The Resolution of International Financial Crises: Private Finance and Public Funds

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Foreword

The series of international financial crises that began in the mid-1990s—the Mexican peso crisis of 1994–95, the Asian financial crisis of 1997, the Russian default of 1998, the Brazilian crisis of 1998–99, and more recently, the situations in Turkey and Argentina—have been very costly to those directly affected and to the global economy more generally. Considerable work has been undertaken within the public, academic, and private sectors to find ways to prevent and better manage such crises. Significant progress has been made, but there is a general recognition that the work is not complete. The issues are complex. While each crisis has had a unique character, there have been a number of common elements from which lessons are being learned.

In terms of crisis prevention, there is broad consensus on the steps countries should take, and the international community has devoted considerable resources to assist in the task. There has been less agreement, however, on how crises should be resolved once they do occur.

It is in this latter area—the resolution of international financial crises—that the Bank of Canada and the Bank of England have undertaken joint work. The paper "The Resolution of International Financial Crises: Private Finance and Public Funds," by Andy Haldane and Mark Kruger, pulls together the work we have done over the past year and a half.

Our objective in this joint effort has been to develop a framework for crisis resolution that aligns the incentives of all parties in a way that deals with the crisis *and* preserves the integrity of the international financial system. It is a framework built on principles, not rules. It is a framework that attempts to be clear about the respective roles and responsibilities of the public and private sectors. This is especially important in light of the substantial changes in recent years in international financial markets. It is also important for the accountability of decisions taken.

The cornerstone of the framework is a strong presumption about the scale of "normal" access to official financing. Such a presumption, we believe, would provide the backstop for debtor-creditor negotiations and help condition expectations in financial markets. With limits on International Monetary Fund lending, private sector involvement becomes a crucial part of crisis resolution. The precise form of private sector involvement is a choice for the debtor country. But it would be selected from a range of options, including both voluntary and involuntary solutions. Among the former, bond exchanges and agreement with creditors to reschedule debt have proved helpful in past crises. Among the latter, standstills are potentially useful in dealing with crisis situations and are included in the framework as an important part of the international community's "tool kit" for crisis resolution.

The international community faces many challenges in promoting the benefits of global economic integration. The prevention and resolution of international financial crises remains one of those challenges. By publishing this joint work, the Bank of Canada and the Bank of England hope to further the debate and discussion of these important matters and to move us closer to agreement on how the international financial system can be improved.

Paul Jenkins/Mervyn King
Ottawa/London November 2001

Since the mid-1990s, the incidence of financial crises among emerging-market countries appears to have increased. In response, governments and international financial institutions have worked intensively on ways to reduce the likelihood and virulence of crises. This is the debate on the so-called “international financial architecture.”

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There is now a fairly widespread consensus within the official community on appropriate crisis-*prevention* measures. For example, the best defence against financial crises is to establish sound macroeconomic fundamentals and to have a credible policy framework able to deal with economic and financial shocks. A broad international consensus has also emerged on the importance of prudent balance-sheet management, with a particular focus on the balance-sheet positions of governments and the financial system. And considerable work has been done by international groups to establish codes and standards of best public policy practice. The official community should not be prescriptive about the adoption of standards. But it should promote transparency about the degree of country compliance with them.

Even with such prevention measures in place, however, crises will still occur from time to time. Moreover, there is less consensus among policy-makers on appropriate crisis-*resolution* measures in these circumstances. The International Monetary Fund (IMF) has responded to crises by providing often large-scale lending packages, conditional on the implementation of macroeconomic and structural reform. These programs are intended to offer bridging finance to the debtor. And this combination of reform plus bridging finance is in turn intended to help catalyze private sector capital flows.

But there is a concern that official lending on this scale may also undermine the incentives of debtors and creditors operating in international capital markets—a moral-hazard risk. And the lack of ex ante clarity about the scale of official assistance represents an additional source of risk for borrowers and lenders operating in these markets. It may also serve to delay negotiations between debtors and creditors should repayment problems arise.

