonds, while only $1 billion is owed to bilateral creditors.

In the summer of 1999, Ecuador sought to negotiate a new IMF program, whose conclusion was a precondition for the release of money committed by the World Bank and the Interamerican Development Bank.[22] The problem facing the government was a fiscal and balance-of-payments crisis. The fiscal balance was deteriorating, and in the context of high unemployment and extreme poverty the government lacked the political support needed to raise taxes sufficiently

[22] Given the structure of the debt, Paris Club negotiations do not figure importantly in Ecuador's story. The Paris Club eventually agreed to consider a multi-year restructuring, but only after an IMF program was in place.

to continue servicing its foreign debts in full while at the same time defaulting on a variety of domestic social and political obligations. The markets appear to have anticipated the country's repayment problems: Figure 4 indicates a steady erosion of the spreads on Ecuador's eurobond since the beginning of 1999 (after its bonds had recovered from the Russian crisis in parallel with other emerging markets). Nevertheless, there was considerable uncertainty in the first half of the year about whether the government would stop paying, or whether it might somehow come up with the resources needed to service its debts.

When negotiations with the IMF bogged down in the summer of 1999, the markets reacted negatively.[23] In August, President Jamil Mahuad announced that the authorities had decided not to pay $96 million of interest due on a subset of the country's $6 billion worth of Brady bonds, whose interest and principal were collateralized. Apparently the authorities' expectation (and that of their foreign advisors) was that this would force the bondholders to come to the table to negotiate restructuring terms. The country bought time and avoided immediate default by paying interest on its non-collaterilized Brady bonds (past due interest (PDI) bonds) while asking investors in collateralized Brady bonds (Discount bonds) to use the 30 day grace period to authorize the release of interest collateral.

Using this collateral to make interest payments would have avoided a formal default on the Discount bonds (and the activation of cross default clauses affecting other instruments) and provided a breathing space for restructuring negotiations. Presumably this was why the Brady

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[23] Although the final impact remained limited, J.P. Morgan's emerging market index showed an increase of borrowing costs (with the spread rising from four to seven percentage points above US Treasuries) in reaction to news from Ecuador (Fuerbringer 1999). Commentators warned that spreads for emerging market borrowers in good standing would react to the IFs acquiescence to policies compromising an instrument explicitly designed to reschedule loans which could not be serviced in the past (Luce and Moss 1999). In addition, bondholders demanded that IFIs themselves be no longer exempted from sharing the costs of the default (Remond 1999).

bonds were chosen as the first instrument to restructure, and why the IFIs acquiesced. The authorities subsequently offered to swap Brady bonds for long term domestic bonds in a voluntary debt exchange, while using the interest collateral as a sweetener to encourage the creditors holding Discount bonds to engage in restructuring talks.[24]

In the event, investors dissatisfied by these terms called the necessary quorum of 25 per cent of all bondholders to vote for acceleration before the authorities could marshal an agreement to restructure.[25] Ecuador was asked to accelerate the principal on its outstanding Brady bonds, constituting the first default on these instruments since their inception in 1990. On 25 October the country also failed to meet its eurobond coupon payments, and it is currently seeking to restructure its private sector external debt.

The markets' presumption throughout this period was that the IMF would condition its assistance on a prior agreement between the country and its creditors to restructure or refinance. Speculation was widespread that, in the absence of such an agreement, the Fund would "force" Ecuador to default. On September 27th -- three days before the government was informed of the decision to accelerate -- the Fund issued a statement that it would not insist that the country reach an agreement with the holders of its Brady bonds as a precondition for official assistance; all that

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[24] Ecuador's Brady bonds were issued in 1995 at a 40 percent discount to re-schedule sovereign loans from western banks. The idea behind asking holders of collateralized bonds to release rolling interest collateral, i.e. to initiate exchanging the collateralized Brady's into new long term unsecured domestic securities by dangling the immediately available collateral to bondholders, was not viewed favorably by many of the bondholders. The group of bondholders in favor of accepting collateral in lieu of interest payments and of entering into restructuring talks consisted largely of cash strapped domestic banks. The second group, arguing in favor of accelerating the bonds to enforce payment of the principle and to secure access to all collateral including that for principal, consisted mostly of foreign creditors and others critical of the long term prospects of Ecuador's economy. After the decision to accelerate, unhappy bondholders appear to have legal options which threaten to tie up the courts for a long time to come.

[25] 25 per cent of the creditors were formally required to accelerate, but the legal options of the remaining bondholders appear to include litigation (Oxford Analytica 1999).

was required were good-faith negotiations. While this decision was consistent with the Fund's policy of lending into arrears, it did not enhance the institution's reputation for consistency, coming as it did after weeks of silence which was widely read as implying that the Fund would lend only if Ecuador restructured first. Moreover, the Fund's belated announcement may also have been wrongly interpreted by the Ecuadorians as "approval of" or "support for" nonpayment. It does not appear that the IFIs warned the authorities that attempting to continue servicing some debts while suspending payment on others would be seen by the markets as "low play." It does not appear that they warned the Ecuadorians that selective nonpayment was more likely to activate cross-default and acceleration clauses than to drive the creditors to the bargaining table.

Ecuador's experience illustrates the difficulty of arranging an orderly restructuring when the appropriate legal and institutional means are absent.[26] It is not possible to drive the bondholders to the negotiating table when there is no negotiating table to be driven to. And contrary to the government's expectations, this selective default did major damage to the country's credit worthiness. In particular, the concentration on Brady bonds destroyed the existing seniority structure, hitting collaterized Bradys before noncollateralized Bradys notwithstanding the market's presumption that the former were senior to the latter, which is likely to drive away potential future senior creditors. It affected domestic bond holders unevenly, i.e. only to the extent to which cross default clauses were activated.[27]

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[26] Ecuador's government and congress, for their part, did not play a particularly effective role in rescheduling the foreign debt. Its efforts to contact the bondholders came too late, and it sent no clear message regarding its intentions and responsibilities. For the most part, it simply reacted to an increasingly public debate on whether the IFIs had decided to force Ecuador to become the first country to default on Brady bonds.
[27] Agnelli and Gavin (1999) emphasize this point.

Finally, the precedential value of the exercise is dubious. Given the prospect of extended negotiations and the markets' negative reaction, officials regarded it as necessary to reassure investors that the Ecuadorian precedent would not be allowed to affect the holders of other Brady bonds or even other Ecuadorian debt instruments. IMF and U.S. Treasury officials were reported as providing reassurances that no spill-over would be allowed from Ecuador to other emerging markets.[28] By suggesting that what had happened in Ecuador would not be allowed to happen elsewhere, the IFIs diminished the precedential value of the experiment.

Ukraine. Circumstances in Romania and Ukraine differ from those of the other two subject countries. The two transition economies both benefit from the fact that the debt burden, at less than 30 per cent of GDP, is relatively light, something which is true for most transition economies, which had limited access to credit markets or had taken extraordinary steps to liquidate the debt. (See Figures 2B and 2C.) Nonetheless, borrowing decisions since the beginning of the transition have created payment peaks which may be too steep to surmount.[29]

Different from the other cases, Ukraine already concluded several exercises in debt rescheduling prior to the elaboration of the new policy. These involved restructuring a fiduciary loan and domestic treasury bills held by foreigners in the autumn of 1998 and again in June of 1999, both while an IMF program was in place.[30] A three-year extended Fund facility effective since September 1998 (and on hold between November 1998 and March 1999) that recently

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[28] See Fuerbringer 1999, Luce and Moss 1999, and Moody's 1999b for three such reports.

[29] At the same time, both are in the midst of a historical process of transformation, as a result of which borrowing needs and repayment capacity differ from those of other emerging markets with similar per capita incomes.

[30] At the beginning of 1999, Ukraine owed approximately $11.5bn, with a debt to GDP ratio of 27%. Of this amount, $1.8 billion was due to private creditors, $3.5 billion to foreign energy suppliers (mostly Gasprom), $1.8 billion to bilaterals and $4.4 billion to IMF and the World Bank. Repayments in 2000-1 total $5.5 billion.

resumed disbursements includes reserve targets implying that these repayment peaks cannot be met and principal can not be repaid under realistic assumptions about privatization receipts. The program therefore implies that the country's obligations will have to be restructured, a process which was underway as this paper went to press.

In June 1999, a bullet payment of $160 million came due on an indexed bond largely held by one investor, the Honk Kong-based Regent Pacific Group. When the government decided not to pay on the grounds that the IMF's reserve target did not permit it, Regent Pacific refused to consider restructuring during the automatic ten day grace period following the nonpayment, subsequently extended several times, threatening to declare the country in default and to invoke cross-default and acceleration provisions. That Ukraine in fact had the resources to make the $160 million payment -- it possessed more than $700 million of reserves at the time -- was surely one factor encouraging its creditor to insist on full payment.

