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Resolution of balance of payments crises

Emergency financing and debt workouts

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Abstract: This paper analyses the history and effectiveness of the two major mechanisms of resolution of balance of payments crisis. It argues that IMF lending has met its counter-cyclical objectives through history and has been improving in terms of providing adequate lending facilities as well as focusing conditionality on macro-relevant areas. In contrast, and despite the spread of collective action clauses, much remains to be done in the area of debt restructuring. In this regard, it proposes a multilateral mechanism that offers a sequence of voluntary negotiations, mediation and eventual arbitration with pre-established deadlines, similar to that used in the World Trade Organization's dispute settlement process.

Keywords: IMF lending, conditionality, debt restructuring, collective action clauses
JEL classification: F33, F34

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1 Introduction

The need to adopt counter-cyclical macroeconomic policies to manage business cycles was the major contribution of the Keynesian revolution to macroeconomic policy-making. In relation to the effects of balance of payments fluctuations, what this implied was the need to break the pro-cyclical response to crises that was expected under the 'rules of the game' of the gold standard. According to those rules, countries with balance of payments surpluses were expected to let the domestic money supply expand, whereas those experiencing deficits were supposed to allow monetary contraction and associated deflation to take place – normally complemented with stringent fiscal adjustment – to bring economies back to macroeconomic balance. These pro-cyclical requirements of the gold standard were made more stringent for many countries – notably commodity-producing developing countries – by the boom–bust cycles in external financing. During crises, this meant that the intensity of the crisis was enhanced by the interruption of external financing – a 'sudden stop' in financing, to use the term in vogue since the mid-1990s.[1]

To at least mitigate these pro-cyclical patterns and, particularly, the severity of the adjustment process during crises, an essential element of the Bretton Woods Agreement was the creation of official emergency balance of payments financing by the International Monetary Fund (IMF). The instrument has changed considerably over time, particularly to manage the large boom–bust cycles in private external financing that has characterized major world business cycles since the mid-1970s, leading in particular to major redesigns of IMF facilities during the crises of emerging economies of the late 1990s/early 2000s and, more recently, of the 2007-08 North Atlantic financial crisis.[2]

When the problem is not illiquidity but insolvency, it is widely recognized that financing is not the appropriate response. This implies that it is essential to accompany emergency financing with debt workouts to manage problems of over-indebtedness. The two problems are, of course, interrelated as, if badly managed, a problem of illiquidity can turn into one of insolvency. However, debt workouts have had the opposite history to that of official financing. In fact, in the absence of financing of any sort, defaults and later debt restructuring with variable 'haircuts' were common phenomena in the nineteenth and the first half of the twentieth centuries, reaching a historical peak during the Great Depression of the 1930s and later debt restructurings. Although these practices did not disappear after the Second World War, and a new mechanism was designed in the 1950s to renegotiate official bilateral debts (the Paris Club) and some ad hoc initiatives have been adopted in recent decades, no regular multilateral instrument has yet been put in place to manage unsustainable debt burdens.

This paper analyses the dual history of these two instruments. The first part looks at IMF emergency financing and some complementary mechanisms. The second considers debt workouts. Both summarize the policy debate that has taken place in recent decades and present proposals on how to move forward.

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[1] The term was coined by Rüdiger Dornbusch in a paper on the 1994 Mexican crisis (Dornbusch and Werner 1994), in which he argued that 'it is not speed that kills, it is the sudden stop', but its popularization owes equally to the work of Guillermo Calvo (for his early work on the subject, see Calvo (1998)).

[2] I follow here the use of this term by Willem Buiter and Rakesh Mohan, among others, rather than that of 'global financial crisis' because the crisis had global effects but its epicentres were the United States and Western Europe.

2 IMF emergency financing

2.1 A brief history of IMF lending

In the original design, one fourth of IMF's quotas had to be deposited in gold and the remainder in each country's currency. The latter has always been largely a bookkeeping entry into the Fund's balance sheet but also an obligation of countries with convertible currencies to effectively provide the resources to the Fund when needed. In turn, countries' maximum cumulative borrowing limits were initially capped at the level of the quotas, with annual drawings of up to one fourth of this. What this implied was that, in the face of crises, the member country could, first, temporarily convert into foreign exchange its gold quota contribution and, if more than that was required, could essentially swap for convertible foreign exchange (basically US dollars in the early years) its domestic-currency quotas. The first came to be known as the 'gold tranche' and the latter as the 'credit tranches', which were expanded in 1952 from three to four tranches of 25 per cent, thus allowing countries to borrow up to 125 per cent of their quotas. These limits were withdrawn from the Articles of Agreement in 1978 and since then have been set by the Board (see below). With the gradual de-monetization of gold in the 1970s and the earlier creation of Special Drawing Rights (SDRs) in 1969, countries were allowed to pay the first tranche in SDRs or convertible currencies; it thus came to be known as the 'reserve tranche'.

A peculiarity of this system has been, throughout, that the IMF has to manage a multiplicity of currencies, many of which are inconvertible and therefore cannot be used for lending (Polak 2005). During periods of exceptional demand for resources, the Fund thus has to raise additional resources to lend. This is done by borrowing from members through a series of 'arrangements to borrow': first the 'general' (created in 1962 and expanded in 1983) and later the 'new' arrangements to borrow (activated in 1998 but tripled during the North Atlantic financial crisis), the former including only developed countries but the latter also some emerging countries.

Although it could be argued that financing was limited, it was associated with a basic principle on which IMF lending was initially based: that it was expected to finance *current account* imbalances, as they had, according to Keynesian theory, the strongest effects on economic activity and employment. This focus was also consistent with the aim of promoting international trade. The two objectives were interrelated, as stated in Article I.ii of the Articles of Agreement, which sets as a basic function of the Fund: 'To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy'. Capital account fluctuations were supposed to be managed through controls on capital flows.[3]

The credit limits were expanded through time as a proportion of quotas. The first major step took place in the mid-1970s using the compensatory financing facilities, the first of which had been created in 1963 to cope with negative trade shocks (especially the deterioration in the terms of trade), but was considerably expanded in its scope and complemented by special oil facilities to respond to the 1973 oil shock. This facility came to represent about half of IMF loans in the second half of the 1970s. The 1974 Extended Fund Facility had also allowed for additional financing relative to quotas and the Articles of Agreement had themselves given the freedom to exceed quotas under exceptional circumstances. However, as we will see below, the major jumps in the rules regarding

[3] In a sense, the original provision is still included as Article VI of the Articles of Agreement, which states that 'A member may not use the Fund's general resources to meet a large or sustained outflow of capital'.

the ratio of borrowing to quota took place at the turn of the century and were associated with a basic twist in the principles of IMF lending, which since the 1960s started to provide financing for *capital account* shocks, which are of a much larger magnitude than the current account imbalances that the original design aimed at. Although some authors still argue that the Fund should keep its original focus on current account imbalances (Akyüz 2005), this does not seem like a viable alternative today.

Historically, IMF lending has played two essential roles: a transitory and a permanent one. The former was managing the severe 'dollar shortage' of the early post-war years. This function was particularly important in relation to Western Europe, until it made its transition to current account convertibility in 1958. It included managing the problems generated by the inconvertibility of the secondary major international currency, the British pound. The permanent function is providing counter-cyclical financing to countries facing balance of payments problems of either domestic or external origin. The first are generated by domestically induced excess domestic demand or exchange rate overvaluation, whereas the latter have their origins in trade but also, increasingly, in financial shocks.

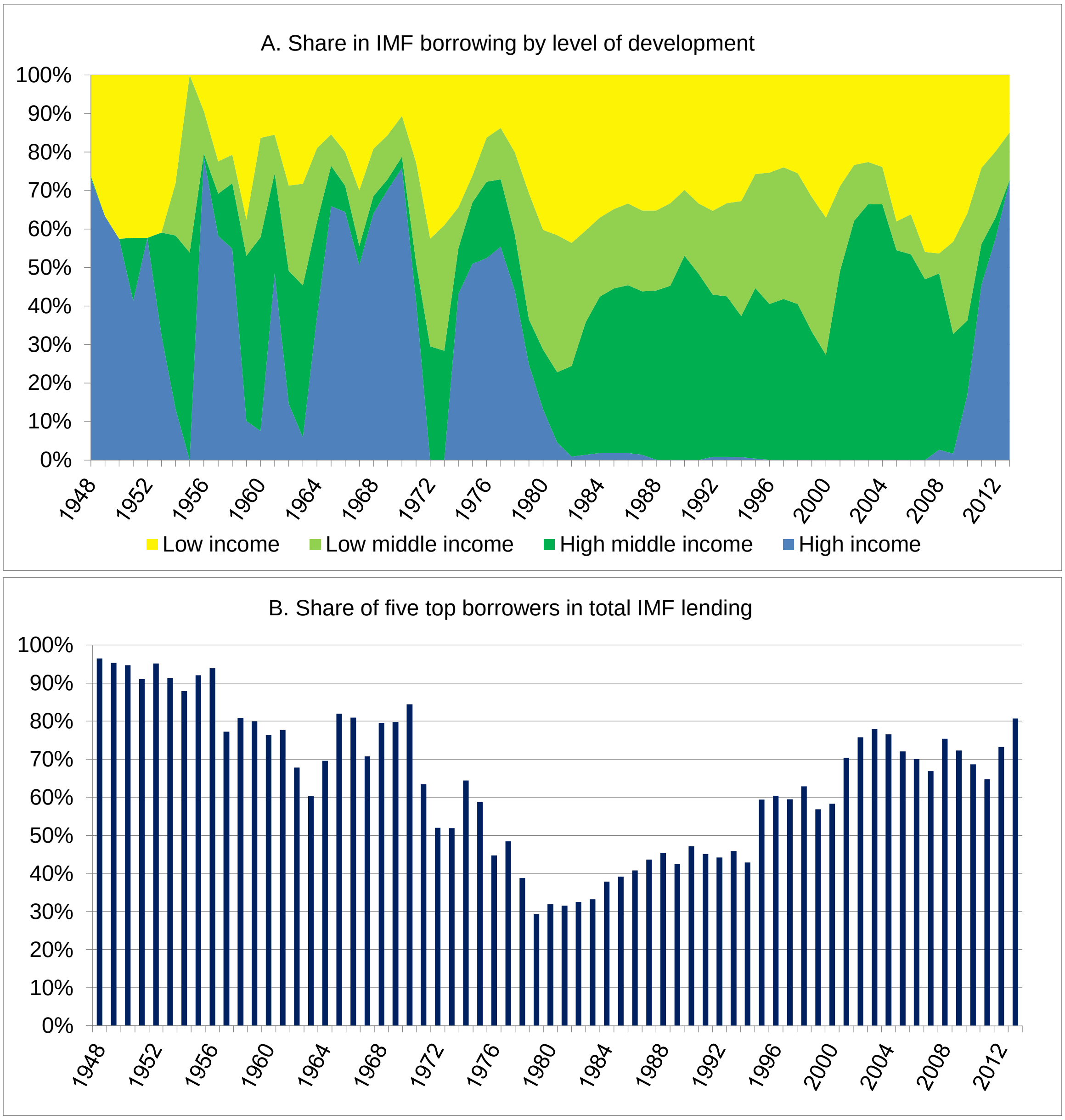
The severe instability that several developed countries faced in the years that preceded the final collapse of the original Bretton Woods arrangement in 1971 is perhaps the earliest case of counter-cyclical financing to manage external capital account shocks, and was associated with the effects of speculative flows in the Eurodollar market on individual countries. In turn, the rapid increase of IMF financing since 2009 is the most recent case of counter-cyclical financing involving capital account shocks that have affected several high-income countries. In relation to the developing world, the collapse of commodity prices in the mid-1950s and the oil shocks of the 1970s are two early cases of counter-cyclical financing to manage trade fluctuations, but the heyday of IMF financing is associated with the series of major capital account shocks that emerging countries faced since the 1980s. We will return to these issues in the next section.

