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

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Revised, May 2000

I. Introduction

Moral hazard is increasingly seen as a problem in international financial markets, and private-sector burden sharing is increasingly seen as the solution. Investors, it is argued, have been able to escape the financial costs of crises through the extension of international rescue loans. These "bailouts" (as they are described by their critics) give governments the funds they require to pay off their creditors, who are then able to exit the crisis country free of losses. Not being subject to the costs of crises, investors disregard the risks of lending, and the consequent lack of market discipline allows feckless governments to set themselves up for a painful fall. Hence, finding ways of ensuring that the creditors do not escape all losses as a result of support provided by the international financial institutions (IFIs) — seeing that investors, rather than being "bailed out," are "bailed in" — is central to any strategy for strengthening market discipline and thereby reducing the likelihood of future crises.[2]

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

[2] Additional reasons for dissatisfaction with the status quo are that the IFIs, as presently capitalized, do not have the resources to engage in a number of simultaneous rescue operations a la Mexico in 1994 and Korea in 1997 (DeGregorio, Eichengreen, Ito and Wyplosz 1999), and that taxpayers in the United States and other countries are reluctant to allow them to do so (International Financial Institution Advisory Commission 2000).

These are easy bromides on which to agree. Moving from bromides to policies is harder. There is no agreement about how the costs of a crisis should be shared among the parties, much less a mechanism for implementing that agreement. Some argue that creditors already bear their fair share of the burden — witness, for example, the losses incurred by investors in Asian stock and bond markets in 1997 and following Russia's default in 1998.[3] Attempts to impose yet additional losses on investors, they argue, would render it less attractive to lend to developing countries, which already find it costly to access international capital markets. The presumption that crisis countries will regularly restructure would dangerously weaken the bonding role of debt. And extending the policy to Brady bonds and eurobonds would hinder efforts to create the predictability and the clear seniority structure needed to support the international transfer of capital.

While the critics have a point, neither is it feasible to simply let the moral hazard problem fester. Hence, the IFIs have been experimenting with strategies for addressing it. In particular, in a small but growing number of emerging markets with structural and macroeconomic problems, they have sought to condition official assistance on the willingness of investors to share in the costs of adjustment (by rolling over maturing loans, lending new money, and/or restructuring existing obligations).

Unfortunately, these experiments with conditioning official assistance on "private sector participation" have been less than successful. Investors have been reluctant to play their designated part. The reason is structural. A new strategy built on statements of intent that does

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

not also change the underlying payoffs will not be taken at face value. Because it is not credible, it will not change the strategies of market participants. It will not alter their interaction with the multilaterals and the debtor.

To illustrate, consider a case (call it "Ukraine") where the IMF commits not to lend to a country with financial problems unless the markets first roll over their maturing credits. By threatening to stand aside and confront investors with a costly default if they fail to contribute, the Fund's intent is to create an alternative to bailouts and the moral hazard they create. But investors have no incentive to commit money to a country with such uncertain prospects if the Fund's own commitment -- that it will not disburse unless the markets contribute first -- lacks credibility. If the alternative to IMF disbursements is default and restructuring negotiations, and the Fund regards restructuring as unacceptably costly for the country and the international community, it will not be able to stand back and allow the country to be consigned to an extended period of divisive negotiations and lost market access. To avoid this painful default and its repercussions, the IMF will back down and disburse anyway, allowing the crisis country to pay off its creditors. And knowing this, investors will not roll over their maturing credits in the first place. The outcome will be the same as before the new burden-sharing strategy was attempted.

The only way of changing this outcome is to change the structure of the game and the associated payoffs (as opposed to merely issuing incredible statements of intent). If restructuring is made less difficult and therefore more tolerable for the crisis country (and, by implication, the international community), then the Fund will be able credibly commit to stand aside if the markets do not contribute. The obvious way of altering the structure of negotiations in this way is by encouraging the introduction of renegotiation-friendly provisions into loan contracts (and, if necessary, using World Bank adjustment lending and IMF contingent finance to strengthen the incentives to move in that direction). The leading proposal along these lines (but not the only one) is the addition of collective action clauses (majority voting, sharing, non-acceleration, and creditor representation provisions) to bond documentation.[4] The addition of collective action clauses would ease the restructuring process. By changing the payoffs to the IFIs, investors, and debtors, it would change equilibrium strategies. Unlike the present approach, it would make it possible for the IMF and the World Bank to credibly commit to bailing in the private sector.[5]

The remainder of this paper elaborates these points. Section II starts by analyzing in more detail the problem of private-sector burden sharing and explaining why this issue has become so

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[4] Other proposals along these lines include forming standing committees of creditors and appointing a mediation service to act as "honest broker" between the debtor and his creditors (two additional suggestions from Eichengreen and Portes 1995), allowing the IMF or another international body to sanction a payments standstill (Miller and Zhang 2000), and requiring all international loan agreements to include an automatic debt rollover with penalty, or UDROP (Buiter and Sibert 1999). Focusing on the first three proposals are appropriate if it is one's judgment that most countries that experience crises have problems with fundamentals that require debts to be restructured in the absence of a bailout; a case can then be made for CACs, creditors' committees and mediation services on the grounds that collective-action problems and information asymmetries hinder the requisite restructuring negotiations. UDROPs and internationally sanctioned standstills are appropriate if one instead believes that most crises are caused by creditor panic, and that all that is required to restore order to financial markets is a cooling-off period. We are of the belief that most crises are rooted in fundamentals; hence we focus on the remedies relevant to this circumstance. Of the three options that then remain relevant, CACs appear to be taken more seriously than standing committees and mediation services by market participants, perhaps because it is believed that problems of collective action more than asymmetric information are the principle obstacle to restructuring negotiations.

[5] The idea of collective action clauses is not new, although we motivate their adoption somewhat differently here. The case for their adoption was advanced by one of the present authors in wake of the Mexican crisis in a paper (Eichengreen and Portes 1995) written for the U.K. Treasury and Bank of England in preparation for the deliberations of the Rey Committee. That committee cautiously endorsed the proposal (see G10 1996). A variety of other official bodies and outside commentators reiterated this case following the Asian crisis. See for example G-22 (1997). The G-7 then placed the issue on its work program for reforming the international financial system.

prominent in the policy debate. It describes the different approaches taken to the problem of encouraging "private-sector participation" in crisis resolution. It emphasizes the difficulties with all these approaches so long as the IFIs cannot credibly commit to stand aside and allow insolvent governments to default. This leads directly to a discussion of the alternative of collective-action clauses.

In Section III we document these points, drawing evidence from the four IFI experiments to date with bailing in the private sector, in Ecuador, Pakistan, Romania and Ukraine. We focus on these countries because they are the four cases where the official community has expressly attempted to implement its new "burden sharing" strategy.[6] In all four cases, the focus is bonds, not the bank loans that created such problems in Thailand and Korea in 1997. It is sovereign debts, not the private debts that were the problem in Indonesia. Focusing on bonds is appropriate insofar as the ongoing process of securitization makes them the wave of the future.[7] And

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[6] To be clear, the common element is ***not*** that these four countries have been forced to default. Rather, these are the four cases where the official community has experimented with new approaches to seeing that the private sector bears some of the costs of crisis resolution, whether through restructuring, rolling over maturing obligations, or contributing new money. And the point is ***not*** that in all four cases the private sector has in fact been forced to restructure, roll over maturity claims, or contribute new money, for, as we shall see, the new strategy has not been particularly successful. At the time of writing, Nigeria is emerging as a fifth test case, but events there have not yet come to a head; until negotiations develop further, discussion of this case would be premature.

[7] This is not to say that bank debt is unimportant, only that it is likely to be less important in the future than the past. In any case, it is not the focus of this paper, since it is not the focus of bail-in efforts in Pakistan, Ecuador, Romania and Ukraine. Courtesy of the crises in South Korea and Thailand (and the Latin American debt crisis of the 1980s), the international community now has considerable experience with this problem, the solution to which involves assembling representatives of the banks and negotiating their forbearance. Observers who question whether past "successes" can be repeated recommend the use of tax and regulatory policy to discourage resident banks and corporations from funding themselves via short-term loans from foreign banks in the first place. See the discussion in Eichengreen (1999a). Another suggestion (e.g. Buiter and Siebert 1999) is to require bank loan agreements to include clauses providing for a debt-rollover-

focusing on sovereign debt is also appropriate insofar as mechanisms already exist for restructuring private debts (namely, domestic bankruptcy and insolvency procedures) through whose operation investors already take a "hit" when debt-servicing problems arise.[8]

As we document, the new strategy has met with at best limited success. Even mixed success has been achieved only in those cases, Pakistan and Ukraine, where some or all of the relevant bonds already include collective action clauses. Thus, the evidence from four case studies on which we focus is consistent with our two central hypotheses: first, that bailing in the private sector remains extremely difficult under prevalent institutional arrangements; and, second, that these institutions need to be changed through the more widespread adoption of collective action clauses to make alternatives to bailouts a viable option.

Before proceeding, it is important to specify the criteria on which the success of alternative approaches to crisis management should be evaluated. First, the international community should prefer approaches which reduce moral hazard, limit the incentives for excessive

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with-penalty option. While we are sympathetic to this approach, we are also skeptical: unlike the collective action clauses in bond covenants discussed later in this paper, which actually exist in the real world (some 40 per cent of the international bonds issued by developing countries in the 1990s are subject to U.K. governing law and therefore contain at least limited collective-action provisions, as we explain below), debt-rollover-with-penalty options remain in the realm of theory; we have no practical experience with them.

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

risk taking by borrowers and lenders, and therefore minimize the incidence of future crises. Second, it should prefer approaches that enhance the access and minimize the cost of external finance for capital-scarce emerging-market borrowers, subject to the preceding criterion.

II. Burden sharing in theory

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

To date, the IMF has explicitly adopted a case-by-case approach to the problem of securing greater private sector burden sharing (IMF 1999a,b). Attempts to secure greater private-sector involvement: writing down liabilities to private investors, and encouraging the markets to provide new money (or roll over existing claims).[9] Securing new money has been difficult. In the unsettled climate that surrounds a crisis, investors prefer to hold off extending additional credit until the uncertainty has been at least partially resolved. If there is even the possibility that the government lacks the willingness or capacity to pay, investors will be reluctant to increase their commitments, and the country's liquidity needs will have to be met by the IFIs.

