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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/69

10:00 a.m., June 27, 2002

**Contents**

**Executive Board Attendance**

A. Krueger, Acting Chair
S. Sugisaki, Acting Chair

| **Executive Directors** | **Alternate Executive Directors** |
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| | A.S. Alosaimi |
| | A.S. Al Azzaz, Temporary |
| A. Barro Chambrier | D. Ondo Mañe |
| | N. Guetat, Temporary |
| I.E. Bennett | |
| | M. Di Maio, Temporary |
| R.F. Cippà | |
| | R. von Kleist |
| | C. Harzer, Temporary |
| | B. Bossone, Temporary |
| | J.N. Santos, Temporary |
| | M.P. Bhatta, Temporary |
| | R.A. Jayatissa |
| W. Kiekens | |
| | B. Andersen |
| | M. Lundsager |
| | P.A. Dohlman, Temporary |
| P. Duquesne | S. Le Gal, Temporary |
| A. Mirakhor | |
| | Y. Lissovolik, Temporary |
| F. Varela | |
| | M.A. Brooke |
| M. Portugal | |
| C.D.R. Rustomjee | |
| A.S. Shaalan | |
| Wei Benhua | |
| | Y.G. Yakusha |
| | N. Yeritsyan, Temporary |
| K. Yagi | H. Toyama |
| A.G. Zoccali | L. Ocampos, Temporary |

A.S. Mountford, Acting Secretary
C.M. Watson, Acting Secretary
P. Cirillo, Assistant
H. Mooney, Assistant

**Also Present**

ECB: B Kisselevsky. IBRD: B. Esdar, Poverty Reduction & Economic Management Office; C.K. Teng, Banking, Capital Markets and Financial Engineering Office; J. Wilton, Financial Credit Risk Office; C. Monga, R. Peters, Europe and Central Asia Region Office. African Department: N. Kirmani. European II Department: J. Odling-Smee, Director; P. Alonso-Gamo, C. Beddies, R. Burgess, S. Fabrizio, S. George, R. Haas, V. Kramarenko, J. Mueller, M. Shadman-Valavi, A. Schipke, N. Sheridan. External Relations Department: T.C. Dawson, Director; O. Stankova. International Capital Markets Department: H. Tran, Deputy Director; O. Bankoglu, C. Blitzer, C. Medeiros, E. Psalida, K. Srinivasan, M. Vera-Martin. Legal Department: F.P. Gianviti, General Counsel; S. Hagan, T. Laryea, Y. Liu, M. Milford, G. Rosenberg. Monetary and Exchange Affairs Department: E. Frydl. Policy Development and Review Department: M. Allen, Deputy Director; T. Arvanitis, A. Kapteyn, A. MacArthur, A. McGuirk, M. Mecagni, C. Rosenburg, B. Setser, Q. Wang. Secretary's Department: M. Da Costa, P. Ramlogan.Treasurer's Department: M. Bozinov, T. Rasmussen. Western Hemisphere Department: A.M. Jul, L. Perez. Office of the Managing Director: J.T. Boorman, A. Tweedie. Advisors to Executive Directors: I. Ábel, A. Baukol, M. Beauregard, S.S. Farid, P.R. Fenton, S. Kropas, Liu F., A. Muganda, C.E. Pereyra, S. Rouai, A.A. Tombini, R. Villavicencio. Assistants to Executive Directors: M. Abbing A. Alber, S. Alcaide, D. Baasankhuu, G.M. Campos, Cao L., N.J. Davidson, N. Epstein, C.J. Faircloth, R. Gauba, T. Hadded, F. Haupt, C. Josz, T. Koranchelian, I. Kupča, B. Mellor, T. Moser, T.P. Nguema-Affane, K.S. Oo, P.R.D. Prasad, J.W. Ralyea III, Y. Saito, T. Segara, J. Sipko, T. Skurzewski, A. Stuart, S. Vtyurina, Yu J.

## 1. DESIGN AND EFFECTIVENESS OF COLLECTIVE ACTION CLAUSES; AND COLLECTIVE ACTION CLAUSES IN SOVEREIGN BOND CONTRACTS—ENCOURAGING GREATER USE

Documents: The Design and Effectiveness of Collective Action Clauses (SM/02/173, 6/7/02); and Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use (SM/02/175, 6/7/02)

Staff: S. Hagan, LEG; Blitzer, ICM; M. Allen, PDR

Length: 2 hours, 30 minutes

Mr. Callaghan submitted the following statement:

Despite there having been a general consensus on the desirability of collective action clauses (CACs) for some time, there has been little real progress. More concerted efforts are needed to ensure widespread adoption of CACs.

The use of CACs is determined by long-standing market practice in the jurisdictions governing particular bond issues rather than an explicit preference by investors.

A coordinated international response that includes the private sector is required to address the design of CACs and their adoption.

While the endorsement of CACs by some private sector organizations is welcome, the majority restructuring threshold they have proposed is unjustified.

Attention should focus on the most critical components of CACs that facilitate debt restructuring: the inclusion of majority restructuring provisions; and majority enforcement provisions.

The most decisive and effective step to ensure that CACs are incorporated in sovereign bond issues would be to change the U.S. securities registration requirement, and listing requirements for the G10 plus Luxembourg, to require CACs.

We do not favor the use of Fund policies on conditionality and access to resources to encourage the adoption of CACs as we see problems with all the options presented.

Encouraging collective action clauses is a key component of the international community's strategy to ensure the more orderly resolution of unsustainable debt burdens. While the staff papers are helpful, more concerted efforts are needed to achieve greater use of CACs in sovereign debt issues. The international community should reflect on the fact that although there has been agreement for a considerable time that CACs are desirable, there has been little by way of concerted action.

All the evidence indicates that what currently dictates the use of CACs is the long-standing market practice of the jurisdiction governing particular bond issues rather than an explicit preference by investors. With this in mind, a considerable degree of skepticism is in order when market participants express a reluctance to see CACs in sovereign issues. It would be interesting to know the significance of those investors quoted in the staff paper who do not purchase instruments with CACs as a matter of policy.

It is also important to keep in mind the significance of the inclusion of CACs in leading to debt restructurings. The existence of CACs can be useful in facilitating restructurings, but the evidence does not point to a greater likelihood of sovereign issues with CACs being restructured. Moreover, as the paper noted, many institutional investors, including U.S.-based institutional investors, already hold Russian U.S. dollar denominated debt which is governed by English law.

The issue hangs in the balance between whether the market considers that more widespread use of CACs will result in more frequent restructurings versus the increased recovery value of the debt if CACs speed the resolution of unsustainable debt burdens, thereby allowing growth to resume and increase the resources available to service debt.

The Emerging Markets Creditors Association (EMCA) and the International Institute of Finance have both endorsed the greater use of CACs. However, the proposal by the EMCA to increase the majority restructuring threshold to 95 percent appears unjustified. As noted, the market has accepted the CACs in English law where the voting threshold is 75 percent. The proposal to increase the threshold to 95 percent appears to be a self-serving attempt to constrain CACs.

From the issuer’s perspective, concerns relate to the effect of including CACs on the cost of debt. Recent work suggests CACs do not effect the cost of debt, although this issue remains very difficult to assess. One difficulty with assessing the cost is that the ultimate effect of the inclusion of CACs in bond issues may not be evident until there is a sufficient proportion of these bonds to facilitate less costly restructuring. Moreover, from the issuer’s point of view any additional cost (if there is any) is payable immediately while any benefit is contingent.

The issues for discussion focus on the design of CACs that the Fund should promote and what the Fund can do to encourage CACs. What is required is a coordinated international response which includes the private sector. There clearly would be a problem if the Fund was promoting one type of CACs, the industrial countries promoting some variant, and the investment houses and organizations arguing for yet another variant. Moreover, it is not clear that the market wants the Fund to be involved in issues such as drafting contractual terms.

The two most critical components for CACs to facilitate debt restructuring are the inclusion of majority restructuring provisions and majority enforcement provisions. It may be preferable to focus on standardizing and promoting existing practices with respect to CACs rather than attempting to incorporate new provisions. As the paper notes, the design features of a number of the proposed new clauses are still unclear and their effectiveness uncertain. Despite this, we note that many of the issues that need to be tackled in developing additional clauses for CACs, such as representation clauses, initiation clauses, and coverage of debt, will also arise when considering the design of a statutory approach.

We would place little weight on claims that achieving better debtor-creditor dialogue by having a designated creditor representative at early stages may unduly delay the commencement of negotiations between debtors and creditors themselves. It would clearly be beneficial for there to be some dialogue between the debtor and creditors while creditors organize themselves in a representative manner, which would take time.

One of the key differences between the contractual and statutory approach is the degree to which they solve the aggregation issue. The concern here is that it is easier for a litigious creditor to gain sufficient stake in an individual bond issue. Some commentators have suggested one response is to increase the proportion of majority enforcement provision from 25 percent to closer to the 50 percent that applies in Samurai bonds. Coupled with the introduction of sharing provisions, this would substantially increase the vulture’s costs and lower their returns, increasing the chances for more orderly resolution of debt problems.

