July 8, 2003

BUILDING ON A DECADE OF EXPERIENCE: CRISIS PREVENTION AND RESOLUTION

By Anne O. Krueger and Matthew Fisher[1] [2]

Prepared for the Centre for the Study of Globalization and Regionalization Conference,
International Financial Crises: What Follows the Washington Consensus?
July 11-13, 2003
University of Warwick

I. INTRODUCTION

1. John Williamson's formulation of the Washington Consensus, now almost 14 years ago, successfully provided a shorthand description of policies that international financial institutions and the U.S. Treasury believed should be followed by counties in Latin America as they emerged from the 1980s debt crisis.[3] It is remarkable how well it has withstood the test of time, and how its principal elements are now recognized as commonsense in the Capitals of almost all emerging market economies. The shorthand used to express the Consensus gave rise to ambiguity as to its scope and limitations, leaving room for interpretation and controversy. It is not worth reopening this controversy, but it certainly is worth emphasizing the policies that the IMF promotes—sound money, prudent fiscal policy, strong financial sector, and open markets.

2. The resilience of the global economic to recent global shocks—including September 11, the war with Iraq, increase in oil prices, sharp swings in asset prices, and the shift in risk preferences—is testament to the substantial progress has been made toward making economies more robust in the face of a turbulent economic environment. This is no small part the result of the implementation of generally sound macroeconomic and structural

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[1] Anne O. Krueger is First Deputy Managing Director of the International Monetary Fund. Matthew Fisher is Senior Advisor of the IMF's Policy Development and Review Department.

[2] The authors are grateful for the helpful comments from, and discussions with, innumerable colleagues. The views expressed are those of the authors, and are not necessarily those of the International Monetary Fund. The usual disclaimer applies.

[3] Williamson, John, 1990, "What Washington Means by Policy Reform," *Latin American Adjustment: How Much Has Happened?* (Institute of International Economics).

policies by a broad range of countries. These have been buttressed by more recent initiatives to help reduce the frequency and mitigate the severity of crises, and initiatives to strengthen the capacity of the international community to resolve financial crises. The international community has a much better understanding of what works and what does not than was the case when the Washington Consensus was first formulated. But more needs to be done. This paper provides a summary of the key issues, and the role of the IMF in promoting these policies and initiatives.

II. THE PREVENTION AND RESOLUTION OF FINANCIAL CRISES

3. A fundamental area of development in the policies that now attract a broad consensus relate to the prevention and resolution of financial crises. Much of the IMF's work in the past decade has been learning more about capital account crises. What are the warning signals that a crisis is imminent? And how best to respond both to the warning signals, and, when necessary, the crises themselves?

4. An important feature of capital account crises is that their origins lie in deteriorations in the various balance sheets in an economy. Trying to understand developments in individual balance sheets, and the ways in which difficulties in one set of balance sheets can propagate across other balance sheets—including possibly to the external accounts—has been an important development in the analysis of vulnerably to, and the development of, crises.[4]

5. A key difference between capital and current account crises is that the former can occur much more rapidly and require a much more immediate response than current account crises.[5] This is because it is not only the current flows of goods and services that can require financing (and be subject to speculation) but also the stock of outstanding financial instruments. Sentiment in financial markets can be subject to abrupt swings. Policy inconsistencies are treated with great suspicion by the financial markets. When there are genuine doubts about the sustainability of macroeconomic policy, those doubts can rapidly translate into a crisis.

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[4] See, for example, Dornbusch, Rudi, 2001, "A Primer on Emerging Market Crises" (MIT), (available at http://web.mit.edu/rudi/www/media/PDFs/APrimeronCrises.pdf), and Allen, Mark; Rosenberg, Christoph; Keller, Christian; Setser, Brad; and Roubini, Nouriel, 2002, "A Balance Sheet Approach to Financial Crisis," IMF Working Paper 02/210 (International Monetary Fund) (available at http://www.imf.org/external/pubs/cat/longres.cfm?sk=16167.0).

[5] See, for example, Checki, Terrence J. and Stern, Ernest, 2000, "Financial Crises in the Emerging Markets: The Roles of the Public and Private Sectors" Current Issues in Economics and Finance, Volume 6, Number 13 (Federal Reserve Bank of New York) (available at http://www.newyorkfed.org/rmaghome/curr_iss/ci6-13.pdf).

Responding to change

6. The IMF—and, of course, its membership—has responded to the challenges posed by the changing nature of crises in several ways. There is now a broad consensus on the key elements of a policy framework needed to manage vulnerability of crises. The principal elements can be summarized as follows.

7. First and foremost, great emphasis must be given to the **sustainability** of macroeconomic policy.[6] This goes beyond what might be regarded as the traditional prescription of developing policy that delivers macroeconomic stability over the medium term.