The use of Fund resources has significantly changed over time, both in terms of the groups of countries classified by levels of development, as well as the variable geography of regions experiencing severe balance of payments crises. As Figure 1.A shows, the major users of lending facilities in the early years were high-income countries (using the 2000 World Bank classification[4]), which remained very important until the mid-1970s. Indeed, high-income countries represented more than half (and in some years close to three-fourths) of IMF financing during about half of the first three and a half decades of IMF history.[5] High-income countries essentially ceased to use Fund resources in the 1980s only to reappear as the major borrowers during the North Atlantic financial crisis. As we will see, the economies involved have changed over time. Low-income countries – notably India – have also been important borrowers since the early years and have represented throughout the Fund's history around 30 per cent of borrowing. However, IMF lending was focused in middle-income countries from the 1980s to the North Atlantic crisis, responding to the series of major crises that these countries faced: the debt crisis of the 1980s, primarily in Latin America, the December 1994 Mexican crisis, and the succession of crises in the emerging economies that started in East Asia in 1997 and then spread to Russia, South America and Turkey.

[4] The 2000 classification is adopted rather than a more recent one as it reflects much better the relative standing of different countries and regions of the world throughout the whole post-Second World War period covered in the analysis.

[5] In particular, in 1948-50, 1952, 1956-58, 1965-70 and 1975-77.

Figure 1: IMF lending



Source: Author's elaboration based on the IMF database.

A persistent characteristic of IMF lending, which is not generally recognized in public debates, is its concentration in a few large borrowers. Indeed, as Figure 1.B indicates, the five largest borrowers at each specific moment have made up 60 per cent or more of IMF lending. The only exception was the two decades from the mid-1970s to the mid-1990s, when the group of major borrowers was more diversified.

The variable geography of IMF lending is summarized in Table 1, which shows the five major borrowers in any year. As shown, the early decades were dominated by three high-income countries (UK, France and Australia, the latter primarily in the 1950s) and India. High-income countries continued to be important in the 1960s and 1970s, with Italy and Spain becoming new major borrowers in the 1970s alongside the UK. Important middle-income countries came to the Fund on a large scale in the 1950s and 1960s, primarily South American nations (Argentina, Brazil, Chile and Colombia), as well as Turkey, Iran and Egypt. Some of them dropped out as major borrowers in the 1970s (particularly Brazil, Colombia and Iran), but the Philippines and Sri Lanka joined the group of major borrowers. In turn, Indonesia and Pakistan joined India as major low-income borrowers.

Table 1: The shifting geography of major IMF borrowers

2000 classification	No. of years	1948-49	1950s	1960s	1970s	1980s	1990s	2000s	2010-13
High-income countries									
United Kingdom	22	1948 1949	1950 1951 1952 1956 1957 1958	1961 1964 1965 1966 1967 1968 1969	1970 1971 1976 1977 1978 1979	1980			
France	10	1948 1949	1950 1951 1952 1953 1957 1958	1969	1970				
Australia	7	1949	1950 1951 1952 1953 1954	1961					
Italy	5				1974 1975 1976 1977 1978				
Spain	5		1959		1975 1976 1977 1978				
Greece	4								2010 2011 2012 2013
Netherlands	3	1948 1949	1950						
Ireland	3								2011 2012 2013
Portugal	3								2011 2012 2013
Denmark	2	1948	1952						
Japan	1		1957						
Canada	1			1962					
New Zealand	1			1967					
Iceland	1							2008	
Upper middle-income countries									
2000 classification	No. of years	1948-49	1950s	1960s	1970s	1980s	1990s	2000s	2010-13
Argentina	32		1957 1958 1959	1960 1961 1962 1963 1964	1972 1973 1976	1985 1986 1987 1988 1989	1990 1991 1992 1993 1994 1995 1996 1997 1998 1999	2000 2001 2002 2003 2004 2005	

Brazil	24		1951 1953 1954 1955 1958 1959	1960 1961 1962 1963 1965		1983 1984 1985 1986 1987 1988 1989	1990 1999	2001 2002 2003 2004	
Turkey	19		1953 1954 1955		1970 1979	1980 1981 1982 1983		2000 2001 2002 2003 2004 2005 2006 2007 2008 2009	
Mexico	15					1984 1985 1986 1987 1988 1989	1990 1991 1992 1993 1994 1995 1996 1997 1998		
Chile	13		1959	1964 1965 1966 1968	1972 1973 1974 1975	1987 1988 1989	1990		
Korea Republic	11					1980 1981 1982 1983 1984 1985 1986	1997 1998 1999	2000	
Venezuela	7						1990 1991 1992 1993 1994 1995 1996		
Hungary	5						1991 1992	2008 2009	2010
Uruguay	1							2005	

Lower middle-income countries

2000 classification	No. of years	1948-49	1950s	1960s	1970s	1980s	1990s	2000s	2010-13
Russia	12						1993 1994 1995 1996 1997 1998 1999	2000 2001 2002 2003 2004	
Philippines	10		1955		1971 1972 1973 1977 1978 1979	1980 1981 1982			
Egypt	9			1960 1962 1963 1964 1965 1966 1967	1971 1979				
Colombia	7		1954, 1955, 1956,	1963, 1967, 1968 1969					
Romania	5							2009	2010 2011 2012 2013

Sri Lanka	4			1968	1970 1971 1973				
Iran	3		1955 1956	1960					
Dominican Rep.	1							2007	

Low-income countries

2000 classification	No. of years	1948-49	1950s	1960s	1970s	1980s	1990s	2000s	2010-13
India	37	1948 1949	1950 1951 1952 1953 1954 1957 1958 1959	1960 1961 1962 1963 1964 1965 1966 1967 1968 1969	1974 1975	1980 1981 1982 1983 1984 1985 1986 1987 1988 1989	1991 1992 1993 1994 1995		
Pakistan	18				1972 1973 1974 1975 1976 1977 1978 1979	1981 1982 1983 1984		2005 2006 2007 2008 2009	2010
Indonesia	15		1956	1966 1969	1970 1971 1972		1997 1998 1999	2000 2001 2002 2003 2004 2005	
Ukraine	8						1996	2006 2008 2009	2010 2011 2012 2013
Bangladesh	2				1974			2007	
Congo D.R.	2							2006 2007	
Myanmar	1		1956						
Sudan	1							2006	

Note: Classification of countries by income level in this and the rest of the tables and graphs according to World Bank in 2000.

Source: Author's elaboration based on the IMF database.

As indicated, the hegemony of middle-income countries in IMF lending was the result of the succession of emerging-country crises since the 1980s. Latin America was predominant in the 1980s and 1990s, with Mexico and Venezuela joining Argentina, Brazil and Chile as major borrowers. Korea,[6] Turkey and the Philippines were also important in the first half of the 1980s, together with two low-income countries, India and Pakistan. Two transition economies, Russia and Hungary, joined the group in the 1990s. In turn, with the outbreak of the East Asian crisis and its contagion to other regions, the major borrowers were Korea, Russia, Argentina, Brazil, and Turkey among middle-income countries, and Indonesia among the low-income ones. Finally, with the outbreak of the North Atlantic financial crisis, most large borrowers were concentrated in Europe, both Western (Greece, Iceland, Ireland and Portugal) as well as Central and Eastern

[6] Here as elsewhere in the document, Korea refers to the Republic of Korea.

(Hungary, Romania and Ukraine), with Pakistan becoming the most important non-European borrower since the mid-2000s.

Overall, therefore, Fund lending has also historically benefited all categories of countries and all regions. The list of countries that have been more frequently (ten years or more) in the IMF list of large borrowers includes high-income countries (UK and France) as well as middle-income (Argentina, Brazil, Turkey, Mexico, Chile, Russia, Korea and the Philippines) and low-income ones (India, Pakistan and Indonesia) from all parts of the world. Interestingly, if we define 'graduation' as the condition of having been a large, frequent borrower for at least ten years and having ceased to be so for at least two decades, France and the UK stand as the earliest examples, followed by Chile and India.[7] At the same time, however, new large borrowers always come into the picture.

2.2 Changes in financing instruments to manage capital account crises

After the 1994 Mexican crisis, the need to create new credit lines to manage balance of payment crises caused by sudden stops in external financing began to be recognized by the Fund. This problem is exacerbated by the fact that the pro-cyclical behaviour of capital flows to developing countries reduces the policy space to adopt counter-cyclical macroeconomic policies. Although IMF conditionality has traditionally relied on austerity (and, in this sense, pro-cyclical) policies, it may nonetheless mitigate the need to adopt pro-cyclical policies in the face of a sudden stop in external financing and the absence of official multilateral support. The North Atlantic financial crisis may have represented a partial turning point in this regard as, in the face of the recessionary risks that the world economy faced, the Fund took an openly counter-cyclical perspective on the economic policies that industrialized countries and, with greater caution, emerging and developing countries, should adopt. This was only partly reflected in the conditionality associated with several of the European programmes, which were strongly pro-cyclical in their design.

The two essential elements of this policy were, first, the acceptance of a much larger scale of financing relative to quotas that had been typical in the past – 'exceptional access' in Fund terminology – a point to which I have referred in the previous section, and, second, the search for contingency or precautionary financing instruments to mitigate and hopefully avoid the contagion effects of crises.

Although there were important precedents that go back to the 1960s, the annual and cumulative amounts of borrowing had increased since 1979, and have essentially been managed to give freedom to respond to the need for exceptional amounts of financing during capital-account crises (IMF 2001). However, as we will see, it was under these new facilities created to manage the emerging market crises of the late 1990s/early 2000s and, even more, the North Atlantic financial crisis, that lending reached very high levels relative to quotas. Contingency credit lines have had a more chequered history.

Exceptional financing came with conditions, which were explicitly set in the early 2000s in terms of four criteria: '(i) the member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within the normal limits; (ii) a rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable; (iii) the member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund's financing would provide

[7] Philippines also drops out from the list of large borrowers but continues to be a borrower until 2005.

a bridge; and (iv) the policy programme 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' (IMF 2003). This was accompanied by stronger procedures for decision-making and programmes evaluation. A major concern of all these principles is that they create a bias toward larger members, which could not be reconciled with the principle of uniformity of treatment of member states. Furthermore, a major exception to these principles was given to Greece in 2010: although the IMF staff judged that debt was not sustainable – a fact that was confirmed with the later debt restructuring in 2012, which many analysts judged to be, in any case, insufficient – it was given a leeway to include an exception for those cases in which there was 'a high risk of international systemic spillovers', an exception that the IMF staff later judged to have been inappropriate (IMF 2013a). The lack of formal debt workouts that countries could then be asked to use under unsustainable debt burdens is, of course, a basic constraint in making these judgments.

In the context of the financial turmoil that the developing world faced after the 1997 East Asian crisis, the IMF created two new credit facilities. The first, the Supplemental Reserve Facility, created in December 1997, served as a framework for the large loans made during the crises in the late twentieth and early twenty-first centuries. This facility came with short maturities, which were later extended, and penalty interest rates (a surcharge of three percentage points above the normal rate for IMF loans during the first year, which was increased by 0.5 points at the end of that period and every six months thereafter until reaching five percentage points), which were at the time exceptional provisions in the light of prior IMF lending history, but became regular policies in relation to exceptional financing.

The other, the Contingent Credit Line, had a more preventive aim. However, it was never used because doing so was perceived as an indicator of vulnerability, and it was suspended in 2003. In 2006 the IMF proposed an alternative line, called the Reserve Augmentation Line. Although the proposal was positive in some respects, since it was an automatic credit line, doubts were raised about the prequalification process and the scale of the resources.

For the poorest countries, the structural adjustment lines created in the mid-1980s were transformed in 1999 into the Poverty Reduction and Growth Facility, in order to explicitly place the focus on poverty reduction. In January 2006, a credit line was added for those countries, aimed at facilitating recovery after negative shocks – not just those coming from trade but also from natural disasters – and conflicts in neighbouring countries. Curiously, the creation of that line coincided with the weakening of the traditional IMF loan, the Compensatory Finance Facility, which languished due to its excessive conditionality and had ceased to be used since the turn of the century.

