EBS/01/160
Revision 1

October 30, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Private Sector Involvement in the Prevention and Resolution of Financial Crises—Revised Draft Report of the Managing Director to the International Monetary and Financial Committee**

The attached revised draft report of the Managing Director to the International Monetary and Financial Committee on private sector involvement in the prevention and resolution of financial crises incorporates comments and suggestions provided by Executive Directors on an earlier draft discussed on September 13, 2001. The report, which will serve as background, is to be submitted to the IMFC in response to the Committee's earlier request. It is not intended to be published.

The report has been cast as much as possible as a stocktaking of the issues raised in the Board discussions on private sector involvement and as such is not intended to be brought to the agenda of the Executive Board, unless an Executive Director so requests by noon on Friday, November 2, 2001.

Questions may be referred to Mr. M. Allen (ext. 38786), Mr. Fisher (ext. 38755), and Mr. Srinivasan (ext. 34589).

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Private Sector Involvement in the Prevention and Resolution of Financial Crises—Revised Draft Report of the Managing Director to the International Monetary and Financial Committee

October 29, 2001

I. INTRODUCTION

1. A central element of the new international financial architecture is to establish a more stable system that would enable sovereign governments and private entities to reap the potential of international capital markets to finance development while containing the risks involved. A vital part of this system is a sound framework to involve the private sector in the prevention and resolution of crises. A robust and fair framework that enables the interaction between troubled debtors, including the sovereign, the official sector led by the Fund, and private creditors, both within and outside the country, will be a major contribution to ensuring that the globalization of financial markets and integration of national economies truly works to the benefit of all. While progress is being made in establishing such an operational framework, many vital questions remain to be answered. This report takes stock of progress to date and outlines the challenges remaining.

II. THE FRAMEWORK FOR INVOLVING THE PRIVATE SECTOR

2. The international community has agreed on many elements of a program for integrating the private sector in the efforts both to forestall and to resolve financial crises. Every case where a member begins to lose the confidence of the market brings home the paramount importance of crisis prevention. The severity and speed of the domestic adjustment needed to reverse deteriorating market sentiment; and the potential for widespread destruction of national and international prosperity should corrective action fail; and the very large resources that the official community finds itself called upon to provide to supply the member with the liquidity it needs; all underscore how important it is to make every effort to prevent crises from occurring. The essence of crisis prevention is for a member to manage its economy, and especially its borrowing, in a way that significantly reduces its vulnerability to changes in market sentiment. The international community, including the Fund, has taken a number of important steps to help forestall crises (Box 1).

Box 1. Crisis Prevention Measures

As discussed in more detail elsewhere, the Article IV surveillance process has been strengthened *inter alia* with the incorporation of financial sector work, attention to members' adherence to internationally accepted standards and codes, and a greater stress on measures to manage and reduce vulnerabilities. This enrichment of the Fund's analytical work, combined with greater policy transparency, including the increased publication of Fund country documents, has strengthened the basis on which the private sector can make investment decisions. This has been accompanied by outreach work to make sure that market participants and others are fully aware of the information put into the public domain by the Fund and others. The establishment by the Fund of the Contingent Credit Line facility (CCL) is another element to sharpen the focus on crisis prevention.

The Fund has also moved to promote a better dialogue between member countries and private investors and creditors. In May 2001, the Capital Markets Consultative Group endorsed a Working Group report on Investor Relations Programs, and Article IV surveillance missions have begun to explore in more depth members' practices in this area. In November, the Fund is holding a joint seminar with the Institute for International Finance on such investor relations programs.

The international community has also agreed that the inclusion of collective action clauses in sovereign bond contracts would be a helpful step in ensuring that any eventual debt restructuring be done in as orderly a manner as possible, and that a minority of creditors not take action that might prevent the majority of creditors preserving asset value. While bonds issued under English law routinely contain such clauses, little progress has been made in including them in bonds issued under the law of New York and other jurisdictions, despite action by some G-7 countries to include such clauses in the international bonds they issue themselves. The importance of working toward the incorporation of such clauses was reaffirmed by the Executive Board in the discussion of sovereign bond restructuring in January 2001.