Faced with Regent Pacific's ultimatum, Ukraine managed to make the payment while avoiding violation of the IMF's reserve target.[31] It scraped together the resources by re-opening a eurobond due in 2001, repayment of which constitutes the last and the largest of the country's impending repayment peaks. The Ukrainian authorities and their bankers "tagged onto" this bond an additional issue, adding DM538 million to the DM1 billion eurobond due in the Spring of 2001. The proceeds were used to finance Regent Pacific's exit. But in fact little cash was raised, and most of the additional issue was swapped at attractive rates against claims on another bond due in the autumn of 2000. Figure 5 illustrates the consequences, namely a staggering repayment peak in March of 2001.[32]

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[31] It also restructured another bond due in the autumn of 2000.
[32] See Clover (1999), Evans (1999) and Rutter (1999) for the perception this maneuver created in the financial press.

The effect has been to maximize the size of the wall against which repayment efforts will ultimately run. Instead of a series of smaller liquidity crises, the country now faces the prospect of a mammoth crisis in 2001. Not surprisingly, the creation of this repayment peak depressed the price of the 2001 bond from above 80 cents on the dollar to 40 cents (see Figure 6) and dried up Ukraine's access to the retail market.[33]

The new burden-sharing strategy did nothing to avert these dangers. The IFIs issued no public warnings about repayment peaks. They did not intervene in rescheduling negotiations to advocate certain types of instruments over others, to promote legal or institutional provisions to improve the organization of bond restructuring in the future, or to insist on the need to smooth the repayment schedule. Their official position was limited to insisting that reserves could not be used to repay private creditors.

With an insurmountable repayment peak looming, in the opening days of 2000 Ukraine appointed ING Barings to lead-manage a syndicate of banks charged with convincing investors to accept a new eurobond in exchange for their maturing issues. The bulk of these bonds are to be exchanged for eurobonds maturing in seven years, denominated in euro or U.S. dollars, and bearing 10 per cent and 11 per cent coupons, respectively, with an initial six month grace period for amortization.[34] Issuing bonds that can be amortized over seven years is more sensible than creating another repayment peak. But this conversion is likely to be more difficult than the 1998-1999 restructuring of domestic treasury bonds, because holdings are more widely disbursed and

[33] The remarkable recovery of Ukraine's eurobond prices after the Russian crisis appears to reflect an assessment of the country's solvency rather than its liquidity.
[34] Commerzbank (2000), p.1. Included are the E516 million international bond issue due in March, the $258 million zero-coupon bond due in September, a $74 million Chase amortizing bond due in October, the DM1.5 billion international bond due in February 2001, and $300 million in other bonds due in 2000 and 2001.

there exist cross-default clauses.[35] Because the most widely held bond is subject to New York law, there is the danger of bondholder lawsuits, which will hold hostage the entire restructuring process.[36] Nonetheless, the IMF has again made the conclusion of a comprehensive rollover a precondition of the resumption of the program suspended last September.

Romania. Romania faced bullet repayments on two obligations in May and June 1999 – one a Samurai bond of $460 million, the other a eurobond of $245 million. Both issues, contracted in 1996, were distributed among German and Japanese retail investors. As a precondition for the IMF Standby negotiated in the spring and summer of 1999, the Fund required the country to roll over 80 per cent of that debt. Predictably, this demand came to nothing: with both bonds trading on secondary markets, all the former lead managers had to do was to point out that they had no bonds left in their inventories. Faced with this reality, the IMF changed course, conditioning its program instead on the country raising $600 million of new money (roughly equal to the amount of the original rollover request).

In the event, Romania managed to raise only $130 million. The vast majority, $108 million, came in form of a "club loan" from a consortium of commercial banks already active in the country.[37] The idea that the country might raise additional funds from its bondholders came to naught.

This outcome was reminiscent of the debt crisis of the 1980s. Then too the IMF had conditioned its programs on the creditors first agreeing (in principle) to ante up additional funds

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[35] Thus, the 1999 restructuring did not trigger cross-default clauses in Ukraine's outstanding eurobonds because the restructured bond was governed by Ukrainian law.

[36] For this reason, the lead manager has specified that 85 per cent of current bondholders must agree before the restructuring proposal can become effective; otherwise, it would be prohibitively expensive to buy off the holdouts.

[37] The remaining $22 million was not really new money but bookkeeping gains from buying back outstanding bonds at sub-par prices.

(Cline 1995). So long as success hinged on the efforts of a small, cohesive group of creditors who feared that their solvency would be threatened by a failure to provide additional resources, this "concerted lending" strategy could work. But once the banks had provisioned against losses, they refused to participate further. The danger that this would hold IMF agreements hostage, at considerable cost to the crisis country, was what led the Fund to adopt its new policy of lending into arrears, breaking the link between its disbursements and new private lending. In a sense, then, the "innovation" of the Romanian program was a step back to the old, untenable state of affairs, allowing a large, loose collection of creditors, retail bondholders among them, to hold official money hostage.

Romania then used its reserves to redeem both the eurobond and the Samurai bond as they matured without IFI support, i.e. before Bank and Fund programs were formally in place. Reserves fell to their low point immediately following these repayments (Figure 7). They then recovered (reflecting the beneficial balance of payments effects of a large currency depreciation in the Spring and renewed efforts at structural reform). By October reserves exceeded the Fund's target by some $300 million.

Despite the fact that the condition of raising $600 million of new finance was not met, in the summer of 1999 the IMF decided to disburse the first tranche of its Standby Agreement with Romania anyway. It did so despite the country having paid off its creditors, contrary to the spirit of the bail-in strategy.[38] However, the Fund limited its first disbursement to the minimum access

[38] Figure 8 shows how sensitive the spreads of a Romanian eurobond maturing in 2001 reacted to the developments leading up to the payment: The recovery from the impact of the Russian crisis was accelerated in the Winter by positive political developments. In early Spring, prices start to reflect the increasing fear of a pending sovereign default – alleviated in late Spring by public announcements that the World Bank was ready to go to Board with a new program and that the IMF had resumed negotiations with the government. As soon as these two programs were concluded, the price of the eurobond clearly indicates that subsequent demands of non-payment

to quota possible and set as a condition for the release of further tranches that new money be raised to the tune of the missing $470 million.

The irony was that Romania's need for new money was hardly pressing. It had managed to retire the debt which caused the problem and was over-performing on external targets like the current account deficit and currency reserves.

But not raising new money would have jeopardized the Standby, which was important for market confidence. The Romanian authorities, together with two investment banks, therefore set off on a road show to prepare the markets for the issue of a new eurobond and possibly a Samurai. In the unsettled conditions of mid-1999, Romania was the only country possessing a non-investment grade (B- and B3) rating with the temerity to approach the markets. Investor response was predictably tepid. Failing to attract much interest in Europe, the road show, by the time it reached the U.S., had become a ghost show. Tapping the Samurai market disappeared from the agenda.[39]

Predictably, the consequences were unpalatable for the IFIs as well as the country. The IMF responded by reducing the sum required prior to first review to a more modest $100 million but without foreswearing the option of again raising the issue before releasing further tranches. Nevertheless, the gesture -- extended slightly earlier than the letter issued a few days before Ecuador's default -- was widely read as giving in to the fact Romania could not raise new funds.[40]

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on part of the Fund (until May and June), and threats of discontinuing the Standby if the necessary new money was not raised, did not carry weight with investors: spreads stayed low, and the anticipation obviously was that the Fund and Bank programs would not be thrown off track by the demand for burden sharing.

[39] As the Romanian press never tires of pointing out, the IFIs in fact may have helped to impair the country's credit-market access by associating it with bail-in "basket cases."

[40] Once again, by the time the decision was made, it altered the signal to the markets in unintended ways. Reflecting wide-spread sentiment, the Wall Street Journal on Nov. 4, 1999, concluded that the IMF, after having "made Romania a poster child for its campaign to force

Forward-looking elements played no part in this attempt to bail in the private sector. The only conditions imposed were the amount of new money and that it have a maturity of no less than two years. Not surprisingly, the bonds offered during the road show were subject to New York law. One of the earlier bonds which was paid off, in contrast, had been subject to English law, allowing for easier restructuring.

Pakistan. Pakistan's debt is heavily dominated by obligations to official creditors (see Figure 9). Impending difficulties in servicing debt to official (and mostly bilateral) creditors led to negotiations between Pakistan and the Paris Club in early 1999. As a condition for rescheduling Pakistan's bilateral obligations, the Paris Club then instructed the government to seek a rescheduling of its commercial debt, including bond debt, on terms comparable to those granted by bilateral creditors.[41]

Specifically, Pakistan was asked to deliver proposals for rescheduling its private bond debt, including an outstanding eurobond, by the end of 1999.[42] But when encouraged to withhold payment on a eurobond earlier in the year, the government refused. Through much of 1999 it remained reluctant to carry out the Paris Club's instructions, fearing that entering into restructuring negotiations would damage its credit. In apparent contravention of the Paris Club, it managed to scrape together the resources needed to keep current on its debt service. But with the military coup late last year, trading of its bonds on secondary markets essentially ceased, and it

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private investors to help rescue countries facing financial crises" had now "backed down and cut the amount of private money that Romania would have to raise."

[41] While the Paris Club took the lead, it is important to note that this initiative took place while an IMF program was in place.