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

The latter can ask the markets to provide matching money, but given the option value of waiting, a positive response cannot be guaranteed.

Collective-action and free-rider problems compound these difficulties. To be sure, new money, by allowing a country to surmount an otherwise disruptive liquidity crisis, can have a high rate of return.[10] But even if investors as a group are better off if they ante up additional funds, each investor may nonetheless prefer that others provide the new money needed to solve the problem. The share of private money will approach zero as collective-action problems grow more severe.

The IFIs could condition their disbursements on the markets first agreeing to provide new money.[11] Imagine that a costly default can be averted only if the markets and the multilaterals ante up, but the multilaterals announce that they will not contribute unless the markets do so first. Knowing that they will suffer the consequences of a costly default if they fail to organize a response, investors have an incentive to find a way around their collective-action problem. This, it will be recalled, was the IFIs' strategy for encouraging concerted lending to crisis countries in the early 1980s.[12]

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

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[10] In other words, in addition to earning interest, the new money may raise the value of pre-existing claims.
[11] There is now some experience with this approach, as we will see below.
[12] Boughton (2000) is a comprehensive account of these cases.

Moreover, default is costly for the country as well as its creditors and, by implication, for the IFIs that have the country's interests at heart. Given the difficulty of restructuring sovereign bond contracts, a default may result in an extended period during which all market access is lost. Since investors are aware of this fact, giving them veto power over multilateral disbursements arms them with an additional weapon to be used in their skirmish with the country.[13] Moreover, investors may doubt, with good reason, that the IFIs are really prepared to stand aside unless the markets ante up new money. They may believe that the multilaterals will offer assistance in the end whether the markets provide new money or not, in order to avoid even more costly disruptions. It follows that the new policy, predicated purely on statements of intent, is not credible and leaves the status quo unchanged.

It may have been this realization that led the IMF to its new policy of lending even when a country is in arrears on its bonds as well as its bank loans. Recent Executive Board decisions permit the Fund to lend to a country even when the latter is in arrears to private creditors, so long as it is making good faith efforts to negotiate and adjust. Lending into sovereign arrears is something that the Fund has long done when a government is making a concerted effort to adjust and has shown good faith in its negotiations with the creditor community. The September 1998 decision by the Fund's Executive Board merely broadened the policy from bank loans to incorporate bonds and other nonbank credits. The rationale is straightforward: the provision of official funds gives the country the essential liquidity it needs to survive the interruption of market

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

access, and the fact that official funds are not conditioned on a prior agreement with investors may induce the latter to accept less than 100 cents on the dollar. Hence, IMF money that goes in the front door does not automatically go out the back door as payoffs to private investors, lessening the moral hazard problem.

But lending into arrears is a feasible strategy for the IFIs only if arrears can be cleared away and the debtor's relations with the markets can be normalized within a reasonable period of time. Otherwise, lending into arrears will have to take place on a scale and for a length of time incompatible with the resources of the IFIs and with the desire for the early normalization of debtor-creditor relations. And so long as debt restructuring remains a complex and messy process, there are reasons to doubt the feasibility of this approach.

For one thing, substituting official funds for private funds for an extended period is both impractical and undesirable. This is evident in the terms of the IMF Executive Board's decision to lend into arrears, which authorized the policy only under circumstances where the borrower is engaged in good-faith negotiations that are likely to clear away the overhang of nonperforming debt at a relatively early date. The point of the bail-in exercise is to rely more on market discipline and less on official finance. This makes lending into arrears problematic if it is not possible to clear away the arrears and restore market access promptly. Both the theory of incomplete contracts (Hart 1995) and evidence (Suter 1992, Aggarwal 1996) suggest that agreement to clear away arrears can be difficult to reach. The efforts of various crisis countries to avoid being declared in default and their resistance to multilateral pressure to go down the restructuring road are testament to their perception that the costs of restructuring are high.

The crux of the matter is thus the very great difficulty of restructuring sovereign debts under prevailing institutional arrangements. Most emerging market bonds are bearer bonds; not only are they widely disbursed, but their owners are not registered with the debtor, the underwriter, or anyone else. This can make it difficult for a government to get in touch with its bondholders to avoid a formal declaration of default, the activation of acceleration and cross-default clauses and the initiation of legal action, which will then close off other avenues of credit market access. Moreover, American-style instruments, governed by New York law, typically require the unanimous consent of the bondholders to the terms of a restructuring and do not even provide for a bondholder assembly, immensely complicating the task of restructuring existing obligations.[14] American-style bonds generally contain no prohibition on legal action by dissident bondholders, exposing those seeking to restructure to lawsuits from "vultures" seeking to hold up the restructuring process.[15]

This brings us to the other approach to encouraging private sector burden sharing: amending loan contracts to include sharing, majority voting, collective-representation, and non-acceleration clauses in order to ameliorate the problems identified above. Such modifications of loan contracts would ease the restructuring process. The restructuring of problem debts could then be left to the consenting adults involved.[16] Countries that attach a high value to the

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

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

[16] Greater reliance on the markets is, after all, the purpose of the bail-in exercise.

maintenance of market access would be free to take the extreme measures needed to keep current on their debts, while restructuring would now be viable for countries without the same capacity to adjust and which therefore attach priority to obtaining an immediate reduction in debt-servicing costs. Countries that value a well-defined seniority structure could choose to restructure junior debts while leaving senior debts untouched. Asking for new money even where it was not needed as an alternative to haircuts, which under present arrangements can be impossibly difficult to administer and which are unattractive even to the borrower, could be avoided because it would now be feasible to restructure instead. Limited IMF lending into arrears would become feasible if renegotiation-friendly provisions in loan contracts could be used to avert a major financial drain and extended loss of market access.

How would these provisions work?[17] Sharing clauses like those included in the syndicated bank loans that dominated international lending in the 1970s, which require the litigant to share the proceeds with the entire class of creditors, would thereby discourage maverick creditors from resorting to lawsuits and erecting other obstacles to a settlement beneficial to the debtor and the majority of creditors. Majority voting clauses would allow the core terms of a loan agreement to be altered by a qualified majority vote of the bondholders rather than requiring their unanimous consent as is typical of bonds currently subject to New York law. This would allow long-standing bondholders with a long-term relationship to the borrower to “bind in” vultures who had purchased the bond at a deep discount following the suspension of payments and were now seeking to hold up any settlement in order to be bought out on favorable terms by the other

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[17] Our discussion of these provisions is brief, since they have been extensively described in the literature. See for example Buchheit (1998a,b,c), or, more recently, Dixon and Wall (2000).

creditors. Collective-representation clauses specify who represents the bondholders (a trustee or fiscal agent) and empower that individual to call a bondholders assembly or meeting would allow orderly solutions to be reached.[18] And non-acceleration clauses establish a minimum threshold of bondholders required to accelerate (demand immediate repayment of principal) following default prior to maturity.

The fundamental objection to this approach is that renegotiation-friendly provisions would make it too easy for countries to walk away from their debts.[19] CACs would weaken the bonding role of debt. They would disrupt credit-market access and raise borrowing costs. On the other hand, provision for orderly restructurings would make emerging-market issues more attractive by minimizing acrimonious disputes, unproductive negotiations, and extended periods when no service was paid and growth was depressed by a suffocating debt overhang.[20] One could readily imagine that CACs, like an efficiently designed bankruptcy code, could reduce rather than raise borrowing costs.[21]

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[18] Explicit provision for representation of the bondholders is, in a sense, an essential concomitant of majority voting clauses, since it is hard to envisage a majority vote in the absence of mechanisms for contacting, assembling and polling the bondholders.

[19] This argument implies that allowing restructuring subject to anything less than 100 per cent consent will create moral hazard for the borrower. Hence, the International primary Market Association has expressed a preference for setting the requisite majority at high levels, say, 90 per cent of bondholders attending a meeting (Dixon and Wall 2000). There is also an opposing argument, suggested to us by one of our referees, that setting the majority requirement so high might allow a relatively small number of private creditors to strategically "hold up" negotiations. The requisite majority can and does vary by bond issue, depending on the import attached to these counterveiling considerations. As Dixon and Wall observe, "There are no optimal fractions, but in practice the most common threshold for majority action clauses included in bond contracts has been a majority vote of 75%."

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

[21] In addition, adding CACs to new loan agreements would not solve the problems created by the existing stock of bonds. The average term to maturity of international bonds is on the order of

Whether CACs raise or lower borrowing costs is an eminently testable question, for bonds governed by UK law typically already include provisions enabling the holders of debt securities to call a bondholder assembly empowered to pass extraordinary resolutions addressing issues relating to the settlement of defaults or other modifications to the original bond covenant subject to the consent of bondholders holding a clear majority of the outstanding principal. Such resolutions are binding on all bondholders so long as the requisite majority has agreed. Thus, it should be possible to determine the impact of collective-action clauses on the cost of borrowing for emerging markets by comparing the pricing of otherwise comparable bonds governed by U.S. and UK law.

An attempt to do so has been made by Eichengreen and Mody (2000). Their results do not indicate a large impact on borrowing costs. But this negligible overall impact disguises very different effects on borrowers with worse and better credit ratings. Collective-action provisions reduce the cost of borrowing for the most credit-worthy issuers, for whom default is unthinkable except in extremis, but who benefit from being able to avail themselves of an orderly restructuring when those exceptional circumstances obtain. For less credit-worthy issuers, in contrast, there is evidence of higher spreads. We conjecture that for less credit-worthy borrowers the advantages of provisions facilitating orderly restructuring are offset by the moral hazard and additional default risk associated with the presence of renegotiation-friendly loan provisions.

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five years, but some have as long as 20 years to run. However, new provisions could be added to existing loans through a voluntary exchange of old bonds for new ones. Such operations could be expensive, but the IFIs could provide concessionary finance to help defray the costs. If attenuating the moral hazard associated with the absence of alternatives to international bailouts is viewed as buttressing global financial stability, then such subsidies from the IFIs could be justifiable on public-good grounds.