The data presented in the papers highlights that changing market practice in the United States is the key to making meaningful inroads into encouraging greater use of CACs. This is something the U.S. administration should reflect on given its desire to promote a contractual solution to facilitate more orderly debt restructuring. It is also evident that statements by the official community in favor of the greater use of CACs has had little if any impact. Similarly, the inclusion by major industrial countries of CACs in their bond issues has had little impact in terms of encouraging their use in the issues by emerging markets.

Real progress requires CACs to become the standard practice for sovereign issues in all jurisdictions. However, it would be too much to expect that a few emerging markets issuers will 'blaze the trail' in terms of promoting the use of CACs. The way ahead should focus on promoting CACs among the investors and marketers of emerging market debt, rather than pushing borrowers to incorporate such provisions in their debt instruments.

Persuading investors in emerging markets of the benefits of CACs will take time. The preferred approach is a coordinated international response. The fastest way to ensure that CACs are incorporated in sovereign issues would be for the U.S. securities registration requirement, and listing requirements for the G10 plus Luxembourg, to be changed to require CACs. If making CACs a requirement for registration under the Securities Act is beyond the Security and Exchange Commission's mandate, then legislation should be introduced to make CACs a requirement for registration. This would be the most decisive and effective step by the international community to promote the use of CACs. It would also appear that legislation is necessary in Germany to remove the current uncertainty over the status of majority restructuring. It would be best to link this legislation with moves to make CACs mandatory.

In terms of what the Fund can do to promote CACs, tracking the use of CACs as part of surveillance may result in greater information flows, but would likely have little impact in promoting the use of CACs.

There are problems in attaching CACs in new bonds issued during Fund arrangements, and these are outlined in the paper. We should be cautious about trying to use the Fund's facilities to achieve ends for which they were not intended. Regardless of how desirable we think the outcome might be, distorting facilities will ultimately damage the Fund's credibility and run counter to the considerable effort that has been devoted to refocus policies on their core objectives. More specifically, problems include the following: if the use of CACs were a condition for the use of Fund resources, or were a requirement for exceptional access, as the paper notes it would be difficult to implement such a policy consistently; if CACs are not current market practice, the introduction of such a requirement in Fund programs would be difficult; linking the use of CACs to Fund programs may result in a stigma being attached to such clauses which may discourage their use in sovereign issues which are not under a program; if a country only includes CACs when it is accessing Fund resources, its total stock of debt may not be covered if it reaches the stage that it needs to restructure its debts; and perhaps most importantly, making any Fund financing dependent on insertion of CACs, or an exchange or retirement of bonds that do not include CACs, clearly runs counter to the guidelines on conditionality for it would be difficult to argue that CACs are critical to an individual program.

Making the Fund's willingness to lend into arrears conditional on a commitment to include CACs in new debt issues in a comprehensive debt restructuring would appear to be introducing CACs after they were needed—namely to facilitate the restructuring.

In short, it would clearly be preferable to put the focus on changing the market standard for the use of CACs rather than trying to do this through linking their use to Fund conditionality.

Mr. Wijnholds submitted the following statement:

The contractual approach should not be seen as a quick or intermediate solution. It should be developed in parallel with the statutory approach.

A legal or regulatory approach to mandate the use of CACs would be the first-best approach to increase the use of the clauses.

I am not generally in favor of making the use of CACs a condition under all Fund-supported programs. To this general rule, one could envisage two specific exceptions.

Industrial countries and institutional issuers -such as the World Bank and regional development banks- could lead by example to promote the use of CACs.

It would seem realistic to promote the inclusion of CACs primarily in the context of new debt.

I would like to begin by thanking staff for an excellent set of papers. Both papers give a very comprehensive account of all relevant issues. In addition, they give a fair and balanced assessment of the work to date and of the possible ways to promote greater use of collective action clauses (CACs). Unfortunately, I found myself in almost full agreement with staff's views. 'Unfortunately', as I concur with staff's observation that the official sector's calls for CACs since 1996 (the year of the G10 Rey report) have not had any impact on market practices and that there is no easy or quick fix to secure more widespread, let alone universal, use of CACs in the future.

The first conclusion that can be drawn from the paper is that it might be incorrect to consider promoting the greater use of CACs as a quick 'intermediate' solution, while treating the work on a statutory regime for sovereign debt restructuring as something for the longer-term.

Even under the most optimistic scenario, it will take years before the bulk of bond contracts contain CACs. In fact, the work on the statutory regime might lead to quicker results. Both approaches are mutually reinforcing and should both be developed in parallel with equal vigor.

Staff discusses a number of measures that might promote the use of CACs. From the paper, it becomes clear that a legal or regulatory approach would be the most effective, or first-best solution. If the use of CACs becomes mandatory, a quick inclusion of the clauses in all (new) bonds will be secured. Furthermore, we do not run the risk that investors associate CACs with crises and investors will not (easily) be able to discriminate against bonds with CACs (as most or all new bonds will contain the clauses). In practice, regulatory or legal changes in the United States (New York) and to a lesser extent Germany would be most effective. I would therefore strongly urge the U.S. and other authorities to consider taking this step, as obviously, this would be the easiest and most thorough way to introduce the clauses championed by undersecretary Taylor.

Given the widespread consensus in favor of promoting the use of CACs—evidenced by references in several IMFC communiqués- some of staff's proposals should be uncontroversial. I would for instance be strongly in favor of encouraging the use of CACs through surveillance. If we agree that the use of CACs in debt contracts entails best practice and benefits the international financial system, we could monitor the use of CACs in Article IV consultations. In addition, it might be useful to pay explicit attention to the percentage of debt containing CACs, in the debt sustainability analysis. I also think it would only be logical to amend the guidelines on public debt management to explicitly endorse the use of CACs. Although I fully support these proposals, I am afraid they might not have a tremendous impact on the proliferation of CACs.

I would not be in favor of making the use of CACs a condition under all Fund supported programs. To this general position with regards to the use of conditionality I see two possible exceptions: the CCL and lending into arrears.

In principle, I can see the logic of making the use of CACs a formal precondition for CCL eligibility. The CCL is a facility for countries that are "maintaining constructive relations with [their] private creditors with a view to facilitating appropriate involvement of the private sector, and [have] made satisfactory progress in limiting external vulnerability through the management of the level and structure of its external debt and international reserves". More in general, the CCL is for countries that implement sound policies. In this light, it seems only logical to expect the use of CACs as an a-priori commitment. Of course, I agree with staff that adapting the conditions for CCL eligibility is not likely to cause a sea shift in favor of using CACs, in particular as the CCL decision expires next year.

Despite some doubts, I would also be able to agree on making the use of CACs a precondition for our lending into arrears policy. If a country is already in the middle of a restructuring, it might be logical and relatively easy to demand the use of CACs in new bonds. My doubts concern the points raised by staff (the risk of associating CACs with restructurings, and the possibility that using CACs negatively effects a country's return to the market). In addition, I note that some restructured debt contains clauses that prohibit additional restructuring (e.g. 'principal reinstating clauses'). Creditors sometimes demand these clauses during the debt restructuring but it would obviously not make much sense to have them together with CACs.

Like Mr. Callaghan, I see many problems with the suggestions to make CACs a precondition for use of Fund resources, or to make it part of the conditionality in Fund supported programs. First, I wonder if demanding CACs can be squared with our Articles and/or our conditionality guidelines (using CACs can hardly be judged macro-relevant). Perhaps one could make the case that they are necessary for safeguarding the use of Fund resources, but I doubt whether we would deny a member in problems access to our resources because it does not use CACs. Second, making CACs part of eligibility criteria or conditionality for 'regular' facilities would associate the clauses with crises. Third, if CACs are indeed associated with crises, it is likely that introducing them will at first lead to higher borrowing costs. The midst of a crisis might not be the right moment to complicate the country's possibilities to tap the markets. Finally, as described in the paper, CACs will only be effective if a sufficient bulk of a country's debt contain them. Therefore, we should pro-actively promote the use of the clauses by all countries at an early stage. Pushing the clauses with countries in crises is too little, too late. For these reasons, I am not in favor of making the use of CACs a (pre) condition under Fund programs.

I would also oppose creating financial incentives, such as subsidizing countries' use of CACs or offering access at a lower rate. In my view, such schemes would be far more market distortionary than a comprehensive statutory approach. A more effective way of ensuring the inclusion of CACs in all debt henceforth would be to amend the articles and to make them a requirement for membership of the Fund. Whether such a fundamental approach could be applied, perhaps simultaneously with the establishment of an SDRM, ultimately depends on the extent of the commitment of the membership to this issue.

Industrial countries and institutional issuers such as the World Bank and regional development banks could also show their commitment through leading by example (including the clauses in their own issued debt). First, this would avoid adverse signaling effects. Second, the 'first mover costs' referred to in the staff paper would be relatively low (and possibly zero) for this category of issuers, while they may be substantial for emerging markets.