[42] The country's bilateral Paris Club debt stands at approximately $3.3 million at the time of writing, its sovereign bond debt to private creditors is split into two floating rate notes and two sovereign bonds worth a total of $750 million. One of them, $150 million worth, fell due in December 1999, and by December 2000, an additional $470 million worth of bonds would have matured. In June of 1999, Pakistan rescheduled commercial bank loans worth $510 million.

became clear that new money was not in the offing. The government was left with no choice but to extend an exchange offer to its creditors. It proposed to exchange bonds carrying coupons of 5 per cent, 11.5 per cent, and Libor plus 3.95 per cent, maturing between December 1999 and February 2002, for a new eurobond with a coupon of 10 per cent but maturing in 2005. It warned investors that they would not receive more favorable terms, which the markets took to mean that bondholders would be faced with "outright payment default and possibly protracted negotiations on debt restructuring" if they failed to accept the offer.[43] Bondholders were given several weeks to indicate their acceptance, by the end of which 94 per cent had opted to do so.

What made this approach possible? Aside from unique political circumstances, a key factor was that Pakistan's eurobond was narrowly held, hardly traded, and in part subject to English law. Because there was provision for a bondholders meeting, and because agreement by only a qualified majority of the bondholders was required to bind the entire group, there was limited scope for maverick creditors to hold up the process in an effort to extract concessionary terms. This allowed the exchange offer to be pushed through in a matter of weeks.[44]

Significantly, Pakistan was widely seen as a candidate for this type of private sector debt restructuring independently of and before the G7's attempt at increased private sector burden sharing was implemented or even formulated. The private sector was aware of the country's problems before the Paris Club addressed the issue and appears to have anticipated that the country's obligations would have to be written down independently of the change in official

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[43] Standard and Poor's (1999), p.1. The impact on the country's credit was immediate. Standard & Poor's lowered its rating on Pakistan's three soon-to-mature eurobonds from CC to D after the exchange offer was issued.

[44] In the event, the Pakistani authorities did not resort to a bondholders meeting, since the long shadow it cast (the threat it posed to potential free riders) provided sufficient to gain all but unanimous consent on the part of the bondholders. The mechanism is analogous to the tendency for a well-designed corporate bankruptcy law to encourage workouts in the shadow of the court.

policy.[45] Figure 9 shows that Pakistan's spreads started to widen even before the G7 and the IMF had started to argue the case for increased burden sharing.[46] Given all this, the Paris Club's Pakistani precedent is less than earthshattering. In fact, the Paris Club's request to reschedule private sector obligations in parallel with the restructuring of bilateral debt must be viewed more as an isolated demonstration of the official community's ability to give haircuts to investors under exceptional political circumstances than the dawn of a new era.[47] For all these reasons, the precedential value of the exercise is dubious.

IV. Implications

This review of the four test cases of the new strategy for achieving greater private-sector burden sharing has a number of implications. Requiring countries seeking IMF assistance to first raise new money is unrealistic, given the palpable reluctance of investors who do not already have a stake in the crisis country to lend into uncertain conditions. Encouraging countries to suspend payments as a way of driving their bondholders to the bargaining table will not work so long as there is no bargaining table to be driven to. The result, more likely than not, will be formal declarations of default and the activation of cross-default and acceleration clauses, leading to an extended period of messy negotiations and lost capital-market access. And given the high costs of default, it is simply not time consistent for the IFIs to plan to stand aside if the markets refuse to roll over maturing claims, restructure problem debts, or provide new money. The fact that default

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[45] As the vice president of one rating agency put it, "the choice of Pakistan as a test case for this new paradigm makes sense because the amoutn of outstanding bons is small, narrowly held, and Pakistan is insolvent rather than suffering from temporary illiquidity. Asia Pulse (1999).

[46] Pakistan is also one of the few emerging markets whose eurobond spreads never recovered from the Russian crisis of August 1998.

[47] Thus, we disagree with Moody's (1999a), which characterized the Paris Club decision as "the beginning of a new phase in the world's international financial system."

and restructuring are so painful and costly for the country, creating an incentive to disburse even if investors fail to comply, places the IFIs in the position of having to back down on their previous conditionality, which undermines their credibility. And since investors are aware of these facts, their behavior is unlikely to be modified by the IFIs' less-than-credible statements of intent. The equilibrium in the game between the IFIs and the markets will remain fundamentally unchanged.

Among the undesirable effects of the case-by-case approach has been the destruction of the rudimentary seniority structure which existed in the markets in question. Ecuador's default hit domestic bondholders only when the holders of Brady bonds activated cross-default clauses, contrary to the markets' presumption that Brady bonds were senior to domestic debts. Nor is it clear why secured (collateralized) Brady bonds should be treated as junior to unsecured PID Bradys or why both should have less seniority than eurobonds. The IFI's acquiescence in this approach to restructuring left an existing instrument of burden sharing in tatters and most immediately hit the segment which was secured by collateral. The idea that some debts are senior to others and that foreign investors who value security can be attracted by issuing senior debts has been a casualty of these ad-hoc bail-in efforts.

Another unintended consequence of this approach is, ironically, moral hazard itself. Only treating new debt as senior to existing debt can entice new lending once a country has made it onto the bail-in list. This guarantee requires the explicit or implicit backing of IFIs if it is to carry credibility in the institutional vacuum just created. It thus runs counter to the stated principle of making private sector loans less, and not more, dependent on official financing.

A second source of moral hazard is that investors will recognize that the subjects of the bail-in exercise are all small countries whose debt problems are unlikely to have systemic repercussions. They will therefore prefer to lend to large countries that are less likely to be the

subject of the bail-in experiment.[48] By lending to such countries, they will then contribute to the very systemic risks that everyone agrees must be avoided. Bail-in candidates, for their part, will find it hard to finance legitimate investments. They will have to live under the threat of investors trying to withdraw at the first sign of trouble, which carries the potential of triggering or accelerating crises.

A final and especially regrettable casualty of these attempts to secure "private sector involvement" has been the effort to change the legal provisions of loan agreements. In all of the cases considered here, the IFIs and G7 countries failed to stake out a position as advocates of new contractual provisions. In no instance were legal or institutional innovations that might help to resolve future difficulties part of the restructuring agreement. In particular, collective action clauses were not mentioned in discussions of how new money was to be assembled. In the case of Pakistan, the conditions set by the Paris Club concerned only the timing and length of the moratorium on repayment. For Ukraine, no conditions regarding maturities and instruments were applied. In Ecuador, the multilaterals never broached the issue of new instruments or new provisions for restructured instruments, instead sitting silently as negotiations got underway. In Romania, the only condition attached to new money was that it be raised with a maturity of no less than two years, adding nicely to the next repayment peak. There, and possibly now in Ukraine, there is not only lack of progress but actual regress: the new money the country was required to solicit would have come via eurobonds governed by New York (rather than, as with previous issues, UK) law. The IFIs and the G7 had their hands full with managing the particulars

[48] Not surprisingly, differences in spreads are visible between the four economies on the current hit list and others, owing to the mere existence of such a list. Witness the differential in spreads, say, between Russia and Ukraine or between Brazil, Argentina and Ecuador before and after assurances escalated that Argentina would not be allowed to join Ecuador on the road to default.

of these four test cases, leaving no intellectual capital free for longer-term considerations.

This is unfortunate because only if the legal provisions and institutional arrangements governing sovereign borrowing are changed will efforts to secure greater private sector involvement in crisis resolution bear fruit. Without them, restructuring will remain unacceptably costly and painful for the country concerned. It will not be possible for the IMF and the World Bank to stand aside if restructuring negotiations fail. And since investors are aware of this fact, they have no incentive to modify their behavior when presented with IMF statements to the contrary. Hence, the current approach to encouraging private sector involvement is doomed to fail.

But if collective action clauses to facilitate orderly restructuring are introduced into loan agreements, the balance of incentives will change. Developing countries will be able to tolerate the still-painful, but now somewhat-less-painful, process of restructuring. Given this new situation, it will be time consistent for the IMF to stand aside.[49] And knowing that the IMF's statements to this effect are now credible, investors will have a greater incentive to participate in the resolution of sovereign debt crises, redressing the moral hazard problem that motivated this effort in the first place.

Regrettably, issuers and investors do not fully appreciate the merits of collective-action clauses. The G7 and the IFIs need to do more to encourage their adoption. The G7 countries can signal the desirability and demonstrate the marketability of these instruments by introducing the relevant provisions into their own debt instruments. At the beginning of 2000, the British government added collective-action clauses to a new euro-denominated issue. The United States needs to follow its example for the relevant signal to be received.

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[49] And to engage in limited lending into arrears.

The IMF, for its part, can condition its programs on countries incorporating these provisions into any new loans they solicit. It can make the adoption of collective action clauses a precondition for qualifying for the Contingent Credit Facility. It can make their adoption a provision of the Fund's code for good practices in the areas of monetary and financial policies. The Basle Committee of Banking Supervisors can key the risk weights on cross-border bank lending to the presence or absence of such provisions. The World Bank can provide resources to countries to buy up old bonds lacking such provisions and replace them with new, renegotiation-friendly instruments. At this point, the moral hazard problem will be on its way to resolution.