Against that backdrop, this paper sets out an alternative framework for the resolution of international financial crises. The framework has the following ingredients. It is based on a presumption that multilateral official finance is limited in size. These limits mean that there would be some point at which the private sector would necessarily be involved in resolving crises. The precise form of private sector involvement will depend on the crisis at hand. A range of private sector involvement options are possible, including voluntary debt rollovers and bond exchanges. From time to time, the crisis may necessitate the debtor calling a temporary payments standstill. This can be done in an orderly fashion, with support from the IMF, so as to benefit creditors as well as debtors. The framework allows for IMF lending limits to be breached in exceptional circumstances. But such exceptional financing would be subject to strict procedural safeguards.

In one sense, the proposal made here is a modest one, because all of its elements already exist. The key difference is that here these elements are put together in the context of a sequenced and structured crisis-resolution framework. Sequenced because the resolution of a crisis can be traced out as a chronological decision tree; and structured because the framework aims to align the incentives of all parties to a crisis. In this way, the incidence and cost of crises would potentially be reduced.

A Spectrum of Approaches to Crisis Resolution

There has been intense debate among academics and policy-makers on the best approach to crisis resolution. At one end of the spectrum, some have suggested that the IMF could provide emergency liquidity assistance in potentially unlimited amounts—an international lender of last resort. At the other end, official finance is seen by some as part of the problem.

Fischer (2000) argues that not only is there a need for an international lender of last resort, but that the IMF has de facto taken on this role. He argues that it is not necessary for an international lender of last resort to be able to issue liquidity in order to be effective. What is needed, in most cases, is the reallocation of resources from liquid to illiquid entities. Since the IMF is akin to a credit union, potential borrowers have access to a pool of resources that the IMF can onlend from member countries. In addition, Fischer notes that the IMF can borrow from the General Arrangements to Borrow (GAB) or the New Arrangements to Borrow (NAB), where necessary.

The International Financial Institutions Advisory Commission (2000), the "Meltzer Commission," also recommends that the IMF act as an international lender of last resort. Liquidity loans would have short maturity (120 days, with one rollover), be made at a penalty rate, and be collateralized by a clear priority claim on the borrower's assets. Moreover, loans would be made only to countries that had met stringent preconditions, including conditions on financial soundness.

Schwartz (1998) argues that official financial institutions engender moral hazard and so do more harm than good. She notes that the private sector successfully dealt with financial panics in the latter part of the 19th century by relying on clearing-house loan certificates by private sector clearing houses. Thus, Schwartz recommends that "in the interest of a more stable and more free international economy" the IMF be abolished, not reformed.

These approaches are unlikely to be optimal. Turning the IMF into an international lender of last resort is impractical as there is neither the capacity nor the political will to provide official money in unlimited amounts with the requisite speed. It is also undesirable because of the risk of moral hazard affecting both debtors and creditors. This would hinder the efficient intermediation of funds from developed to developing countries.

Equally, a world without official finance would also be suboptimal. This would ensure the maximum degree of private sector involvement. But crisis resolution would come about through a combination of greater policy adjustment by the debtor and / or greater financing by the private sector. So output losses would be sharp and payment interruptions frequent and disorderly. Such an outcome would have adverse consequences for creditors as well as debtors—a deadweight cost. In short, it too would hinder the efficient functioning of the international financial system.

Between these two extremes, there is a middle way. This would recognize that modest amounts of official money can serve as a deterrent to self-fulfilling crises and provide time for policy adjustment. For example, the Independent Task Force sponsored by the Council on Foreign Relations, Inc. (1999) argued that the IMF should return to normal lending limits for crises that do not pose a systemic threat. In exceptional circumstances, the IMF should turn to the NAB / GAB or a "contagion facility." And activation of the systemic facilities would require a supermajority decision by creditors.

The Current Framework for Crisis Resolution

Some progress has also been made by the official sector in cultivating that middle way. For example, the statement by the G-7 at the Cologne Summit in 1999 set down some principles and tools for dealing with crises. By themselves, however, these principles and tools do not constitute a fully-fledged framework for crisis resolution. We know the ingredients of such a framework but still lack a recipe for combining them. In this respect, we would highlight two aspects of the current framework that warrant attention.