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

III. Burden sharing in practice

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

Figures 1 and 2 summarize the debt situation in these countries using national accounts and Bank for International Settlements data.[22] Debt and debt service have been on the rise in all four countries. There has been a decline in the relative importance of long-term debt, with the possible exception of Pakistan, although multilateral finance has risen, in both absolute and

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

relative terms, thereby filling the gap.[23] The growing importance of claims on the private sector is evident in all four countries.[24]

Notwithstanding these similarities, these four countries had fundamentally different problems when they became the subjects of the IFI's efforts to encourage private sector participation. Ecuador and Pakistan were experiencing very serious economic and political crises, creating reasons to doubt they had the capacity to service their heavy inheritance of debts. Both countries subsequently defaulted on their international obligations. Pakistan incurred sanctions as a result of its nuclear tests and a loss of investor confidence as a result of its military coup, while Ecuador has suffered a very severe recession and continuing political unrest, including a short-lived military takeover. Ukraine and Romania, in contrast, have relatively light debt loads, as is typical of the transition economies, but sharp repayment peaks that will create liquidity problems unless their maturing debts are rolled forward. Romania has managed to meet its obligations to date, while Ukraine is in the process of restructuring.

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

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

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

problems has followed a broadly similar pattern and encountered similar problems in all four instances.

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

In the summer of 1999, Ecuador sought to negotiate a new IMF program, whose conclusion was a precondition for the release of money committed by the World Bank and the Interamerican Development Bank.[25] The problem facing the government was a fiscal and balance-of-payments crisis. The fiscal balance was deteriorating, and in the context of high unemployment and extreme poverty the government lacked the political support needed to raise taxes sufficiently to continue servicing its foreign debts in full while at the same time defaulting on a variety of domestic social and political obligations. The markets appear to have anticipated the country's repayment problems: Figure 4 indicates a steady erosion of the spreads on Ecuador's eurobond since the beginning of 1999 (after its bonds had recovered from the Russian crisis in parallel with other markets). Nevertheless, there was considerable uncertainty in the first half of the year about whether the government would stop paying, or whether it might somehow come up with the resources needed to service its debts.

When negotiations with the IMF bogged down in the summer of 1999, the markets reacted negatively.[26] In August, President Jamil Mahuad announced that the authorities had

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

[26] Although the final impact remained limited, J.P. Morgan's emerging market index showed an increase of borrowing costs (with the spread rising from four to seven percentage points above US Treasuries) in reaction to news from Ecuador (Fuerbringer 1999). Commentators warned that spreads for emerging market borrowers in good standing would react to the IFs acquiescence to

decided not to pay $96 million of interest due on a subset of the country's $6 billion worth of Brady bonds, whose interest and principal were collateralized. Apparently the authorities' expectation (and that of their foreign advisors) was that this would force the bondholders to come to the table to negotiate restructuring terms. The country bought time and avoided immediate default by paying interest on its non-collaterilized Brady bonds (past due interest (PDI) bonds) while asking investors in collateralized Brady bonds (Discount bonds) to use the 30 day grace period to authorize the release of interest collateral.

Using this collateral to make interest payments would have avoided a formal default on the Discount bonds (and the activation of cross default clauses affecting other instruments) and provided a breathing space for restructuring negotiations. Presumably this was why the Brady bonds were chosen as the first instrument to restructure, and why the IFIs acquiesced. The authorities subsequently offered to swap Brady bonds for long term domestic bonds in a voluntary debt exchange, while using the interest collateral as a sweetener to encourage the creditors holding Discount bonds to engage in restructuring talks.[27]

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policies compromising an instrument explicitly designed to reschedule loans which could not be serviced in the past (Luce and Moss 1999). In addition, bondholders demanded that IFIs themselves be no longer exempted from sharing the costs of the default (Remond 1999).

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

In the event, investors dissatisfied by these terms called the necessary quorum of 25 per cent of all bondholders to vote for acceleration before the authorities could marshal an agreement to restructure.[28] Ecuador was asked to accelerate the principal on its outstanding Brady bonds, constituting the first default on these instruments since their inception in 1990. On 25 October the country also failed to meet its eurobond coupon payments, and at the time of writing it is still seeking to restructure its private-sector external debt.

The markets' presumption throughout this period was that the IMF would condition its assistance on a prior agreement between the country and its creditors to restructure or refinance. Speculation was widespread that, in the absence of such an agreement, the Fund would "force" Ecuador to default. On September 27th -- three days before the government was informed of the decision to accelerate -- the Fund issued a statement that it would not insist that the country reach an agreement with the holders of its Brady bonds as a precondition for official assistance; all that was required were good-faith negotiations. While this decision was consistent with the Fund's policy of lending into arrears, it did not enhance the institution's reputation for consistency, coming as it did after weeks of silence which was widely read as implying that the Fund would lend only if Ecuador restructured first. Moreover, the Fund's belated announcement may also have been wrongly interpreted by the Ecuadorians as "approval of" or "support for" nonpayment. It does not appear that the IFIs warned the authorities that attempting to continue servicing some debts while suspending payment on others would be seen by the markets as "low play." It does not appear that they warned the Ecuadorians that selective nonpayment was more likely to activate cross-default and acceleration clauses than to drive the creditors to the bargaining table.

[28] 25 per cent of the creditors were formally required to accelerate, but the legal options of the remaining bondholders appear to include litigation (Oxford Analytica 1999).

Ecuador's experience illustrates the difficulty of arranging an orderly restructuring when the appropriate legal and institutional means are absent.[29] It is not possible to drive the bondholders to the negotiating table when there is no negotiating table to be driven to. Since the country's bonds lack collective-action and bondholder-representation clauses, the difficulty of conducting restructuring negotiations is extreme.[30] And contrary to the government's expectations, this selective default did major damage to the country's credit worthiness. In particular, the concentration on Brady bonds destroyed the existing seniority structure, hitting collaterized Bradys before noncollateralized Bradys notwithstanding the market's presumption that the former were senior to the latter, which is likely to drive away potential future senior creditors. It affected domestic bond holders unevenly, i.e. only to the extent to which cross default clauses were activated.[31]

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

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

[30] To be sure, while this may be part of the explanation for the lack of progress to date, it is not the entire story. As Dixon and Wall (2000) write, "Since defaulting in October 1999, Ecuador — whose obnds do not have CACs — has made little progress on reaching agreement on a restructuring. It is likely, however, that political and economic issues rather than the absence of CACs have been the key factors in impeding progress."

[31] Agnelli and Gavin (1999) emphasize this point.

markets.[32] By suggesting that what had happened in Ecuador would not be allowed to happen elsewhere, the IFIs diminished the precedential value of the experiment.

Ukraine. Circumstances in Romania and Ukraine differ from those of the other two subject countries. The two transition economies both benefit from the fact that the debt burden, at less than 30 per cent of GDP, is relatively light, something which is true for most transition economies, which had limited access to credit markets or had taken extraordinary steps to liquidate the debt. (See Figures 2B and 2C.) Nonetheless, borrowing decisions since the beginning of the transition have created payment peaks which may be too steep to surmount.[33]

Different from the other cases, Ukraine already concluded several exercises in debt rescheduling prior to the elaboration of the new policy. These involved restructuring a fiduciary loan and domestic treasury bills held by foreigners in the autumn of 1998 and again in June of 1999, both while an IMF program was in place.[34] A three-year extended Fund facility effective since September 1998 (and on hold between November 1998 and March 1999) that recently resumed disbursements includes reserve targets implying that these repayment peaks cannot be met and principal can not be repaid under realistic assumptions about privatization receipts. The program therefore implies that the country's obligations will have to be restructured, a process which was underway as this paper went to press.

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

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

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

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

Faced with Regent Pacific's ultimatum, Ukraine managed to make the payment while avoiding violation of the IMF's reserve target.[35] It scraped together the resources by re-opening a eurobond due in 2001, repayment of which constitutes the last and the largest of the country's impending repayment peaks. The Ukrainian authorities and their bankers "tagged onto" this bond an additional issue, adding DM538 million to the DM1 billion eurobond due in the Spring of 2001. The proceeds were used to finance Regent Pacific's exit. But in fact little cash was raised, and most of the additional issue was swapped at attractive rates against claims on another bond due in the autumn of 2000. Figure 5 illustrates the consequences, namely a staggering repayment peak in March of 2001.[36]

The effect was thus to maximize the size of the wall against which repayment efforts would ultimately run. Instead of a series of smaller liquidity crises, the country now faced the prospect of a mammoth crisis in 2001. Not surprisingly, the creation of this repayment peak

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

depressed the price of the 2001 bond from above 80 cents on the dollar to 40 cents (see Figure 6) and dried up Ukraine's access to the retail market.[37]

With an insurmountable repayment peak looming, in the opening days of 2000 Ukraine appointed ING Barings to lead-manage a syndicate of banks charged with convincing investors to accept a new eurobond in exchange for their maturing issues. The bulk of these bonds were to be exchanged for eurobonds maturing in seven years, denominated in euro or U.S. dollars, and bearing 10 per cent and 11 per cent coupons, respectively, with an initial six month grace period for amortization.[38] Fortunately for Ukraine (and consistent with our argument), four of the five debt instruments subject to this offer contained CACs. The exchange offer was conditioned on the holders of these bonds first giving their votes to an exchange agent who would act as their proxy at a bondholders' meeting and thereby bind in non-participating bondholders. According to Dixon and Wall (2000), "The CACs are though to have contributed to the success of the restructuring, and over 98% acceptance had been attained by the [April] cut-off date for the exchange."

Romania. Romania faced bullet repayments on two obligations in May and June 1999 – one a Samurai bond of $460 million, the other a eurobond of $245 million. Both issues, contracted in 1996, were distributed among German and Japanese retail investors. As a precondition for the IMF Standby negotiated in the spring and summer of 1999, the Fund required the country to roll over 80 per cent of that debt. Predictably, this demand came to nothing: with

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[37] The remarkable recovery of Ukraine's eurobond prices after the Russian crisis appears to reflect an assessment of the country's solvency rather than its liquidity.

[38] Commerzbank (2000), p.1. Included are the E516 million international bond issue due in March, the $258 million zero-coupon bond due in September, a $74 million Chase amortizing bond due in October, the DM1.5 billion international bond due in February 2001, and $300 million in other bonds due in 2000 and 2001.

both bonds trading on secondary markets, all the former lead managers had to do was to point out that they had no bonds left in their inventories. Faced with this reality, the IMF changed course, conditioning its program instead on the country raising $600 million of new money (roughly equal to the amount of the original rollover request).