Third, it would be little assuring when the G7 and G10 countries develop bond clauses for emerging markets that they would not be prepared to include in their own debt. Leading by example by industrial countries and institutional issuers would be particularly useful if their example was quickly followed by investment grade emerging markets. Perhaps staff or Management could take this up with the Management of the World Bank.

In addition, we could start an effort to persuade major issuing houses to encourage their clients to include CAC's in their new debt. We could also take CACs to the road and explain their usefulness in detail to other important market participants (including rating agencies, but also retail investors). We should be able to explain that there are certain risks attached to holding non-CAC debt (i.e., that a small minority can potentially reduce the value of bonds held by the majority) and that CACs are not as scary as they are sometimes made out to be. Perhaps management can discuss this line of thought with the Capital Markets Consultative Group and report back to the Board.

With regard to the types of clauses that should be included in bond contracts I feel that majority restructuring provisions alone would not suffice. They need to be complemented by enforcement provisions, which discourage free riding behavior, as well as initiation clauses, which allow for a stay and structure the negotiation process. The precise contents and shape of the package of clauses that are needed, is currently fleshed out by working groups of the G7 and G10. This work is envisaged to result in a set of relevant model clauses. The IMF could usefully build on the G7/G10 work. Measures to encourage a greater use of CACs should typically be targeted at the full package of relevant clauses.

It would seem realistic to promote the inclusion of CACs primarily in the context of new debt. Although the inclusion of CACs in the existing stock of outstanding bonds would be desirable in itself, the costs of accomplishing this may be prohibitively high, especially for the less advanced countries. Although the burden for debtor countries could in theory be eased through official sector subsidies, as noted, such subsidies would be distortionary and I would not support them. In addition, it is not evident that the total cost of exchanging all outstanding debt would outweigh the benefits of a speedier introduction of CACs.

Mr. Portugal submitted the following statement:

There seems to exist a positive spirit for achieving a wider use of existing collective action clauses in new international sovereign bond issues. This could be an efficient alternative to improve the process of restructuring sovereign debt that might garner sufficient consensus amongst creditors and issuers to be actually implemented. The Fund may have some role to play in this process. However, attempts to create new conditionality or eligibility requirements to force the use of collective action clauses are likely to be counterproductive and would raise a number of difficult issues. The most promising route to increase the use of existing collective action clauses seems to be a joint and constructive effort that would need to have the ownership of major institutional investors and major bond issuers. Among other things, governments of industrial countries can help in this process by leading through example, including collective action clauses in their own international bond issues, and by dispelling uncertainties about the use of these clauses in their jurisdictions.

Our strong view is that any initiative to widen the use of collective action clauses should be limited exclusively to new international sovereign bonds.

The costs associated with debt exchange operations to replace the current stock of US$244 billion of bonds that lack collective action clauses with new bonds will be very large. Debt exchanges may create an additional risk factor, increasing costs to issuers. In addition to documentation costs and higher premia to bondholders, there would be substantial commission fees to be paid to investment houses.

The staff acknowledges that an attempt to include collective action clauses in instruments other than sovereign international bonds—for instance, syndicated loans, domestic debt or international private bonds—raises difficult issues. Yet the staff seems to continue to entertain such ideas and proposes to discuss them in a future paper. We are disappointed to see that there is still a plan to consider these issues.

An inclusion of collective action clauses in domestic public debt and private external debt would substantially increase costs and will exclude any possibility of support by many emerging market countries. Including collective action clauses in domestic public debt is likely to seriously undermine the development of national capital markets and to lead to a greater need of external financing in the long term. Moreover, as recognized by the staff and many market participants, this is not actually needed since the sovereign already has legal means in its own jurisdiction to protect its assets against attachment and to deal with “vulture creditors”.

As the staff paper has indicated, there has been reluctance by issuers and their creditors to include collective action clauses in jurisdictions where they are not already the established market practice. The staff recognizes the existence of short-term costs associated with the required change in documentation, and that there is a potential signaling problem. The staff believes, however, that there would not be a permanent increase in borrowing costs and quotes studies that have found little evidence of increased costs. However, as the staff recognizes, these findings are highly sensitive to the econometric technique used, the type of corrections to data quality problems, and the treatment of endogeneity. The staff also reports that informal contacts with market participants indicate that there is likely to be resistance to the change and that some institutional investors indicated that, as a matter of policy, they do not buy bonds with collective action clauses, while others do so only on a selective basis. It seems clear, therefore, that there will be costs associated with the introduction of the collective action clauses in jurisdictions where they are not the market practice, the only doubt being how large and how prolonged these costs will be.

This situation argues strongly in favor of limiting any attempt to introduce collective action clauses in jurisdictions where they are not used to the existing majority restructuring and enforcement provisions. The costs associated with a representation clause, initiation clause, or aggregation clause will be much higher and market resistance much stronger. On the other hand, the benefits of some of these new clauses may be small.

Contacting bondholders has not proven to be difficult in earlier restructurings. A representative without powers to negotiate on behalf of bondholders would be of little value and could even delay the process. Similarly, an initiation clause to provide for a cooling off period during which litigation would be avoided seems equally unnecessary. It is also likely to encounter strong resistance by investors and to increase borrowing costs. I would like to ask staff if there were actually cases of maverick litigation during the initial period of recent sovereign debt restructurings. The idea of having an aggregation clause to aggregate voting across debt instruments is completely unrealistic, meets strong resistance from creditors, and would not be in the interest of the debtor either. Preserving the diversity of creditor interests in relation to the debtor, of which different debt instruments are a reflection, is actually an asset that can facilitate a negotiation and restructuring. The staff's fear of holdout creditors disrupting the restructuring process by acquiring a controlling position in a single bond seems exaggerated. Again I ask the staff if there are concrete examples of such a situation in the recent sovereign restructurings.

An important aspect regarding majority-restructuring provisions would be the establishment of the voting threshold. Bonds issued in the London market currently have a threshold of 75 percent or even 66 percent, while the Emerging Markets Creditors Association (EMCA) has suggested a threshold of 95 percent. This is an issue where I believe there might be room for some compromise in-between the two figures. I encourage the staff to talk further to other investors, in addition to the EMCA. To inform the discussion, the staff could collect information of what have been the average and modal percentages of participating creditors in recent bond restructurings, including through exchange. Our chair disagrees with the EMCA proposal concerning excluded bonds, which would exclude any entity "under the jurisdiction of, formally affiliated with or under the control of" the issuer. This is too encompassing an exclusion that would exclude all nationals of the sovereign issuer since they are under its jurisdiction. While the principle of excluded bonds is acceptable, it should be limited only to bonds held by or on behalf of the issuer.

Using a trust deed may not achieve the objectives that staff ascribes to such idea. Trustees tend to be highly risk averse and are unlikely to act quickly or to act without very broad bondholder support. A trustee is also likely to require the advice of an investment bank before acting, which would increase costs further. While we would be willing to explore further the idea of using a trust deed, we are not enthusiastic about it.

It would be totally inappropriate for the Fund to create new conditionality to force countries to include collective action clauses in their bond issues. The staff analysis of this issue was done under the assumption that there is a strong relationship between the introduction of collective action clauses and Fund lending. The staff neither discusses such assumption nor presents strong argumentation in its support. This is quite understandable since such argumentation would be hard to find. The purpose of Fund conditionality is to safeguard the use of Fund resources. Collective action clauses may facilitate an eventual sovereign debt restructuring. However, if a restructuring is not expected during the program and repayment period, there would be no connection between the existence of such clauses and safeguarding Fund resources. Hence, it would be inappropriate to introduce such clauses as part of program conditionality. On the other hand, if a restructuring is expected during the repayment period of Fund resources, it means that the program is not sustainable and the Fund should not lend into it. Moreover, the Fund enjoys a de facto preferred creditor status that has served to protect its resources well during restructurings. Using conditionality to force the introduction of collective action clauses would also go against the current policy of streamlining conditionality only to those measures that are critical to the macroeconomic objectives of programs.

It would be particularly inappropriate for an international public organization such as the Fund to force its weaker members to engage in expensive debt exchange operations, having to pay high commission fees for a hypothetical future benefit. While Wall Street firms may be quite keen to promote such exchanges and amass huge fees, if the Fund would use its leverage to push members in this direction, this would raise serious ethical questions.

When members approach the Fund to borrow, they are in most cases facing a situation of financial distress. This would be the wrong moment to try to include collective action clauses in bond contracts. Our chair would also oppose requiring the inclusion of collective action clauses for lending into arrears. While in some of these situations a bond restructuring may be required, the fact that all bond conditions would actually be changed diminishes the need for such clauses, while their inclusion would make the negotiations more difficult. In addition, such use associated with an actual restructuring would further stigmatize these clauses.

A policy of not lending, or not lending above a certain level, to countries that have not included collective action clauses in its bonds would be quite hard for the Fund to maintain if a member is prepared to undertake the required adjustment. Such a policy would not be credible. In order to avoid the perception of penalization, the staff suggests linking the use of these clauses to the provision of higher or additional access, and mentions the CCL and the SRF as examples. But since these facilities have no access limit, it is difficult to understand how the access could be said to be higher or additional.