First, there is a need for greater clarity regarding the amount of official financing. The size of official packages has varied considerably across recent IMF programs. And in a number of recent large-country cases, normal IMF access limits have been breached, often by a significant margin. Too much discretion regarding official actions leads to confusion among debtors and creditors and time-consistency problems among policy-makers. Greater clarity about the scale of official financing would help to condition the actions and expectations of debtors and creditors about the roles they are expected to play in resolving crises.

Second, some of the crisis-resolution tools identified by the official sector have so far been underutilized. One example would be the inclusion of collective-action clauses in bond contracts to facilitate debt restructuring. Another would be a payments standstill, which provides a debtor with temporary respite from debt payments and allows for an orderly working out of debt problems. Too often in the past, sovereign default has been disorderly, with the work-out process slow, inefficient, and inequitable. A better approach would recognize that default is a natural feature of the market mechanism, not something to be avoided at all costs. But it would seek to limit the costs of sovereign default when they do occur.

A Clear Framework

The framework presented here aims to strike a balance between official lending, debtor adjustment, and private sector involvement, recognizing that each has a role to play in the resolution of crises. But those roles and responsibilities need to be made clear ex ante to all parties. Indeed, this is precisely the role of a crisis-resolution framework.

The key elements of this proposed framework are as follows:

A presumption of limited official finance

When crises strike, macroeconomic policies have to be adjusted to offset the adverse effects of shocks. But policy adjustment usually takes time. If policy is not credible, or if financial markets are impatient, then the prospect of adjustment may not be sufficient to change expectations. A country can fall victim to a self-fulfilling speculative attack.

Official money can help in these circumstances, serving as bridging finance during the period of domestic adjustment and helping catalyze private capital flows.

Official money can help in these circumstances, serving as bridging finance during the period of domestic adjustment and helping catalyze private capital flows. But such lending needs to be limited, to prevent the adjustment incentives of debtors from being dented, or official money simply substituting for private capital flows. For this reason, there should be a clear presumption that "normal" official lending limits apply in times of crisis.

Greater clarity about the limits on IMF lending would deliver three important benefits. First, it would reduce uncertainty, among both creditors and debtors, about the extent of the public sector contribution. Private creditors demand compensation for that uncertainty through a risk premium, which increases the cost of borrowing for emerging markets. A clearer framework for crisis resolution would reduce that uncertainty premium, to the benefit of both debtors and creditors.

Second, limits would reduce the potential for the private sector to game the official sector into providing more money ex post than would have been optimal ex ante. The official sector has to strike a balance between the need to resolve the current financial crisis and the need to prevent future financial crises. In short, the official sector faces a time-consistency problem (Kydland and Prescott 1977).

This balance between ex ante and ex post efficiency is familiar from a corporate bankruptcy context (Eichengreen and Portes 1995). The IMF faces a similar dilemma (Miller and Zhang 1999). As Rogoff (1999) argues, bailouts by the IMF encourage greater risk-taking by banks in industrialized countries, and those banks are also likely to take risks because of domestic support arrangements.

Policy-makers are, of course, familiar with the time-consistency problem. It crops up in all fields of public policy—fiscal, monetary, regulatory, etc. In response, they have often adopted clearer public policy frameworks. For example, in the monetary policy sphere, inflation targeting combines clarity about the objective of policy—the inflation target—with discretion about how best to achieve this target. It is a framework of "constrained discretion," with clear roles and responsibilities for the different players. This helps mitigate time-consistency problems in monetary policy.

The adoption of a clear framework for crisis resolution could offer the international financial community similar time-consistency benefits. It would set out the presumptive constraints on official lending. And debtors and creditors would then have the discretion to operate in their own best interests, subject to these constraints.

Some have argued that the official sector should pursue a policy of "constructive ambiguity" in the resolution of crises. An analogy is sometimes made with domestic lender-of-last-resort facilities, where ambiguity is used to mitigate moral hazard. But international moral hazard can be mitigated in ways that do not introduce costly uncertainty into the framework for crisis resolution—for example, by limiting lending.