The North Atlantic financial crisis led to further reforms in all of these areas. Following the demand for a precautionary credit line, the IMF Board responded in October 2008 with the creation of the short-term liquidity facility (SLF). It provided rapid access to loans for countries with 'sound macroeconomic policies' and could be disbursed without the traditional IMF ex-post conditionality. Loans had a three-month maturity and were renewable twice during a twelve-month period; borrowing limits were up to 500 per cent of a country's quota. Yet, as the global crisis deepened and spread through the developing world, no country called upon the SLF. In fact, the same day that the IMF announced the creation of the SLF, the US Federal Reserve finalized reciprocal swap arrangements with Mexico, Korea, Singapore, and Brazil – four countries which would have most likely qualified for IMF loans under the SLF. These swap lines, although shorter in terms of maturities, were clearly superior to IMF loans in terms of flexibility and lack of conditionality. Two countries, Mexico and Korea, which were potential users of the SLF, used the

Fed's facilities (see below), indicating that they viewed the SLF as inferior to the Fed swap line. Indeed, Mexico openly praised the SLF but explicitly said it would not use it.

As a result of strong pressure to take more daring measures, in March 2009 the IMF approved perhaps the most ambitious reform of Fund lending in history (IMF 2009a). This reform was adjusted later on to improve its novel features. First, the IMF created the Flexible Credit Line (FCL), which had preventive purposes and lacked ex-ante conditionality, for countries with solid fundamentals but a risk of facing problems in their capital account. Although three countries rapidly used this credit line, the fact it has not been used by other countries could indicate that it is not sufficiently attractive. Its terms were improved in August 2010, when the scale of the resources was increased and the period for which it can be used was extended. Reflecting the discussions surrounding similar credit lines in the past, the additional problem of this line is that it artificially divides countries into two groups: those which have 'good' policies and those which the IMF does not classify under this category, which can obviously increase the risks that the market perceives for countries in the second group.[8] So, this classification implicitly transformed the IMF into a credit rating agency.

This is why the other reforms adopted in March 2009 were probably of greater importance. The first of these was to double the other credit lines and to allow a wider use of the ordinary Fund agreements (the Standby agreements) for preventive purposes (the so-called 'high-access precautionary arrangements'). In August 2010, an additional step was taken, with the creation of the new Precautionary Credit Line (PCL), for countries which the IMF deems to have good policies but which do not meet the criteria of the FCL. It was later transformed into the Precautionary and Liquidity Line, to allow countries to use it to obtain funds of rapid disbursement for six months. The other significant reform introduced in March 2009 was to eliminate structural benchmarks, and thus the relationship between IMF disbursements and structural conditionality. These reforms were accompanied by the elimination of several existing credit lines, including the compensatory finance facility.

In terms of low-income countries, the IMF made new announcements about its concessional credit lines (IMF 2009b). Apart from doubling the credit limits, in accordance with the March 2009 reforms, it increased the global capacity of the IMF loans to these countries through three facilities; (i) the Extended Credit Facility (ECF), which replaced the Poverty Reduction and Growth Facility (PRGF) and provides help to countries with difficulties in their balance of payments; (ii) the Standby lines, which can now be used for dealing with external shocks (which used to be addressed, as we saw, through a special credit line) and other balance of payments needs; and (iii) a rapid credit facility for limited support during emergencies (like a natural disaster or a temporary external shock) with a limited conditionality, called the Rapid Credit Facility (RCF). The IMF also decided that all low-income countries would receive an exceptional cancellation of all owed interest payments on concessional loans until the end of 2011, as well as lower rates of interest on future loans.

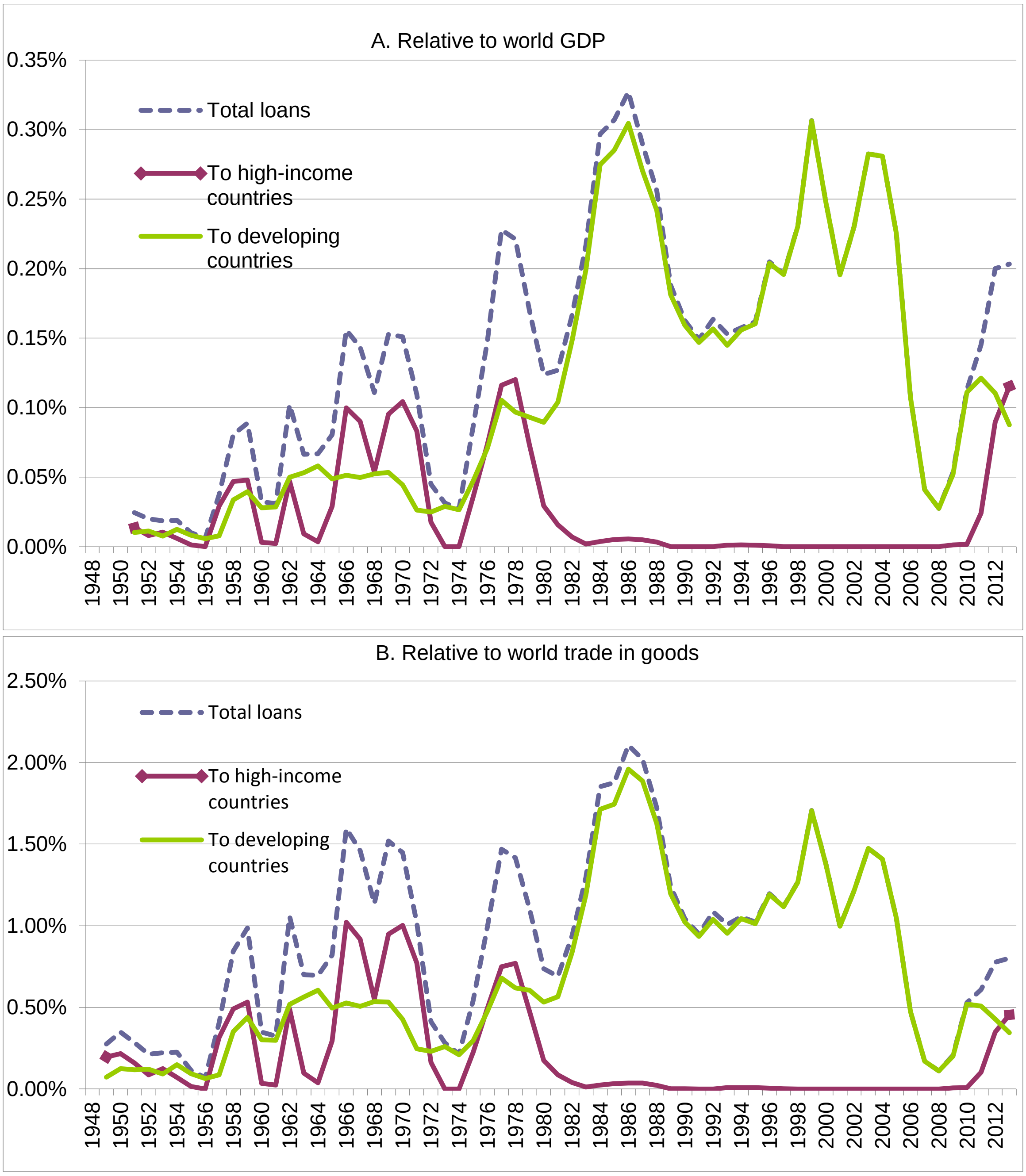
[8] Just before the creation of the FCL, the then United Nations Development Programme (UNDP) Administrator, Kemal Derviş (2008) expressed at the time concern that programmes such as the SLF and the Fed's swap facilities effectively created two groups of countries. In this regard, he pointed out that such an 'all or nothing categorization will create serious political tensions… [and] will also make it politically difficult for these governments [who are left out] to engage in such negotiations if other countries have immediate access to assistance from the IMF or Central Bank swaps'.

In December 2009, the IMF further reformed its concessional loan lines from a single design to a menu of options (IMF 2009c). The menu aimed to be more flexible to different situations facing low-income countries in relation to two factors: their vulnerability to debt and their macroeconomic and public finance management capacity ('capacity' in IMF terminology). Within this framework, countries whose debt vulnerability is high will always have concessionary loans, but those with limited vulnerability and high capacity can eventually access non-concessionary facilities.

Shortly after the creation of the Flexible Credit Line, three countries requested and were granted access to it. Interestingly, on the eve of the 2 April 2009 G-20 meeting in London, Mexico became the first country to use the new facility. As we pointed out above, it had explicitly refused to use the SLF, and now requested almost three times the amount borrowed during its 1994 crisis. Poland and Colombia soon joined. When these initial approvals expired, the three countries have continued to demand these credit facilities, but none has drawn on them, nor have there been new users of the FCL. This raises questions both as to whether it is a good criterion that countries should be recurrent demanders, and also why the facility has not been used by other nations. In turn, only one country (Morocco) has demanded the Precautionary Credit Line. The limited use of these contingency lines reflects, no doubt, the 'stigma' associated with borrowing from the IMF.

Since the Lehman Brothers collapse, demand for IMF loans grew rapidly. A novelty was the fact that, for the first time since the 1970s, the IMF included among its borrowers high-income countries: Iceland in 2008, Greece and Ireland in 2010, Portugal in 2011, and Greece again in 2012. The credits to the last two countries, together with other large loans to Central and Eastern Europe (particularly to Romania and Ukraine) represented close to three-fifths of total disbursed loans at the end of 2010. Several middle-income countries have also used IMF facilities since the collapse of Lehman Brothers, including the preventive facilities, but demand from these countries fell in 2010. In the case of low-income countries, demand has been steadier and, as we have seen, preceded the North Atlantic financial crisis but absorbed a limited amount of resources.

Figure 2: IMF lending relative to world GDP and trade



Source: Author's elaboration based on the IMF database.

Overall, as Figure 2 shows, IMF lending has clearly fulfilled its counter-cyclical role. The largest amounts of IMF lending up to the 1970s were associated with borrowing by high-income countries, with peaks during the turbulence that preceded the collapse of the original Bretton Woods arrangement in 1971 and after the first oil shock. Developing countries were also large borrowers after the oil shock. The two peaks that followed, which surpassed previous levels relative to both world Gross Domestic Product (GDP) and world trade, were associated with the emerging countries' crises of the 1980s and late 1990s/early 2000s. The most recent peak reached during the North Atlantic financial crisis involved, like that of the second half of 1970s, both high-income and developing countries. In turn, lending has experienced sharp reductions after all these peaks. This was particularly so in the years prior to the Lehman Brothers collapse, when demands for IMF resources were very low, and came mainly from low-income countries; only one low middle-income country, Honduras, had demanded a Standby Agreement prior to the Lehman bankruptcy, in April 2008.

It is important to underscore, however, that there has been a clear downward trend in IMF lending relative to world GDP and, particularly, world trade over the past three decades. Indeed, recent levels of financing are, relative to trade in goods, only about two-fifths of the historical peak in IMF lending in the mid-1980s. The comparison is worse relative to the trade in goods and services (not shown) and, particularly, relative to any financial aggregate. For example, if we calculated IMF lending relative to the Bank of International Settlements data on outstanding debt securities (which is, however, a fragmented series for the 1980s), recent lending is only slightly over one-tenth of the relative levels of the mid-1980s. The comparisons would be less bad if we added in Figure 2 the precautionary credit facilities that were created during the North Atlantic financial crisis but which have not been disbursed.

On the other hand, as a result of decisions regarding exceptional financing, the ratio of large loans to quotas sharply increased during the three most recent lending cycles. Table 2 summarizes the evolution of that ratio for the five top borrowers, defining exceptional financing as borrowing over three times countries' quotas. As the table indicates, during the 1980s, the average level of exceptional financing was 3.7 times the quota amount, with Korea, Mexico and Turkey as the countries with the largest relative amounts of borrowing. This increased to 6.6 times during the 1995-2007 cycle, with Turkey and Korea as the worst cases. In the most recent cycle, 2009-2013, it reached 9.3 times, with Greece, Portugal and Ireland as the cases where the ratio reached the highest levels, in a few cases over 20 times the quota level.

Fund lending has thus clearly met its counter-cyclical objective, but it has tended to lag behind other global aggregates over the past three decades. This is despite the fact that the international financial system demands the IMF to be more active as a source of emergency financing, particularly to manage capital account shocks. The responses it has adopted during recent crises and particularly during the North Atlantic one have been overall improvements but it needs to continue making progress in designing financing facilities that are automatic and have simpler prequalification processes. These two conditions are particularly important to overcome the stigma associated with borrowing from the IMF, which is closely related to the conditionality associated with it, the issue to which I now turn.