8. As crises can occur even when governments are pursuing what would be regarded as conventionally sound policies, they have to pay much close greater attention to factors such as debt sustainability and debt management. Governments need to be able to demonstrate to the financial markets that their overall debt burden is manageable, and is likely to remain so under most circumstances. Whereas analyses of countries in earlier years focused on likely trends in the balance of payments, attention now turns as well to the future course of total debt, recognizing the country's planned fiscal trajectory and financing needs. Anticipating the primary surplus for future periods and the real interest rate the country is likely to be paying on its outstanding indebtedness enables a calculation of the evolution of the stock of debt. Contrasting that evolution with likely growth rates of real output enables a judgment (and sensitivity testing) of the country's ability to sustain its current policies. In IMF's regular policy discussion with our members (Article IV surveillance), debt sustainability is now routinely examined. In countries with IMF programs, debt sustainability going forward is a necessary condition for IMF support.

9. The balance between domestic and foreign debt is not the central issue here. Creditors will take an overall view of debt sustainability. The denomination of the debt, however, can be important, depending on the exchange rate regime in place.

10. The second area concerns **exchange rate policy**. There is a recognition that the requirements for sustaining fixed exchange rates are more onerous than had previously been recognized. As a result, there is much more skepticism about the benefits of fixed exchange regimes rates, especially among emerging markets.

11. A number of countries that operated fixed exchange rate regimes in the 1990s experienced a combination of large-scale short-term inflows into domestic currency

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[6] See "IMF Discusses Assessments of Sustainability," Public Information Notice 02/69, 2002, (International Monetary Fund) (available at http://www.imf.org/external/np/sec/pn/2002/pn0269.htm)

instruments from non-residents in search of yield (the so called, “carry trade”), and a tendency for residents—many of whom were not naturally hedged—to benefit from “cheap” financing by borrowing in foreign currency (either directly, or intermediated through domestic banks). One of the key lessons of the l990s is that, with open capital accounts, countries can be extremely vulnerable to capital account crises if there is any doubt about either the sustainability of the exchange rate peg or the sustainability of debt servicing. The problem, of course, was that a perception of an imminent change in the exchange system led to massive portfolio reallocations. In a similar vein, when exchange rate risk materialized, unhedged borrowers experienced acute stress, and in many cases insolvency. This had important ramifications for the stability of banking systems and fiscal accounts.

12. A third area of policy focus concerns **structural reforms.** This has gone far beyond the reform of labor and product markets, though these clearly remain essential when developing sustainable policies. There is now a consensus behind reform in other areas of the economy. Countries need properly functioning and well-regulated financial sectors. As capital has rapidly grown more mobile, so have weak financial sectors become more vulnerable. Banks and other financial institutions need to be well-structured and properly supervised. The laws governing financial relationships—and as discussed above—bankruptcy laws[7]—need to be clear and effective. The IMF has worked hard to encourage governments to press ahead with such reforms.

13. Another important strand in the work on structural reform concerns the critical importance of the appropriate **sequencing of reforms**, particularly as regards the combination of capital account liberalization and financial system reform.

14. Finally, there is a consensus that, because of the role of confidence in determining investors’ behavior, the importance of **transparency of policy** has increased greatly. Simply put, the provision of timely, reliable, and internationally comparable information improves the environment for the private sector’s decision taking—including their assessment and management of risks. It is hoped that this will help avoid large-scale build-ups of vulnerabilities. Moreover, if investors are continuously informed of changes in economic policies and circumstances in individual countries, the likelihood of a sudden swing in sentiment is greatly reduced relative to those times when release of information “surprised.” Accordingly, encouraging—and helping—governments to develop sustainable policies has gone hand in hand with efforts to make such policies more transparent. The IMF itself now publishes many more of the documents it produces (including, with the agreement of the governments concerned, Article IV—surveillance—papers, as well as program papers) (see

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[7] See “Orderly & Effective Insolvency Procedures Key Issues”, 1999, Legal Department (International Monetary Fund) (available at http://www.imf.org/external/pubs/ft/orderly/index.htm).

Box 1).[8] The IMF has developed, and encouraged governments to adopt, standards and codes meant to lead to greater transparency.[9] The easier it is to understand what is happening, whether it be at the policymaking level or, for example, in measuring financial sector stability, the easier it will be to reassure creditors and investors.

15. It must be recognized that countries, some of them with very limited resources, can be overwhelmed by the speed of change and the need for reform. The IMF has in recent years worked hard to provide **technical assistance** to enable governments to develop and implement the sort of changes described above.[10] Such assistance might take the form of expert help in developing statistical reporting systems, or legal advice in drawing up new bankruptcy laws, or systems for trading public sector expenditures. The more the IMF can do to help countries develop effective policy frameworks as well as effective policies, the more successful will be our efforts to prevent crises before they start.

16. Substantial progress has been made in recent years in reducing countries' vulnerability to crises. In many respects, the world economy is now more resilient to shocks. Moves toward more flexible exchange rate regimes, strengthening of domestic financial systems (particularly through enhanced banking supervision), and rebuilding official reserves have contributed to making economies more robust and less vulnerable to crises. It should not be forgotten that the crises in Asia, Russia, and Brazil of the late 1990s were typically associated with pegged exchange rates, a mix of monetary and fiscal policies that attracted short-term capital hoping to benefit from high domestic interest rates, and generally inadequate banking supervision. But sight should not be lost of the fact that there are a number of emerging market countries that have high debt burdens and continue to experience fiscal pressures.