In the event, Romania managed to raise only $130 million. The vast majority, $108 million, came in form of a "club loan" from a consortium of commercial banks already active in the country.[39] The idea that the country might raise additional funds from its bondholders came to naught.

This outcome was reminiscent of the debt crisis of the 1980s. Then too the IMF had conditioned its programs on the creditors first agreeing (in principle) to ante up additional funds (Cline 1995). So long as success hinged on the efforts of a small, cohesive group of creditors who feared that their solvency would be threatened by a failure to provide additional resources, this "concerted lending" strategy could work. But once the banks had provisioned against losses, they refused to participate further. The danger that this would hold IMF agreements hostage, at considerable cost to the crisis country, was what led the Fund to adopt its new policy of lending into arrears, breaking the link between its disbursements and new private lending. In a sense, then, the "innovation" of the Romanian program was a step back to the old, untenable state of affairs, allowing a large, loose collection of creditors, retail bondholders among them, to hold official money hostage.

Romania then used its reserves to redeem both the eurobond and the Samurai bond as they matured without IFI support, i.e. before Bank and Fund programs were formally in place.

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

Reserves fell to their low point immediately following these repayments (Figure 7). They then recovered (reflecting the beneficial balance of payments effects of a large currency depreciation in the Spring and renewed efforts at structural reform). By October reserves exceeded the Fund's target by some $300 million.

Despite the fact that the condition of raising $600 million of new finance was not met, in the summer of 1999 the IMF decided to disburse the first tranche of its Standby Agreement with Romania anyway. It did so despite the country having paid off its creditors, contrary to the spirit of the bail-in strategy.[40] However, the Fund limited its first disbursement to the minimum access to quota possible and set as a condition for the release of further tranches that new money be raised to the tune of the missing $470 million.

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

But not raising new money would have jeopardized the Standby, which was important for market confidence. The Romanian authorities, together with two investment banks, therefore set off on a road show to prepare the markets for the issue of a new eurobond and possibly a Samurai. In the unsettled conditions of mid-1999, Romania was the only country possessing a

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40 Figure 8 shows how sensitive the spreads of a Romanian eurobond maturing in 2001 reacted to the developments leading up to the payment: The recovery from the impact of the Russian crisis was accelerated in the Winter by positive political developments. In early Spring, prices start to reflect the increasing fear of a pending sovereign default – alleviated in late Spring by public announcements that the World Bank was ready to go to Board with a new program and that the IMF had resumed negotiations with the government. As soon as these two programs were concluded, the price of the eurobond clearly indicates that subsequent demands of non-payment on part of the Fund (until May and June), and threats of discontinuing the Standby if the necessary new money was not raised, did not carry weight with investors: spreads stayed low, and the anticipation obviously was that the Fund and Bank programs would not be thrown off track by the demand for burden sharing.

non-investment grade (B- and B3) rating with the temerity to approach the markets. Investor response was predictably tepid. Failing to attract much interest in Europe, the road show, by the time it reached the U.S., had become a ghost show. Tapping the Samurai market disappeared from the agenda.[41]

Predictably, the consequences were unpalatable for the IFIs as well as the country. The IMF responded by reducing the sum required prior to first review to a more modest $100 million but without foreswearing the option of again raising the issue before releasing further tranches. Nevertheless, the gesture -- extended slightly earlier than the letter issued a few days before Ecuador's default -- was widely read as giving in to the fact Romania could not raise new funds.[42]

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

Pakistan. Pakistan's debt is heavily dominated by obligations to official creditors (see Figure 9). Impending difficulties in servicing debt to official (and mostly bilateral) creditors led to negotiations between Pakistan and the Paris Club in early 1999. As a condition for rescheduling Pakistan's bilateral obligations, the Paris Club then instructed the government to seek a

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

[42] Once again, by the time the decision was made, it altered the signal to the markets in unintended ways. Reflecting wide-spread sentiment, the Wall Street Journal on Nov. 4, 1999, concluded that the IMF, after having "made Romania a poster child for its campaign to force private investors to help rescue countries facing financial crises" had now "backed down and cut the amount of private money that Romania would have to raise."

rescheduling of its commercial debt, including bond debt, on terms comparable to those granted by bilateral creditors.[43]

Specifically, Pakistan was asked to deliver proposals for rescheduling its private bond debt, including an outstanding eurobond, by the end of 1999.[44] But when encouraged to withhold payment on a eurobond earlier in the year, the government refused. Through much of 1999 it remained reluctant to carry out the Paris Club's instructions, fearing that entering into restructuring negotiations would damage its credit. In apparent contravention of the Paris Club, it managed to scrape together the resources needed to keep current on its debt service. But with the military coup late last year, trading of its bonds on secondary markets essentially ceased, and it became clear that new money was not in the offing. The government was left with no choice but to extend an exchange offer to its creditors. It proposed to exchange bonds carrying coupons of 5 per cent, 11.5 per cent, and Libor plus 3.95 per cent, maturing between December 1999 and February 2002, for a new eurobond with a coupon of 10 per cent but maturing in 2005. It warned investors that they would not receive more favorable terms, which the markets took to mean that bondholders would be faced with "outright payment default and possibly protracted negotiations on debt restructuring" if they failed to accept the offer.[45] Bondholders were given several weeks to indicate their acceptance, by the end of which 94 per cent had opted to do so.

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

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

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

What made this approach possible? Aside from unique political circumstances, a key factor was that Pakistan's eurobond was narrowly held, hardly traded, and in part subject to English law. Because there was provision for a bondholders meeting, and because agreement by only a qualified majority of the bondholders was required to bind the entire group, there was limited scope for maverick creditors to hold up the process in an effort to extract concessionary terms. This allowed the exchange offer to be pushed through in a matter of weeks.[46]

Significantly, Pakistan was widely seen as a candidate for this type of private sector debt restructuring independently of and before the G7's attempt at increased private sector burden sharing was implemented or even formulated. The private sector was aware of the country's problems before the Paris Club addressed the issue and appears to have anticipated that the country's obligations would have to be written down independently of the change in official policy.[47] Figure 9 shows that Pakistan's spreads started to widen even before the G7 and the IMF had started to argue the case for increased burden sharing.[48] Given all this, the Paris Club's Pakistani precedent is less than earthshattering. In fact, the Paris Club's request to reschedule private sector obligations in parallel with the restructuring of bilateral debt must be viewed more as an isolated demonstration of the official community's ability to give haircuts to investors under

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[46] In the event, the Pakistani authorities did not resort to a bondholders meeting, since the long shadow it cast (the threat it posed to potential free riders) provided sufficient to gain all but unanimous consent on the part of the bondholders. The mechanism is analogous to the tendency for a well-designed corporate bankruptcy law to encourage workouts in the shadow of the court. Dixon and Wall (2000) reach the same conclusion, namely, that "anecdotal evidence suggests that at the margin the backdrop provided by the bonds' CACs and presence of a trustee may have been helpful in dissuading creditors from litigation."

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

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

exceptional political circumstances than the dawn of a new era.[49] For all these reasons, the precedential value of the exercise is dubious.

IV. Implications

This review of the four test cases of the new strategy for achieving greater private-sector burden sharing has a number of implications. Requiring countries seeking IMF assistance to first raise new money is unrealistic, given the rational reluctance of investors who do not already have a stake in the crisis country to lend into uncertain conditions. Encouraging countries to suspend payments as a way of driving their bondholders to the bargaining table will not work so long as there is no bargaining table to be driven to. The likely result will be formal declarations of default and the activation of cross-default and acceleration clauses, leading to an extended period of messy negotiations and lost capital-market access. And given the high costs of default, it is not time consistent for the IFIs to stand aside if the markets refuse to roll over maturing claims, restructure problem debts, or provide new money. The fact that default and restructuring are so painful and costly for the country places the IFIs in the position of having to back down on their previous conditionality if investors fail to comply, which undermines the multilaterals' credibility. And since investors are aware of these facts, their behavior is unlikely to be modified by the IFIs' less-than-credible statements of intent. To put the point in game-theoretic terms, the equilibrium strategies the IFIs and the markets will remain unchanged.[50]

Among the undesirable effects of the case-by-case approach has been the destruction of

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

[50] A simple extensive-form game illustrating the point is specified and analyzed in Eichengreen (2000).

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

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

A second source of moral hazard is that investors will recognize that the subjects of the bail-in exercise are all small countries whose debt problems are unlikely to have systemic repercussions. They will therefore prefer to lend to large countries that are less likely to be the subject of the bail-in experiment.[51] By lending to such countries, they will then contribute to the very systemic risks that everyone agrees must be avoided. Bail-in candidates, for their part, will find it hard to finance legitimate investments. They will have to live under the threat of investors

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

trying to withdraw at the first sign of trouble, which carries the potential of triggering or accelerating crises.

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

This is unfortunate, for only if the legal provisions and institutional arrangements governing sovereign borrowing are changed will efforts to secure greater private sector involvement in crisis resolution bear fruit. Otherwise, restructuring will remain unacceptably costly and painful for the country, and it will not be possible for the IMF and the World Bank to stand aside if restructuring negotiations fail. And since investors are aware of this fact, they have no incentive to modify their behavior when presented with IMF statements to the contrary.

If, however, collective action clauses to facilitate orderly restructuring are introduced into loan agreements, the incentives will change. Developing countries will be able to tolerate the still painful, but now less painful, process of restructuring. It will then be time consistent for the IMF to stand aside.[52] And knowing that the IMF's statements to this effect are now credible, investors will have a greater incentive to participate in the resolution of sovereign debt crises, redressing the moral hazard problem that motivated this effort in the first place.

From this point of view, it is regrettable that between 1995 and 2000 there has been an increase in the proportion of bonds governed by New York law.[53] Why borrowers remain reluctant to include CACs in their new issues is unclear, given the evidence that, for issuers with investment-grade ratings, doing so could in fact reduce rather than raise borrowing costs. It could simply be that this evidence is not widely known. It could be that individual governments prefer being bailed out by the IFIs to having to restructure their debts even in the presence of CACs, but that interests of the international community differ.[54] It could be that governments that have traditionally issued debt securities governed by New York law fear that switching to U.K. law will be seen as a signal that they have hidden motives — that they are intending to restructure their debts.[55] Why governments have been reluctant to move in this direction — and what can be

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52 And to engage in limited lending into arrears. See Williamson (2000) on this point.