Our chair continues to strongly oppose any change in the Articles to include an obligation to adopt collective action clauses. This would be an inappropriate legal use of the faculty to amend the Articles, since such amendment falls outside the Fund's current purposes and was never envisaged by members when they first subscribed to the Articles. As the staff recognizes, the amendment would be impractical to enforce. Moreover, it is highly unlikely such an amendment would get the minimum 85 percent vote.

While the Fund could cover the topic of use of collective action clauses during its surveillance, this is likely to be ineffective and to further overburden the surveillance process, which is already overloaded with too many objectives. The best contribution that the Fund could give to the process is to continue to research the topic.

The best way to proceed on this issue would be for major issuers of sovereign international bonds and major institutional investors, with the participation of leading investment houses, to discuss a process that would have the ownership of all parties involved to gradually include existing collective action clauses in new bonds issued in jurisdictions where they are currently not used. I see as a precondition for such an effort a clear understanding by the Fund and its main shareholders that this process: (i) will be limited exclusively to new international sovereign bonds; (ii) will be limited to existing majority action and enforcement provisions; and (iii) would not be the object of conditionality. Moreover, while the Fund may still continue to study the issue of a statutory approach to sovereign debt restructuring, at some point in the future, when the process of wider use of collective action clauses is to be implemented, it would need to be seen as an alternative to the statutory approach.

Obviously, the timing for a concrete move would have to be carefully considered. The current adverse conditions of international capital markets for emerging markets would not be a suitable time.

While a few have already done so, industrial countries could lead by example, including collective action clauses in their own international bond issues. Major industrial countries in whose jurisdictions there are still doubts about the legal status of collective action clauses could take action to dispel such uncertainties. I would like to know from staff what is the current status of the draft law presented to the German government by a group of practitioners to deal with this issue. The staff also indicated in paragraph 33 of SM/02/173 that it is unclear whether a clause limiting individual bondholders' rights to initiate litigation would be valid under Japanese law. What would be the required steps to dispel such lack of clarity?

Industrial countries could also examine the ideas presented by our chair during the IMFC meeting to deal with the problem of "vulture creditors", namely, extending to other jurisdictions the attachment immunity for foreign central bank assets which already exists in the United States and England; the adoption of rules to protect from attachments payments flowing to and from clearing systems like Euroclear, Clearstream and DTC; and case-by-case participation of the official sector of the creditor country as "amicus curiae" in legal proceedings initiated by holdout creditors.

Mr. Low and Mr. Bhatta submitted the following statement:

Staff have presented some suggestions on ways to encourage greater use of collective action clauses (CACs) in international sovereign bonds, but the irony is that all the options relate to "enforcing" greater use of CACs through financial incentives rather than "encouraging" greater use through changing sentiments and acceptability of CACs by both market participants and sovereign bond issuers.

Staff indicated that they have consulted the private sector (bond investors) to obtain their views on the use of collective action clauses in the international sovereign bonds, but it is not clear to us whether staff have similarly sought the views of existing and prospective sovereign issuers. We believe that it would have been a much better approach to have sovereigns readily including CACs in the international bonds that they issue instead being imposed on them. We wonder whether their reluctance to include such clauses in their bonds is largely because it is not the established market practice to do so, or because of more fundamental economic concerns. Further clarification from staff is appreciated.

We cannot support any proposal to require Fund members to include CACs in their international sovereign bonds as a condition for access to Fund financing either through the application of conditionality in existing Fund programs or through the provision of higher levels of access or creation of new facilities just to "reward" members for using CACs. As noted by staff, in pursuing these approaches, we would have to assume that there is a strong relationship between the introduction of CACs and the objectives of the policies that govern the use of Fund resources which is a rather tenuous assumption. Furthermore, this would only promote the use of CACs amongst Fund members that currently have financing programs with the Fund. It will exclude a Fund member that currently does not need to borrow from the Fund, but nevertheless continue to tap the international bond market. In the event that such a member need to restructure its debt in the future, its bonds may not include CACs, and thus defeat the Fund's objective of ensuring that a country's sovereign bonds contain CACs when it matters most. Another significant concern of the staff's proposed approaches is that they would introduce an asymmetric application of CACs mostly in developing and emerging market countries, but not in the industrial and advanced economies. This will only exacerbate the concern that countries that use CACs will be stigmatized by market participants and raise the cost of fund raising by such countries.

A key reason why CACs have not be more widely used appears to be the reluctance of market participants to accept such clauses as an established market practice even though they have become a standard feature in the London market. Obviously, market participants would not consider the inclusion of CACs in sovereign bonds favorably if they perceive this as limiting their leverage and flexibility for taking action in the event of a default of the sovereign bond. However, they would not have any reason to question the inclusion of such clauses if it is the established market practice for bonds issued in all of the major financial centers. As noted by staff, U.S. Law does not prohibit the inclusion of such clauses in international sovereign bond contracts. Therefore, we believe that the most promising approach to ensure that the usage of CACs in international sovereign bonds as a standard market practice is for all major international financial centers to require sovereign bonds issued under their jurisdiction to include such clauses. However, we are disappointed that staff had devoted only two paragraphs of the entire paper to discuss this approach, although they have admitted that it merits further exploration. Given that the G-7 have publicly stated that they support the greater use of CACs in international sovereign bonds, they could take the all important step to agree that all international sovereign bonds issued under their jurisdictions have to contain CACs. We believe that if there is the political will, the apparent legislative challenges could be easily overcome.

Staff have raised the concern that investors may stay away from bonds that contain CACs or demand a higher pricing from the issuers. However, it is hard to believe that investors will stay away from such bonds if almost the entire universe of sovereign bonds will contain CACs. Furthermore, there is no reason for them to demand a higher pricing from any issuer if CACs are standard in all the sovereign bonds issued in the major financial centers. We would therefore urge staff to seriously explore this approach further.

We do not believe that it is realistic to seek debt exchanges to convert all existing international sovereign bonds into new ones containing CACs. The practical difficulties in managing such a massive conversion is unimaginable, without even taking account of the risk of potential adverse market reactions. It would probably take years before the conversions could be completed, not very different from the many years it would take for most of the old bonds to mature, or to establish a workable SDRM. Therefore, we would suggest that we should not be overly ambitious but focus our efforts on new bonds only. Once the use of CACs become established market practice and more of the stock of bonds begin to contain CACs, perhaps it would then be much easier and even advantageous for sovereign issuers to undertake debt exchanges to replace their old bonds with new ones.

Our view is that the Fund should for the moment promote only the use of clauses found in existing bonds, namely the majority restructuring and majority enforcement clauses. The acceptability of the other clauses, namely representation, initiation and aggregation is open to debate depending on whether one looks at from the point of view of an issuer or an investor. Expanding the Fund’s work to these other clauses would only raise more questions and could possibly delay our efforts to encourage the use of CACs. It would, nevertheless be useful if staff could survey the views of issuers as well as investors to gain a better understanding of the pros and cons of such clauses.

With the above considerations in mind, we do not believe that amending the Fund’s Articles of Agreement to require the use of CACs is an acceptable approach. This is not what the Articles should be used for and it would set an unacceptable precedent for justification of future amendments of the Articles and undermine the credibility of the Fund as the market could interpret this to mean that the Fund can easily amend its Articles to impose its demands on market participants.

Mr. Andersen and Mr. Alber submitted the following statement:

We would like to thank the staff for an interesting set of documents. The two papers on CACs provide an excellent overview of the issues involved and break the ground for further progress in this complex and difficult area. The work of the Fund in this field has already initiated a lively debate and enhanced understanding of the need for CACs in the financial community. The coming discussion on SDRM, combined with the insights provided by these papers, will allow a comprehensive assessment of the situation and assist in constructing the best strategy for the Fund to advance its objectives.

Orderly debt restructuring seeks to ensure inter-creditor equity, avoid bailing out of private creditors and minimize the problem of “free riders,” in addition to being a vital part of crisis prevention and resolution mechanism. An appropriate balance needs to be found between individual creditor’s rights and efficient procedures to enforce a majority will. The aim is to safeguard the collective good that orderly and efficient sovereign debt restructuring can create for the international community.

Both majority restructuring and majority enforcement provisions are needed for efficient debt restructuring that addresses the collective action problem. But a form of an initiation clause could be useful as well. It has been used successfully in corporate reorganizations, e.g., under Chapter 11 bankruptcy law, in order to stop a creditor’s grab race for a debtor’s assets. In the context of a contractual approach to sovereign debt restructuring, such clauses would, by providing a standstill period, be useful addition to the majority enforcement clauses.

At the heart of the CACs dialectic is the question of a voting threshold. If the majority is too small, an issuer’s debt could be bought up in order to commandeer the restructuring process and the likelihood for a bondholder to be a part of a discontent minority would greatly increase. If the majority were too large such as above 90 percent as has been proposed, the majority action clause would lose nearly all efficiency. Even a 75 percent supermajority rule cannot prevent vulture funds to buy in and unite with other bondholders to achieve a blocking position. The exact threshold to choose must await further technical study and may be inspired by similar provisions in, for example, company law where majority- and minority-shareholder rights are defined.