Table 2: Cases of large exceptional financing (over three times the quota level)

First cycle: 1980s, in %			Second cycle: 1995-2007, in %			Third cycle: 2008-2013, in %		
Korea	1981	418	Mexico	1995	607	Turkey	2008	465
	1982	446		1996	527		2009	426
	1984	345		1997	384	Hungary	2008	406
Philippines	1981	309		1998	339		2009	735
Turkey	1981	379	Korea	1997	1026		2010	735
	1982	440		1998	1501	Iceland	2008	476
	1983	349	Russia	1998	318	Ukraine	2009	510
Mexico	1987	312	Indonesia	1998	431		2010	674
	1988	306		1999	359		2011	674
	1989	332		2000	400		2012	511
	1990	395		2001	349		2013	245
	1991	406		2002	313	Romania	2009	591
				2003	333		2010	951
Average		370	Turkey	2000	333		2011	1026
				2001	1165		2012	899
				2002	1685		2013	506
				2003	1682	Ireland	2011	879
				2004	1437		2012	1315
				2005	1063		2013	1548
				2006	600	Pakistan	2009	463
				2007	380		2010	549
			Argentina	2001	525	Greece	2010	1110
				2002	498		2011	1592
				2003	493		2012	1719
				2004	429		2013	2113
				2005	314	Portugal	2011	1117
			Brazil	2003	628		2012	1787
				2004	531		2013	2076
			Uruguay	2005	526			
			Average		661	Average		932

Note: Borrowing as per cent of quota at the end of each year.

Source: Author's elaboration based on the IMF database.

2.3 IMF conditionality

Debates on IMF conditionality are almost as old as the Fund. The early years were the period in which countries had almost automatic access to IMF lending, despite the opposition to such automaticity by the United States. But the US position finally prevailed and conditionality was adopted as Fund policy in 1953, except for drawings on the gold or reserve tranche. The essential defence of conditionality was that it was necessary to guarantee that countries could return to sustainable balance of payments positions and could repay their loans – or, in Fund terminology, that Fund resources were safeguarded. Under crisis conditions, adjustment generally meant adopting contractionary macroeconomic policies. This was, of course, a partial return to the 'rules of the game' of the gold standard, though now mitigated by access to some limited amounts of financing and the possibility of depreciating the exchange rate, both of which helped smooth out the adjustment process. It was always understood, of course, that adjustment should be less severe when deficits were expected to be temporary and self-reversing.

Adjustment maintained the essential asymmetry between surplus and deficit countries and the global recessionary bias that this generates. In a sense, this problem became worse in the post-Second World War years, as surplus countries were no longer subject to the rule that forced them to automatically expand their money supply – a rule that had been implemented, in any case, with latitude to avoid excessive monetary expansion even under the gold standard. This asymmetry was the reason why Keynes had advocated for automatic financing of deficits (Keynes 1942-43), but his views were defeated in the negotiations that led to the Bretton Woods Agreement.

Soon the debate on automaticity vs. conditionality became associated with the *origins* of balance of payments deficits, in particular with whether they were generated by expansionary domestic policies or by adverse external shocks – in the terminology that became fashionable, under 'circumstances beyond a country's own controls'.[9] This was the background to the decision to design fairly automatic credit facilities, notably the compensatory financing facility in the 1960s and the oil facilities in the 1970s; the latter did not last too long, but the first one did, indeed until 2009, though its low-conditionality features were gradually dismantled, as mentioned in the previous section. It could, of course, be argued in defence of conditionality that, unless external shocks were only temporary in nature, countries still had to adjust and thus conditionality was equally required. This is the basic reason why these automatic facilities were eventually dismantled.

The nature of the debate changed in the 1980s and 1990s, when it became associated with the growing scope of the structural conditionality attached to lending. This process started with the Latin American debt crisis but even more so with the transition from socialist to market economies in Central and Eastern Europe. Criticisms of the costs of structural adjustment were common already in the 1980s but became frontal after the East Asian crisis.[10] Critics emphasized that macroeconomic policy conditions tended to be pro-cyclical and thus enhanced rather than mitigated the effects of external shocks, but also that they were rigid and uniform ('one size fits all') and not tailored to countries' specific characteristics. They also underscored the fact that these conditions included structural conditions on economic liberalization that reflected orthodox views on economic reforms, the effects of which were controversial and excessively intrusive on domestic decision-making processes. They thus violated the principle of 'ownership' of policies by countries, which became widely recognized as a precondition for policies to be effective. Furthermore, some critics also underscored the fact that those conditions often reflected pressures from influential countries on what they wanted specific borrowing countries to do (e.g., opening up their financial sectors to foreign investment, particularly during the East Asian crisis).

As a result of these pressures, in the late 1990s the IMF began to reconsider the fiscal and structural conditions attached to its programmes. This led to the drafting of an interim guidance note on conditionality in 2000 but, particularly to the approval of the IMF Board, in September 2002, of new guidelines on conditionality (IMF 2002b). The new guidelines put at the centre three basic

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[9] This is probably the main issue that was debated around 1980. See the edited volume by Williamson (1983a) and his own summary of that debate (Williamson 1983b).

[10] For the early criticism of the high costs of structural adjustment, see Cornia, Jolly and Stewart (1987). The best-known criticism after the East Asian crisis is that of Stiglitz (2002).

principles: (i) member countries' *ownership* of policies, or in terms of the guidelines, that 'the member has the primary responsibility for the selection, design, and implementation of its economic and financial policies'; (ii) the requirement that structural conditions should be '*macro-relevant*' and mainly focus on the core competencies of the Fund (monetary, fiscal and exchange rate policies, as well as financial system issues); and (iii) the need to streamline conditionality, which came to be known as 'parsimony', which implies that conditions must be *critical* to achieve the programme goals. Additional principles included tailoring policies to country needs, which means that policies should be relevant to the specific country, including its capacity to implement them; clarity in the specification of conditions, and co-ordination with other institutions, particularly the World Bank in areas that are not the core competencies of the Fund.

Further efforts were made in later years to implement these principles. In 2005, the IMF Board reviewed the application of the new guidelines and concluded that progress had been made. However, in 2008 the IMF's Independent Evaluation Office (IMF-IEO) completed an assessment of structural conditionality in IMF-supported programmes (IMF-IEO 2008). The report highlighted that conditionality needed to be even more focused and relevant. A new plan approved in May 2008 called for sharpening the application of the 2002 guidelines on conditionality by demanding better justification of criticality, establishing explicit links between goals, strategies and conditionality, and enhancing programme documents.

There was at the time an open debate about whether or not conditionality was in fact being streamlined. Whereas Abdildina and Jaramillo-Vallejo (2005) found evidence that the average number of conditions had declined, Killick (2005) found that there was no reduction in the number of conditions in programmes for low-income countries and that reliance on conditionality remained high. The latter was probably correct, as more recent evaluations by the Fund indicate that the number of conditions actually increased in 2002-04 (IMF 2012: Figures 8 and 12).

The IMF-IEO evaluation gave an in-depth numerical analysis of conditionality over time and across sectors. Reviewing the entire lending operations of the Fund between 1995 and 2004, it found that IMF programmes for both middle- and low-income countries had an average of 17 structural conditions, and found no statistically significant difference in the number of conditions after the 2002 guidelines were approved. In Poverty Reduction and Growth Facility (PRGF) arrangements, the average number of conditions had declined from around 16 to 15, while in Standby Arrangements/General Resource Account (SBA/GRA) they had risen from 18 to 19.

The report showed, however, that conditionality had shifted away from privatization of state-owned enterprises and trade reform into IMF core areas: tax policy and administration, public expenditure management, and financial sector reform. Furthermore, even though the number of conditions had not declined significantly, the bulk of structural conditions had only limited structural depth: more than 40 per cent of them called for preparing plans or drafting legislation and about half called for one-off easily reversible changes. The IMF-IEO's conclusion was that the streamlining initiative had not reduced the volume of conditionality partly because structural conditions continued to be used to monitor other initiatives such as donors' support programmes and the European Union (EU) accession process. Also, in some cases, economic authorities in countries requested specific conditionality to help them leverage their domestic policy goals.

A later investigation indicated that additional advances were achieved after the IMF-IEO's recommendations were incorporated into conditionality policy. Particularly, the volume of conditionality decreased in standby arrangements and continued to concentrate in macro-relevant areas, but these two advances were less typical in programmes with low-income countries (Griffith-

Jones and Ocampo 2012). For the first type of programmes, the average number of structural conditions per country in the period 2008-10 was 16.5, but this average was biased by a few highly conditional programmes, particularly that of Ukraine; if this programme is excluded, the average for 2008-10 fell to 14.3 compared to 19 in the period analysed by the IMF-IEO. For low-income country programmes, the average number of structural conditions per country in the period 2008-10 was 14.5, very similar to the earlier period. As per the content of the structural conditions, the study found that, although most conditions were in the Fund's core mandates – public financial management and financial sector soundness – it continued to push conditions in areas beyond these mandates, though less so if compared to the period before 2007. These non-core areas included state-owned enterprise reform, social policies, civil service reform or regulatory reform; this was particularly so for low-income countries.

As we saw in the previous section, two major reforms were introduced in this area in 2009: the elimination of structural performance criteria for all programmes and ex-ante conditionality for the Flexible Credit Line. The 2011 evaluation by the Fund (IMF 2012) showed the positive effects of the first of these decisions. It indicated that structural performance criteria had increased in 2002-04 and remained stable in 2004-08, but their discontinuation led to a sharp reduction, particularly in GRA programmes. This was reinforced by a reduction in structural benchmarks and prior actions, but quantitative performance criteria had remained constant throughout the period analysed (2002-11) at 5-6 per review. However, this process was interrupted in 2010 and, particularly, in 2011, when structural benchmarks increased again, largely associated with some highly conditional programmes with European countries. This has been confirmed in an independent study, which analysed loans approved between October 2011 and August 2013, and found that the number of structural conditions was increasing, driven by the high number of conditions in some specific programmes—for Côte d'Ivoire, Cyprus, and Greece, in particular (Griffiths and Todoulos 2014).

Aside from this advance in 'parsimony', conditionality became more focused on core Fund competencies. Indeed, structural conditionality has increasingly focused on core Fund areas, particularly on fiscal, followed by financial sector, issues, and particularly in GRA programmes, with a relative growth of fiscal and decline of financial issues in 2002-11. Monitoring of external debt has also been important in PRGF programmes. In turn, after declining up to 2009, conditionality on macro-social critical issues increased in 2009-11 (particularly civil service and public employment and wages, and pension reform), while wage bill ceilings for low-income countries have tended to disappear. Aside from the reversal of these positive trends in 2010-11, the IMF review also indicated that the depth of structural conditions had actually increased, indicating that there was a trade-off between the volume and the depth of conditionality. A final troublesome conclusion was that there was inadequate co-ordination with surveillance, as only 48 per cent of conditions were foreseen in prior Article IV consultations, although the review argued that this was partly due to changing global economic conditions.

One final troublesome issue relates to the character of some of the macroeconomic policies adopted in IMF programmes, which many analysts continue to perceive as pro-cyclical (Weisbrot et al. 2009).[11] However, the record here has probably improved as a reflection of the clearer IMF preference for counter-cyclical policies during the North Atlantic financial crisis. An evaluation of

[11] This study indicated that in 31 out of 41 countries with IMF agreements, countries had been subject to pro-cyclical fiscal and/or monetary policies, and that the IMF had relied on overly optimist growth forecasts. The latter issue has been emphasized in several evaluations of the IMF throughout the years.

fiscal policies in IMF reports (including not only programmes but also Article IV consultations) indicated, indeed, that in 2008-09 most countries introduced fiscal stimulus programmes, but also that premature expenditure contraction (particularly measured as a proportion of GDP) became common in 2010 and tended to intensify in later years (Ortiz and Cummings 2013). This is confirmed by Griffiths and Todoulos (2014), who underscored the persistence of politically-sensitive conditions related to tax and spending policies, including social security reform, in 2011-13 programmes. In several of the countries entering into a funding agreement with the IMF, it may be fair to say that adjustment policies were required to correct overly expansionary (and thus pro-cyclical) policies during boom years or imposed by policy decisions adopted by countries themselves (e.g., decisions to maintain the currency board in the case of Latvia, or for Eurozone countries to remain as members of the currency union).