17. Of course, we must avoid complacency, and recognize that despite best efforts at prevention, crises will still occur. The 15 or so years since the resolution of the 1980s debt crisis have witnessed large-scale capital flows to emerging market borrowers. But we are now moving into a period in which an increasing number of emerging markets have become

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[8] See "The Fund's Transparency Policy—Review of the Experience and Next Steps," 2002, (International Monetary Fund) (available at http://www.imf.org/external/np/pdr/trans/2002/eng/052402.htm).

[9] See "Standards & Codes," 2003, (International Monetary Fund) (available at http://www.imf.org/external/standards/index.htm).

[10] See "Technical Assistance: A Factsheet," 2003, (International Monetary Fund) (available at http://www.imf.org/external/np/exr/facts/tech.htm).

Box 1. Key Elements of the IMF's Publication Policy [1]

- Voluntary publication of Article IV consultation and use of Fund resources (UFR) staff reports. About 70 percent of such reports discussed by the Executive Board over the past year have been published.

- Voluntary publication of Public Information Notices (PINs) following Article IV consultations and Board discussions on regional surveillance papers, of concluding mission statements, of background documentation for Article IV consultation discussions, and of documentation for staff-monitored programs. PINs have been published for more than 80 percent of country staff papers.

- A presumption of publication for program documents—Letters of Intent, Memoranda of Economic and Financial Policies and other documents stating a government's policy intentions. However, a member may notify the Board of its decision not to consent to IMF publication. About 90 percent of these documents have been published.

- A presumption of publication for staff reports on policy issues, together with PINs (on issues dealing with administrative matters of the IMF, publication can be proposed on a case-by-case basis). All but one of the policy papers discussed by the Executive Board since adoption of this policy have been published (with associated PINs).

- The publication of Poverty Reduction Strategy Papers (PRSPs), interim-PRSPs, and PRSP progress reports is required for management to recommend endorsement by the Executive Board (100 percent publication rate).

- Deletions to published documents are limited to highly market-sensitive information, mainly exchange rate and interest rate matters. Corrections are limited to factual changes and characterizations of the authorities' views.

- The authorities of the country concerned may publish a statement with the staff report commenting on the staff or Executive Board assessment or both (a "right of reply").

- Public access is given in the IMF's archives to Executive Board documents that are over 5 years old; to minutes of Executive Board meetings and other related documents that are over 10 years old; and to other documentary materials that are over 20 years old, subject to certain restrictions.

[1] See "The Fund's Transparency Policy—Progress Report on Publication of Country Documents", 2003, (International Monetary Fund) (available at http://www.imf.org/external/np/pdr/trans/2003/040403.htm).

mature borrowers—that is to say, countries that regained access to capital markets have allowed their debts to increase to levels at which future net borrowing needs to be kept strictly in line with the growth in their payments capacity. This has a number of implications.

- First, although some resurgence in capital market activity has recently been seen, in the period ahead a return of net debt creating flows to emerging markets to the scale of those witnessed in the 1990s should not be expected. Indeed, the recent trends in net flows to emerging market sovereigns may be comforting to the extent that it may indicate that debt markets are not repeating the bubble behavior experienced in other asset markets.

- Second, with only limited capacity to take on additional debt in the context of resolving crises, countries' room for maneuver to address building tensions may be more restricted than was the case in the past.

- Third, close attention to developments in countries' vulnerabilities, and prompt corrective action, is more important than ever.

Resolution of financial crises

18. There is a consensus that, not withstand best efforts at prevention, in a hopefully very limited number of cases countries may experience rising debt or other capital account pressures—including unanticipated external shocks—that may develop into full-blown crises.

- In some cases, the source of the difficulties may lie in the balance sheet of the public sector. As a result of some combination of bad policies and bad luck, a sovereign may experience acute liquidity difficulties, and in extreme cases may find that its debt burden has become unsustainable.

- It is also likely that other cases will occur where the source of the problem may lie in financial (or nonfinancial) corporate sectors. Recent crises have demonstrated the ways in which difficulties in one set of balance sheets in an economy can rapidly propagate across to other sectors, and spillover to the external accounts.

This suggests that the resolution of individual crises will need to be tailored to the diversity of situations that countries may confront.