53 Although English-law bonds are in fact still twice as common as New York law bonds (Dixon and Wall 2000). This increase has been largely at the expense of Luxembourg law.

54 If so, the IMF could condition its programs on countries incorporating these provisions into any new loans they solicit. It could make the adoption of CACs a precondition for qualifying for the Contingent Credit Facility. It could make their adoption a provision of the Fund's code for good practices in the areas of monetary and financial policies. The Basle Committee of Banking Supervisors could similarly key the risk weights on cross-border bank lending to the presence or absence of such provisions, while the World Bank can provide resources to countries to buy up old bonds lacking such provisions and replace them with new, renegotiation-friendly instruments. Again, any associated subsidies could be justified on international-public-good grounds.

55 Thus, the fact that the British and Canadian governments have either issued or plan to issue international bonds including CACs may send the markets the message that this is not necessarily the case.

done about it — is an important topic for future research.

V. Conclusion

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

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

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

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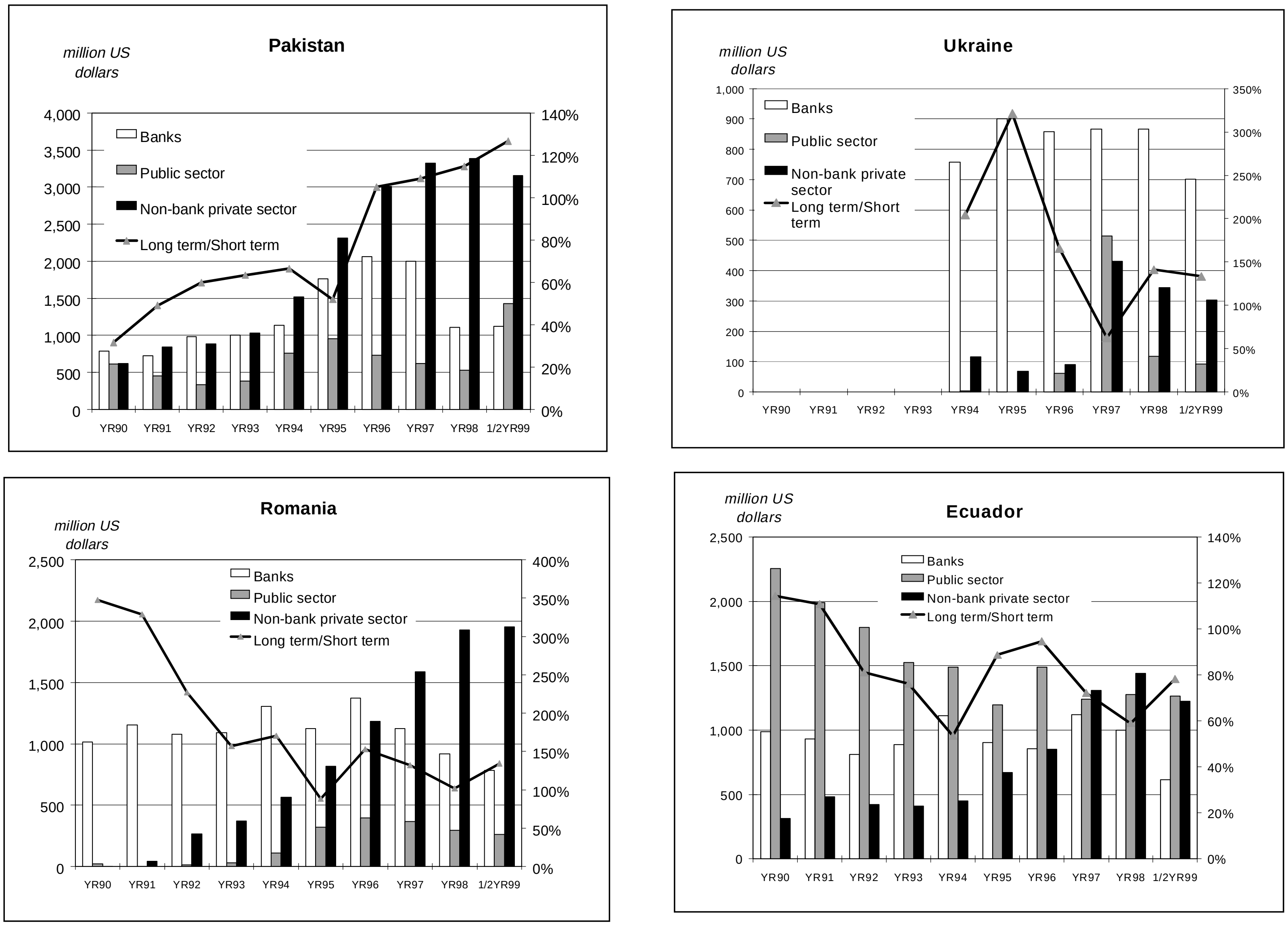
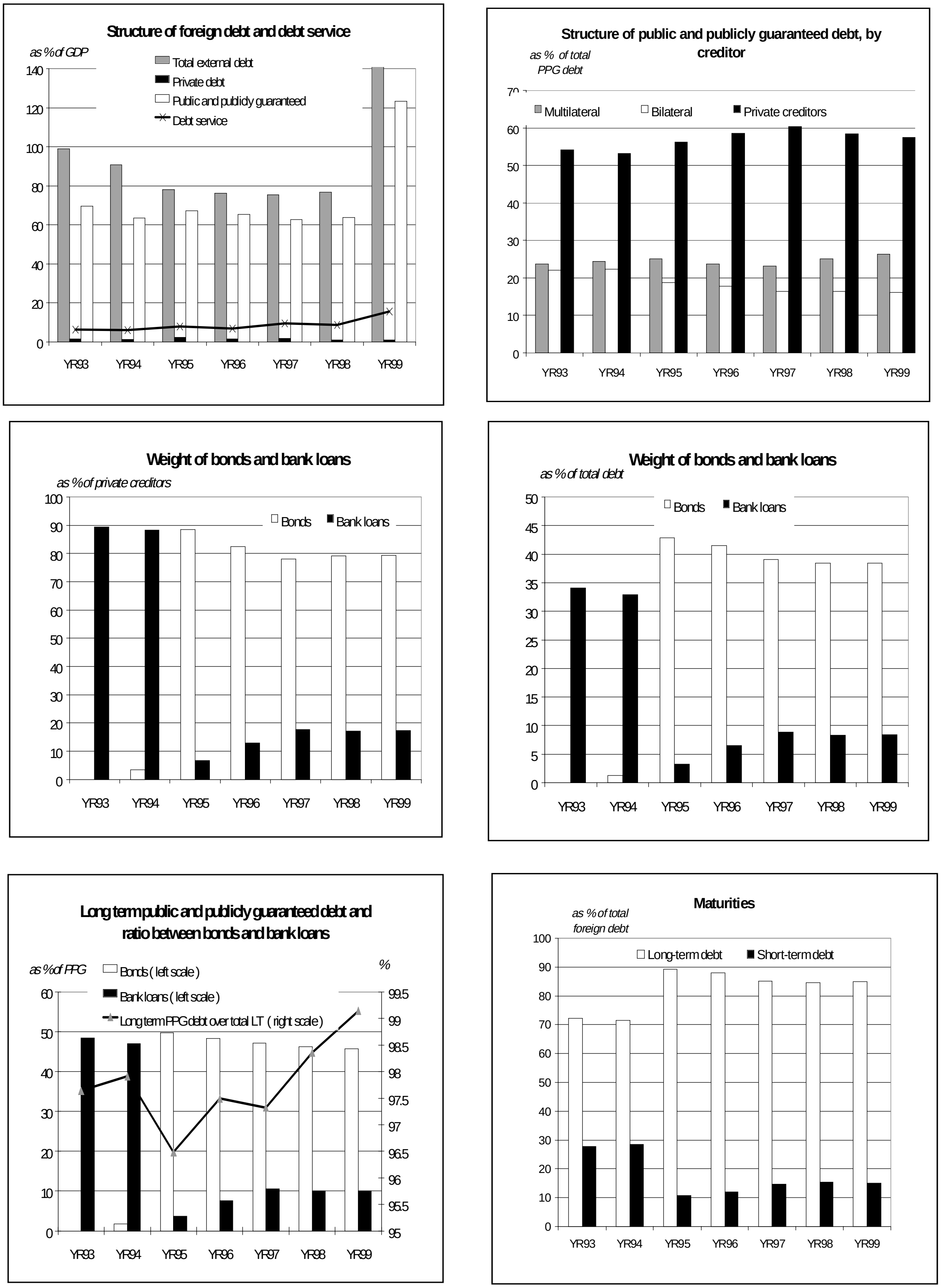
FIGURE 1. CONSOLIDATED CROSS-BORDER CLAIMS IN ALL CURRENCIES AND LOCAL CLAIMS IN NON-LOCAL CURRENCIES