There are several ways to address the collective representation problem, e.g., using a trustee as practiced under English trust law, a consultative group or a bondholders protective committee. But there are also certain obstacles to the use of trustees. As trustees need a certain minimum support from the bondholders, their hands can also be tied by the fear of being sued by disgruntled bondholders. The new representation or engagement clause certainly does address the administrative problem but whether it will be the preferred solution is not clear at this stage.

The new aggregation provision would certainly be a valuable addition to an efficient restructuring process, but its implementation can be difficult, with bonds issued under different jurisdictions and possible different interpretations. Preliminary market reactions indicate a concern that the provisions could facilitate voting manipulation. This problem could be handled within a statutory approach, where an independent dispute settlement mechanism would ensure the integrity of the voting process. The possible technical/legal problems with aggregate CACs should be further analyzed, along with the possibility to obtain the same result as part of a statutory approach to debt restructuring.

We believe that including CACs in bonds of the G10 and other industrial economies would be a way of changing market practice and increase the possibility for broader progress. We also believe that it is appropriate that first mover costs and possible signaling costs be borne by strong issuers. The United Kingdom and Canada have made first steps, but a broader undertaking by more G10 countries would minimize these potential costs. Such an effort would increase the likelihood that emerging market issuers initiate collective action clauses in their bonds.

High priority should be given to the introduction of CACs in standard bond documentation in major jurisdictions. A G10 working group is currently investigating the possibilities for introducing “model clauses” in bond contracts. Future discussions in the IMF should take notice of the results of this work.

The Fund should promote the use of CACs in new bond issues and track their use as a part of its work on surveillance and crisis prevention, including sustainability analysis and promotion of guidelines for best market practices in debt management. The possibility of encouraging voluntary debt exchanges to solve the stock problem should be further analyzed. From the point of view of facilitating orderly and swift debt restructuring sooner, rather than in the very long run, changes in the existing debt stock or an introduction of the SDRM would be necessary.

Since CACs are not a standard element of industrial countries’ sovereign debt contracts, it is premature for the Fund to try to force the issue by requiring countries that seek assistance from the Fund, to pull the cart by initiating the use of CACs in bond issues. Nor can use of such provisions be a condition for the Fund’s membership at this stage. However, incentives for the inclusion of CACs in debt issued in comprehensive debt swaps may be considered. Like Mr. Wijnholds, we see some merit in considering introducing CACs as a part of the Fund’s lending into arrears policy. The issue of Fund promotion of CACs could be revisited at a later stage and in the light of the progress made under a voluntary approach.

Mr. Yagi and Mr. Toyama submitted the following statement:

We welcome staff’s work on the legal effectiveness of, and the methods used to promote the use of Collective Action Clauses (CACs). While the contractual approach based on CACs is less comprehensive than the statutory approach, it can be easily implemented solely based on agreement between bond issuers and bond purchasers/bondholders. In addition, unlike the statutory approach that can be activated only when the institutional mechanism is established, the contractual approach can be introduced step by step. The studies on the two approaches are not mutually exclusive, but instead complement each other. When conducted in parallel, they would produce twice the benefits by shedding multifaceted light on problems to be addressed, and motivate debtor countries and market participants to give more thought to the issue. Indeed, we have come to see welcoming initiatives by the private sector to sincerely study CACs.

It is significant that the staff paper on the legal effectiveness on CACs discovers that the validity of CACs, if carefully articulated, will not likely be nullified and that it is not the law but the market practice that has hindered introduction of CACs in New York State where a large chunk of international sovereign bonds are issued. In this regard, the ongoing G10 and other forums' initiatives to promote the use of CACs by drafting model provisions are welcome, and we expect this work will produce outcomes by the autumn meetings. Considering that the court where a suit is filed may apply a set of laws other than the governing law designated in the contract, depending upon the private international law rules of the country, it will also be necessary to study the validity of CACs against laws of countries where bond issuers have large assets or where a clearing system is located. If the next step includes aggregation of CACs, it will also be necessary to study how valid clauses should be formulated across jurisdictions, to cope with a case where a country issues bonds in plural jurisdictions.

The paper on the methods to promote the use of CACs enumerates the reasons for reluctance on the side of market participants and bond issuers to introduce CACs. Paramount among them is that issuing countries are concerned about the possibility that introduction of CACs would indicate the prospect of default in the future. On the other hand, the fact that draft provisions by market participants set the threshold level as 95 percent shows their strong apprehension over possible debt restructuring they do not want. These responses clearly reflect the fact that there are few precedents where the Fund did not move for assistance when sovereign debt became unsustainable, inducing one to overly count on the possibility that his interest will be saved, including assuming that the Fund will eventually provide assistance. This would result in moral hazard. In other words, there seems to exist a recognition that introduction of CACs will only make the Fund better off at the expense of bond issuers and bondholders. Unless such moral hazard is wiped out, it is difficult to expect a voluntary move to introduce CACs.

However, it is not the case that CACs would not serve solely in the interest of the Fund. In case sovereign debt becomes unsustainable, an orderly restructuring of debt will maximize the total interest of bond issuers and bondholders. That relevant parties duly recognize this benefit would be the most effective driving force for promoting the use of CACs. While it is the role of the Fund to help a member who helps itself, the ex ante expectation of markets should be disciplined as if the Fund's assistance would be non-existent or at least limited, which would facilitate more voluntary use of CACs as insurance. In this regard, the first thing we have to consider among any attempts to use the Fund's activity as leverage to promote the use of CACs is to make clear the cost incurred by bond issuers and bondholders without CACs. Bond issuers will consider utilizing a jurisdiction where insertion of CACs is a market practice, and jurisdictions where CACs have not been a market norm will voluntarily move for introduction of CACs from a competitive standpoint.

On the design of CACs, it is most important that the provisions be formulated to serve the goal of facilitating orderly restructuring sovereign debt, but at the same time, it is also essential that the provisions will be acceptable to the market. Also, the provisions should be valid in all major countries where bonds are issued and a clearing system is located. A study into these issues has just begun and, in particular, the reaction from market participants is preliminary. Detailed configuration as to whether the provision should be formulated as a majority restructuring provision or a majority enforcement provision or what is appropriate for the threshold level could be better decided later when other forums have presented their views.

We can approve the significance of a representation clause and an initiation clause. It will be necessary to study the validity of these clauses against the legal system of relevant countries. Also, since CACs only for a particular issue of bonds would have limited consequences, a study on the introduction of an aggregation clause that bundles various debts is essential, if the contractual approach would eventually have to have similar significance to the statutory approach.

On the question as to whether the Fund should promote the use of CACs by making it a condition for its financing, one has to fully consider the relationship between the goal and its methods, the probability for the goal to be attained, and any adverse side-effects.

It is appropriate that staff will monitor how much CACs are used in its surveillance activities. Consultation with the authorities can be a good opportunity to inform them of the merits of CACs.

On the question of whether the use of CACs should be a condition for access to the CCL, given that the CCL is yet to be used—although we long for a Board meeting this fall to discuss the methods for facilitating the use of the CCL—making the use of CACs a condition for access to the CCL may not produce major results, as pointed out by staff.

Using CACs as a condition for exceptional access to Fund resources, under all Fund-supported programs, or for lending into arrears, may facilitate the use of CACs, as countries prudent enough to prepare for this assistance would fulfill the necessary conditions. We must note, however, that a trial to introduce CACs at the time Fund assistance is actually needed would be costly, increasing the amount of needed assistance. Also, we do not believe it appropriate that these Fund activities would not be made available only because CACs are not used. To remedy these adverse consequences, it seems conceivable to establish a lead period—for example, three years—before the conditioning becomes effective. However, a country that is in a critical situation throughout this period will not be able to fulfill the requirement. That said, we think the use of CACs would serve as an indicator for the degree of self-help efforts by a member country when the Board judges on assistance to that country.

The proposal that the Fund provide additional financing in exchange for retiring existing debt that lacks CACs has merit in that the objectives and functions of other facilities would not be compromised. It is a practical method for breaking the status quo. As staff points out, such financing raises the question of equal treatment vis-à-vis countries that have already inserted CACs in their bonds. But these countries would be rewarded by being deemed favorable when Fund assistance is required. What is important is to make a breakthrough in the market. If the new facility is used to bring some bonds with CACs into the market, it follows that a market where the CACs have not been used will change its practice. Such financial assistance, of course, should be conditional on a strong program which would reestablish a sustainable macroeconomic path.

To make use of CACs a requirement for Fund membership is like using a sledgehammer to crack a nut. While the importance of CACs has increased, they are technical ramifications. Also, such a requirement would give the impression that CACs are burdens, rather than benefits, that have to be endured by a country in return for membership.

On steps outside of the Fund, it is meaningful that industrial and emerging countries with investment grade insert CACs when issuing international sovereign bonds to give momentum to changing market practice. On the other hand, a change of securities regulations to make CACs a requirement for exemption from the disclosure requirements seems out of the question, given the objectives of these regulations.