V. Conclusion

Nothing we have written questions the need to address the moral hazard created by multilateral assistance to crisis countries. Our analysis does, however, challenge the wisdom of the case-by-case approach taken in Pakistan, Ecuador, Romania and Ukraine. Requiring countries seeking IMF assistance to first raise new money is unrealistic, given the reluctance of investors who do not already have a position in the crisis country to lend into uncertain conditions. Demanding that creditors roll over their maturing claims as a condition for multilateral assistance may be slightly more realistic, given incumbent investors' stake in the country, but still must overcome formidable collective action problems when the creditors are bondholders. Encouraging countries to suspend payments as a way of driving the bondholders to the bargaining table will be disastrous so long as there is no bargaining table to which to be driven. The result will be formal declarations of default, the activation of cross-default and acceleration clauses, and an extended period of messy negotiation and lost capital-market access.

Given the fact that default and restructuring are so painful and costly, it is simply not time

consistent for the IFIs to plan to stand aside if the markets refuse to roll over maturing claims, restructure problem debts, or provide new money. Because these realities create an incentive to disburse even if investors fail to comply, the IFIs are then placed in the position of having to back down on their previous conditionality, which undermines their credibility. And since investors are aware of these facts, their behavior is unlikely to be modified by the IFIs' less-than-credible statements of intent. The equilibrium in the game between the IFIs and the markets will consequently remain unchanged. This approach to "bailing in the private sector" will not work.

Fortunately, there is an alternative: introducing collective-action clauses into loan agreements. Under present institutional arrangements, restructuring is unappealing except under the most extraordinary circumstances. Collective-action provisions would make it feasible to pursue this alternative. Debtors and creditors could decide when restructuring was desirable; it would no longer be necessary for the issue to be forced by the IFIs. Limited IMF lending into arrears to countries engaged in good-faith negotiations would become feasible. No longer would the only alternatives be paying off creditors in full with official funds or enduring a costly, extended interruption to market access. This, and not ad hoc efforts to bail in the private sector, is the forward-looking solution to the moral hazard problem.

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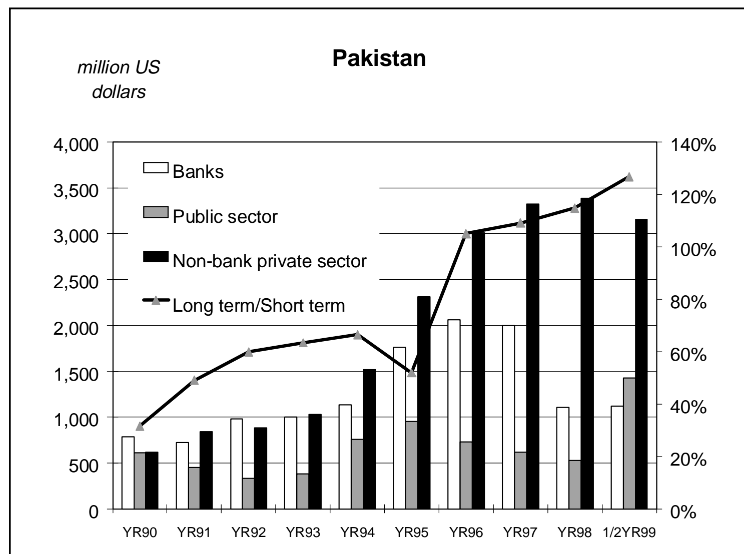
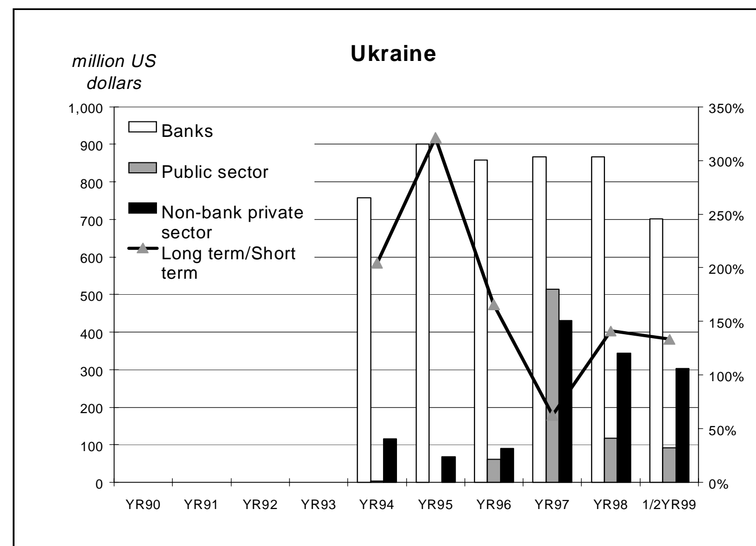
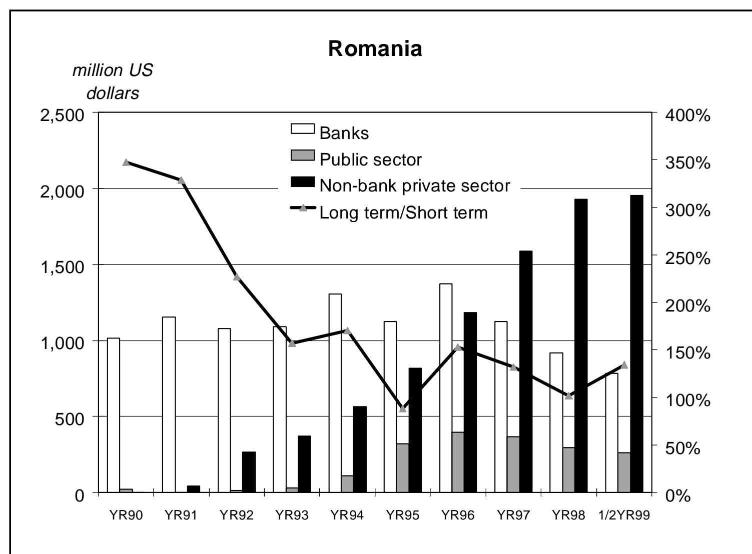
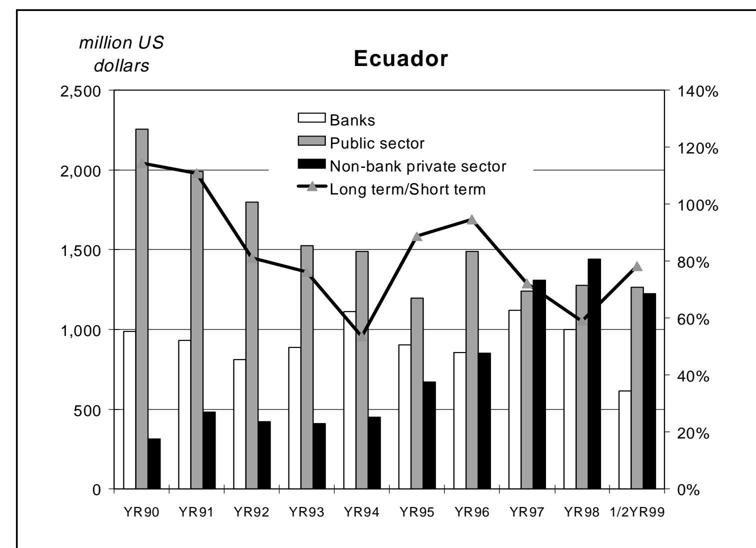
FIGURE 1. CONSOLIDATED CROSS-BORDER CLAIMS IN ALL CURRENCIES AND LOCAL CLAIMS IN NON-LOCAL CURRENCIES