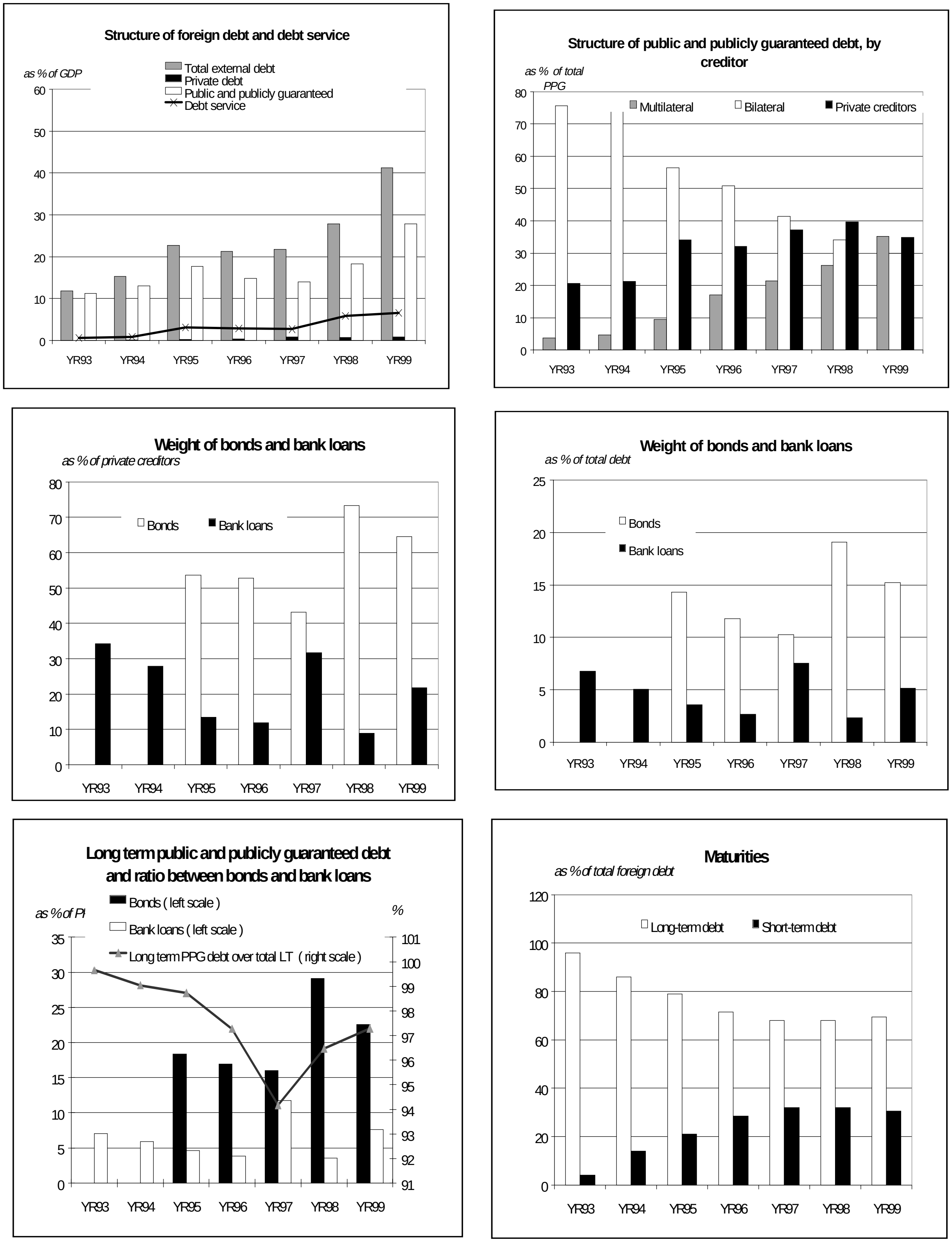
Source: *Bank for International Settelments* (2000)

FIGURE 2A. ECUADOR



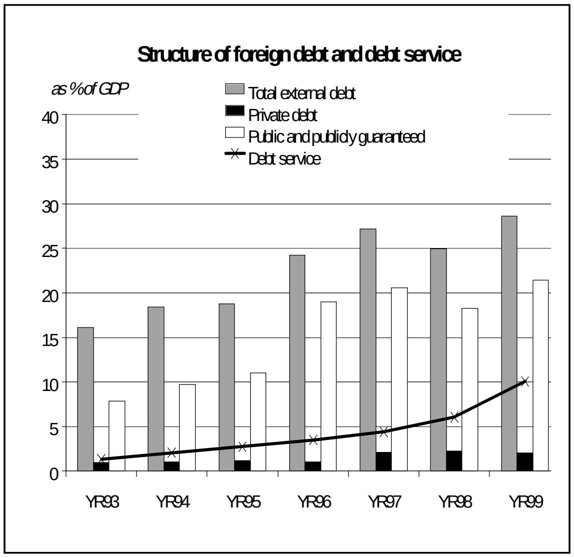
Source: World Bank, *Live data base*, January 2000

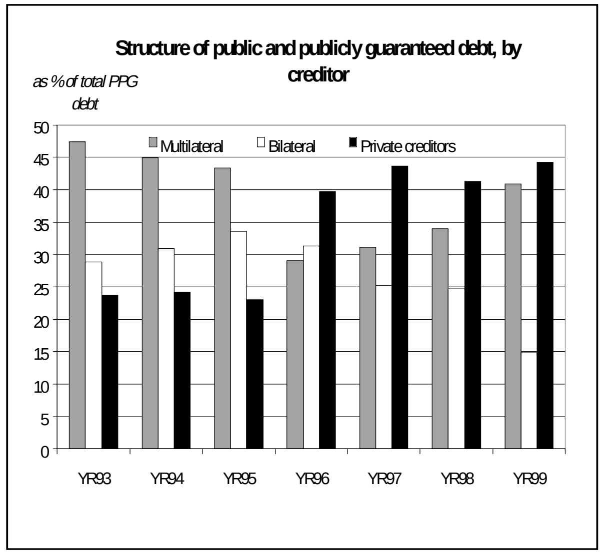
FIGURE 2B. UKRAINE

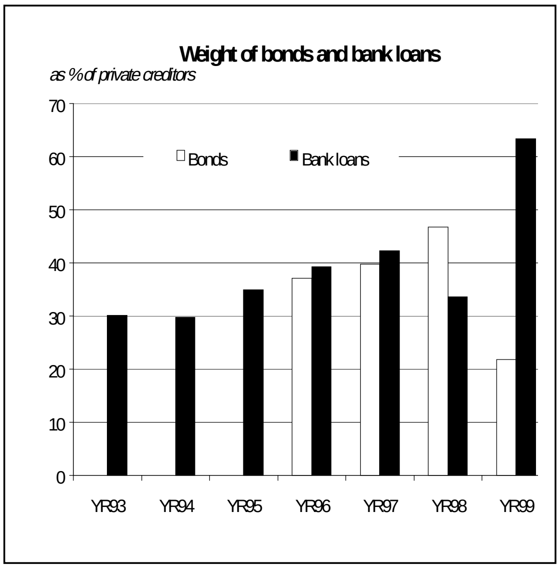


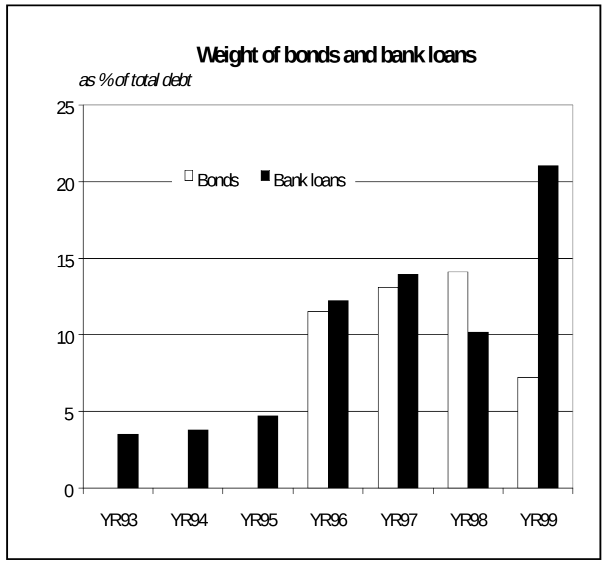
Source: World Bank, *Live data base*, January 2000