Another preventive measure that has been endorsed by the international community has been the use by sovereigns of contingent lines of credit from the private sector that could be drawn on in times of difficulty. Recent experience, however, has been disappointing—a drawing of a contingent credit line by the sovereign has led to a reduction in the private sector's exposure elsewhere—and efforts are needed to address the challenges identified to encourage wider use of this instrument.

Private sector involvement in crisis prevention can also be secured through the establishment of efficient and transparent insolvency mechanisms in debtor countries, which create a predictable framework for reorganizing illiquid corporations and, if necessary, liquidating them. By resolving issues of insolvency efficiently at the level of the individual financial or corporate debtor, crises can be prevented from spreading throughout whole sectors and economies and destroying the value of large classes of assets and the prosperity of the country.

3. The framework for involving the private sector in crisis resolution, relying as much as possible on market-oriented solutions and voluntary approaches, was endorsed by the IMFC at its meeting in Prague in September 2000. The basic principles underpinning this framework are that official financing is limited, debtors and their creditors must take responsibility for their decisions to borrow and lend, and that contracts must be honored. The approach to be taken in individual cases is based on an assessment by the Fund of a member's

underlying payment capacity and its prospects of regaining market access. Cases are expected to fall broadly into four categories:

- Those where policy adjustment and official financing should allow the member to regain full market access reasonably quickly. However, extraordinary access to Fund resources should be exceptional, and resort to high levels of access to Fund resources presumes substantial justification, both in terms of its likely effectiveness and of the risks of alternative approaches;

- Those where official financing and policy adjustment needs to be combined with encouragement to creditors to reach voluntary arrangements to overcome their coordination problems;

- Those where the early restoration of full market access on terms consistent with medium-term external sustainability is judged to be unrealistic, and a broader spectrum of actions by private creditors, possibly including comprehensive debt restructuring, may be warranted in the context of a Fund-supported program to provide for an adequately financed program and a viable medium-term payments profile; and

- Those extreme cases where the member may have to resort to a temporary payments suspension or standstill pending sufficient action by its creditors to support the restoration of viability. In such cases, the Fund would be prepared to continue providing financial support for a member's adjustment program despite arrears to private creditors, provided the country is seeking to work cooperatively and in good faith with those creditors and is meeting other program requirements.

4. Since the Prague meeting of the IMFC, work on involving the private sector in crisis resolution has proceeded in both the analytic and practical areas. The Executive Board discussions in January 2001 of international sovereign bond restructurings and in August 2001 of the relative treatment of claims of private sector and Paris Club creditors have helped clarify the treatment of the third category of cases listed in the framework above. The Executive Board discussion in September of the determinants and prospects for the pace of market access by countries emerging from crises, provided further basis, even if only preliminary, to determine the approach for involving the private sector in future crises. A seminar was held on July 26 on outstanding PSI issues, and a paper has been prepared on the design of and experience with Fund-supported programs in capital account crises (Box 2). On the practical side, the Fund has supported the adjustment efforts of Argentina and Turkey; in both cases the actions of the private sector are crucial to ensuring balance of payments viability (Boxes 3 and 4).

Box 2. Recent Developments on PSI

Sovereign bond restructuring

With the rescheduling of sovereign international bonds issued by Ecuador, Pakistan, and Ukraine, financial market participants have now recognized that such bonds are not immune from debt restructuring, and that bondholders, along with other creditors, may need to contribute to the resolution of severe liquidity crises. In the recent cases, it proved possible to reach reasonably timely and orderly agreements with creditors that provided cash-flow relief and a repayment profile that helped move the member's balance of payments toward medium-term viability. Participation rates in the debt exchanges were high, and creditor litigation did not materialize in these three cases. The way in which countries reach agreement with their creditors may, however, affect the market's pricing of capital for other countries. Thus, collaborative approaches to negotiations with creditors are preferred, provided that they lead in a reasonable time to agreements that are consistent with members' return to balance of payments viability.