19. In any event, there is typically at least a brief period between the recognition that a member has a building capital account or an acute debt problem and the outset of a full-blown crisis. But in such circumstances, time is the friend of neither country authorities nor private investors. Nevertheless, there is likely to be a window of opportunity for taking corrective actions that offer the prospect of resolving crises in a fashion that limits the scale of economic dislocation and preserves assets' economic value. The challenge confronting policy makers is to utilize the window, and thereby to avert an even worse outcome. On occasion, the debate over alternative approaches to strengthening arrangements for resolving crises—and particularly sovereign debt restructuring—has tended to become polarized. This

is regrettable. The development of sound public policy demands dispassionate analysis of the strengths and limitations of alternative approaches. It must not be allowed to become the advocacy of one approach to the exclusion of others. The objective should be to develop effective tools that allow a country that has an unsustainable debt burden to reach agreement with its creditors on a restructuring that—in conjunction with the sustained implementation of appropriate policies—offers the prospect of restoring sustainability while limiting the scale of economic dislocation and preserving assets' economic value.

- In some cases, a combination of the forceful implementation of corrective policies, market-based liability management operations, and official financing may allow for a rapid and orderly resolution of the crisis.
- In other cases, it may be necessary to complement the sustained implementation of corrective policies and the provision of official financing, with concerted measures to reprofile—or in some cases even reduce—debt service burdens. Here too the design of the measures to resolve a crisis will need to be carefully formulated to reflect the member's situation.[11] In some cases, it may be necessary to restructure the debt of the sovereign. But if sovereign debt restructuring is the hammer in the international community's toolbox, we must recognize that not every crisis is a nail! Other cases may need to address some combination of the liabilities of nonsovereign debtors and capital flight.

The IMF's access policy

20. The IMF, through its role both as an advisor and as a lender, will continue to play a key role in the resolution of financial crises. And so access policy—the conditions under which the IMF is willing to extend support for a member's adjustment program, and the scale of such support—will remain an important parameter in the resolution of crises.[12] The scale of potential financing needs has increased as a result of the increasing integration of countries into the global economy, and with it the risk of abrupt changes in market sentiment and reversal of capital flows.

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[11] A useful summary of issues is provided in "Crisis Resolution in the context of Sovereign Debt Restructuring," 2003, (International Monetary Fund) (available at http://www.imf.org/external/np/pdr/sdrm/2003/012803.pdf).

[12] See "IMF Concludes Discussion on Access Policy in the Context of Capital Account Crises; and Review of Access Policies in the Credit Tranches and the Extended Fund Facility," 2003, (International Monetary Fund) (available at http://www.imf.org/external/np/sec/pn/2003/pn0337.htm).

21. In some cases, it may be appropriate for the IMF to provide large-scale access in support of a forceful adjustment program. This would be done with the expectation that, as policies take hold and confidence builds, this support will have a catalytic effect in facilitating a return to national and international capital markets. But it would only be appropriate for consideration to be given to large-scale access to the IMF's resources in cases where:

- The member country is experiencing exceptional balance of payments pressures on the capital account, resulting in a need for IMF financing that cannot be met within the normal limits;
- a rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable;
- the member has good prospects of regaining access to private capital markets within the time IMF resources would be outstanding, so that the IMF's financing would provide a bridge; and
- the policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans, but also its institutional and political capacity to deliver that adjustment.

22. In other cases, however, these conditions may not be satisfied, and so it would not be appropriate for the IMF to provide exceptional access to its resources. Accordingly, in such cases, the resolution of crises must entail some form of concerted refinancing or restructuring of the claims on sovereign and/or nonsovereign debtors.

Strengthening the arrangements for resolving sovereign debt difficulties

23. The focus of the IMF's current efforts is on promoting the inclusion of collective action clauses (CACs) in debt contracts,[13] and, more generally, on finding ways to improve arrangements for sovereign debt restructuring within the existing legal framework.

Process of debt restructuring

24. A number of commentators have highlighted the absence of procedural clarity regarding the conduct of debtors and creditors. They have argued that greater predictability and transparency in the restructuring process would be beneficial from the perspective of facilitating restructurings, and increasing the chances that agreements can be reached without

[13] See "IMF Continues Discussion on Collective Action Clauses in Sovereign Bond Contracts," Public Information Notice 03/53, 2003 (International Monetary Fund) (available at http://www.imf.org/external/np/sec/pn/2003/pn0353.htm).

major dislocations or loss of asset values. These concerns have contributed to calls for a voluntary Code of Good Conduct, which would establish best practice for the conduct of debtors and creditors, in the context, *inter alia*, of debt restructurings. The various proposals that have emerged—including, importantly, from the Banque de France and Institute of International Finance—are constructive, and could help provide greater predictability to the restructuring process under any legal framework.

- A Code could be made applicable to a broad set of circumstances, ranging from periods of relative tranquility to periods of acute stress, and could constitute an established set of best practices. In contrast, proposals for strengthening arrangements for debt restructuring have a more limited scope and purpose—to facilitate the resolution of financial crises.
- By its very nature, a voluntary Code, while potentially helpful, could not resolve collective action problems.
- Finally, a Code could only be effective to the extent to which it is able to attract broad support among debtors and their creditors. Accordingly, the most promising approach to developing a code that could form the basis of a consensus would be for it to be developed jointly by debtors, their creditors, and other interested parties (including the IMF). Conversely, it appears unlikely that a Code designed by the IMF would attract broad support, though the IMF stands ready to collaborate with others in the elaboration of a code.