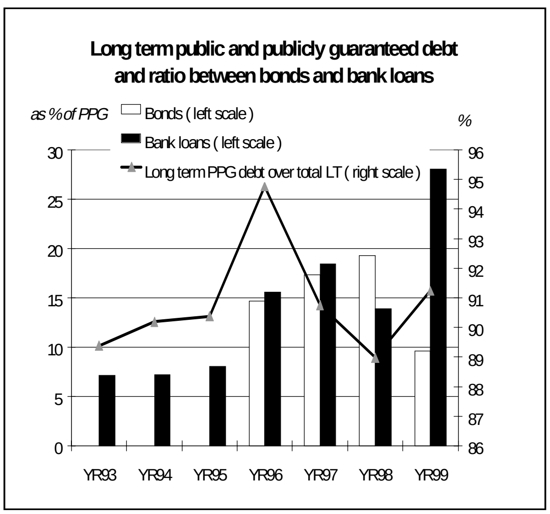
FIGURE 2C. ROMANIA

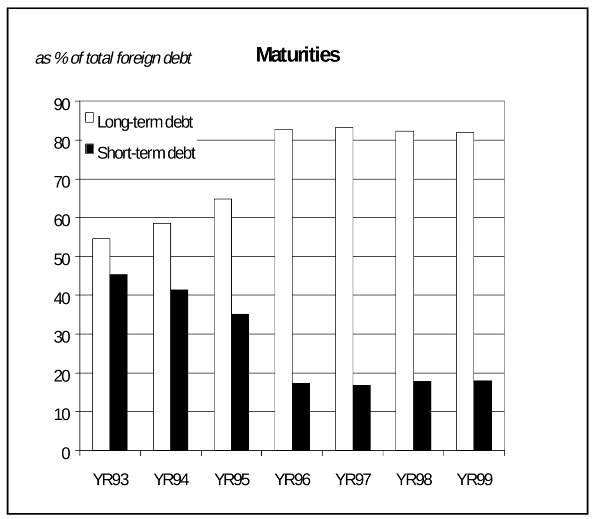






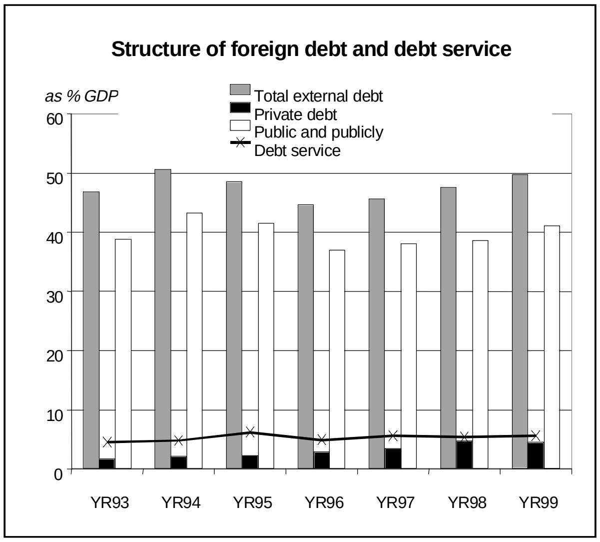


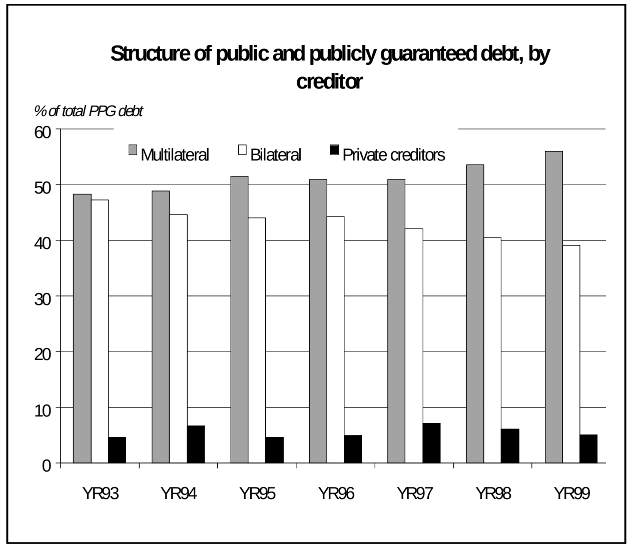


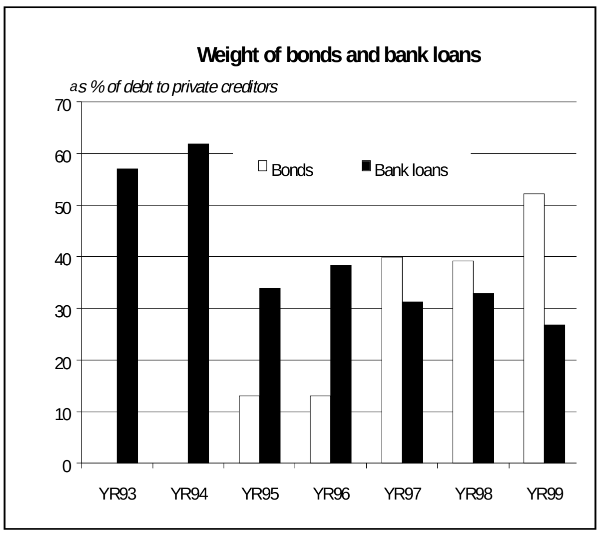


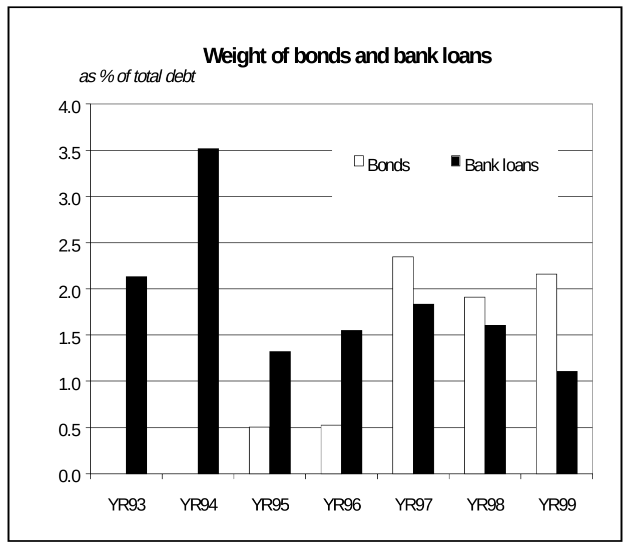
Source: World Bank, *Live data base*, January 2000

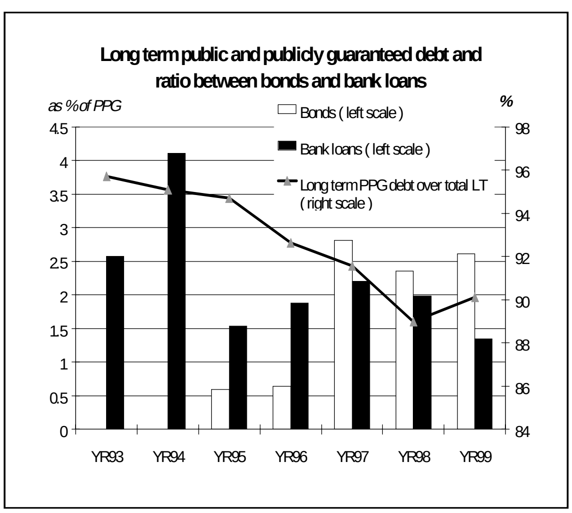
FIGURE 2D. PAKISTAN

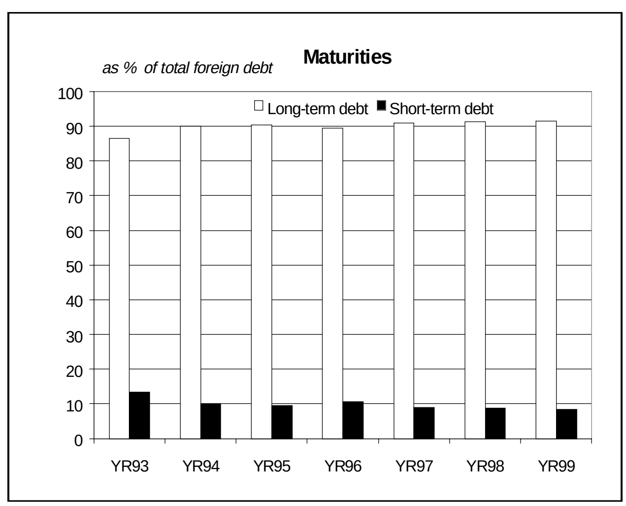






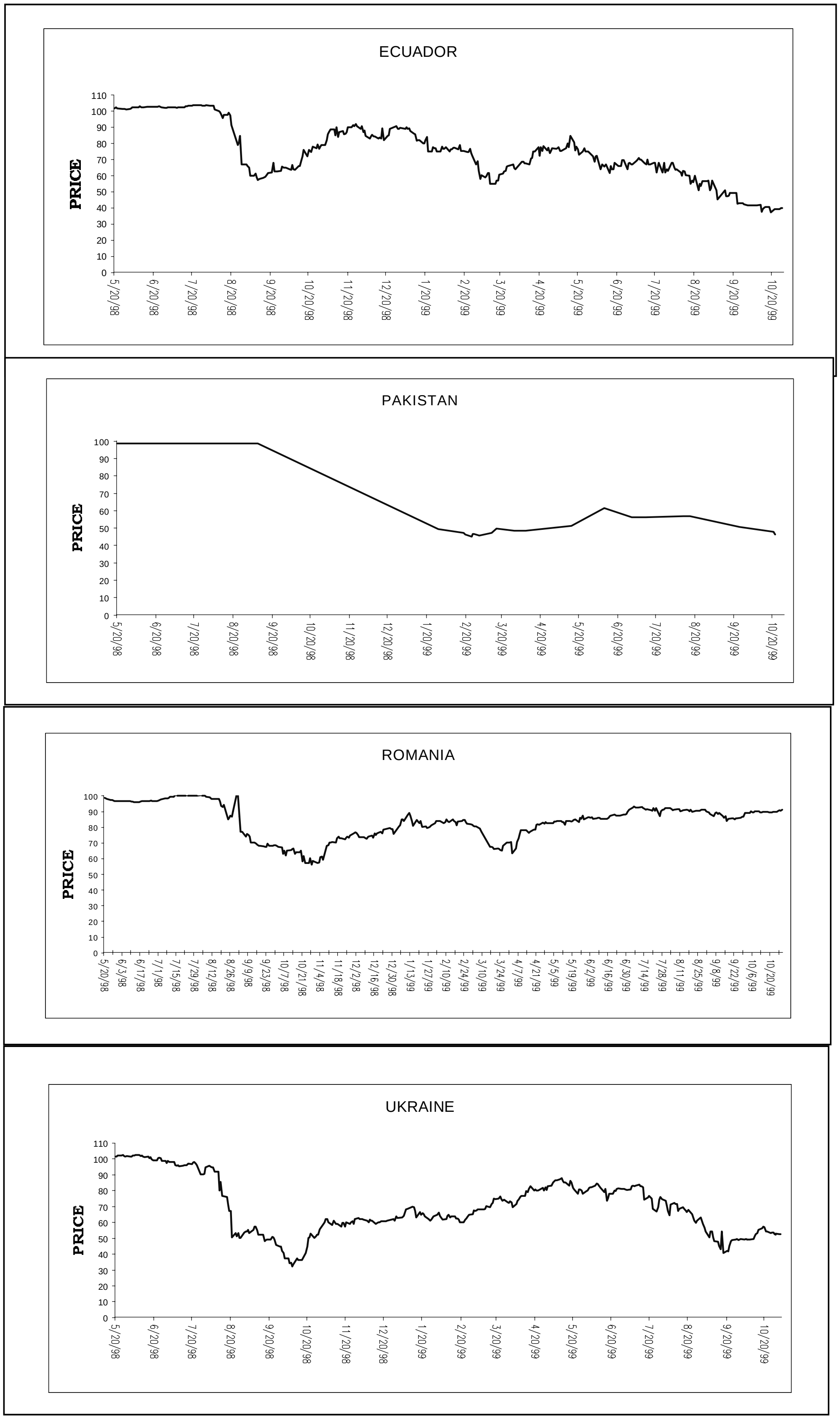






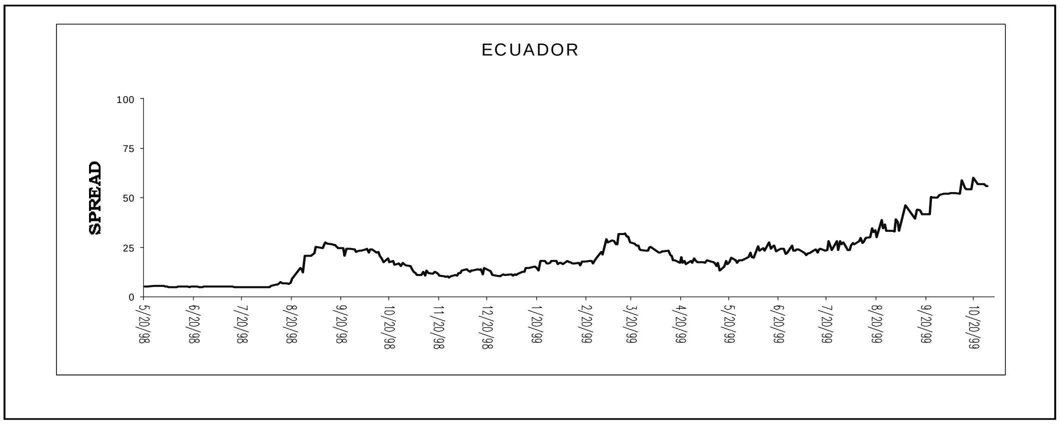
Source: World Bank, *Live data base,* January 2000