Comparable treatment of private sector and Paris Club claims

The principle of comparable treatment between different groups of creditors underlies the Paris Club's approach to restructuring debt. However, financial market participants have been unsure how this principle would be applied in practice, given the very different structure of official sector and private sector claims, and the different techniques they normally apply to restructurings. Reducing this uncertainty should help markets become more stable and improve the pricing of sovereign debt instruments. Recognizing this, the Paris Club has recently expanded the information it makes publicly available on its activities, and started a dialogue with the private sector. Issues of restructuring arise regularly in the third of the categories of cases listed in the text, and in August the Executive Board had a preliminary discussion of some of the issues involved. Executive Directors saw advantage in the Paris Club's clarifying the way it would apply the principle of comparable treatment. They stressed the importance of close cooperation and the exchange of information between the Fund and the Paris Club to ensure that questions of private sector involvement, comparability of treatment, and medium-term viability were addressed effectively in the design of programs. However, they also felt that there was no alternative to dealing with issues of comparability on a case-by-case basis, rather than by applying abstract principles.

Seminar on private sector involvement issues

A seminar on private sector involvement in crisis resolution was held on July 26, 2001 and was attended by representatives of some industrial and emerging markets governments, Executive Directors, members of the academic community, and Fund management and staff. The seminar provided an opportunity to take stock of how the private sector had been involved in recent cases, in particular those of Argentina and Turkey, and to discuss views on strengthening mechanisms in this area. While participants in the seminar expressed broad support for using a catalytic/voluntary approach to securing PSI at least initially, some were of the view that a more concerted approach would be more effective in certain circumstances. Views diverged on whether intermediate forms of PSI, including through the introduction of interest rate caps on debt payments and limited debt write-downs, could work on bonded debt. Participants also diverged in their views on the effectiveness and ramifications of standstills, although they were generally opposed to official sanctioning of a standstill by the Fund on behalf of the international community.

Assessing the determinants of and prospects for market access

Most recently, the Executive Board considered a staff paper that assessed the determinants and prospects for the pace of market access by countries emerging from crises. It was noted that the initial conditions or the nature of the crisis that led to the loss of access to markets determine the speed at which countries can reaccess markets. Countries that lose market access as a result of a minor spillover from crises elsewhere, generally regain market access quickly (in a matter of weeks) as the effects of such developments pass. For countries that lose market access because of severe adverse developments in global financial markets that undermines the sustainability of domestic policies, or because of policy missteps, regaining market access generally takes many months, and, on occasion, more than a year. It was noted that determinants of market access are many, including external conditions, credibility of policy stance, structural reforms, creditor-debtor relations, with their relative importance depending on the circumstances of each case.

Box 3. IMF Program with Argentina

The crisis in **Argentina** in November 2000 reflected market concerns regarding the sustainability of the fiscal position and the exchange regime, against the backdrop of pessimism regarding growth prospects and heightened uncertainty in international capital markets. The economic program supported by an augmentation and front-loading of Fund resources,[1] sought to bolster the prospects for economic growth through the combination of structural measures and to provide a limited fiscal boost in the short term while assuring fiscal sustainability over the medium term.

The program envisaged involvement of the private sector on a market-based, voluntary approach intended to complement Argentina's objective of accessing international capital markets in a spontaneous fashion as soon as confidence returned. During the opening weeks of 2001, in fact, the authorities took advantage of favorable market conditions to accelerate the implementation of their financing plan. But despite the promising start, the strengthened program encountered difficulties in February–March, and the prospects of an early resumption of spontaneous market access were set back. However, the arrangements to secure the continued involvement of the private sector were broadly effective, and were not a source of financing pressures.