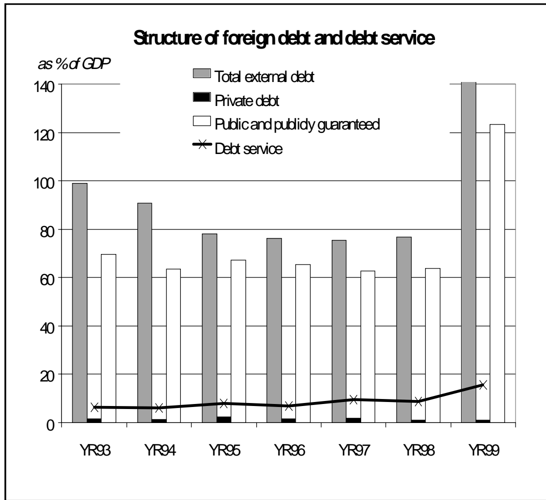


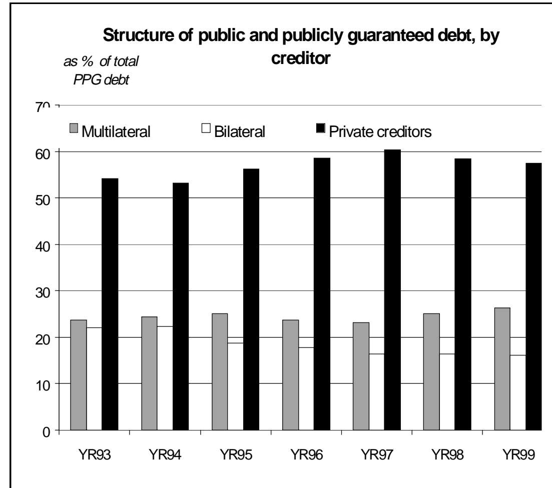


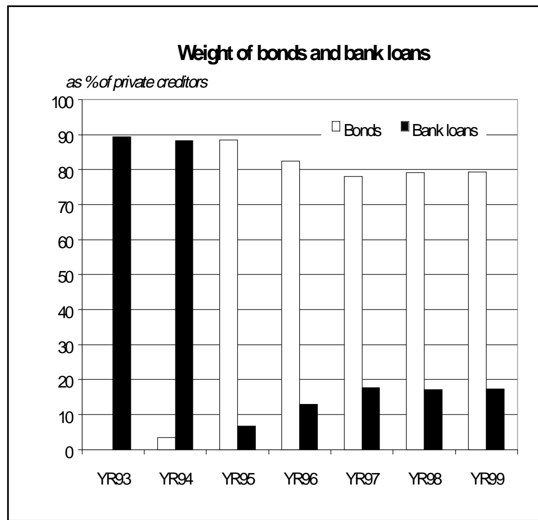


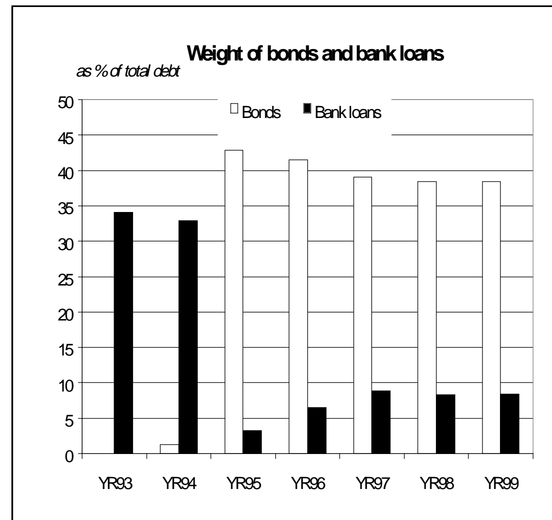
Source: *Bank for International Settelments* (2000)

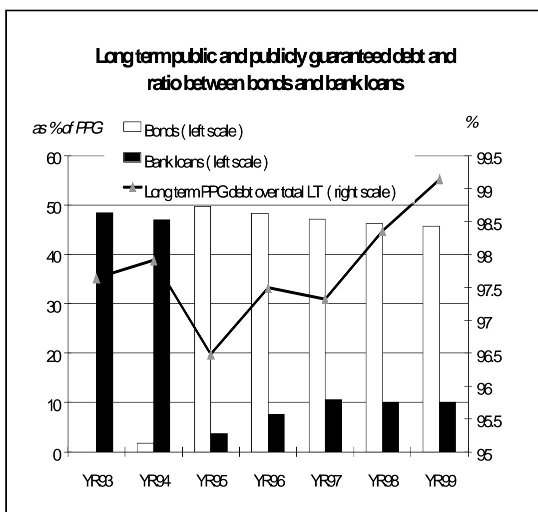
FIGURE 2A. ECUADOR

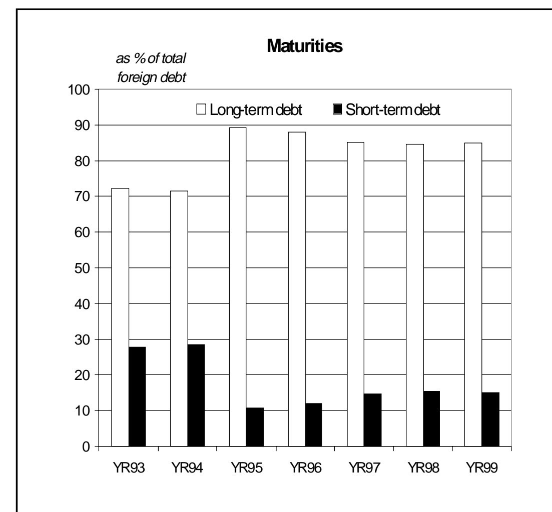






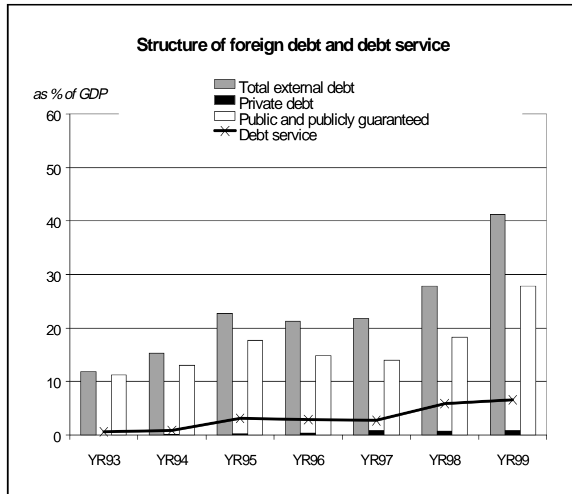


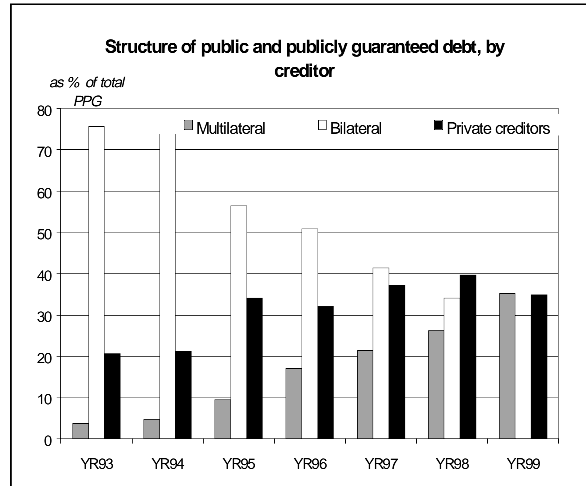


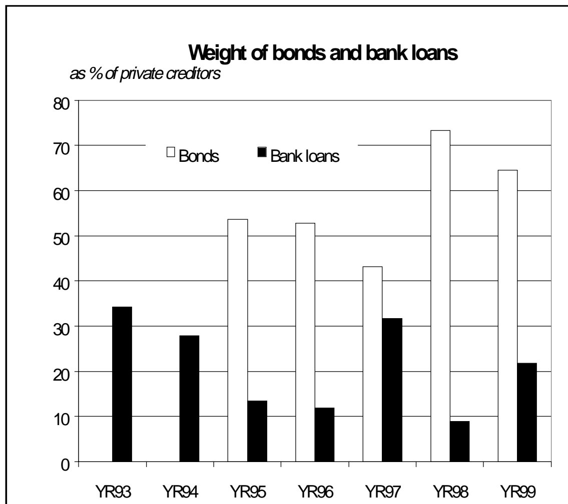


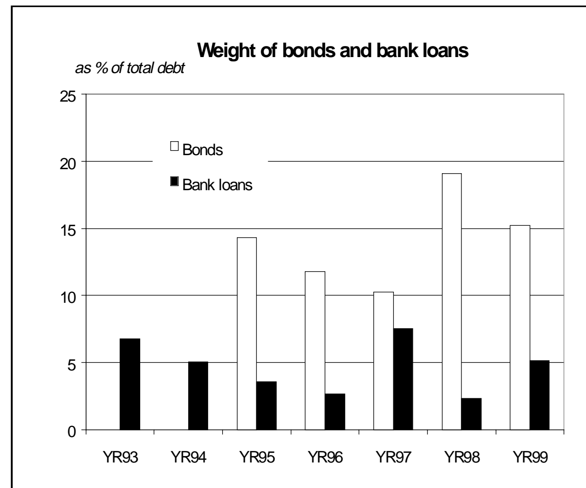
Source: World Bank, *Live data base*, January 2000