Third, a related benefit of lending limits is that they would guard against moral hazard. Moral hazard applies to both debtors (by blunting incentives to undertake the necessary adjustment and reform) and creditors (by blunting incentives to undertake effective risk management). Moral hazard is clearly a question of degree. Every insurance contract possesses some degree of moral hazard. And the empirical evidence on the moral-hazard effects of official lending is not conclusive. Nevertheless, anecdotal evidence of the importance of moral hazard is widespread. And the longer the current system of non-binding lending limits persists, the greater the scope for moral hazard to increase in the future.

The nature of private sector involvement

While there is broad agreement on the need for private sector involvement in crisis resolution, there is still uncertainty about what precisely it means and how best to bring it about.

Crisis lending by the official sector and private sector involvement are two sides of the same coin. So with limited IMF lending, private sector involvement would at some stage become an element in resolving all crises.

The precise form of private sector involvement is, above all, a choice for the debtor country, in consultation with its creditors. A spectrum of private sector involvement options is possible. Both voluntary solutions (such as bond exchanges and debt rollovers) and involuntary solutions (such as standstills) should be acceptable, in principle, by the official community. The role of the official sector is to make clear on what terms and conditions official finance will be available, and the limits of that finance. The debtor country must then decide for itself which option to take. The appropriate option will depend on the specifics of the crisis at hand.

In the majority of crisis cases, it should be possible for debtors to secure private sector involvement voluntarily, either by raising new money in the markets, or by reprofiling existing money in consultation with creditors. This has worked effectively in helping resolve crises in the past—for example, in Korea in 1997 and in Brazil in 1999. For countries with unsustainable debt burdens, market-based bond exchanges, which write down the face value of debt outstanding—for example, as in Pakistan in 1999 and the Ukraine and Ecuador in 2000—are a second voluntary means of resolving crises.

On occasion, however, the combination of limited IMF lending and policy adjustment may be inadequate to mobilize sufficient private finance on a voluntary basis—for example, if capital flight is pervasive. In such situations, it would be counterproductive for the official sector to continue financing private capital flight. What is needed is some backstop measure to provide debtors and creditors with a breathing space to arrive at a co-operative outcome—a standstill.

The role of standstills

Standstills should not be construed as a way of relieving debtors of their obligation to service their debts in full and on time. Rather, they are a way of enhancing the effectiveness of the crisis-management process. In particular, they offer three benefits.

First, they can promote creditor coordination. An orderly standstill can break the circuit of destabilizing and, ultimately, self-fulfilling creditor expectations. By reducing creditor externalities, standstills can be a positive-sum game, advantageous for debtors and creditors alike. In a domestic context, Diamond and Dybvig (1983) show that allowing banks to suspend withdrawals can be a fully efficient mechanism for eliminating collective-action problems among creditors.

Second, standstills can align creditor and debtor incentives. Creditors will be more willing to reach voluntary agreements quickly if there is a credible threat of a standstill. And debtors will be more willing to negotiate if they know that official monies are limited. So having standstills as a backstop should prevent the prolonged debt negotiations that have characterized a number of recent IMF program cases. For example, in the case of Korea in late 1997, a large official assistance package did little to reduce capital flight and stabilize the balance of payments. It was only after "the Federal Reserve Bank of New York called a meeting to convince key U.S. banks that a rollover of their maturing interbank lines was in their own interest as not all of them could exit at the same time" that debtors and creditors were able to arrive at a solution (IMF 2000).

Third, standstills can help ensure that payment stoppages are orderly. Standstills provide a safe harbour while debtors put in place remedial policy actions—for example, macroeconomic policy adjustment or debt restructuring. In this way, they are potentially useful both in cases where a country faces a short-term liquidity problem that necessitates the reprofiling of debt service, and in cases of unsustainable debt burdens where debt reduction is required.

The decision to call a standstill lies with the debtor. But the official sector can play a useful supporting role. Such support could take the form of the IMF's lending-into-arrears (LIA)—the provision of bridging finance. IMF lending would occur only under strict conditions, however, including the debtor negotiating with its creditors in good faith, creditors being treated equally, and the process having a definite time limit. That would ensure that debtors play fair during a standstill, neither calling them too often nor maintaining them too long. These guidelines would help ensure that a standstill is orderly.