In order to alleviate concerns about the large near-term debt-service obligations, Argentina launched a "mega" debt-swap in mid May 2001. The exchange was voluntary, and bonds with a face value of US$29.5 billion were exchanged. The debt exchange, while expensive, provided cash-flow relief and had a temporary positive effect on markets' perception about Argentina, which, however, soon gave way to renewed concerns about fiscal sustainability, fuelled in part by an adverse reaction to the introduction of the trade compensation mechanism. Spreads again rose sharply, while financing sources for the public sector virtually dried up. To address this new crisis, the authorities on July 11 proposed a drastic program of fiscal adjustment, aimed at achieving a balanced fiscal budget from August 2001 onwards. On September 7, the Executive Board approved an augmentation of Argentina's stand-by credit by approximately US$8 billion to about US$22 billion in support of this strengthened program. US$3 billion of this augmentation could be used to support a voluntary and market-based operation by Argentina to increase the viability of its debt profile.

---

[1] The total amount of the Stand-By Arrangement was augmented by 245 percent of quota to 500 percent of quota (about US$14 billion), with 100 percent of quota under the augmentation to be provided under the Supplemental Reserve Facility (SRF): about US$3.4 billion was made available immediately. The mix of resources exceeded the normal 300 percent of quota limit of financing under the credit tranches, and reflected the substantial dimensions of Argentina's financing problem.

Box 4. IMF Program with Turkey

The origins of **Turkey**'s financial crisis can be traced to the buildup of banking system vulnerabilities associated with the limited capacity for banking supervision, fiscal weakness, weak governance, and the overheating of the economy, in the context of a disinflation strategy based on a pegged exchange rate. The strengthened economic reform program, that received enhanced access to Fund resources in December 2000 of about US$7.5 billion (600 percent of quota) under the SRF facility, included an acceleration of the reform of the private banking system, fiscal adjustment, and privatization.[2]

Under this program, the continued involvement of the private sector in the resolution of the financial crisis was to be achieved primarily by the catalytic approach. This was complemented by a voluntary commitment from international banks to maintain aggregate exposure in the form of interbank and trade-related credit lines extended to the Turkish banking system at the December 11, 2000 level. Banks were also asked to maintain exposure on trade lines provided directly to the nonfinancial corporate sector. The government extended a guarantee on all liabilities of Turkish banks, including foreign and off-balance-sheet liabilities.

Until late January 2001, there were encouraging signs that the catalytic approach was starting to bear fruit. Turkey was able to place a €0.7 billion bond with European retail investors, and aggregate foreign bank exposure to the Turkish banking system was maintained. Foreign banks' commitment was, however, conditional on the maintenance of macroeconomic and financial stability in Turkey and on each other's continued maintenance of exposure. Despite the strengthening of the economic program, market concerns about policy implementation and the government's financing situation persisted, and the maturity of much of the domestic and external funding remained very short. Political developments triggered a further crisis on February 19, 2001, which led to a floating of the exchange rate, and banks withdrew close to US$3 billion of exposure in the last week of February. After a period of stabilization, withdrawals resumed in May, despite an augmentation of Turkey's Stand-By Arrangement by about US$8 billion (664 percent of quota) on May 15 and further meetings between the authorities and international banks on June 12 and 13, at which the latter signaled their intention to maintain their current exposure and to seek to rebuild their lines as the economic program was implemented.

The authorities undertook a market-based swap of some US$7.7 billion of domestic government debt in June to reduce rollover risk and help alleviate concerns about domestic banks' foreign exchange positions. However, the reduction in immediate rollover risk was only modest, and concerns over the impact of political squabbling on program implementation led to an increase in yields in subsequent treasury bill auctions. Since then yields have begun to fall, but the stabilization of the exchange rate and resumption of capital inflows will depend on increased market confidence in the authorities' commitment to program implementation.

---

[2] The original 1999 program was a 3-year stand-by arrangement at the maximum access limit of 300 percent of quota, equivalent to about US$4 billion.