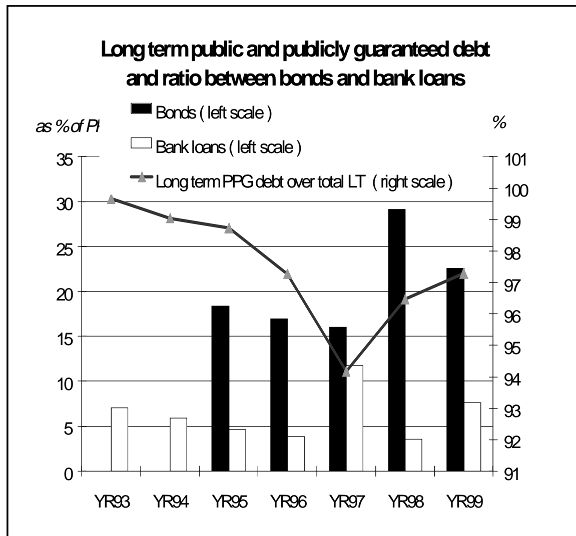
FIGURE 2B. UKRAINE

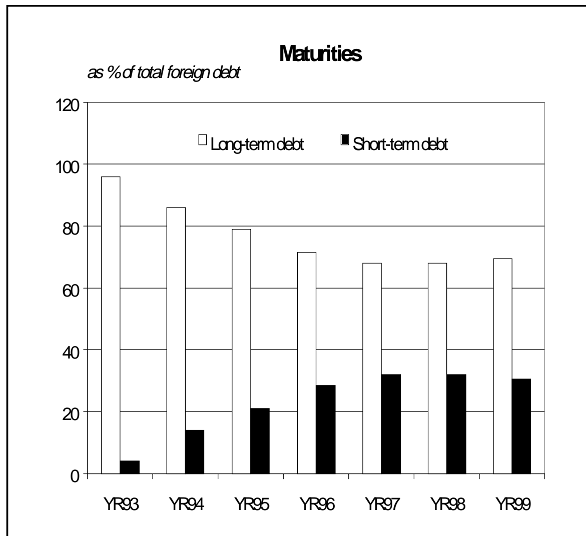






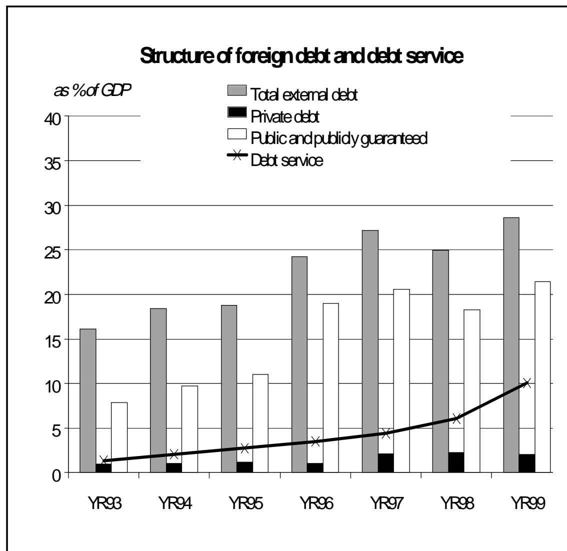


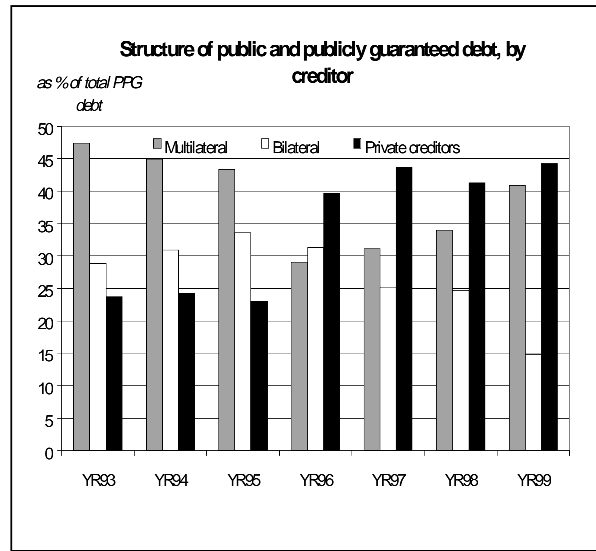


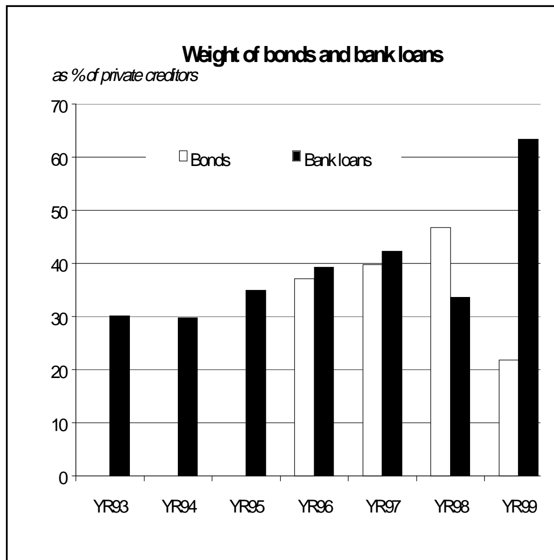


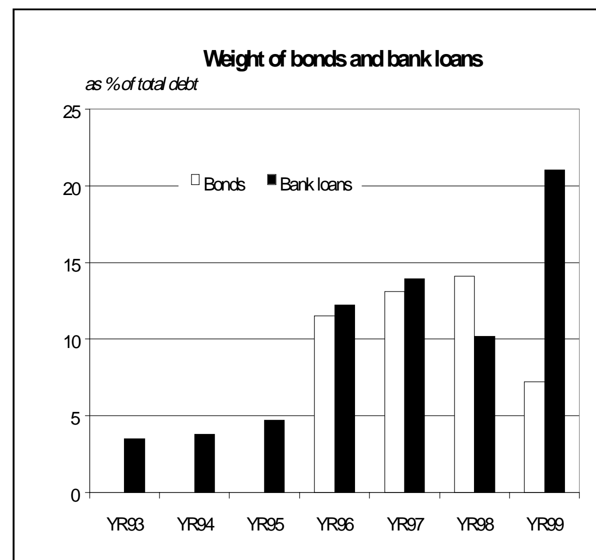
Source: World Bank, *Live data base*, January 2000