Mr. Kelkar and Mr. Jayatissa submitted the following statement:

Further progress needs to be made to reach a strategy to promote the use of CAC.

Threshold provisions in a strategy to promote the use of CAC should not be too restrictive.

Application of CAC to existing debt could be detrimental.

Introducing new provisions which add to cost and delay the process of promoting the use of CACs need to be avoided.

Use of Fund conditionality to promote CACs is not advisable.

We thank the staff for the two informative papers on the subject, which deal with the issues relating to the development of standardized strategy to introduce more orderliness into debt workouts.

It appears that the existing provisions and structures of many sovereign bonds have flexibility to facilitate orderly debt restructuring, despite considerable variations in the provisions of among many sovereign bonds, about the inclusion or exclusion of majority restructuring and majority enforcement provisions. It is encouraging that the differences in various provisions are a matter of practice rather than any hurdles under the prevailing laws. While, we do not have the expertise to make any specific comments on the legal aspects of the subject, we would wish to offer some general remarks.

First, despite the several papers discussions we had on this subject and, as highlighted by Mr. Callaghan in his preliminary statement, we are yet to find a generally acceptable mechanism to encourage greater use of collective action clauses. We have a long way to go in making recommendations to our Governors a reasonable strategy on this. Nevertheless, a greater understanding of the existing mechanisms and their implications for sovereign debt workout as well as for market development would be useful. In this regard, we consider the discussion on the issues raised in the present set of papers is another step forward.

Second, in a common strategy to promote greater use of collective action clauses, the provision for majority restructuring threshold should not be excessively restrictive. We tend to agree with the view of market participants that a 95 per cent threshold could be too restrictive and reduce the effectiveness of majority restructuring provision. The experience with the English Law (75 percent threshold) needs to be further studied, before coming to the conclusion that it is too low.

Third, while it would be useful to promote greater use of collective action clauses in sovereign debt restructuring, it is difficult to assume that these provisions do not have a significant impact on cost of funds to borrowers. Would the staff be able to prejudge what effect would an international common strategy have on cost of Funds as well as on market development? Would it not lead to a slowdown of private capital flows to emerging markets? Application of CAC to existing debt could be detrimental, as it would entail heavy costs to borrowers.

Fourth, in the context of promoting private sector involvement and parallel restructuring of private sector instruments, the approach to restructuring exercises through instruments like collective action clauses should be consistent between private debt and sovereign debt. This is also relevant for orderly pricing and functioning of fixed-income market as a whole.

Fifth, we feel that it would be desirable to go along with provisions most acceptable to the market participants and which would help in protecting both creditor and debtor interests rather than introducing new strategies, as it may add to costs and make the process more complicated. However, we are not against exploring mechanisms to promote market innovations.

Sixth, we too feel that while the aggregation of claims across instruments would be helpful, we do not see that this is practicably feasible and we understand the rationale for negative market reaction to this proposal.

Last but not the least, we share the views expressed by Mr. Callaghan on the role of the Fund, and particularly the inadvisability of the use of Fund conditionality to promote greater use of CAC. However, we have no objection to the Fund collecting information in market developments for analytical purposes and as part of bilateral or multilateral surveillance. We also share the views expressed by Mr. Wijnholds on the possibility of using CAC as conditionality with regard to the CCL and lending into arrears. The use of effective action clause may be encouraged but the option should be given to market participants to select which is best for them.

Mr. Bennett submitted the following statement:

CACs have a valuable contribution to make in facilitating the timely and orderly resolution of crises. But they are not a panacea; they must be supported by a strong policy on access to Fund resources. And there is still a need for a SDRM.

There are a variety of steps the Fund can take to overcome the “first mover” problem, including further outreach, the development of model clauses and technical assistance.

But there will probably still be a need for additional incentives. Accordingly, we would support making the use of CACs a requirement of the policies governing exceptional access and lending into arrears.

It is time to take concrete steps to encourage the widespread use of CACs.

The staff papers provide a comprehensive and well-balanced discussion of the issues at hand.

Let me say, at the outset, that we view Collective Action Clauses as a useful element of the toolkit for crisis resolution. They should not be seen as a substitute for other elements of the kit, such as the SDRM, but they have a valuable contribution to make in facilitating the timely, and orderly resolution of crises. They also should not be viewed in isolation from other policies, especially access policy.

We agree with the staff that, with the possible exception of Germany, the different treatment of CACs across various national jurisdictions is more a matter of practice than law. Thus, CACs could be introduced into bonds issued in all international jurisdictions.

The most critical components of a contractual approach already exist in the form of majority restructuring and enforcement provisions. The key design issues are the voting threshold and the extent to which non-arms-length bonds are excluded from voting. The creditor community fears that if the threshold were set too low and if bonds held by entities connected to the sovereign were allowed to vote, that their rights would effectively be infringed upon. These are legitimate concerns, but I think we should be aware that self-interest may color some of the market participant's proposals. I would be comfortable with a 75 percent threshold and following the U.K. example, which is based on the freedom of contract, on non-arms-length bonds. The staff paper notes that borrowers who issue bonds governed by U.K. law are not penalized by markets.

I also agree with the staff that there is merit in "representation clauses" which would empower a representative to negotiate on behalf of the creditors in a non-binding manner. In practice, however, it may be difficult to find a representative who is acceptable to all parties concerned and I would not want us to become bogged down on this issue.

There does not seem to be much of a case for "initiation clauses". The recent experience of Argentina suggests that the risk of a "rush to the courthouse" is relatively small.

If possible, we would favor including CACs in syndicated bank debt that is securitized.

It is one thing to develop good clauses, another to make sure that they are actually included in international bonds, and still another for them to be activated.

With respect to encouraging the widespread adoption of CACs, we need to overcome the "first mover" problem. The Fund can help overcome the barrier posed by market practice through its market outreach efforts, and by drafting model clauses and providing technical assistance to members wishing to adopt CACs. As well, we would encourage other industrial countries to join Canada and the United Kingdom in adopting a policy of including CACs in foreign currency borrowing. But, I also think that we should be pragmatic and realize that this will probably not be sufficient to achieve our aim.

It is also doubtful that the Fund can provide enough financial sweeteners to produce the desired result. Therefore, it will be necessary to resort to making the use of CACs a requirement for, at least, some types of access to Fund resources. I realize that there are counter-arguments, but I think that on balance a case can be made for making CACs a requirement for exceptional access and lending into arrears. But for this to work it must be credible that the IMF will deny a loan to a country that does not use CACs—even if all other aspects of its program were acceptable and it meets the criteria for the type of lending. This might be particularly difficult to render credible with respect to exceptional access which is meant to apply in cases of contagion and systemic vulnerability. It will take a strong access policy for this approach to be effective. The new access policy will have to be clear, predictable, and widely known.

We would note further that even if CACs are included in bond contracts, there have to be incentives to activate them. When a country runs into trouble, its creditors probably will not agree to reduce their payment streams if they have reason to believe the IMF eventually will come through with a large assistance package. Thus, CACs alone are not enough to provide debtors and creditors with the incentive for early resolution of their problems. Presumptive limits would be key in this regard. Indeed, the more I think about the broad subject of crisis prevention and resolution, the more convinced I become that all roads go through access policy. Access policy sets the incentives for everyone.

We strongly support the effort to encourage the widespread use of CACs and think that it is time to move from generalities to specifics. We encourage the staff to proceed with drafting model clauses that could be discussed by the Board and to prepare a paper on how the requirement to include CACs in new bond issues could be incorporated into the Fund's policies governing exceptional access and lending into arrears. At the same time, it is important to recognize that CACs are only one tool for crisis resolution and to be effective they need to be supported by other policies, most notably a good access policy. As well, in light of the aggregation and stock of existing debt problems, the widespread adoption of CACs would not obviate the need for a SDRM.

Mr. Mirakhor submitted the following statement:

We thank the staff for their balanced, fair, and comprehensive report and their work on the design and promotion of broader use of collective action clauses (CACs). Before turning to issues for discussion, we have three general comments:

First, while we support the Fund's role in crisis resolution, we believe that emphasis and focus should always be on crisis prevention. To balance the message regarding prevention and resolution, the offer of an incentive structure to promote CACs and ultimately facilitate debt restructuring should be complemented by comparable incentives to promote other Fund initiatives, like standards and codes, to encourage countries to implement good policies with the objective of improving their credit risk and preventing crises. Such an incentive structure could, for example, make CCL more attractive. We, therefore, encourage the staff to focus on such an incentive structure for the forthcoming review of the CCL.

Second, since CACs are considered under the umbrella of private sector involvement (PSI), their use and effectiveness should be achieved with coordinated international action plan that includes the private sector in efforts to design a market standard for the use of CACs and their adoption.

Third, the staff report points out that, despite previous calls and encouragement from the official sector for a broader use of CACs, there is little evidence of a change in market practices. This conclusion leads us to believe that before adopting a general policy that could affect Fund's operations and membership, it would be helpful if the G-10 and other industrial countries could lead by example and include CACs in their sovereign debt. Moreover, we appreciate staff comments on Mr. Callaghan's suggestion that the "fastest way to ensure that CACs are incorporated in sovereign issues would be for the U.S. securities registration requirement, and listing requirements for the G10 plus Luxemburg, to be changed to require CACs."