5. Both Argentina and Turkey faced financial crises in late 2000, despite Fund support of their adjustment programs. In both cases, the Fund provided additional financial resources, reflecting the strength of the authorities' commitment and their willingness to adopt measures deemed necessary to ensure the success of the economic program and the full servicing of all debt obligations. The Fund also judged that the combination of official financing, supported by market-based and voluntary agreements with specific private sector creditors and strong policy adjustments, would allow the countries to regain full market access in a reasonable time frame.

III. TENTATIVE CONCLUSIONS FROM RECENT EXPERIENCE

6. The cost of crises means that the return on prevention is very high. As previously mentioned, a number of important measures to forestall crisis have been taken. But more work is needed. In addition to enhanced surveillance and progress on specific measures aimed at preventing crises, including the promotion of standards and codes and the establishment of early warning indicators, strong efforts will need to be focused in promoting collective action clauses in bond contracts, overcoming the challenges identified to encourage the use private contingent credit lines, and to further enhance creditor-debtor relations. With regard to collective action clauses in bond contracts, it should be noted that even if the more advanced members lead the way by promoting the incorporation of such clauses in new bond issues, supported by Fund efforts through surveillance and/or moral suasion to encourage other members to follow suit, the existing stock of bonds that do not contain such provisions implies that we are still a good distance away from a point where the debtor could be assured that if it reached agreement with the majority of creditors, it will be protected against the minority. On the issue of private contingent credit lines, the appetite of international banks for such contingent exposure is limited, and recent experience has shown that this is reflected in restrictive conditions governing activation and the use of dynamic hedging techniques that offset the increase in private sector exposure to a member in crisis when such lines are drawn. Progress on efforts by members to promote good relations with their creditors, including through the establishment of formal investor relation programs, will be monitored closely in the context of Article IV discussions, and a report on progress will be provided in due course.

7. Despite a strengthening of efforts to prevent crises, the Fund and the international community will continue to need to be prepared to support members that run into difficulties. The international community agreed on a general framework for resolving crises in Prague, but more work needs to be done before there is full consensus and clarity on all its elements. The most difficult questions remaining relate to the appropriate scale and nature of official financing in face of crises of differing characteristics, on how the private sector can be engaged in helping the member overcome its difficulties, and on the mechanisms for restructuring the sovereign's debt in circumstances in which the official community, through the Fund, sees such action as being necessary.

8. Recent experience and analytic work has highlighted that capital account crises vary enormously in their origins, and a fuller understanding of them should help in tailoring appropriate solutions.

- Some are primarily caused by a temporary shortage of foreign exchange reserves to meet expected demand, which may include the sovereign's demand for foreign exchange to service external obligations.

- Some have their origin in doubts about the solvency of the sovereign or about the ability of the sovereign to refinance its obligations.

- Some originate in the banking system, as bank creditors' fears of generalized insolvency or illiquidity in the banking system threaten a run on bank deposits.

- Some originate in the corporate sector, where a shock may cause the insolvency of important debtors or whole sectors, as was the case in some of the Asian crisis cases.

In each case, while the crisis may originate in one part of the economy, it may rapidly spread to other parts, as corporate insolvency affects the banking system, as banking sector problems raise the issue of the implicit guarantees of the sovereign, and as attempts by resident and nonresident investors to seek safer havens deplete foreign exchange reserves. While some crises may be domestic in origin, they increasingly have an international dimension, since globalization has meant that sovereigns, banks, and corporates all frequently have liabilities to both residents and nonresidents, and often in both local and foreign currencies. Understanding the vulnerabilities that lie behind these crises and pinpointing the precise actions that should ensure that crises are avoided, or that are needed to restore market confidence following the onset of crises, has priority. Such understanding would provide a stronger basis for prevention, as well as for determining the needs for external financing and for assessing the costs and benefits of alternative strategies for resolving the crises that do occur.