Overall, therefore, there have been advances since the mid-2000s in reducing the volume of structural conditionality—though with some backtracking since 2010—and focusing it in macro-relevant areas that are the competence of the IMF. Eliminating structural benchmarks, and thus the relationship between IMF disbursements and structural conditionality, was a significant step forward in 2009, as well as the creation of a preventive credit line that carries no ex-ante conditionality. This is very important, as current, as well as historical conditionality, are the reasons why borrowing from the IMF carries a stigma that, as we will see in the next section, is not present in other forms of counter-cyclical financing.

2.4 Complementary financing mechanisms

The response to the North Atlantic financial crisis included a myriad of complementary financing mechanisms in addition to IMF emergency lending: the largest issuance of Special Drawing Rights (SDRs) in history (an issue not dealt with in this paper), the active utilization of central banks' swap credit lines, the creation or expansion of regional monetary arrangements, and the rapid expansion of lending by multilateral development banks (MDBs). Overall, this is certainly the most ambitious response of official counter-cyclical financing in history.

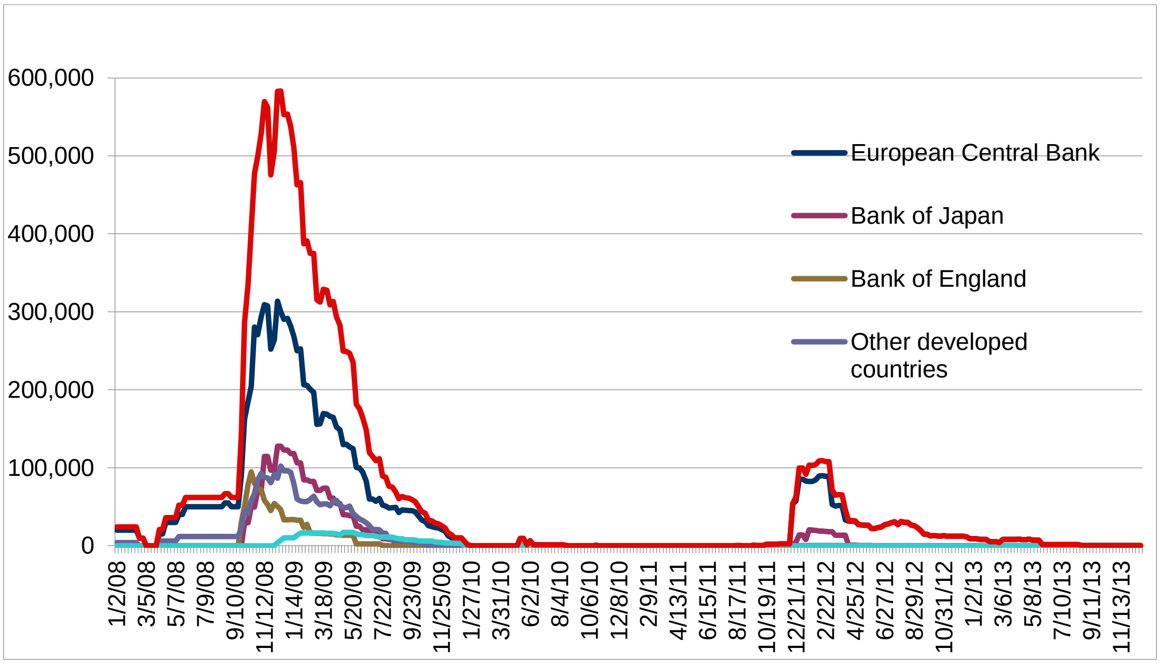
Many swap credit lines have been created in recent years, including those China has extended to other emerging and developing countries.[12] However, because of the role that the US dollar plays in the global monetary and financial system, Federal Reserve funding is particularly critical for other central banks. Strains in dollar funding overseas can also disrupt financial conditions in the US and it is thus of interest to the Fed itself. Like other facilities of its kind – and, in fact, like IMF funding itself – Federal Reserve funding involves transactions in which dollar liquidity is exchanged, at the prevailing market exchange rate, for a similar amount of the currency issued by the central bank drawing on the Fed facility. It involves also a commitment by the foreign central bank to buy back its currency on a specified future date (which can be the next day or as much as three months later) at the same exchange rate, thus eliminating any exchange rate risk. Between 12 December 2007 and 29 October 2008, the Federal Open Market Committee (FOMC) authorized swap arrangements with 14 foreign central banks, which expired on 1 February 2010. In May 2010, in response to the re-emergence of strains in short-term dollar funding markets abroad, dollar liquidity swap lines with five developed countries' central banks were re-established. Since then, these authorizations have been extended several times.

[12] Its development bank has also facilitated large amounts of financing to other emerging and developing countries.

The first wave of swap credit lines included four emerging economies (Brazil, Korea, Mexico and Singapore), which were given credit lines for up to US$30 billion. Two of these countries, Mexico and Korea, which were potential users of the IMF's short-term liquidity facility (SLF) that had been created in October 2008, activated the Fed lines in order to help private firms who were facing a scarcity of dollar liquidity after the Lehman collapse, indicating that they viewed the SLF as inferior to the Fed swap line, both in terms of speedy access to dollar liquidity and lack of conditionality.

As Figure 3 indicates, the major users of these facilities were the European Central Bank (ECB) and the Bank of Japan. The Bank of England and the central banks of several other developed countries – Switzerland, Australia, Sweden, Denmark and Norway, in that order – were also important users. Korea and Mexico also made use of the Fed swap line but with a lag and in relatively smaller amounts.[13] The swap lines had started to be used before the Lehman Brothers collapse, but it was the bankruptcy of this investment bank that led to a massive use of these facilities: over half a trillion dollars over the next two months, which is about *four* times the increase in IMF lending over a longer time period (2007 to 2013). The facilities declined rapidly during the first semester of 2009 and ceased to be used by the end of that year. The second episode of large use came in late 2011 as a result of the worsening of the Eurozone crisis. It was less intense than the previous episode and essentially concentrated in the ECB.

Figure 3: Weekly use of US Fed swap facilities (millions of dollars)



Source: Author's elaboration based on data from the US Federal Reserve.

At the regional level, emergency lending was reinforced by old and new mechanisms in Europe and by the Chiang Mai Initiative of ASEAN + 3 (China, Korea and Japan). In the first case, it involved both financing mechanisms for all European Union members (the Balance of Payments

[13] Korea started using it in the week of 12 December 2009, with a peak at US$16,350 million between the weeks of 18 January 2009 and 28 March 2009; it then gradually reduced its use until the week of 16 December 2009. In turn, Mexico borrowed US$3,221 million from the week of April 29, 2009 to that of 6 January 2010.

Assistance Facility, a pre-existing mechanism, and the new European Financial Stabilization Mechanism) and also mechanisms specifically for Euro members (the temporary European Financial Stability Facility put in place in 2010, and the permanent European Stability Mechanism inaugurated in October 2012). In turn, the Chiang Mai mechanism was expanded (to US$240 billion to date) and multi-lateralized, and a monitoring unit to support it was put in place in Singapore. Other initiatives of a smaller scale have been adopted in other parts of the world (IMF 2013b).

In relation to MDBs, the crisis placed their counter-cyclical role at the centre of the global agenda, an issue that most had not previously recognized as an essential role – together, of course, with the long-term objectives of poverty reduction and the provision of international public goods. Of course, increased lending by the MDBs when private funds dry out is not liquidity financing, but rather long-term financing to the public and, secondarily, the private sectors; but their disbursement facilitates the adoption of domestic counter-cyclical policies and increases the foreign exchange available to countries. The basic advantage of these facilities is that many more countries are willing to use them – i.e., their use carries no stigma – and their basic disadvantage that they involve smaller magnitudes of funds and a longer disbursement period. Interestingly, the recognition of the counter-cyclical functions of MDBs has also been highlighted in recent years in relation to the European Investment Bank and to national development banks.

As Table 3 indicates, the MDBs serving emerging and developing countries increased their commitments by 124 per cent in 2009-10 compared to their average level of lending in 2004-07. Disbursements came with a lag, increasing by 82 per cent. The lag between commitments and disbursements took place despite the use or creation of fast-track facilities in all cases. All the major institutions played an important role, and remarkably so the World Bank/IBRD (International Bank for Reconstruction and Development). Regional development banks also expanded their lending rapidly, notably the Asian Development Bank in terms of commitments and the African Development Bank in terms of disbursements. The least dynamic was the World Bank/IDA (International Development Authority). Among regional development banks, the least dynamic was the European Bank for Reconstruction and Development, which serves the transition economies.

An additional response of MDBs to the crisis was the rapid way in which they addressed the paralysis of trade financing. The resources that they committed for that purpose were US$9.1 billion, on top of the US$3.2 billion that they were already providing. Due to the high rotation of trade credits, these resources provided a much larger amount of financing. An evaluation by the International Chamber of Commerce at the time indicated that 55 per cent of the banks analysed were using the resources of MDBs in the summer of 2009 (ICC 2009).

Table 3: Lending by multilateral development banks, 2004-12 (millions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Commitments									
World Bank/IBRD	11,045	13,611	14,135	12,829	13,468	32,911	44,197	26,737	20,582
World Bank/IDA	9,035	8,696	9,506	11,867	11,235	14,041	14,550	16,269	14,753
International Finance Corporation (IFC)	4,753	5,373	6,703	8,220	11,399	10,547	12,664	12,186	15,462
Subtotal World Bank Group	24,833	27,680	30,344	32,915	36,101	57,499	71,411	55,192	50,797
African Development Bank	4,326	3,277	3,904	4,895	5,435	12,643	6,314	8,782	6,536
Asian Development Bank	5,039	5,761	7,389	10,770	12,174	20,389	18,935	21,717	21,571
European Bank for reconstruction and Development	5,093	5,346	6,149	7,664	7,464	10,987	11,924	12,659	11,437
Inter-American Development Bank	5,468	6,738	5,774	8,812	11,085	15,278	12,136	10,400	10,799
Subtotal regional banks	19,926	21,122	23,216	32,141	36,158	59,296	49,309	53,558	50,344
Total	44,759	48,802	53,560	65,056	72,259	116,795	120,720	108,750	101,140
Disbursements									
World Bank/IBRD	10,109	9,722	11,833	11,055	10,490	18,564	28,855	21,879	19,777
World Bank/IDA	6,936	8,950	8,910	8,579	9,160	9,219	11,460	10,282	11,061
International Finance Corporation (IFC)	3,152	3,456	4,428	5,841	7,539	5,640	6,793	6,715	7,981
Subtotal World Bank Group	20,197	22,128	25,171	25,475	27,189	33,423	47,108	38,876	38,819
African Development Bank	2,042	1,842	1,863	2,553	2,866	6,402	3,867	4,873	5,193
Asian Development Bank	3,559	4,745	5,758	6,852	8,515	10,581	7,976	8,266	8,592
European Bank for reconstruction and Development	4,596	2,859	4,768	5,611	7,317	7,649	7,950	9,320	7,711
Inter-American Development Bank	3,768	4,899	6,088	6,725	7,149	11,424	10,341	7,898	6,883
Subtotal regional banks	13,965	14,345	18,477	21,741	25,848	36,056	30,133	30,357	28,379
Total	34,162	36,473	43,648	47,216	53,037	69,479	77,241	69,233	67,198

Note: IBRD, IDA, and IFC data refers to the fiscal years ending in June.

Source: Author's elaboration based on the various banks' reports.