Standstill guidelines

Standstill guidelines provide a framework for the resolution of sovereign debt problems. They are, in some respects, akin to bankruptcy procedures. For this reason, some have asked whether sovereign payments standstills should have a statutory basis. This would require a change in the law in all jurisdictions in which a debt contract might need to be enforced. The advantage of this is that it would confer legal protection on a debtor calling a standstill.

But changes in the law in many jurisdictions would also be a formidable exercise. Moreover, it is clear that countries, having sovereign rights, are different from corporations in several important respects. Sovereign debtors do not require a court's permission to call a standstill. Moreover, creditors cannot easily seize the domestic assets of a sovereign. Nor can they insist that a country's management be replaced. Because of these differences, many of the benefits of a standstill can be achieved within a non-statutory framework, underpinned by a set of guidelines (see Schwarcz 2000). These guidelines would then form the conditionality that applied to the IMF's lending-into-arrears. An illustrative set of guidelines might include:

1. Transparency. The debtor should communicate effectively by releasing all pertinent information to all creditors on a timely basis.
2. For the debtor to be bargaining in good faith, offers must be reasonable. Debtors that are illiquid should be offering rescheduling that maintains the value of their obligations in net present-value terms. If debt reduction is necessary, the amount of the haircut offered by the debtor should not be greater than necessary to achieve a sustainable medium-term debt profile.
3. Creditors should, as far as possible, be treated equally. This means that not only should individual creditors (foreign and domestic) within a class of instruments be treated the same, but that holders of different instruments be treated according to the seniority of their contracts. A presumption of seniority should not be made where none exists in the debt contract.
4. Net new money should be granted seniority over existing claims, consistent with the "super-priority" principle in a corporate-insolvency context. Trade credit should be exempt from the standstill to help maintain production.
5. The process should be explicitly time-limited, to prevent debtors maintaining standstills too long. Should the time limit expire as a result of the debtor failing to submit to creditors a reasonable offer, then the guidelines will have been breached. If, however, the time limit expires as a result of some or all creditors failing to accept a reasonable offer made by the debtor, then the debtor is not in breach of the guidelines.

As long as the debtor is taking action that complies with the guidelines, the IMF should be willing to offer support by LIA. With this framework in place, there would be incentives for debtors and creditors to reach timely agreement on a debt reprofiling. It would also be reasonable to hope that, for a debtor country following the guidelines, the risk of litigation from a creditor would be reduced. That is because creditors would know that when a debtor has followed the guidelines, and is therefore treating all creditors in an even-handed manner, it would be easier to persuade the courts to side with the debtor and not allow a minority creditor to grab a country's assets. Past experience shows that courts do take the behaviour of debtors into account. It is true that the recent case *Elliot Associates versus Peru* shows that creditors can prevent a negotiated agreement from coming into effect. But the recent experience of restructuring debt in Russia, Pakistan, Ukraine, and Ecuador offers some encouragement. And either way, there is real merit in putting in place guidelines that could be used by courts in their interpretation of the behaviour of debtors and creditors.

Clearly, these guidelines would need to evolve in the light of experience, to ensure they strike the right balance between creditor moral hazard on the one hand (IMF loans financing capital flight) and debtor moral hazard on the other (debtors calling standstills too frequently or maintaining them for too long). But all regulation needs to be dynamic and responsive to the changing behaviour of market participants.

Potential costs of standstills

A number of potential costs of standstills have been identified. While they should not be taken lightly, many of these costs are more apparent than real.

One argument against standstills is that they undermine the primacy of contracts. This argument does not, however, hold up under close scrutiny. The presumption should always be that debtors meet their obligations in full and on time. But faced with a genuine liquidity shortfall or an unsustainable debt burden, meeting contractual terms may be impossible. In such cases, sovereign debtors need a safe harbour. Bankruptcy law provides this in a corporate context. Everyone accepts this as an important part of the capital market mechanism; it supports, not supplants, market forces. The same is true in an international context, where standstill guidelines can serve as surrogate bankruptcy law.