9. A number of conclusions have emerged from both experience and analytic work concerning the involvement of the private sector in the resolution of crises. First, efforts to restore access to private flows through Fund-supported programs, including those supported by voluntary agreements between sovereign debtors and their creditors, are likely to be most successful against the background of a policy environment and economic prospects that help build market confidence in the members' ability to regain market access on a sustainable basis. In circumstances in which markets perceive substantial risk of failure, private capital outflows may continue, restoration of market access may be delayed, and voluntary debt exchanges for improving the member's debt profile are likely to be expensive. In such cases, difficult judgments would need to be made on the choice between further strengthening the program beyond that judged necessary on economic grounds to help address concerns of market participants, providing additional assistance buttressed by policy adjustments to allow time for market sentiment to turn, or to change tack and adopt a concerted approach to secure private sector financing. All the approaches are prone to additional risk and have costs. Strengthening the program, through further tightening of economic policies, could risk alienating domestic stakeholders and policy-makers without having a positive impact on market sentiment; providing additional assistance would raise the typical concerns associated with large-scale financing packages, with the added risk that the member's failure to regain access to markets may trigger the perception that a concerted approach to securing private sector involvement is imminent; and finally, the use of concerted means to secure private sector involvement raises the specter *inter alia* of disruptive litigation and damage to the member's prospects of market access.

10. Second, concerns regarding the effectiveness of the catalytic approach have made more urgent the need to explore middle (intermediate) solutions that lie between the catalytic

approach and more extreme approaches, including comprehensive debt restructuring and payments suspension, to secure private sector involvement. This is a high priority area for our work ahead. It is, however, quite conceivable that in the absence of a credible legal framework that addresses sovereign debt workouts, and is endorsed by the official community, middle (intermediate) solutions—which have so far remained elusive—will likely be difficult to implement and sustain. Efforts to seek voluntary agreements with creditors may yield more substantial results in the case of domestic investors than of nonresident investors, especially in circumstances where the strength of the financial position of the banking sector and the public pension system is strong enough to accommodate an increase in the volume and duration of the sovereign claims they hold. This should, however, not be seen as a reason for protecting certain classes of investors from the risks they assumed in extending credit.

11. A third conclusion concerns the possible legal difficulties that might be encountered by sovereigns seeking to use an exchange offer as an approach to restructuring their debt. Despite the relative success of Ecuador, Pakistan, and Ukraine in restructuring certain international bonds, the process of restructuring a substantially larger and more widely held bond stock that is governed by the laws of a number of jurisdictions may be much more difficult and disruptive. Moreover, although creditor litigation was not a major issue in the previous cases, recent developments in strategies for litigation against sovereign debtors, evident from Peru's experience, raise questions as to whether resort to legal remedies could become a more important factor in shaping the outcome of future restructurings. This could affect both the willingness of sovereigns to approach their creditors for a restructuring that might entail a credible threat of default, as well as the process of restructuring, to the extent that cooperative creditors are concerned about the ability of dissenting creditors to undermine collaborative approaches to resolving debt difficulties and to resort to litigation.

12. A fourth conclusion is that resort to concerted techniques to resolve a particular payments issue may have far reaching ramifications. In the case of a possible restructuring of sovereign debt, for example, the possibility of pronounced effects on other sectors of the economy will depend, *inter alia*, on the extent to which debt and debt-service reduction may be required, the openness of the capital account regime, the financial strength of the domestic banking system and banks' holdings of government debt instruments, and the ability to resolve any banking sector difficulties without recourse to the government budget. In several recent cases, members made considerable efforts to avoid use of a concerted approach to restructure their debt, in view of the ramifications that might follow. Indeed, those members whose economies are highly integrated with the international financial system have gone to extraordinary lengths to deliver the fiscal adjustment that allows them to avoid having to approach their creditors for a restructuring. In light of this, and bearing in mind that exceptional access to official resources should only be granted in situations where it is most needed and most likely to be effective, the Fund has made every effort to support these members when prospects of their efforts to avoid a restructuring were good. This, however, underscores the fact that, absent an effective legal framework for the orderly resolution of the problem of insolvent debtors, there will always be strong pressures on the official sector to provide large credits in the hope of preventing the excessive cost of disorderly debt

resolution. Clearly, if the costs of restructuring, both to the member involved and to the international financial system, could be made, or be shown to be substantially less than now perceived, the member might have more options in terms of the degree of adjustment it needed to undergo, and the Fund might have more flexibility in the financing it provided.