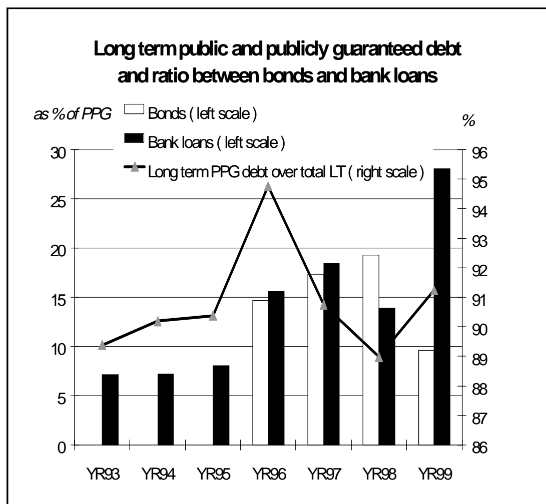
FIGURE 2C. ROMANIA

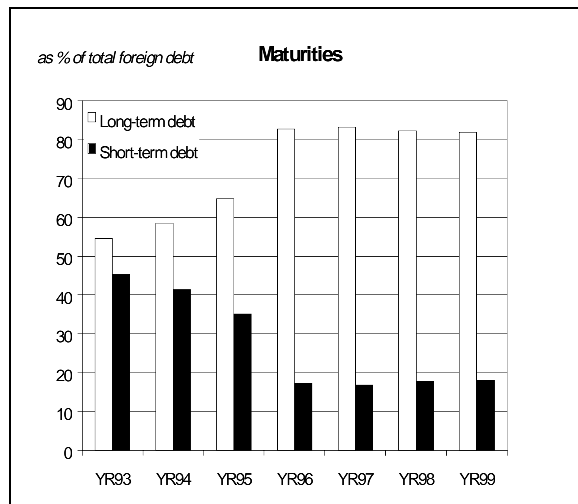






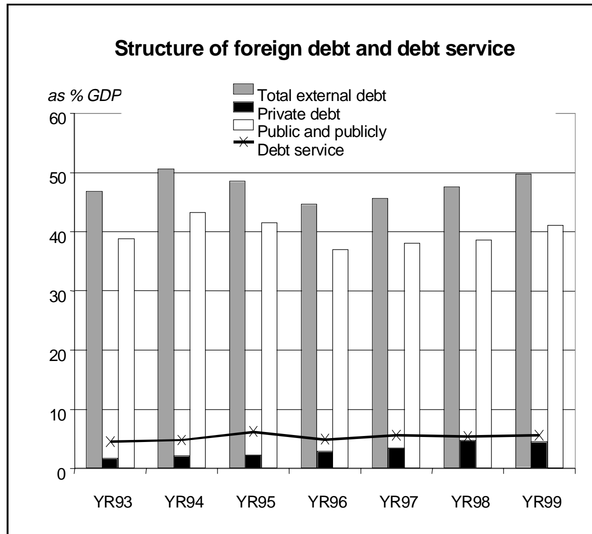


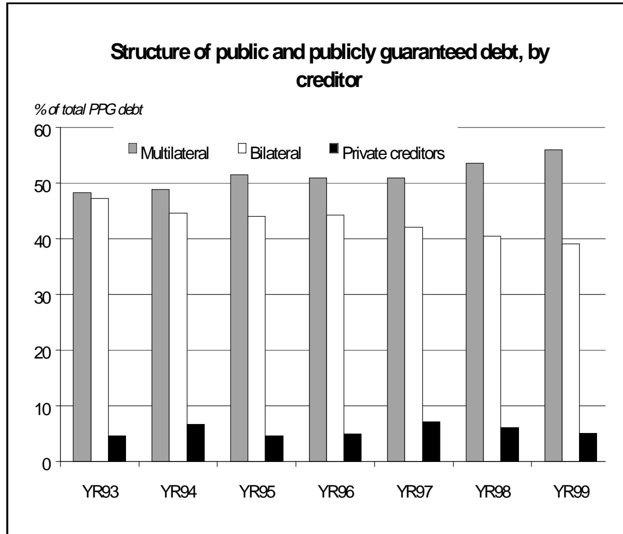


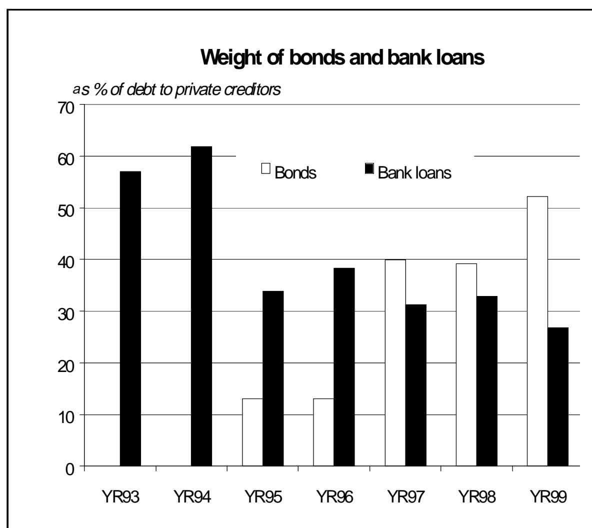


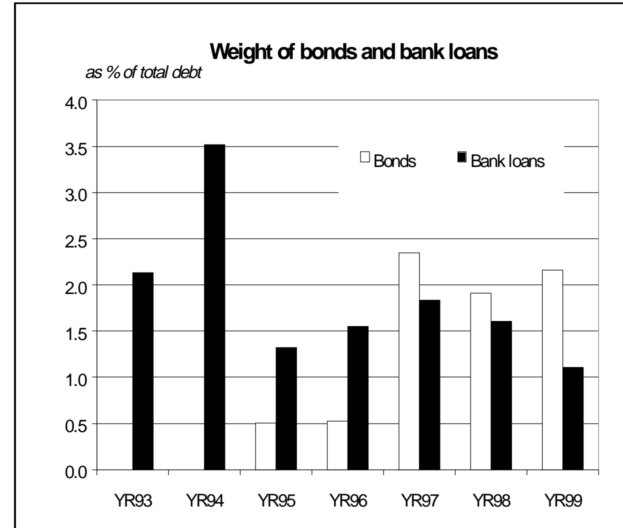
Source: World Bank, *Live data base*, January 2000

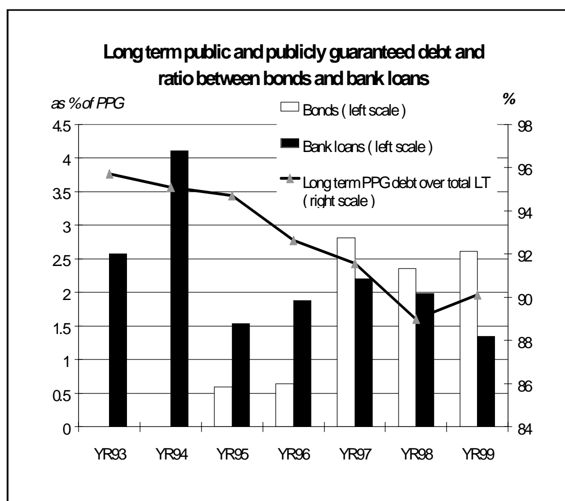
FIGURE 2D. PAKISTAN

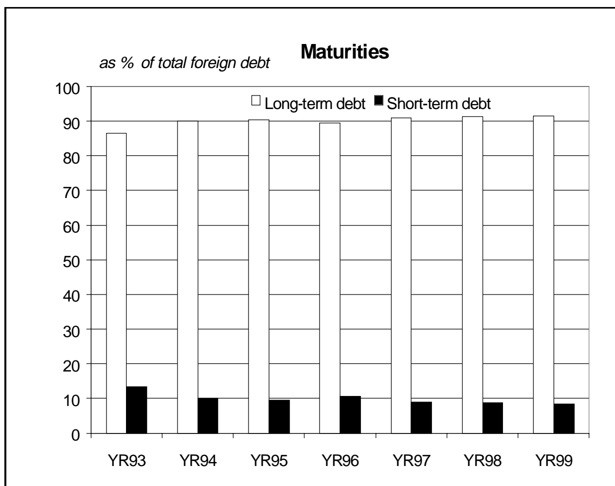






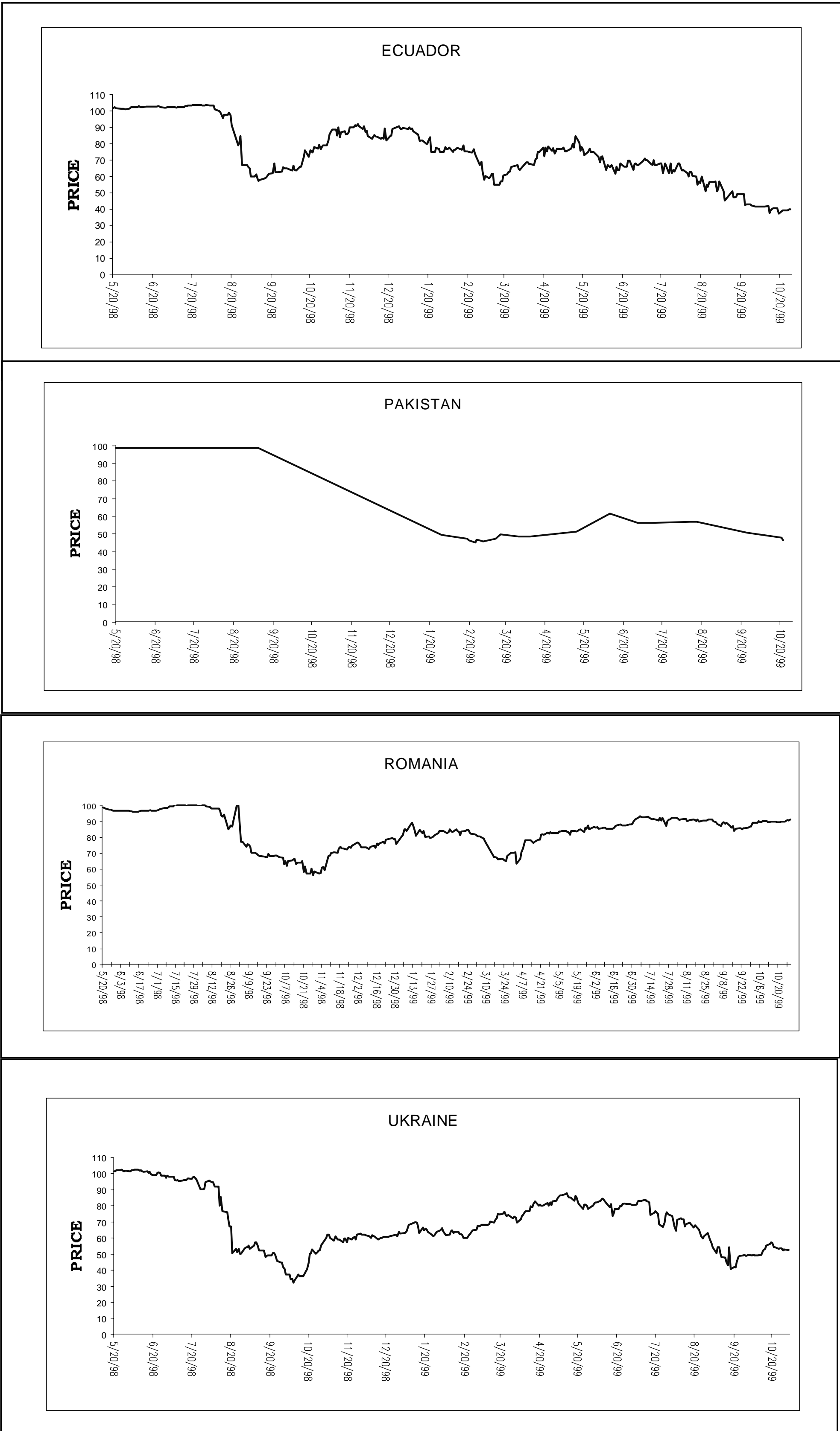






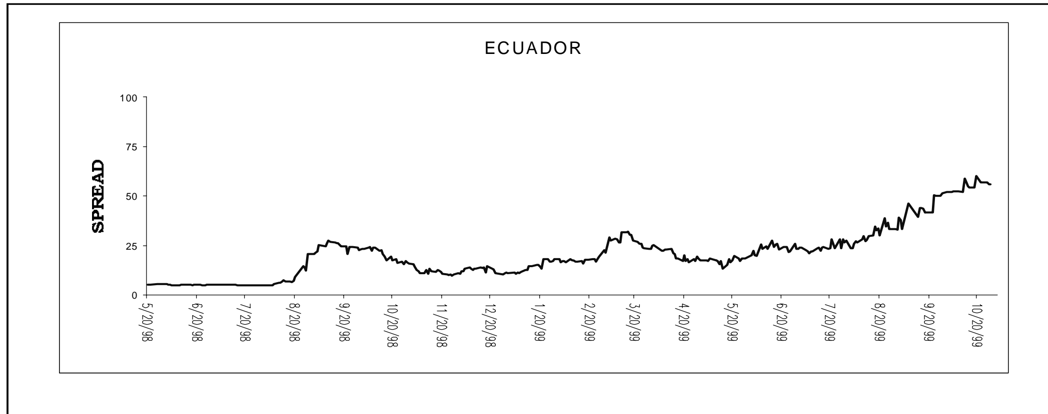
Source: World Bank, *Live data base*, January 2000