Increased lending required, in turn, the capitalization of all major institutions. The G-20 agreed in April 2009 to support the capitalization of MDBs. The Asian and African Development Banks agreed in 2009 to a 200 per cent increase in their capital. Although the expectations of the Latin American and Caribbean countries were not fulfilled, the Inter-American Development Bank also agreed a capitalization of US$70 billion in March 2010, which represented close to a 70 per cent rise in callable capital. This was followed by a 50 per cent increase in capital for the European Bank for Reconstruction and Development, agreed in May 2010. The President of the World Bank initially argued that, due to the capital cushions that the institution had, the IBRD did not require additional capital. However, in April 2010, it agreed on a capital increase of US$86.2 billion, which included a general increase of US$58.4 billion and a selective increase of US$27.5 billion to allow emerging and developing countries to enlarge their share in the capital of the institution. This capitalization was clearly insufficient and implied that the World Bank would be unable to respond to a new sudden stop in external financing for developing countries in the future the way it had during the North Atlantic financial crisis. In fact, as Table 3 indicates, IBRD financing has declined sharply from its peak, though it has remained above pre-crisis levels. This is not true of IDA and IFC, which have been more resilient and, in fact, the latter has continued to expand. Regional development banks have also been resilient, with the Inter-American Development Bank being the one that has reduced financing more sharply in recent years.

In any case, the amount of financing provided by the MDBs was much smaller than the contraction of private external financing, and this is also true of the IMF.[14] Since private capital markets recovered relatively fast (starting in mid-2009), this implies that their role in mitigating the sudden stop in external financing was moderate at best. This also implies that official financing can only moderately smooth out boom–bust cycles in private financing and that the main instrument to reduce the volatility of external financing is that of capital account regulations, particularly regulation on inflows during the boom phase of the cycle. Also, notoriously, the weakest response was that of official development assistance, which only modestly increased during the early phase of the crisis and declined after peaking in 2010 (United Nations 2013), a victim of austerity programmes in place in developed countries. The net result of this is that the counter-cyclical response to the North Atlantic financial crisis benefited to a larger extent high and middle-income than low-income countries (Griffith-Jones and Ocampo 2012).

3 The need for an international debt workout mechanism

3.1 The historical and conceptual demand for a debt workout mechanism

As is widely accepted, beyond the traditional trade-off between financing and adjustment in the face of balance of payments crises, the global financial architecture cannot rely exclusively on emergency lending (or 'bailouts', as they are generally called) for two major reasons, which can be seen as two sides of the same coin. The first is that it may result in unsustainable levels of foreign indebtedness. The second is that it may generate moral hazard for creditors, as official resources are very often used to effectively bail out the private sector. Furthermore, the absence of an effective debt workout forces debtors to adopt excessively contractionary adjustment policies during crises, and may have negative long-term effects in terms of access to and cost of financing, as well as credibility and attractiveness to FDI. For all these reasons, an international financial architecture must have complementary mechanisms to finance situations of illiquidity and debt workouts to manage debt crises; the latter plays the role that bankruptcy procedures play at the national level. The dividing line between when to use one or the other has been traditionally set as that between 'liquidity' and 'solvency' but, as we well know, this line is not easy to draw, as in many cases the lack of liquidity financing may lead into insolvency. In fact, one of the major arguments

[14] Based on World Bank data, it can be estimated that the contraction of private external financial flows (i.e., excluding foreign direct investment) toward emerging and developing countries was US$534 billion between 2007 and 2008, or US$249 billion if we compare with 2006, to avoid comparison with the peak 2007 levels. This compares to a peak increase in disbursements of MDBs of about US$30 billion. IMF financing increased by SDR 90 billion or close to US$140 billion, but a large amount was directed toward peripheral Europe.

in favour of emergency financing is to prevent problems of access to liquidity during crises from turning into insolvency.

However, advances made in improving emergency financing during recent crises have not been matched by the development of an institutional framework to manage countries' debt overhangs. The only regular mechanism of this type in place is the Paris Club, which is officially an informal arrangement serviced by the French Treasury and deals exclusively with official creditors. The system has otherwise relied on ad hoc arrangements as well as those with voluntary renegotiations, relying on the 'comparability principle' in the agreements of debtors with banks and bondholders – i.e., comparable restructuring terms – under the so-called 'contractual approach'. The debtors, in turn, have to rely on moral suasion, as there is no legal basis for the comparability principle, often leading to lengthy negotiations, non-participation by some creditors ('holdouts') and costly litigation. The principle relies on informal and imperfect co-ordination of debtors and creditors and on complementary bilateral and multilateral financing, all usually under IMF guidance. However, the problem with this patchy 'non-system' is that debt restructurings generally (or even always) come too late, after over-indebtedness has had devastating effects on countries and thus on their capacity to service debts. This is also an inefficient outcome from the point of view of creditors. It is also horizontally inequitable, as it does not treat all debtors or all bona fide creditors with uniform rules.

Debt defaults and renegotiations have, of course, an old history, which matches the sequence of boom–bust cycles of international finance. Before the Second World War, the typical mechanism was voluntary negotiations between creditors and sovereign states, followed (if they failed) by inter-governmental arbitration. Under this practice, sovereign states unilaterally defaulted. Creditors, generally bondholders, then organized themselves into creditor committees. If they failed in their efforts to negotiate a successful agreement with the defaulting sovereign states, they sought assistance from their own governments. Representatives of the creditors' governments then negotiated and pressured the debtor, leading on more than a few occasions to a military intervention in the territory of the country that had defaulted.[15] Interestingly, when the latter did not happen, this regime tended to grant greater degrees of relief from private creditors than the current system, but only after lengthy and in some cases repetitive negotiations, which allowed arrears to accumulate to the point where they even exceeded the original principal (Suter and Stamm 1992). Furthermore, the mix of default and debt renegotiations produced a much better result for debtor countries than the current system. This comes across clearly in a comparison of Latin America in the 1930s vs. the 1980s: default was one of the mechanisms that supported recovery during the 1930s, whereas debt service was a major drag in the 1980s; in turn, the debt renegotiations after the 1930s default were more generous than those that took place under the Brady plan in the early 1990s (Ocampo 2014).[16]

The destruction of international finance during the Great Depression also led to the absence of significant private financing for several decades, and thus of demands for sovereign debt workouts. Since official financing became the dominant form of financing, renegotiations with official creditors took centre stage. The mechanism created was the Paris Club, which emerged out of

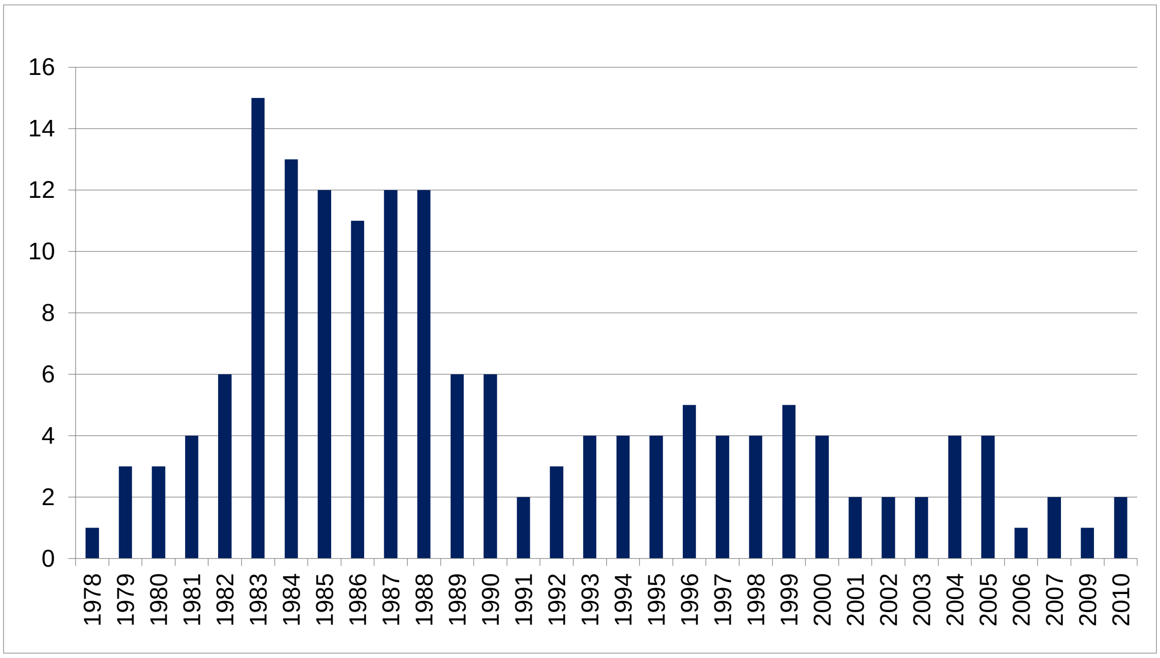
[15] Even though the international legal framework was the 'Convention Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts', adopted as part of a set of conventions on the laws of war at The Hague in 1907. This was a response to a practice that had been typical in the nineteenth century, but there was no reluctance to use force on subsequent occasions (e.g., the Dominican Republic in 1916).

[16] See an analysis of the magnitude of the relief for Latin America in the debt restructurings after the 1930s default in Jorgensen and Sachs (1989).

Argentina's traumatic renegotiations with creditors in 1956 but became a regular institution thereafter, although its agreements have never had a clear legal status. With the reconstruction of an international private financing mechanism in the 1960s, in the form of the so-called 'Eurodollar market', boom–bust cycles of financing came back and with them, defaults and debt renegotiations. The boom in financing to developing countries became very strong in the 1970s, and particularly so since the mid-1970s, when the recycling of petrodollars was matched by an oligopolistic setting in which large international banks sought to place loans in a way that would allow them to expand or at least maintain their market share (Devlin 1989). As Figure 4 shows, this was followed by the first contemporary phase of debt renegotiations, which started in the late 1970s and peaked in the 1980s (see also Panizza, Sturzenegger and Zettlemeyer 2009, Figure 1). The largest number of renegotiations took place with Latin American countries, but these were accompanied by a few Central and Eastern European countries (particularly Bulgaria, Poland and Yugoslavia), African countries (notably Nigeria and South Africa) and a few Asian countries (Philippines) (Cruces and Trebesch 2013).

The 'London Clubs' were also set up in the late 1970s to renegotiate bank debts, but these are not a formal set up but a generic name for a mechanism of voluntary debt renegotiations, which have similarities to the way they were done prior to the Second World War. However, negotiations with private creditors in the 1980s were mainly done under the leadership of the United States government, and with support from the IMF, which followed at the time a policy of not lending to countries that were in arrears with private creditors. Although creditor committees played a central role in co-ordinating banks, the positive view held by their architects of these committees as a central mechanism to facilitate the return of market access and growth (see, for example, Rhodes 2011) contrasts with the perception of them as a mechanism that tilted the negotiation in favour of creditors and, in any case, did not produce either growth or a rapid return to markets (Garay 2010; Ocampo 2014). Rather, an alternative perception of the way the Latin American debt crisis was managed in the 1980s is that it was successful in avoiding a banking crisis in the US but only by displacing its effects to debtor countries.

Figure 4: Number of debt restructurings



Source: Author's elaboration based on data from Cruces and Trebesch (2013); reproduced with the permission of American Economic Review.

Indeed, the failure of the early waves of reschedulings (Devlin 1989) finally led US authorities to promote complementary mechanisms: additional financing through the 1985 Baker Plan and an ad hoc debt relief initiative, the Brady Plan, in 1989. The latter became one of the sources of the new wave of renegotiations in the first half of the 1990s (see again Figure 4). It provided limited relief, particularly if compared with the renegotiations of defaults from the 1930s in the 1940s/1950s, but it helped create a bond market for emerging-country debt, which became the framework for renewed financing in the 1990s. It also led to a change in IMF policy in favour of the principle of 'lending into arrears', which was also adopted in 1989 into commercial debt policy, accepting the principle that the Fund could finance countries in arrears so long as they continued to negotiate with creditors in 'good faith'; it was modified in 1998-99 to include bonds and a less stringent interpretation of what 'negotiating in good faith' means (IMF 2002a). However, neither the Brady Plan nor the related policy of lending into arrears served, as could have been possible, as a framework to develop a debt workout mechanism, a proposal that was at the centre of recommendations by some institutions (notably the United Nations Conference on Trade and Development (UNCTAD)).