25. Recent adaptations in IMF policies could be complementary to a Code. Last year the IMF's Executive Board adopted a modification of the lending into arrears policy—the policies that govern the circumstances under which the IMF can provide financial support for a member's adjustment program during the period in which it has arrears to private creditors, and is attempting to reach agreement on a restructuring.[14] This policy establishes expectations regarding the behavior of debtors that are receiving financial support from the IMF in such circumstances:

26. The debtor should engage in an early dialogue, which should continue until the restructuring is completed:

- The debtor should share relevant, non-confidential information with all creditors on a timely basis. This would include an explanation of the adjustment program and the

[14] See "Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion" (International Monetary Fund, 2002) (available at http://www.imf.org/external/pubs/ft/privcred/073002.htm).

financial circumstances that justify a restructuring, as well as a comprehensive picture of all domestic and external claims on the sovereign.

- The debtor should provide creditors with an early opportunity to give input on the design of the restructuring strategy. This could help address the specific needs of different types of investors, thereby increasing the likelihood of a high participation rate.

27. In addition, in cases in which creditors have organized a reasonably representative committee on a timely basis, there is an expectation that the member would negotiate with such a committee. The IMF's policy suggests a number of principles that should guide the debtor's conduct during negotiations. In formulating these principles, IMF staff drew on the expertise of workout specialists reflected, for example, in the report by the Council on Foreign Relations (CFR),[15] and efforts by International Federation of Insolvency Professionals (INSOL) to distill best practice for nonsovereign workouts.[16]

Resolution of collective action difficulties

28. Most proposals for improving sovereign debt restructuring have, at their heart, recognition of, and measures to, address collective action difficulties, as well as measures designed to increase the predictability of restructuring process. Difficulties of collective action can potentially complicate the process of reaching agreement on a restructuring. There is a danger that individual creditors will decline to participate in a voluntary restructuring in the hope of recovering payment on the original contractual terms, even though creditors—as a group—would be best served by agreeing to a restructuring.

29. The problem of collective action is probably most acute prior to a default, where individual creditors may have some reasonable hope of continuing to receive payments under the terms of their original contracts. Following a default, the options facing creditors—particularly those who have no interest in litigation—are more limited and so the problems of collective action may be less acute.

30. Whether or not in practice collective action problems will be an obstacle to the restructuring process will depend on a number of factors. The incentives for individual investors to decide whether to participate in a restructuring, or to hold out in the hope of receiving more favorable terms, would depend on an evaluation of the extent to which a

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[15] See "Key Recommendations from the Roundtable on Country Risk in the Post-Asia Crisis Era" (Council on Foreign Relations) (available at http://www.cfr.org/publication.php?id=3810).

[16] See "Statement of Principles for a Global Approach to Multi-Creditor Workouts" (INSOL International) (available at http://www.insol.org/statement.htm).

proposed deal protects their individual interests and the likely payoff of alternative strategies. In the evaluation of these payoffs, the expected market value of the claim on a post-restructured basis will be compared with: (i) the probability that the debtor would service the original claim, and the likely market value of such a claim that continued to be serviced; and (ii) the likely risk and return of seeking to obtain recoveries on distressed debt, in the event that the claim is not serviced.[17]

31. Proposals for mechanisms to resolve collective action difficulties fall into two broad categories. The first are voluntary in character, and rely on contract. The second rely on a statutory framework.

The contractual approach

Collective Action Clauses (CACs)

32. The IMF continues to support actively efforts to develop, and promote the adoption of, collective action clauses in sovereign debt contracts.[18] There is no doubt that the widespread adoption of CACs would be a major step, and could be helpful in facilitating agreement on restructurings. Recent developments provide grounds for cautious optimism that we are witnessing a shift in market practice toward more use of CACs. For all too long, this had been elusive.

33. Among the major issuers, Mexico led the way in March of this year with its successful placement of a $1 billion bond governed by New York law that includes collective action clauses.[19] In particular, (i) investors holding 75 percent of outstanding principal can vote to modify the payment terms; and (ii) acceleration of the bonds following an event of

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[17] Factors that will have a bearing on the first point include the economic circumstances of the debtor, the extent to which nonparticipating claims may be small, rated as "selective default" by credit rating agencies (not withstanding the fact that they continue to be paid), and the likely liquidity of the instrument. Factors that will have a bearing on the second point include the appetite for litigation (including willingness to bear the financial costs and possible reputational damage), and the availability of assets vulnerable to attachment.

[18] The inclusion of CACs in sovereign debt contracts was a key recommendation of the report of the Group of 10 on "The Resolution of Sovereign Liquidity Crises," May 1996 (available at http://www.bis.org/publ/gten03.pdf). The design of CACs was also considered at a recent Group of 10 Working Group on Contractual Clauses, September 2002 (report available at http://www.bis.org/publ/gten08.pdf).