Figure 3. The Evolution of Eurobond Prices



Source: Reuters

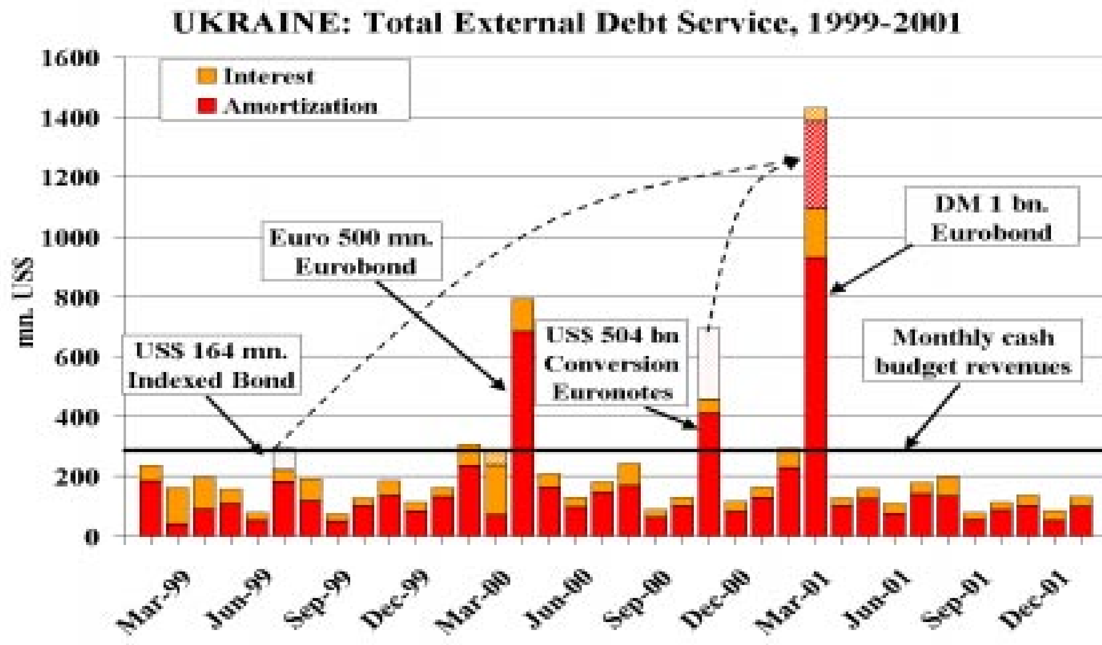
Figure 4. Evolution of Eurobond Spreads[50]



Source: Reuters

[50] $350 million 5 year bond issued 4/18/97 over 5 year US Sovereign issued 12/31/96.

Figure 5



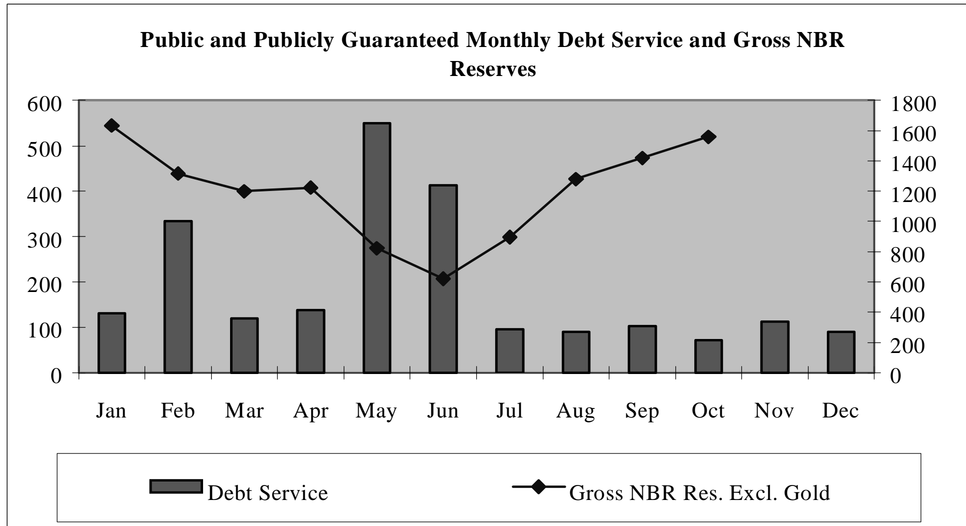
Source: The World Bank

Figure 6. Evolution of Eurobond Spreads[51]

Source: Reuters

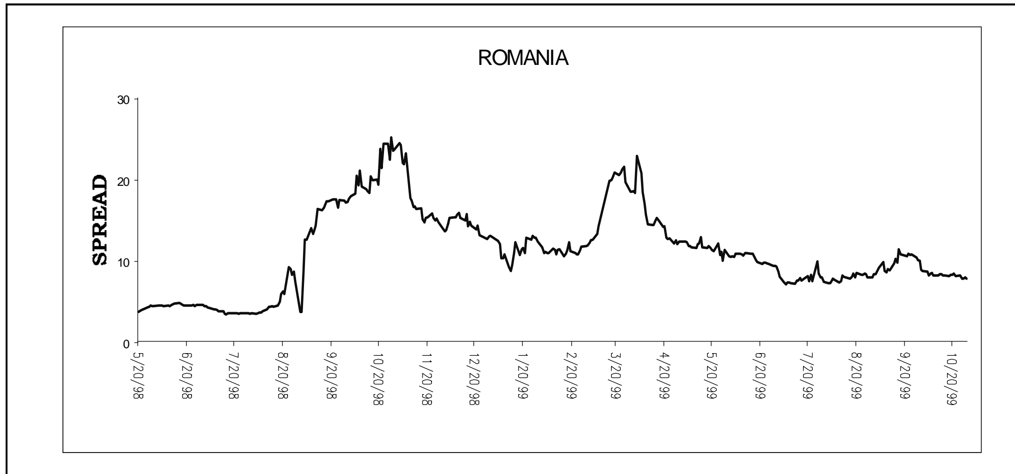
[51] DEM 750, 3 year bond, issued 2/11/98 over 5 year German Sovereign, issued 8/19/97.

Figure 7



Source: The World Bank

Figure 8. Evolution of Eurobond Spreads[52]



Source: Reuters

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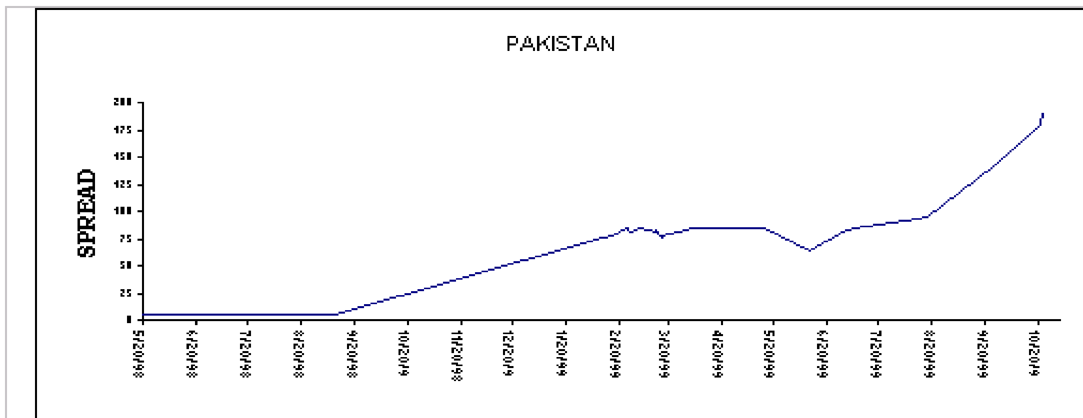
[52] Five year DEM 600 million bond issued 6/3/97 over 5 year German Sovereign, issued 8/19/97.

Figure 9. Evolution of Eurobond Spreads[53]



Source: Reuters

[53] 3 year $300 million bond issued 5/20/97 over 5 year US Sovereign issued 12/31/96.