13. The experience gained from involving the private sector in crisis resolution and analytic work has heightened the importance of a cautious approach to policy formulation in this area. The complexities of crises and the way in which they spread through an economy, on the one hand, and the difficulty in finding approaches which might reduce the costs of crisis resolution, on the other, point to the urgency of ensuring that macroeconomic, exchange rate, and financial sector policies are fully conducive to avoiding crises. It is recognized that many corrective measures are politically and economically difficult. Nevertheless, delays in adopting appropriate policies are likely to prove costly in terms of the later difficulty of averting or resolving crises. The Fund has a key role to play here in providing policy advice based upon comprehensive assessments of economic and financial developments and prospects, but its effectiveness in helping to produce a more stable global financial system depends critically on the willingness of members to frame policy on the basis of cautious assumptions, to act promptly to correct policy weaknesses, and to sustain policy implementation. At the same time, there is also onus on the private sector to make efficient use of the information being disseminated by the Fund, and the official community more generally, to strengthen risk management and thereby help prevent the build up of vulnerabilities.

IV. THE APPROPRIATE SCALE OF OFFICIAL FINANCING

14. Article I of the Articles of Agreement mandates the Fund to provide temporary financing to assist members to adjust their balance of payments in ways that are not unduly destructive of national and international prosperity. Each emerging market crisis has had the potential for massive destruction of prosperity, both within the member directly affected, and, to different degrees, internationally through its trade and financial links and contagion.

15. The amount and the duration of official financing required to support the member's program to return to stable growth and external viability depends on the nature of the member's problem and the behavior of private creditors. If a member in crisis is judged to be facing a temporary credit crunch, and if it is determined that there is a reasonable prospect that market access might be restored reasonably quickly, then there is a reasonable case for providing financing to help the member cover its needs until market support returns. The process whereby a country regains access to financial markets, however, depends upon a host of complex issues that require difficult judgments. In the event that the policy reform does not yield the expected improvement in confidence, even with Fund financial support, previous experience suggests that difficult judgments would be required to determine whether policy adjustments or additional financial support are warranted.

16. Studies of recent capital account crises show that the extent of adjustment required of countries in the face of capital outflows, even if temporary, was generally much greater than

programmed.[1] Thus, even the relatively large exceptional financing packages supporting some recent programs did not protect the member from having to undertake much socially and politically painful adjustment. While the access to Fund financing was large when compared with normal access limits, it was not large when compared with the size of the member's financing needs. In addition, there were problems with other sources of official financing that had been committed in a number of these cases. This reflects the fact that capital account crises tend to be much larger, with the depth and spread more pronounced, especially under fixed exchange rate regimes, than the more traditional current account crises with which the Fund has normally dealt. The potential drain on foreign exchange reserves rises sharply as creditors, both domestic and foreign, suddenly seek to switch their exposure from resident debtors to nonresidents. This contrasts with the more gradual exhaustion of foreign exchange reserves when the current account is not sustainable.

17. Fund financing should strike the appropriate balance between the necessary assurance that credit will revolve rapidly and the need for the financing to last long enough to reduce the risk of a near-term liquidity crisis. Importantly, it should neither be based on maturities that are too short to allow market confidence to return nor should it be a substitute for medium-term private sector credit. In combination with the member's adjustment program, external official financing must provide the market with confidence that the member has adequate resources to meet its needs. In some cases, a rapid reflux of private capital market financing should allow the Fund to be repaid quickly, and for these cases the Supplementary Reserve Facility (SRF) has been designed. In other cases, markets will only get the assurances they need if the Fund's financing is of sufficient maturity to reduce the risk of a near-term liquidity crisis. In such cases, Fund assistance may have to be on credit tranche terms, rather than SRF terms.