A second argument against standstills is that they may encourage debtors to default. Given emerging-market economies' dependence on international capital, it seems unlikely that they would wilfully default on their obligations. Moreover, the IMF can play a useful role in guarding against strategic default, by refusing to lend-into-arrears to those countries. The conditions attached to lending-into-arrears would also help ensure the debtor played fair during the standstill phase.

A credible, well-managed standstill ought to enhance value for longer-term investors by mitigating the costs of coordination failure.

Some have argued that including standstills in the framework for crisis resolution might encourage investors to "rush for the exit" at the first sign of trouble, thereby triggering a crisis. Investors with a short time horizon will always want to get out quickly, regardless of the institutional arrangements in place. Against this, the situation for relationship lenders, who value returns over the medium term, is quite different. A credible, well-managed standstill ought to enhance value for longer-term investors by mitigating the costs of coordination failure. So the incentive for longer-term investors to rush for the exits will be reduced. This would mitigate—and potentially offset—the negative consequences arising from the behaviour of skittish investors.

Others have argued that standstills may require capital controls to be enforceable, and that these are administratively impossible or extremely costly to impose. In the vast majority of cases, however, capital controls would not be needed to enforce a standstill; it would simply be a case of the sovereign ceasing payments temporarily. Occasionally, this moratorium may need to extend to the banking system. On rare occasions, when capital flight is large and persistent, capital controls may be required to provide a breathing space. But these cases would be the exception, not the rule. And because these controls would be temporary, their costs would not be punitive.

Another concern regarding standstills is that they might lead to contagion. Spillovers are a fact of life in a world of large, cross-border capital flows. The issue is whether standstills would worsen these spillovers. Orderly standstills, as part of a coherent crisis-resolution framework, ought to mitigate uncertainties about the work-out process and preserve value. In this way, they may well relieve contagion risks by comparison with the counterfactual case of disorderly default.

An apparently powerful argument against standstills is that they may increase the cost of borrowing and reduce the flow of capital to emerging markets. This might happen, for example, because markets raise their perceived probability of a sovereign default. Given the high cost of borrowing for emerging markets, this argument is a potentially potent one. But it is only part of the story.

First, a lower volume of capital flow does not necessarily translate into lower welfare for a country. Before the Asian crisis, more capital flowed to emerging markets than could readily be absorbed. The bust that followed the boom was very damaging to the countries concerned. A lower but more stable flow of capital would have been welfare-enhancing.

Second, even if aggregate capital flows are lower in a world of standstills, the composition of capital flows—less short-term and more long-term lending—is likely to improve. This improved composition of capital would reduce countries' susceptibility to future crises, by reducing the probability of capital-flow reversals.

Third, there are good reasons for believing an orderly framework for standstills will not raise the cost of capital for emerging markets. In pricing country risk, markets take account of three factors: the probability of a country defaulting; the recovery value in the event of a default; and a compensation for risk—a risk premium. An enhanced role for payments standstills might arguably increase the perceived probability of default (though it is possible that the expectation of a standstill could actually *reduce* the incidence of default). But against that, a predictable framework for crisis resolution will increase the recovery value on debt in the event of default and lower the degree of uncertainty regarding work-out procedures. In this way, the cost of capital for sovereigns may well be reduced with a clear crisis-resolution framework in place.

Exceptional Finance

While the framework is founded on the principle of limited official finance, exceptional events do sometimes occur. No rule or constraint is inviolable. So there is a need to preserve the incentives and credibility of a system of official lending limits, while allowing for a degree of flexibility to deal with truly exceptional circumstances.

The IMF has long had the ability to lend beyond normal limits by invoking an exceptional-circumstances clause or, more recently, through the provision of loans under the Supplemental Reserve Facility (SRF), a short-term facility introduced in late 1997 in the wake of the Asian crisis. But procedural safeguards on these facilities are limited, and the definition of exceptional circumstances is left vague. Procedural safeguards need to be buttressed.