A new wave of defaults and renegotiations would soon come as the result of the sequence of crises in the emerging economies that took off in East Asia in 1997. Many took the form of voluntary reschedulings, specifically debt exchanges in which 'bumps' in the debt service schedule were smoothed out, with maturities effectively extended. Since these reschedulings were voluntary, the terms of the new bonds had to be attractive enough to induce creditors to participate. So, as Spiegel (2010) has shown, even in cases when some investors experienced losses in the short term, returns to investors were quite good over the long term. A few, more traumatic renegotiations did provide larger relief, particularly those with Russia in 1998 and Argentina in 2005 and 2010. The latter took centre stage in recent debates as a result of successful demands by holdouts in US courts in 2012-13 (see below).

In the case of low-income countries, public sector financing continued to play the major role. The problems of their indebtedness led to years of serial rescheduling at the Paris Club, accompanied by new credit leading to debt overhangs. Under strong pressure from civil society (particularly the Jubilee Coalition), these countries became the focus of another ad hoc initiative: the Heavily Indebted Poor Countries Initiative (better known by its acronym HIPC), launched in 1996 and strengthened in 1999, and the subsequent Multilateral Debt Relief Initiative (MDRI) of 2005. The major differences between these initiatives and the Baker Plan were their focus on low-income countries and the inclusion of relief and later write-off of multilateral debts.

Therefore, the existing framework, which mixes the Paris Club and voluntary renegotiations with private creditors and occasional ad hoc debt-relief initiatives (the Brady Plan and HIPC/MDRI), has had two fundamental deficiencies.

First, as the IMF (2013a: 15) has recognized, 'debt restructurings have often been too little and too late', a view that is shared by many other analysts.[17] In fact, on several occasions, renegotiations (including those in the Paris Club) have been a way to postpone, not to solve the problem. Furthermore, due to limited relief offered at each stage (with the notable exception of the 2005 MDRI), renegotiations have frequently been sequential, effectively postponing their potential benefits. The debt overhang that persists for several years has devastating effects on countries but also has adverse effects on creditors, given the limited capacity of debtors to pay. In short, the

[17] See, for example, Bucheit et al. (2013).

current system does not guarantee a ‘fresh start’ or a ‘clean slate’, the conditions that are generally identified as the basic characteristic of a good bankruptcy procedure.

The second deficiency is that existing mechanisms do not guarantee equitable treatment, neither of different debtors nor of different creditors. Indeed, a repeated criticism of the member countries of the Paris Club is that the private creditors do not accept the restructuring conditions agreed by the members of the Club, while still benefiting from the reduction of the burden on debtor countries, an issue that was particularly important in the HIPC Initiative. In turn, private creditors argue that they are forced to take larger haircuts in other cases in which the Paris Club only agrees to reschedule payments when the capacity to pay private debts is reduced by limited growth, the lack of debt reductions in Paris Club negotiations (the typical situation in the case of middle-income countries) *and* the ‘preferred creditor status’ of multilateral financial institutions.

The case for an orderly debt workout mechanism can thus be constructed on both efficiency and equity grounds (Stiglitz 2010). From the point of view of the efficiency in debt markets, it should guarantee appropriate incentives for creditors and debtors to negotiate an acceptable contract, allowing both to properly assess the risks which they are incurring and recoveries in case of default, and thus to estimate the adequate risk spreads of the particular loan or bond issue. Creditors should also feel sufficient confidence that their property rights are adequately protected in case of default. At the same time, the rules should avoid incentives for the borrower, if s/he runs into trouble, to unduly postpone the decision to renegotiate or default, as that would also undermine the asset values of creditors. If that happens, an efficient regime should minimize the loss associated with debt restructuring and facilitate growth in the economy involved, again protecting in this way the creditors’ asset values.

In turn, equity considerations require that all debtors and creditors be treated with similar rules, which should include seniority principles for different obligations – including, in particular, seniority for financing that is made available during the period of restructuring. In turn, this requires that the system avoid free riders, and particularly eliminate the capacity of holdouts to initiate legal disputes that affect the interests of creditors who participate in well-structured collective action. Equity conditions also require that a debtor does not offer exceptional prerogatives to creditors who provide financing when s/he starts to face payment difficulties, as those prerogatives would undermine the asset value of existing creditors.

Obviously, well-structured contracts are an essential element of capital markets. However, it would be impossible to include all possible contingencies in contracts. It is also costly or outright impossible for individual creditors to monitor all other debt contracts which a debtor has incurred or is negotiating and which might impinge on their own. Furthermore, different contracts would not necessarily be consistent among themselves, and also vary according to different legal traditions. For all these reasons, negotiations have to be considered a normal way to handle unforeseen events and, if they happen, to aggregate claims under rules that are fair and respected by all parties. In short, a well-functioning debt workout regime can actually reduce risks and transaction costs, even in the case of unexpected events that may lead to default.

A major issue is whether a potential debt workout mechanism could generate moral hazard for either debtors or creditors. Given the view of many debtors that the negotiations with creditor committees are imbalanced and, particularly, that IMF support comes with strong conditionality, it is quite unlikely that the expectation of debt restructuring would generate incentives to over-borrow. Indeed, as already noted, experience indicates that borrowing countries tend rather to postpone the use of any restructuring mechanism, largely to maintain good relations and avoid confrontation with private creditors. In the words of Bucheit et al. (2013: V), 'incentives are stacked against timely recognition and restructuring of unsustainable debts'. There might be more moral hazard concerns for lenders, particularly for those who consciously incur risks because they perceive that they can sell their assets before an eventual default. But even these concerns are unlikely to be important relative to the really important fact: the 'contagion of optimism' that characterizes booms followed by the opposite 'contagion of pessimism' that characterizes busts, with herding behaviour generating the associated boom–bust cycles. In short, the way in which over-borrowing is monitored during booms should, of course, be a major concern of macroeconomic policy and of international co-operation, and it is unlikely that a properly designed workout mechanism would worsen the problem. Indeed, over-borrowing has been present in a system that lacks such a mechanism.

However, creditors' moral hazard issues can become a major problem when a crisis erupts and there are expectations that official resources will be supplied. Under these circumstances, a delay in debt restructuring does represent a bailout of private creditors, with the flight of private capital forcing in turn a larger amount of official financing. If the debt is in fact unsustainable, official financing will in fact have 'socialized' private obligations. Furthermore, this situation will force creditors who have not jumped the ship to incur larger debt losses in the case of a restructuring, thus generating major inter-creditor equity issues. Herein lies the importance of timely actions to manage unsustainable debt burdens. The management of the 2010-12 Greek crisis can be considered as one of the best examples in history of a situation in which delay in debt restructuring led to a major socialization of debts by Eurozone institutions and governments, under conditions which, moreover, left the country with debt ratios that most analysts considered unsustainable.

3.2 Incomplete reform efforts and proposals

The lack of a multilateral framework for dealing with international debt crises involving private creditors has been a major concern of many analysts in recent decades. There have been thus numerous proposals since the 1970s to create international debt/bankruptcy courts or forums for mediation or eventual arbitration of problems of over-indebtedness. These initiatives proliferated after the 1994 Mexican crisis, and especially after the 1997 Asian crisis. The corresponding proposals came from both the political right, for whom the elimination of 'moral hazard' associated with public guarantees to private credits is an essential prerequisite for the good functioning of financial markets, as well as from the left, who saw excess debt levels as a strong obstacle to development.

The major initiative at the time was the decision of the G-10 central bank deputies to launch in February 1995 a G-10 working party under the leadership of Belgium's Jean-Jacques Rey, whose report proposing new provisions in bond contracts – collective action clauses (CACs), though they were not called as such in the report – to facilitate consultations and co-operation in the event of a crisis came out in May 1996 (G-10 1996). It was based, in turn, on proposals by Eichengreen and Portes (1995). In the late 1990s, this view was aided by the frustration of Paris Club members with the unwillingness of private creditors to go ahead with their relief efforts. Although this initiative continued to be in the background, particularly because of European support, these proposals never received at the time the explicit endorsement of the US Treasury (Gelpern and Gulati 2010). The inability to agree on the generalization of CACs was paradoxical given the fact that there was already a tradition of using such provisions in London bond issues where, by the terms of bond contracts, creditor co-ordination in bond issues is handled by a trustee, who is given the prerogative to negotiate or initiate legal proceedings. Most sovereign bonds, however, were issued under New York law and required unanimous consent to change their financial terms; moreover, the fiscal agents that distributed payments from the debtor in New York bonds did not have the powers of the trustees under British law. It could be added that creditors felt well protected by New York law, where conditions in bond contracts were very difficult to change, at least until they increasingly began to face actual defaults.

In turn, the major attempt to negotiate a statutory approach to sovereign debt crises – a Sovereign Debt Restructuring Mechanism (SDRM) – was led by the IMF in 2001-03, with initial encouragement from the US Treasury Secretary Paul O'Neil. The objective, in the terms of Krueger (2001, 2002), then IMF Deputy Managing Director, was to create a catalyst that would encourage debtors and creditors to come together to restructure unsustainable debts, by facilitating an orderly, predictable, and rapid restructuring while protecting asset values and creditors' rights. A major issue behind this proposal was also the sense that in a financial landscape in which bond financing, rather than banks, was playing a more prominent role, the growing heterogeneity of creditors had worsened the collective action problems associated with managing debt overhangs, and speculators who had bought bonds at distressed prices were interested in litigation rather than participating in restructuring[18] (i.e., they preferred to remain as 'holdouts').

The proposal varied through the period when it was considered, particularly in relation to the role of the Fund in the process, reflecting the debates that the initial proposals raised, particularly the opposition to the Fund having a very active role in debt negotiations or in the approval of the final agreements. According to the proposal, the mechanism would be triggered by the debtor country, leading to a renegotiation process with some core features: (i) qualified majority voting, with the possibility of aggregating debts within broad categories (e.g., votes by bank lenders and bondholders would not be aggregated); (ii) stay of credit enforcement (which was dropped by the time of the final proposal); (iii) protecting collective creditor interests by adopting policies that protected asset values, which could include controls on capital outflows to prevent capital flight (an independent decision that governments could in any case take on their own); and (iv) establishing a process for private creditors to potentially agree to give seniority to new private lending during a crisis (similar to lender-in-possession financing in corporate bankruptcy); short-term trade financing (involving banks) and inter-bank claims were understood to be exempt from restructuring as their disruption would impose a severe economic burden and lessen the likely recovery of value by bondholders. Given the strong opposition to the inclusion of domestic debts in these restructuring processes, it was in the end accepted that the proposal would generally involve only external debts – although in cases in which governments had substantial domestic bond issues outstanding, it was presumed that a parallel process under domestic law would restructure those bonds and the external creditors would not approve the restructuring of their claims unless satisfied that the burden-sharing with holders of domestic bonds was fair in some sense.[19] The mechanism required, in turn, independent arrangements for verification of creditors' claims, resolution of disputes and supervision of voting. In the final versions of the proposal, although the mechanism would be put in place by an amendment of the IMF Articles of Agreement, it would create a new judicial organ with safeguards to guarantee that it operated independently of the Executive Board and the Board of Governors, and provisions that the members of the organ would not be subject to interference from the staff, directors or IMF members.

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[18] The expectation of high gains when bonds have been bought at very low prices is precisely why they are called 'vulture funds' in popular discourse.

[19] See Hagen (2005). This is the most authoritative account, as the author was at the centre of the negotiations.

This proposal was rejected by both the United States, under clear pressure from its financial sector and the internal opposition within the Treasury from Under-Secretary for International Affairs, John B. Taylor, as well as by various developing countries (notably Brazil and Mexico) who feared that a mechanism of this nature would end up limiting, or increasing their costs of, access to international capital markets at a time when it was quite limited. There was also a clear opposition from the private sector to the IMF being at the centre, given the conflict of interest (since it is also a creditor), whereas civil society opposed Fund involvement due to the conflict of interest from being both a creditor and a decision maker, and because of the conditionality associated with its financial programmes. This is why ad hoc voluntary renegotiations continued to be the norm. In the early twenty-first century, the most important examples have been the Argentine debt renegotiations of 2005 and 2010, and the Greek renegotiation of 2012.