V. Issues on Standstills

18. Many emerging market members fear that it is impossible to approach creditors for a restructuring without being forced into declaring a standstill on debt payments and going into full default. They fear that this will cause extensive destruction of domestic prosperity, and that the market reaction will carry contagion to other economies. While the Prague framework recognizes that members may have to resort to a temporary payments suspension or standstill pending sufficient action by their creditors, and while the Fund has indicated its willingness in some circumstances to lend into arrears, members generally seek to avoid this extreme situation since they fear that the process will be very disorderly and costly.

19. The range of options available to a member country in difficulty, as well as to the Fund, might be wider if ways could be found to make the suspension of payments more

---

[1] IMF—Supported Programs in Capital Accounts Crises—Design and Experience, SM/01/245.

orderly, without sacrificing the principle that debts should be paid whenever possible. In particular, there would be advantages if the suspension of payments could be reached through a collaborative agreement with creditors. In such an event, a standstill could function as a circuit-breaker, causing a stay on capital withdrawal from the country, and could minimize the extent of an eventual restructuring. It should be noted, however, that creditors are unlikely to be willing to consider a suspension of payments unless there is a legal mechanism to ensure that their forbearance will not be abused by a minority who will press for full payment. In some circumstances, it may not be possible to reach a voluntary agreement with creditors, leaving the debtor only with the option of declaring a unilateral moratorium on payments. This could raise a number of practical issues (including, for example, the risk of triggering capital flight), as well as the legal problems that may result from a default. In addition, it may adversely affect the country's prospects for regaining market access on terms consistent with external viability.

20. In some cases, the inability to service debt can be dealt with at the level of the banking or corporate sector, but a series of problems could arise in other cases, when a restructuring of sovereign obligations, including any taken over from the corporate sector, is required. Can a country properly restructure its obligations to non-residents while continuing to service those to residents? Can it be confident that by restructuring some claims, it will enhance the value of the remaining claims? Can it restructure claims without damaging the solvency of the financial sector and precipitating a run on banks and a foreign exchange crisis? Would a restructuring have to be accompanied by the general imposition of exchange controls, and what effect would this have on an economy hitherto integrated into the world economy? These questions all go to the economic consequences of declaring inability to service the sovereign's debt and trying to restructure it.

21. While a sovereign might be able to create the legal basis for restructuring obligations governed by domestic law, there are a series of legal questions concerning foreign creditors' rights. This points to the need to keep under close review developments in the design of debt instruments and the results of litigation strategies in order to assess whether or not it would be desirable to give further consideration to the possibility of a range of measures, including giving the Fund the ability to endorse a temporary stay on creditor litigation, and the establishment of an international sovereign debt adjustment mechanism.

VI. AGENDA FOR THE FUND

22. The ways in which the Fund's work program on the involvement of the private sector in the prevention and resolution of crises will be carried forward in the period ahead will be discussed by the Executive Board. Key elements of the agenda could include:

- Developing a deeper understanding of financial crises and the ways in which they can spread through economies, so as to strengthen further the effectiveness of Fund surveillance and the development of early warning indicators.

- Analysis of the economic costs and benefits of voluntary debt swaps, including the implications for private sector involvement and sovereign market access in the near term.

- Analysis of the deterrents to and the impact of using intermediate approaches to involving the private sector in crisis resolution.

- Further consideration of policies regarding access to the Fund's resources in the context of resolving capital account crises. This could include further consideration of the factors that have a bearing on when exceptional access is appropriate and the scale and terms of official resources that may be required.

- Continuation of efforts to assess better medium-term domestic and external debt sustainability and the viability of a member's financing plan in the context of program design.

- Analysis of the legal risks and obstacles that hamper restructuring and, in that context, a consideration of the feasibility of establishing a legal framework that could provide greater support for sovereign debt workouts, including the use of debt restructuring and standstills.

- Analysis of the design and impact of debt restructuring programs in members that are highly integrated in the capital markets and where a substantial portion of the debt of the sovereign is held by the domestic banking sector.