[19] Prior to the Mexican issues, Egypt, Lebanon, and Qatar issued bonds that included CACs and were governed by New York law.

default requires the consent of investors holding 25 percent of outstanding principal. In contrast, previous Mexican bond issues in the New York market have included no provision for majority action with regard to the modification of payment terms or of acceleration.

34. Subsequently there have been a number of further issues of bonds governed by New York law that include CACs. Mexico placed a second such issue, followed by Brazil, South Africa, and Belize. Also, in the context of the comprehensive debt restructuring completed by Uruguay in May of this year, the new instruments also include CACs. South Africa and Korea follows Mexico's lead with a 75 percent voting threshold, while Brazil, Belize, and Uruguay bonds have an 85 percent threshold. In addition, the bonds issued by Uruguay include a novel feature that provides for some limited degree of aggregation across bonds for decision taking purposes in the event of a subsequent restructurings.

35. What price did these countries have to pay be to incorporate CACs into a bond? The spread at issue was inline with the secondary market yield curves, suggesting that any premium paid for CACs was negligible.[20] The bonds have continued to trade well in secondary markets.

36. Although there will likely be many benefits to the widespread adoption of CACs, the limitations of this approach are well known. While they provide for collective action among holders of individual bond issues, they do not provide for the aggregation of voting *across* instruments. Moreover, CACs can be introduced in *new* instruments, but do not address the problem of the *outstanding stock of bonds and other debt instruments* that do not include these clauses.

JP Morgan proposal

37. A contractual approach has been suggested by JP Morgan, which is based upon a variation of use of collective action clauses.[21] This proposal recognizes—and seeks to address—the problems of aggregation across debt instruments and the stock-of-debt

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[20] Prior to the Mexican bond issue, a number of market participants argued that issuers would face an increase in their cost of funds if they included CACs in their debt instruments. Econometric studies failed to detect any such pricing effect. See Gugiatti, Mark and Richards, Anthony, 2003," Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets" (available at http://www.rba.gov.au/PublicationsAndResearch/RDP/RDP2003-02.html) and Eichengreen, B. and Moody, A., 2000, "Would Collective Action Clauses Raise Borrowing Costs?," NBER Working Paper No. 7458 (available at http://papers.nber.org/papers/W7458).

[21] Bartholomew, Ed. "Two Step Debt Restructuring" 2002 J.P Morgan, New York. (available at http://www.emta.org/keyper/barthol.pdf).

instruments that do not include collective action clauses. The approach involves a two-stage process. In the first stage, investors holding international bonds and a wide range of credit instruments would exchange their existing instruments for new instruments. These would preserve repayment terms, but would be linked by collective action clauses, which would provide for an aggregation across instruments of reaching for the second stage—the agreement on the terms of the final restructuring.

38. As the collective action problem reflects a divergence between what may be optional for investors acting individually as opposed to in a group, how could the collective action problem associated with agreement on the first stage be overcome? JP Morgan has suggested a system of carrots and sticks. The carrot would take the form of an up-front cash payment for participation, while the stick would take the form of the aggressive use of exit consents, which—by eroding the contractual rights of investors who elect not to participate in the first stage—would reduce the attractiveness of a holdout strategy.

39. The proposal is ingenious. And it warrants further consideration. But there are some doubts regarding its feasibility. In a pre-default case time is of the essence as a restructuring must be completed before resources available for debt service are exhausted. Accordingly, the two steps would need to be conducted back-to-back in the same timeframe, which would negate any advantage of getting creditors into a collective framework. Yet in these cases collective action problem may be most acute. Decisions regarding participation in the first and second stage would be taken at the same time, and so, of course, the operation would be equivalent to a straightforward exchange that, by its nature, does not resolve collective action problems.

- In a post-default case, in circumstances where there may be substantial doubts about the future course of economic policies and the terms of an eventual restructuring proposal, would investors be willing to surrender their individual contractual rights and enter into a collective process? Indeed, would such a move be consistent with portfolio managers' fiduciary responsibilities to their end investors? Is there a danger that they would decide to preserve their rights under their existing instruments while they wait and see what will happen?

- Without an effective and transparent mechanism for resolving disputes—whether between creditors or between a debtor and its creditors—would investors consider that the first stage of the process provides adequate protection against the inclusion of fraudulent claims? Here too we must be cognizant of investors' fiduciary responsibilities. There is perhaps a question of whether the procedure could be made subject to independent arbitration.

40. Aggregation of voting for decision taking by investors is generally considered to be an essential feature of statutory frameworks for corporate rehabilitation. The potential benefits of aggregation appear to carry over to sovereign workouts. The JP Morgan proposal

is one approach. But there is a need for further exploration of approaches to contractual arrangements for aggregation in the context of new sovereign bond issues.