One of the major problems with this voluntary approach had been that those parties that do not accept the terms of the agreements (the holdouts) were able to go to the courts in the countries whose laws govern the contracts, to claim full payment. These demands have been successful in several cases in the past, a fact which obviously discourages participation – a problem that affects in particular the so-called 'pre-emptive negotiations', i.e., those that take place before default – and generates severe equity issues, particularly when holdouts have bought the debts at distressed prices. The alternative solution to this problem was the spread, since 2003, of the use of collective action clauses (CACs) for international bonds issued in the United States; as previously noted, this mechanism was already used in other markets, especially in London. This mechanism defines in the debt contract the majorities necessary to restructure a sovereign bond issue, nullifying the legal standing of non-participating holders of the bond issue (but not nullifying the right of other creditors to sue). As we saw, this alternative had been increasingly favoured in conceptual terms since the 1994 Mexican crisis, but only received its final impetus as a result of the search by the US government and financial sector for alternatives to the SDRM initiative (Gelpern and Gulati 2010).

The use of CACs in New York contracts became widespread after the decision by one of the major debtors opposed to the SDRM, Mexico, to include those clauses in a bond issue in March 2003; they then found that the premium paid for CACs was, if anything, negligible. The corroboration of this fact in later issues by other countries dispelled the fear that CACs would raise the cost of borrowing, and led to their generalization. This has been recently reinforced by the decision of the Eurozone countries to include CACs in all bond issues starting in 2013. This trend was combined with agreements on 'codes of conduct'. The one that stands out is the 'Principles for stable capital flows and fair debt restructuring in emergency markets' adopted in 2005 by the Institute of International Finance, a private organization composed of large international banks (IIF 2005). The code was slightly amended after the Greek restructuring.

The IMF (2013a) has recently underscored several deficiencies of this market-orientated papproach. The first is that incentives remain for both debtor countries and creditors to delay restructurings, which implies that they tend to come too little and too late, leading both to the negative effects of overhangs and to recurrent renegotiations. Furthermore, the unsuccessful Argentinean litigation in US courts in 2013-14 on the interpretation of the *pari passu* clause[20] has exacerbated the collective action problems by increasing the leverage of holdouts, as it has prohibited Argentina from making

[20] This clause has been generally interpreted as equal ranking but it has come to be interpreted by NY courts in this case as equal 'ratable payments', which increases the negotiating power of holdouts, affects third parties, and may even undermine the doctrine of sovereign immunity.

payments on its restructured debts if it does not pay in full its unrestructured debt. The incentives to participate in any restructuring would thus be significantly reduced. On the other hand, the need to aggregate different claims by including aggregation clauses in debt contracts is now broadly accepted and essential to guarantee inter-creditor equity among bondholders, but until recently only four countries (Argentina, the Dominican Republic, Greece and Uruguay) had included these clauses in their issues, with Uruguay leading the way in 2003. Aggregation is required in Eurozone bonds since 2013, with 75 per cent of bondholders summed across all relevant issues approve a proposed restructuring, plus 66.66 per cent of the holders of each individual bond issue.

Based on the problems raised by Argentina's litigation, the International Capital Market Association (ICMA 2014a and 2014b) and the IMF (2014) proposed the inclusion of aggregation clauses in debt contracts as well as a revision of the pari-passu clause[21]. Mexico led again the way, by including the new clauses in a November 2014 debt issue in New York –Kazakhstan had done so for a new issue in London in October—, with no effects on the cost of the issue. It also changed from a fiscal agent to a trustee to represent the bondholders in negotiation with debtors (the London system). Following the 2003 experience, when Mexico led the way in introducing CACs in New York issues, these conditions are likely to spread. In any case, aggregation does not exclude the possibility of blocking majorities in individual issues[22] and fails to guarantee the coherence between bond and other debt contracts, particularly with syndicated bank lending. Also, according to the IMF (2013), the impact of credit default swaps has not been fully tested, and certainly reduces the incentive to participate in debt renegotiations and introduces a whole new set of actors into the process, some of whom may be simple speculators with no debt in their hands.

To these considerations we could add that, although the revised CACs could solve future problems, they would not solve the legacy of existing debt for some time, which would be made worse by the aggregation problems that would continue in place so long as aggregation clauses are not included in debt contracts. The traditional division between external and internal debt is also being blurred by the increasing participation of international funds in the domestic debt markets of emerging economies. Furthermore, the traditional separation between official and private creditors, and those of their restructuring mechanisms, has been made more complex by the rise of the official lenders who are not members of the Paris Club (notably China), the now traditional institutional setting in which bilateral debts with bilateral public creditors are renegotiated. The inequities that could be generated between the two realms of restructuring have been noted by both sides, with different views about the associated issues. This may imply that in the future, 'aggregation' should refer not only to liabilities with private creditors but to *all* obligations, including multilateral lending, with proper seniority rules, favouring in particular creditors who provide funding during crises.

In a parallel way, the United Nations has been part of this debate, reflecting the call in the 2002 Monterrey Consensus on Financing for Development for financial crisis management mechanisms 'that provide for fair burden-sharing between public and private sectors and between debtors, creditors and investors' (United Nations 2002, point 51). This has led to numerous consultations in the context of the UN's Financing for Development process (Schneider 2014), UNCTAD's proposals of some 'Principles on Sovereign Lending and Borrowing' (Espósito, Li and

[21] Change of language was introduced to eliminate any interpretation requiring ratable payments (see previous footnote).

[22] This is what happened with some London issues in the Greek renegotiations of 2012; at the time there were, in any case, no aggregation clauses.

Bohoslavsky 2013) and, perhaps most importantly, the proposals by the United Nations Commission of Experts on Reforms of the International Monetary and Financial System, better known as the Stiglitz Commission (United Nations 2009).

The need to have a better framework for debt resolution remains, therefore, one of the major gaps of the international financial architecture. It has led to extensive debate, which referred in the past to emerging economies but now also to the European periphery[23], and to numerous proposals on how to reform the system[24]. Following Schneider (2014), there are three basic ways forward. The first one would be to improve the 'contractual technology'. This would require the need to generalize the use of aggregation clauses in bond contracts. This is the approach taken by the Eurozone since 2013, and more recently by the International Capital Market Association and the IMF. The basic problem is how to manage creditors who may still obtain a blocking position for a particular bond issue. It would also require the new pari passu clause and the generalization of the system of trustees to represent bondholders in negotiations, and perhaps some formal standstill provision. Even the best of all solutions in this area face, in any case, the problems previously mentioned: the long transition that has been associated with the fact that CACs only started to be used in New York in 2003, aggregation clauses are only starting to spread, and there are the additional problems associated with the management of debts with the private vs. the official sectors, external vs. domestic liabilities, and credit default swaps.

The second route is the negotiation of a statutory regime, which would create an International Debt Court, with clear rules on priority of claims and inter-creditor equity that would be legally enforceable in the main financial markets. According to the foregoing analysis, the Court would ensure that the agreed international principles of a fresh start, equitable sharing of haircuts and priority of claims against the debtor government were followed. It would thus correct the two main flaws in the ad hoc structure which has arisen over time: it would lead to restructurings that benefit both creditors and debtors (the essence of a good arrangement in this field) and it would give equitable treatment to different debtors and creditors according to principles that could be agreed internationally. The Stiglitz Commission has put on the table the most interesting proposals in this field (United Nations 2009: ch. 5). The mechanism could also work on the basis of case-by-case arbitration panels convened by the relevant parties under internationally agreed arbitration rules (Kaiser 2013). There are also other academic proposals as well as a few on a specifically European mechanism of this type.

The best alternative would be, however, to mix the voluntary and statutory solutions, by creating a mechanism similar to the World Trade Organization's (WTO) dispute settlement mechanism,[25] in which there is a sequence of voluntary negotiations, mediation and eventual arbitration that take place with pre-established deadlines, thus generating strong incentives to reach agreement under the 'shadow of the court'; the existence of the mechanism could also encourage its timely use, but this is not guaranteed. The process would start with the declaration of moratorium by the debtor country, which would unleash the negotiations. As in national bankruptcy regimes, the first step

[23] See, for example, the essays collected by Herman, Ocampo and Spiegel (2010a) and Paulus (2014), respectively.

[24] See an inventory of proposals in IMF (2013a) and Das, Papaiouannou and Trebesch (2013), as well as proposals by the Stiglitz Commission (United Nations 2009), the Brookings Institution's Committee on International Economic Policy and Reform (Buchheit et al. 2013) and civil society, particularly those of Kaiser (2013), among others. See also the excellent survey by Panizza, Sturzenegger and Zettlemeyer (2009) of the economic and legal issues involved.

[25] My own early ideas on the subject were included in Herman, Ocampo and Spiegel (2010b). Of course, in contrast to the WTO mechanism, which involves controversies among countries, the mechanism would involve a negotiation between a debtor country and private creditors.

would be the attempt by the defaulting country to reach a voluntary agreement with creditors. The process should also serve as a framework to co-ordinate the positions of creditors within and across different classes of lenders (including eventually official creditors, both Paris Club members and non-members). If this first stage fails within the agreed deadline, the institution in charge would move to mediating in the dispute as an 'honest broker'. Again, if the deadline for this second stage ends without an agreement – or, if requested by both parties before the deadline – this broker would arbitrate the dispute, leading to a decision which is legally binding for all parties. As in national 'debtor-in-possession financing', it would also have the authority to ask creditors to provide new financing to the country undergoing debt restructuring. These new debts, as well as all financing provided when the country is in default (e.g., IMF 'lending into arrears', loans by multilateral development banks and official bilateral creditors and private trade financing) would have seniority over defaulted debts.

The mechanism could be created as an independent body under the UN system. This would require negotiating a new international treaty, which would be a time-consuming effort both in terms of negotiations and ratifications, with the possibility that countries which host major financial centres would not ratify it. So a better alternative would be that which was tried in 2001-03, an amendment to the IMF Articles of Agreement, so long as it could function through a system of *independent* panels of experts and a body with final judicial decision-making capacity, similar to those used under WTO's dispute settlement This is implicit in Krueger's (2002) proposal that the debt resolution organ would operate independently of the Executive Board and the Board of Governors, and with strong provisions to avoid interference from the IMF staff, directors or member states.

As Herman, Ocampo and Spiegel (2010b) have argued, it would be desirable for this mechanism to operate as a single system for relief. Although the poorest countries may require special treatment to support their recovery after crises, this task should be left to the aid regime – i.e., to official development assistance. A complementary but major task of multilateral development co-operation is to support countries that have undergone debt restructuring to have a smooth and hopefully speedy return to markets. Multilateral Development Banks (MDBs) can play a crucial role in this regard, through co-financing or the issue of guarantees to new debt issues by countries. A Sovereign Debt Restructuring Facility within the IMF, combining IMF lending and debt restructuring, could also play that role (Buchheit et al. 2013) but is less desirable, as many more countries are willing to use MDBs rather than IMF facilities (see the second section of this paper).

The workout mechanism designed should deal primarily with sovereign debts, but there are two other individual cases that should be taken into account. They are private-sector debts that are 'nationalized' during crises as part of bailouts, particularly of financial sectors, and cases where private-sector debts cannot be serviced because they would generate balance of payments problems. In the first case, the external liabilities should be treated as corporate debts that should be renegotiated as such, as part of the cleaning of the balance sheet of the institution involved, and may therefore involve larger amounts of haircuts. This procedure would help reduce the pressure exercised by foreign creditors to take over private-sector debts during crises, which has been a practice in many emerging and developing countries in the past and has added substantial amounts of previously private-sector debt to the sovereign state's obligations. In the case of balance of payments crises, an agreement should be reached as to how domestic private debtors can convert their payments in local currency into foreign exchange.

Finally, three complementary mechanisms would be required. The first is an international registry of debt, which would be best managed by the institution in charge of debt restructuring. The second is the creation of effective mechanisms for creditor co-ordination for individual renegotiations, a problem that has become more complex given the diversity of creditors. This should be part of the rules that establishes the eventual mechanism. The third is a Sovereign Debt Forum, which could be a multi-stakeholder process that could be organized under the umbrella of the UN Financing for Development process, thus providing for the participation not only of governments and international institutions but also of the private sector and civil society.

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