Figure 3. The Evolution of Eurobond Prices



Source: Reuters

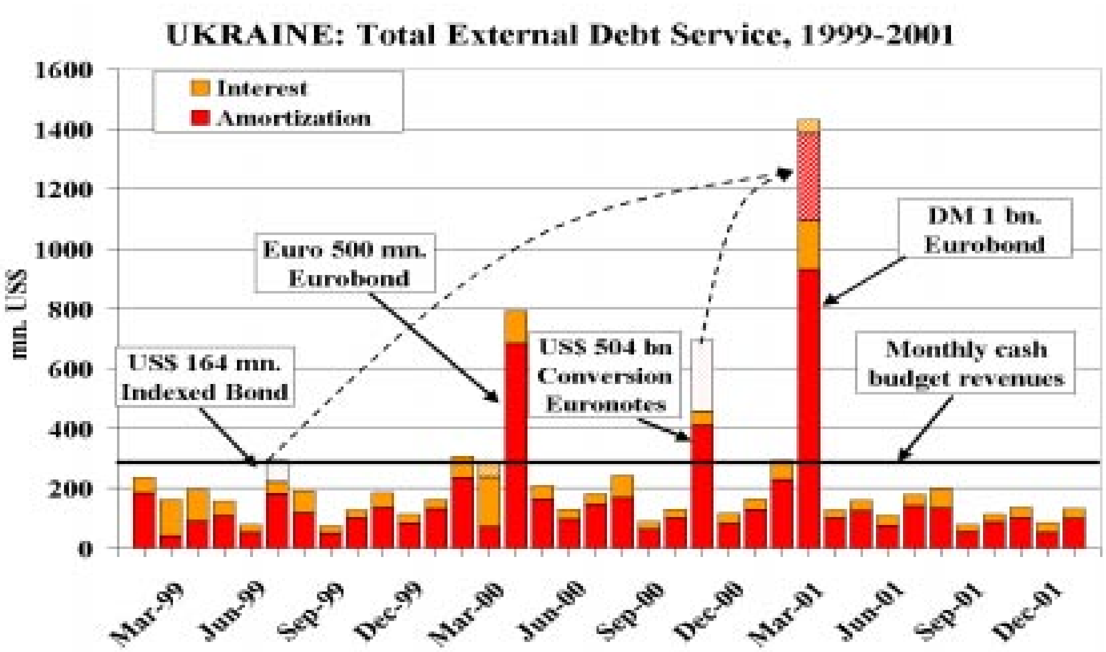
Figure 4. Evolution of Eurobond Spreads[56]



Source: Reuters

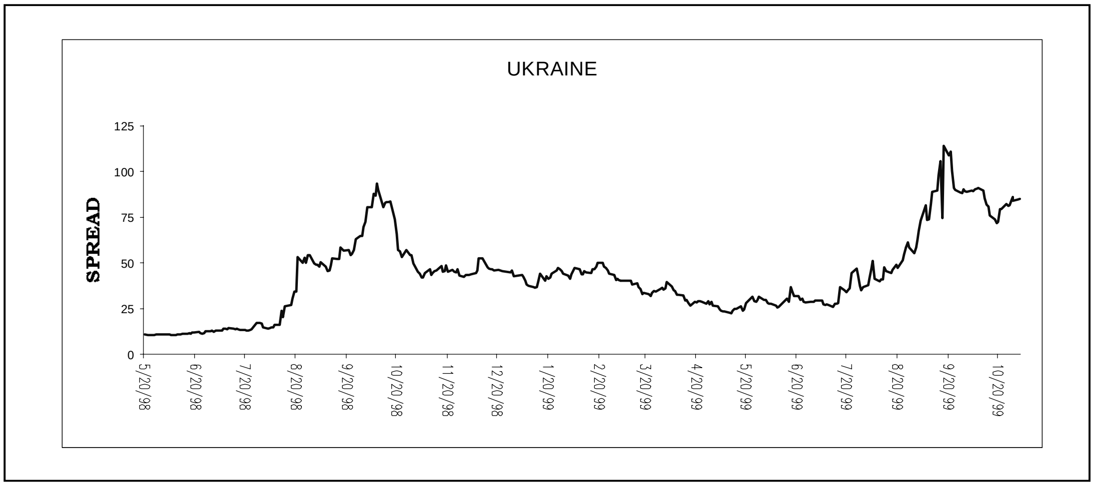
[56] $350 million 5 year bond issued 4/18/97 over 5 year US Sovereign issued 12/31/96.

Figure 5



Source: The World Bank

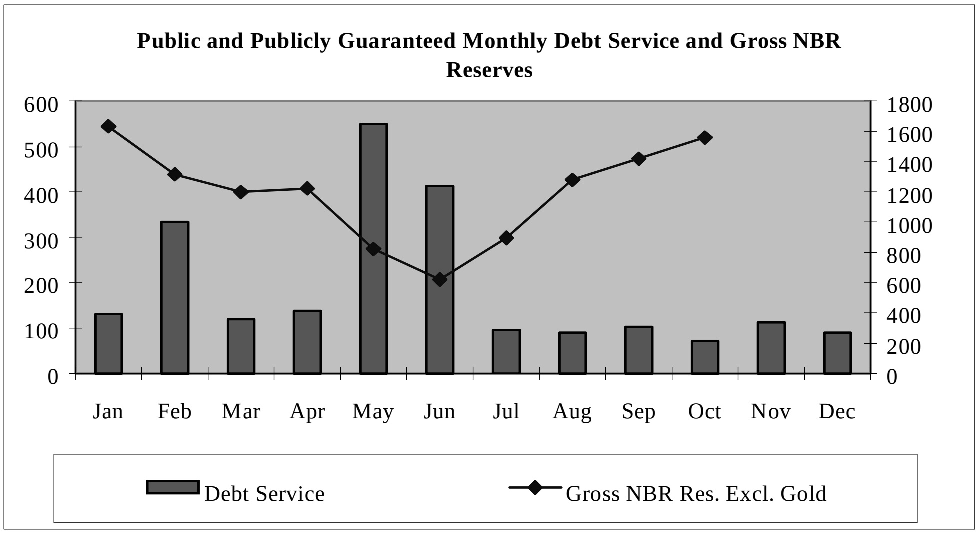
Figure 6. Evolution of Eurobond Spreads[57]



Source: Reuters

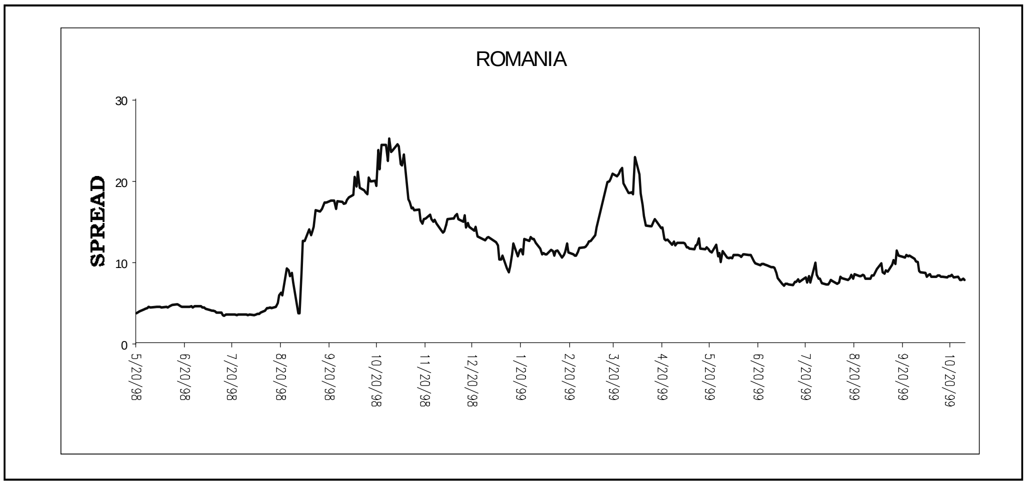
[57] DEM 750, 3 year bond, issued 2/11/98 over 5 year German Sovereign, issued 8/19/97.

Figure 7



Source: The World Bank

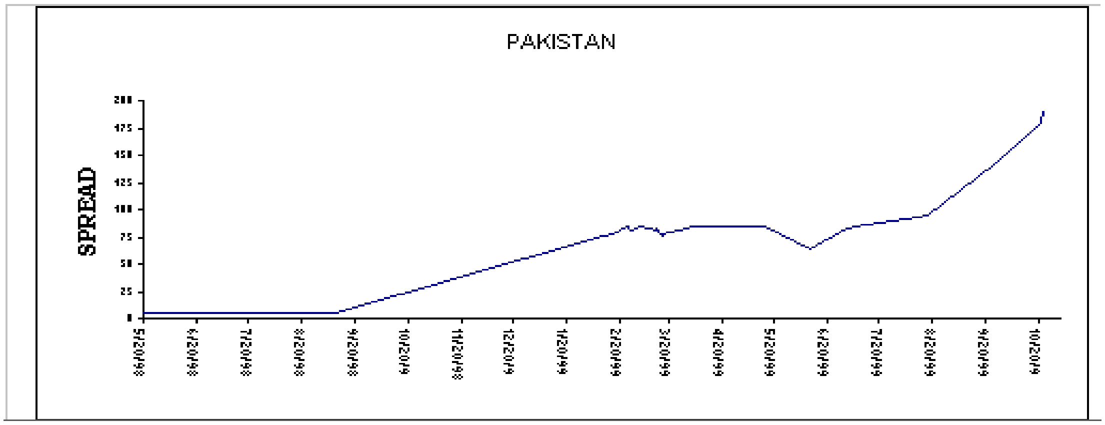
Figure 8. Evolution of Eurobond Spreads[58]



Source: Reuters

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

Figure 9. Evolution of Eurobond Spreads[59]



Source: Reuters

[59] 3 year $300 million bond issued 5/20/97 over 5 year US Sovereign issued 12/31/96.