One possible model of procedural safeguards for exceptional lending is the U.S. Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991. The Act allows the FDIC to exempt a bank from "least cost resolution" provisions if it believes that the financial security of the United States is threatened and FDIC assistance would mitigate adverse effects. This judgment would be made by the Secretary of the Treasury, based on the recommendation of two-thirds of the FDIC Board and the Board of Governors of the Federal Reserve, following consultation with the President. The General Accounting Office is required to review the basis for the decision ex post to ensure that regulators are held responsible for the spirit of the Act (Bentson and Kaufman 1998).

One possible model of procedural safeguards for exceptional lending is the U.S. Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991.

Similar rules for good governance can be developed for IMF lending in the context of international financial crises. First, there is a case for identifying more clearly than at present the circumstances that would justify a departure from normal lending limits. For example, one justification for exceptional finance could be situations that threaten the stability of the international monetary system. This is consistent with the rationale the IMF uses when it seeks supplementary financing from the NAB countries.

Second, the mechanism for taking such a decision needs to be better defined. A special IMF Staff report could be prepared demonstrating that exceptional circumstances exist. In addition, the Staff's findings would have to be confirmed by a supermajority of the Executive Board. If a decision was taken to provide exceptional financing, the Staff report should be made public in the form of an open letter from the Fund's Managing Director.

Third, it would be necessary to ensure that official monies were not financing capital flight on an ongoing basis. A floor on reserves could be established to serve as a brake on capital outflows. If the reserve floor was breached, additional official monies would be suspended.

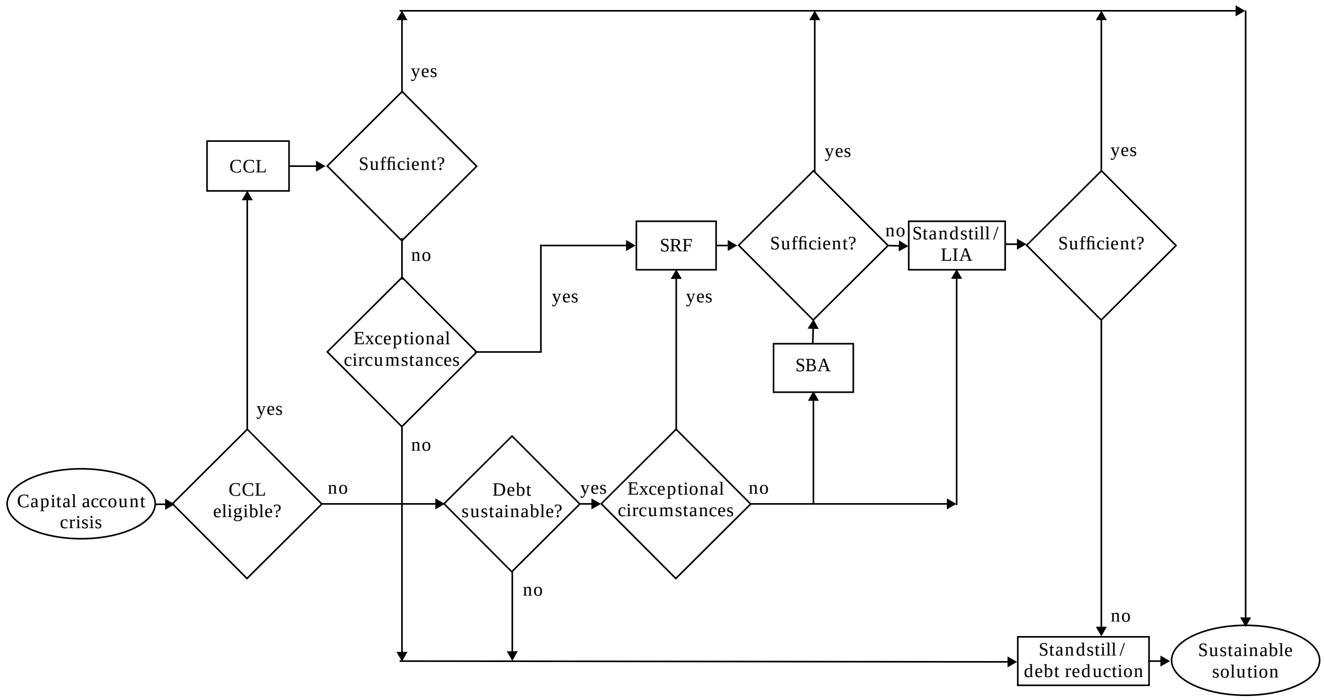
Finally, those taking the decision to grant exceptional access would be accountable for their actions ex post and subject to an independent evaluation. This function could be performed by the Fund's new Independent Evaluation Office.