Statutory approaches

41. There has been a range of proposals for statutory approaches to improving the arrangements for sovereign debt restructuring. A number of commentators have argued that the integration of capital markets will require a strong, centralized legal framework to support its operation. This is not a new issue. The drafters of the U.S. Constitution grappled with the question of which essential powers in the economic arena would need to be conferred on the Federal Government, in order to support the inevitable growth of interstate commerce. Interestingly, the framers of the Constitution decided that the Federal Government should have the authority to enact a unified federal bankruptcy law. How—they must have wondered—could a fragmented, state-by-state insolvency framework support an increasingly interdependent economy? The analogy is loose but—at a certain level of abstraction—is apt. Credit markets can only develop in a stable manner if the legal and institutional frameworks that support them also evolve. Nevertheless, the discussion here is limited to a proposal that seeks to use established statutory and judicial processes.[22]

42. An approach suggested by two American lawyers involves using the existing statutory rules of civil procedure in the countries whose laws are typically chosen to govern sovereign debt obligations to affect a restructuring of those instruments when necessary.[23] In the United States, these are the so-called "class action" rules; in England, they are called "representative actions." In a nutshell, a group or committee of representative creditors, with the acquiescence of the sovereign debtor, would commence in domestic court a class or representative action on behalf of all similarly situated debt holders. Under this approach, there would be a judicial mechanism for resolving disputes among creditors and between a debtor and its creditors. A proposed restructuring—in the form of a settlement of the class

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[22] A proposal for a statutory Sovereign Debt Restructuring Mechanism (SDRM), which would be implemented through an amendment of the IMF's Articles of Agreement, was developed by the IMF at the request of the International Monetary and Finance Committee—which is made up of 24 Ministers of Finance. At its April 2003 meeting the Committee concluded that it is not feasible to move forward to establish the SDRM. The proposal was summarized in the "Report of the Managing Director to the International Monetary and Finance Committee on a Statutory Debt Restructuring Mechanism" (International Monetary Fund) (available at http://www.imf.org/external/np/omd/2003/040803.htm).

[23] See Buchheit, Lee C. and Gulati, Mitu, 2002, "Sovereign Bonds and the Collective Will," Emory Law Journal, Volume 51, Number 4.

action—that enjoyed widespread creditor support could then be made binding on all affected creditors through a court judgment.

43. The proposal involves complex legal analysis. But the most important elements are recognition of the need for aggregation across debt instruments, and the need for a statutory framework to bind dissident creditors.

44. The authors of this innovative approach have highlighted legal uncertainties regarding, for example, whether domestic court would accept a mandatory class action covering sovereign debt instruments. There are also uncertainties regarding the criteria that a judge would apply to assessing the acceptability of a restructuring proposal. The authors have suggested that these and other issues may need to be addressed through new legislation in order to provide some measure of predictability and procedural clarity to the approach.

45. A second set of difficult questions relates to the application of the approach to cases in which a debtor has issued debt in a number of jurisdictions. Perhaps innovative solutions could be found to minimize these difficulties. But discussions with a range of legal practitioners, however, suggest that it would be difficult to capture the benefits of aggregation without a uniform—and unified—legal framework.

Dealing with banking system crises

46. In addition to the work on improving the sovereign debt restructuring process, there is also a need to develop further the thinking on a number of other issues arising in the context of a crisis. One is how best to assist members in addressing systemic banking crises, particularly in cases in which the system is highly dollarized, and/or cases in which systems are highly exposed to sovereign debt.

47. With highly dollarized banking systems, issues arise regarding the extent to which liquidity assistance can be sustained in the event of a crisis, where that assistance has to be provided in a currency that the government does not have the ability to create. The inability of a central bank to serve as a credible lender of last resort in these circumstances may end up fueling a run and leading to greater economic disruption. In this context, questions may arise as to the extent to which it would be appropriate for the official sector to step in with additional financing to boost the central bank's lender-of-last-resort capacity, which in turn raises several issues regarding debt sustainability and the adequacy of macro policies.

48. As the recent cases of Argentina and Uruguay illustrate, the combination of a highly-dollarized banking system and a rigid exchange rate regime can result in vulnerabilities that are difficult to manage. In this context, severe liquidity losses stemming from a bank run will quickly feed into a currency crisis and eventually necessitate a sharp exchange rate adjustment. The adjustment in relative prices may in turn induce an unsustainable debt profile and severe balance sheet problems in the corporate sector. These problems will be further compounded when the banking system is heavily exposed to the sovereign's unsustainable debt, as a restructuring will inevitably lead to further deterioration in banks' balance sheets.

Thus, measures to stem the effects of debt restructuring on the banking system also need to be considered in greater depth.