On the design of CACs, in order to increase the chances for their broader use, it is important to seek standardization of existing best provisions, namely majority restructuring and majority enforcement. The inclusion of new types of clauses does not seem helpful to the process since the market itself is not convinced of their usefulness. In this regard, our own experience with Pakistan's debt restructuring has been useful in suggesting that the two clauses and the 75 percent threshold, included in bonds governed by English law, are effective and sufficient, and should become the standard. Adopting a high voting threshold in majority restructuring provisions, like the 95 percent advocated by some market participants, will not be helpful in promoting wider acceptance of CACs.

The staff have made a number of proposals to promote the use of CACs in international sovereign bonds. We have no difficulty with tracking the use of CACs under Fund surveillance. Such exercise could promote the contribution of the ICM department to surveillance. However, we doubt that this exercise, which should cover the entire membership, will, by itself, contribute to a wider use of CACs. The staff have also made a number of proposals to make the use of CACs as part of Fund conditionality or as a condition for access to Fund resources. The staff paper and the statements of Mr. Portugal and Mr. Callaghan have made compelling arguments why CACs should not become part of Fund conditionality, and we agree with them. Moreover, as mentioned by other Directors, these proposals contradict the current drive to streamline Fund conditionality and facilities.

Mr. Palei and Ms. Vtyurina submitted the following statement:

Although it is always implied in the staff documents, it is worth noting that the Fund's efforts to improve surveillance and the effectiveness of prevention remain the main venues of dealing with debt crises. What matters most for investors is the intrinsic health of the economies and their growth potential, while the precise fashion of the sovereign bankruptcy is and will always remain a secondary concern. As the staff have put it in the report, "investors prefer to trade on the basis of the sovereign's underlying credit quality, not on the basis of specific legal provisions in the documentation". Of course, this notion does not lessen the importance of the progress on the SDRM, and we certainly welcome the staff' papers that address possible steps forward within the contractual approach. The staff have prepared a set of useful papers on the experience with the use of collective action clauses (CACs) and on the ways to promote their use in various financial centers.

We hope that a more focused work on the improvements to the SDRM within the contractual approach will make the sovereign debt rescheduling a more transparent, more predictable, and more expeditious process. Such an outcome is certainly in the interests of all the parties involved. In our view, while a more active use of CACs is called for, the issuance of bonds with CACs should not have detrimental effects on emerging markets' access to foreign financing.

Our position calls for an active dialogue between the interested parties towards an acceptable set of the main features for a template on sovereign bonds issuance. As the private sector now seems to have unambiguously accepted the need for a greater use of CACs, it is still seeking further reassurance that there would be no major shift of a balance in favor of a debtor in the event of restructuring. Under the circumstances, the degree of ownership of such a template is a prerequisite for its acceptance as an industry standard.

One of the key issues in promoting a greater use of CACs in the bond contracts is the decision on whether to follow the voluntary approach or make their use mandatory. We recognize that the voluntary approach was not effective despite repeated calls from the official community for a desired shift towards the use of CACs in the sovereign debt instruments. In this light, we see some merit in introducing mandatory requirements on the use of CACs in major jurisdictions. However, it is not clear whether such an approach is feasible, and we would appreciate it if the staff could elaborate on this issue. At the same time, we are not prepared to endorse a mandatory approach to the promotion of CACs by the Fund. In our view, inclusion of the use of CACs in the Fund's conditionality would be counterproductive, and here we agree with many arguments offered by the staff as well as other Directors. The Fund should follow a voluntary approach in its activities.

The staff analysis suggests that there is no conclusive evidence that the cost of issuing differs depending on legal provisions or jurisdictions; otherwise, there would have been a clear evidence of the "mark-up" on bonds with CACs. At the same time, potential cost increases in the event of the inclusion of CACs in the contracts is still one of the main preoccupations of the issuers. The main argument here is that the cost implications remain marginal only because there has not been a major shift from one type of bonds to another. When this shift becomes significant, such differences may emerge. The private sector, in its turn, seems to be apprehensive that the inclusion of CACs in all bond contracts could create the potential for abuse and weaken certain "creditor rights". Overall, it is still not clear whether there could be a high price to pay for the debtor supposedly gaining greater leverage in the workout process. To reiterate our earlier point, these concerns point to the delicate nature of the current situation and to the dangers of hasty solutions that would aim at mandatory approaches by the Fund in promoting CACs.

We see it important to promote a voluntary inclusion of CACs in sovereign bond contracts by all parties involved. To this end, we fully share the staff's proposals in paragraphs 62–64, namely to encourage major sovereign issuers and issuing houses to lead by example, and to support and promote the inclusion of CACs in sovereign debt of industrial countries and leading emerging market economies.

We agree that for the success of the workout process efforts should be concentrated on promoting the importance of the majority restructuring and enforcement provisions in CACs. The trust deeds similar to those under the English law should not be seen as an alternative to the creditors' committees, and, most likely, both forms will be used in the foreseeable future. Similarly, broader dialogue is called for to determine whether the representation or initiation provisions could be a part of a standard template. On the latter, we would be interested to know if there were any precedents of "maverick litigation" mentioned in paragraph 44 of the companion paper. Although the absence of the aggregation provisions is the major weakness of the contractual approach, we suspect that the promotion of such provisions will face resistance in the private sector since it is likely to be very difficult to introduce them simultaneously into the existing contracts. Such an operation could also be difficult from a legal point of view. We have similar doubts about feasibility of the introduction of “super” collective clauses. Here, the risk of voting manipulation stands out as one of the serious concerns. Not least, the use of such provisions may further fuel the private sector’s calls to make the multilateral and official debt be a part of such proposed restructuring.

We agree that, in its surveillance activities, the Fund should promote CACs primarily with respect to the new debt issuance. We would strongly support the tracking of international bond documentation by the ICM as part of the Fund’s surveillance of its members and capital markets, as well as for the purpose of building expertise in this area and providing advice to its members. Thus, we endorse all of the staff’s suggestions made in paragraphs 33–34.

We do not believe that the use of financial “rewards” can advance the use of CACs, and we do not support creation of a special facility to provide financing on favorable terms to cover for extra costs of swapping the old debt.

Finally, the proposal to amend the Fund’s Articles for the purposes of fostering the use of CACs does not appear to be realistic and is not consistent with a voluntary and gradual approach to the introduction of CACs.

Mr. Cippà submitted the following statement:

The SDRM proposal has created a new interest in CACs on the part of market participants.

Taking this development into account, the drafting of bond documentation and the introduction of CACs should be left to market participants.

The Fund should encourage the introduction of CACs mainly through its surveillance activity and by continuing its work on an SDRM.

This Chair, as many others, has been a long standing proponent of the introduction of collective action clauses (CACs) in international sovereign bond documentation, because a wide-spread use of such clauses would allow a more efficient restructuring of unsustainable debt. As we are all aware, however, market participants did not share our enthusiasm, and broad official endorsement failed to get market participants interested in a more widespread use of CACs. That is until last November. The SDRM proposal put forward by Mrs. Krueger and staff seems to have served as a wake-up call for market participants, and CACs—until then easily dismissed - were suddenly found to be much more attractive. The prospect of an SDRM has created a new situation, in which market participants attach more value to the introduction of CACs.

Whether words will be followed by action remains to be seen. For the time being, however, I think we should give market participants the benefit of the doubt and act on the assumption that they now wish and find ways to adapt market practice. It is under these altered circumstances that we should clarify the role of the Fund in encouraging greater use of CACs in sovereign bond contracts.

The Fund should not be involved in the drafting of bond documentation; this is best left to markets. The question remains, however, how the official sector should act when there is a clause or a disposition in a clause which evidently defeats the logic of the contractual approach. The suggested 95 percent voting threshold for the majority restructuring provision is a case in point. Here, we should let market participants know that this would not meet our demands for a contractual approach, particularly if considered as a serious alternative to the SDRM.

The corollary to leaving things to the markets is surveillance. It is necessary that all participants, the Fund as well as market participants. I would also welcome more information about CACs from the ICM. With a few exceptions, I think the Fund cannot do much more to encourage the introduction of CACs.

The major exception concerns the CCL. Making the use of CACs a condition for eligibility for access to the CCL seems to be warranted as it represents an adequate observable standard for good policies.

In my view, it would not be credible to make access to Fund resources, whether regular or exceptional, dependant upon the use of CACs. Likewise, the introduction of CACs should not be part of Fund conditionality because—as pointed out by staff—it would link access to a specific policy rather than to the overall strength of the program. Finally, going a step further, making the use of CACs a condition for Fund membership would run against the logic of the contractual approach.

In a nutshell, the introduction of CACs must hinge on the private sector's willingness to participate in such an initiative. The Fund should encourage the dialogue but leave this issue primarily to the private sector. In my view, the best the Fund can do is to continue its work on an SDRM.