A Framework for IMF Intervention

The flow chart (Chart 1) is intended as a summary of the framework. It is shown as a decision tree, tracing

Chart 1

Chronology of Crisis Resolution



out the chronology of crisis in terms of the options open to the debtor in moving from crisis to a sustainable solution.

Consider a stylized example. The first order of business would be an assessment of the country's debt burden. If a country's debt burden is not sustainable, then the provision of official finance risks worsening a country's financial position: the solution to the country's problem is less debt, not more. Moreover, since official creditors typically have seniority, this additional official finance reduces the value of existing private claims.

In assessing a country's medium-term debt sustainability, too much emphasis has in the past been put on the profile of the country's debt-to-GDP or debt service-to-exports ratios, with the debt burden judged to be sustainable if the ratios are falling over time. This sort of analysis says nothing about the sustainable level of these ratios (Cohen 2000). Sustainability analysis should also assess sustainability thresholds.

If debt is unsustainable, creditors will be required to reduce their exposures in net present-value terms. In these circumstances, it is important that there is an efficient means of organizing creditor-debtor negotiations during the work-out. It is also important that creditor losses be allocated fairly. Standstill guidelines provide one means of ensuring that the debt work-out process is efficient, equitable, and expeditious.

If the debt burden is sustainable, the presumption would be that normal IMF lending limits applied. Some countries may be eligible for the IMF's Contingent Credit Line (CCL), if they have satisfied the requisite ex ante conditionality. Other countries may be eligible for a Stand-By Arrangement (SBA), in which case, they would be required to abide by the requisite ex post conditionality. In most cases, limited official assistance of this type would be sufficient to buy time for the country to overcome a crisis.

In more severe cases, however, official finance may not by itself be sufficient. The country may need to approach creditors in order to raise new money, or to work out a reprofiling of its existing debt service. Because the country's debt burden is sustainable, creditors would not suffer losses in net present-value terms under such a rescheduling. So it should be possible to raise net new financing through market-based, voluntary procedures, such as debt rollovers, swaps, and exchanges.

But if a voluntary agreement cannot be reached, or if capital flight is pervasive, the country has recourse to a standstill in order to halt the liquidity drain. The IMF can support the standstill by lending-into-arrears if the country is abiding by its standstill guidelines. The amount of official resources available under LIA would be limited to the amount not previously drawn under the SBA, so that there is an overall limit on access to IMF resources.

The presumption of normal limits applies to both SBA- and CCL-eligible countries. Additional financing would be available but only under exceptional circumstances. These require additional justification. The additional resources would be provided under the SRF. Funds available under the SRF are of shorter maturity and higher cost than under the SBA.

Conclusions

There is both a need and a desire for greater clarity in the framework for crisis resolution. A clear understanding of the respective responsibilities of the private and official sectors is fundamental in this regard. A central element in shaping private sector expectations is knowledge that the official sector will behave predictably. Constraints on IMF lending are a key step in that direction. They ensure that private sector involvement is a crucial part of crisis resolution. And they help encourage debtors and creditors to seek co-operative solutions to crisis.

A central element in shaping private sector expectations is knowledge that the official sector will behave predictably.

In resolving crises and securing private sector involvement, the official sector must decide how much official finance will be made available and on what conditions. The debtor country must then decide which option to follow. One such option is a payments standstill. The official sector should stand ready to support standstills if they are implemented in an orderly fashion. In exceptional circumstances, it may be necessary to breach normal lending limits. But such financing would be subject to stringent safeguards. A framework with these characteristics—constraints, clarity, and orderliness—has the potential to reduce the incidence and cost of crises.

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