III. DISTRIBUTION OF INCOME

49. Another theme of the IMF's work, not directly related to crisis prevention and resolution, concerns the distribution of income. Policy makers, academics, and civil society have placed considerable emphasis on helping to ensure that the poor and disadvantaged share in the fruits of economic growth. There is also a broad recognition of the importance of ensuring that those adversely affected by reforms receive a measure of protection through well-designed and targeted countervailing measures and, in some cases, through the creation of social safety nets. Some have even gone so far as to suggest a range of reforms designed to improve income distribution without reducing growth, though these have yet to attract a consensus.[24]

50. Reforms in this area have been an important element of IMF support for members' adjustment policies, particularly for low-income countries. Programs supported through the IMF's concessional window, the Poverty Reduction and Growth Facility (PRGF), are based on the set of policy measures presented in countries' poverty reduction strategy papers (PRSPs). These are developed through an open and broad-based participatory process that seeks to ensure that the views of all stakeholders are considered in the development of governments' economic policies, including, critically, the prioritization of public expenditures. Depending on the degree of specificity and detail in a country's PRSP, the country's macroeconomic policy reform measures may need to be clarified in the context of program discussions between the country authorities and IMF staff.

51. One of the key features of PRGF-supported programs is that staff are to demonstrate that any adverse effects on the poor of substantial macroeconomic adjustments (e.g., a big tax increase, subsidy reform, or exchange rate realignment) or major structural reforms (e.g., civil service downsizing, privatization, or price liberalization) incorporated into program design have been carefully considered and, where appropriate, that countervailing measures have been built into the program. While low-income countries are expected to carry out and integrate poverty and social impact analysis into the design of their strategies, they face a number of challenges, including data, analytical, and institutional capacity constraints. As part of the lead agency framework established between the World Bank and the IMF, the Bank has the lead role in this area, with the IMF providing support in its areas of core competence.

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[24] See, for example, Birdstall, Nancy, and de la Torre, Augusto, 2001, *Washington Contentious: Economic Policies for Social Equality in Latin America* (Carnegie Endowment

(continued…)

IV. CONCLUSION

52. The Washington Consensus has, in many respects, become the accepted commonsense policy framework for most emerging market countries, though on occasion the term has led to controversies that distract from the policies. It has evolved beyond Washington—and reflects the changing challenges confronting countries and incorporates lessons from experience.

53. This paper has argued that the most important change to the Consensus has been the focus on the prevention and resolution of financial crises. Six areas were the authors believe a consensus has emerged may be summarized as follows:

- **Sequencing.** There is no dispute about the importance of implementing reforms in a suitably phased and sequenced fashion. This is particularly important in the financial area and with the liberalization of capital movements.

- **Sustainability.** The conduct of economic policies needs to be put within the framework of the management of vulnerabilities, and ensuring medium-term sustainability. This has focused attention on debt management and the analysis of debt sustainability.

- **Exchange rate policy.** It is evident that the requirements for maintaining pegged exchange rates are stringent, and, as a result, there is skepticism about the benefits of fixed rates.

- **Structural reform.** A critical factor behind periods of financial instability in a wide range of economies has been weakness in domestic financial systems. As a result, considerable attention is now focused on the reform and strengthening of banking systems and other parts of domestic financial sector. There is also recognition of the critical importance of prudential supervision.

- **Institutional development.** Market economies can only develop in a stable manner if the legal and institutional frameworks that support them also evolve. One topical example is the need for countries to adopt efficient and predictable bankruptcy frameworks, including the statutory backdrop of efficient out-of-court workouts.

- **Transparency.** There is now broad agreement regarding the benefits of the transparency. The provision of timely, reliable, and international comparable

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for International Peace and Inter-American Dialogue) (available at http://www.ceip.org/files/pdf/er.Contentious.pdf).

information improves the environment for private sector decision taking. Keeping investors abreast of economic developments reduces the likelihood of abrupt swings in sentiment when investors are surprised. To this end, countries and international institutions have promoted transparency in policies and economic developments. More generally, the IMF has encouraged governments to adopt a wide range of standards and codes.

54. Despite best efforts at prevention, crises will inevitably occur. And there is a need to strengthen the capacity of the international community to resolve crises. To some extent, the agenda here is a list of aspirations, rather than concrete policy recommendations. Specifically:

- **Recent progress with the incorporation of collective action clauses into sovereign debt contracts must be sustained**.

- **There is a need to improve the existing arrangements for restructuring sovereign debt.** The intention is not to make sovereign debt restructuring an easy option. But rather to allow debtors with unsustainable debt burdens to reach agreement on a restructuring without unnecessary dislocation and loss of asset values. Of course, nobody believes that this is the complete answer to the difficulties of resolving financial crises. The restructuring of sovereign debt is likely, as a practical matter, to need to be complemented by other measures. Including those to stabilize and restructure the domestic financial system, and perhaps resolve balance sheet difficulties in the corporate sector. It may also need to be conducted against the background of temporary resort to some combination of exchange controls and a deposit freeze.

- **The restructuring process would be enhanced through greater transparency and predictability.** There are strong complementarities here between a possible Code of Good Conduct, the recent revisions to the IMF's lending into arrears policy—which establishes expectations regarding debtor's behavior vis-à-vis their creditors. However, further progress is needed.

- **There is a need to develop further approaches to resolving systemic banking crises.** This is especially important in cases in which the system is highly dollarized, and/or cases in which systems are highly exposed to sovereign debt.