Mr. Varela and Ms. Alcaide submitted the following statement:

We would like to thank staff for their clear and comprehensive papers prepared for today's discussion on Collective Action Clauses.

We think that the current approach to restructuring sovereign debt needs to be improved in order to create a more predictable and less costly process towards the restoration of sustainability. Two ways are currently explored by the international community to achieve this goal: the statutory and the contractual approach. Regardless of the outcome of today's discussion, we should continue working on the statutory approach and we look forward to more opportunities to analyze it.

We think that it is worth exploring and deciding on possible ways to encourage a further use of collective action clauses in sovereign bonds. We can draw three clear ideas from the staff papers presented to us. First of all, the papers clarify which are the main clauses that could be used in further efforts by international community to promote them, namely the majority restructuring provisions and the majority enforcement provisions. Second, the papers clearly show the relevance of encouraging a more extensive use of those clauses. And third, they give a convincing explanation regarding the underlying reasons why the CACs have not been widely used.

At the same time, there are still some points that need further clarification and decisions by the Board, particularly what other clauses could be added to the existing ones and whether their introduction is considered relevant and feasible, to what sort of debt should these clauses be incorporated, and how better to persuade debtors and investors to use them.

Before given a direct response to the main questions raised by staff, we think that it is worth to highlight the underlying reasons behind our exercise on CACs. First, the contractual approach is basically justified because it follows a market-based solution for a more predictable and efficient sovereign debt restructuring. This aspect is highly relevant and it should be taken into account when designing the incentives to increase the use of CACs among market participants. A second aspect that needs to be taken into account is that CACs are a public good, the benefits of them spreading to the whole international community cost, and not only to the emerging markets. This has a bearing when considering the distribution of implementing and adopting the CACs.

From the above, we can withdraw three straight-forward conclusions which are relevant in our exercise of further encouraging the use of CACs. On the one hand, that the use of CACs should be universal and not limited to countries which are running debt sustainability risks. On the other hand, that the cost of implementing the CACs should be shared among investors and debtors, and should not be assumed only by the issuers. Finally, that the incentives adopted to encourage their use should be respectful with a market-based approach.

Following the reasoning expressed in previous paragraphs, the international community and particularly the Fund should promote a broader use of CACs. We should avoid measures which are against market practices and, particularly, the use of CACs as a condition to access Fund resources. On the contrary, we believe that there is sufficient scope to promote the use of CACs by a voluntary approach, including the use of Fund surveillance, with the use of persuasion among market participants encouraging the universal use of CACs and ultimately by introducing regulatory requirements in relevant jurisdictions.

We think the use of CACs could be further encouraged by the following six ways:

The Fund can promote the use of the existing CACs through its surveillance exercise. This is a powerful measure to induce a change in the behavior of major issuers. As staff points out, the use of CACs could be analyzed during Article IV consultations on member countries, as well as during Board discussions on multilateral surveillance in which the Fund should encourage a more extensive use of these clauses.

We endorse the idea of amending IMF/WB guidelines on public debt management, to consider the use of CACs as best practice. This could also help to encourage further use of CACs.

We also share the idea that the Fund make efforts to encourage a change in the market standard for the documentation of sovereign bonds and also to provide technical assistance to incorporate CACs in bond contracts. We consider quite relevant to develop a new documentation template incorporating the CACs that could be used not only for emerging market bonds, but by any issuer. The Fund could actively participate, together with major issuers, investors and firms.

The exercise of persuasion could go a long way in promoting further use of CACs. In this regard, we think that the example provided by major issuance houses and institutional investors could be very helpful, not only by developing new model clauses, but also encouraging issuers to make use of CACs in new bonds.

Moreover, we think that it would be very useful that industrial countries lead by example with the incorporation of these clauses in their bond issuance. This measure would additionally help to change the view that the use of CACs may be associated with countries with poor credit.

While we believe that the promotion of the use of CACs by the Fund through its surveillance exercise, and the adoption of the same clauses by industrial countries leading by example could serve to encourage a wider use of them, a more efficient way to achieve the same objective would be to make the use of such clauses a requirement for access to the financial market of all major financial centers. A change in the listing requirements in the United States, Japan and some European centers, does not seem to be too complicated when compared with the benefits that would accrue to the international community stemming from generalized used of CACs. In those cases where a change in the securities registration requirements would be more difficult, the solution would be to modify the legislation so as to make compulsory the incorporation of such clauses in sovereign bonds. Even recognizing that the compulsory implementation of CACs contradicts a purely market-based approach to the use of CACs, it could be the most efficient way to promote a general use of them.

The use of these measures should focus on new issues, so as to promote the incorporation of CACs gradually in the overall debt stock. Although we are aware of the time that will be needed to change the whole debt stock and recognizing the difficulties associated with the process, we think that attempting to make mega-swaps in order to introduce CACs more rapidly, is both costly and hazardous. These mega-swaps could be difficult to be implemented in periods of stability since there are no sufficient incentives to the debtor country, particularly when taking into account the associated costs; whereas in periods of instability, it will compound the risks and difficulties that the country is undergoing.

We do not agree with the idea of making the use of CACs a condition for Fund programs. Nor we would favor their mandatory use by the Fund in cases of countries applying for exceptional levels of access or for lending into arrears. The Fund, on those occasions, could stress the benefits of using CACs, but they should never be imposed as a requisite, since their introduction in the same moment of the crisis could turn out very onerous and could lead to the stigma association of the clauses with countries in crises. Additionally, we think this request could be inconsistent with the current exercise of streamlining conditionality and the need to justify the criticality of measures set in the macroeconomic programs.

A more effective and consistent way for the Fund to encourage the use of these clauses by these countries would be by providing positive incentives to the use of these clauses in old and new bonds, such as lower charges on those purchases made to meet this special need. Nevertheless, measures proposed by staff such as the creation of a new facility, seem difficult to implement.

We do not share the idea mentioned in paragraph 65, on the financing by the international community of some of the first mover costs. The first mover problem does not only involve one country or one bond issuance; it requires an extensive adoption of CACs until they can be considered a general practice.

On the type of clauses to be included in sovereign bonds, we find very important to widely extend the use of the existing majority restructuring and enforcement clauses. We think that the 75 percent voting threshold generally used in bonds under the English law, appropriate. On the contrary, the 95 percent proposed by some investors would seem excessive and would reduce efficiency.

With respect to the new clauses mentioned in the papers, while we do not consider the provisions of initiation and representation decisive, we find the aggregation provisions essential to allow for less complex debt restructurings, although we agree that their design and implementation may be very difficult.

Ms. Lundsager and Mr. Ralyea submitted the following statement:

The United States strongly advocates a market-based approach to sovereign debt restructuring as a key aspect of the official sector's efforts to improve crisis resolution. These efforts are part of a larger endeavor to reduce uncertainty in emerging markets and ultimately help make the sovereign debt of all countries investment grade. The approach should support a more orderly restructuring process by providing for three things: a mechanism to bind minority creditors to decisions by the majority to change financial terms of an agreement; a road-map for interaction between a sovereign and its creditors in the event of a payments suspension; and temporary protection from legal action during a payments suspension.

The design of such an approach should not be as difficult as some would have us believe. Existing majority restructuring and majority enforcement provisions and new clauses would help accomplish this objective. It is possible that greater use of trust arrangements would also be helpful. Pursuit of a statutory approach should be considered complementary to this contractual approach.

The time is ripe to move forward expeditiously with the contractual approach. A level of support is emerging from the private sector, which has expressed a desire to work with the official sector to develop the contractual approach. The June 3 letter from the IIF, EMTA and other major associations representing investors to G-7 Finance Ministers declaring their support for an approach that includes the use of collective action clauses in sovereign debt contracts is but the latest example.

Consequently, we expect the staff to continue working assiduously on this important issue and to encourage more aggressively member countries to use CACs. Discussion and monitoring of the use of CACs should become a regular part of Fund surveillance with a strong presumption for CAC use in all use of Fund resource cases. At the same time, we would like to see further exploration of options to provide enhancements for IMF borrowers that commit to use CACs and believe that such options should also be explored by the World Bank as well. It will be essential to review progress at the Annual Meetings in September.

We note that the Fund paper on incentives seems to stress the difficulties associated with the exchange of existing debt, while underplaying the degree of private sector support and higher feasibility of implementing the contractual approach. We understand that the June 3 letter from the private sector may have been released too late to be reflected in these papers. However, before either of the papers are published, we would like the papers—particularly the incentives paper—to be revised to present a more balanced view of private sector's views of the contractual approach, as reflected in the June 3 letter.

While we welcome further study of ways to create incentives for sovereigns to use CACs, from our standpoint, the benefits of CACs for both sovereigns and their creditors are clear. On those grounds alone, we strongly encourage emerging market sovereigns that are coming to the market in the next few months to include CACs in their debt contracts.

Below are our reactions to the key issues and proposals raised in the staff papers. Going forward, attention should focus on developing appropriate clauses, encouraging countries to include those clauses in new debt issues, and persuading market participants of the utility of those clauses.

On aggregation, we agree with the staff that achieving aggregation contractually would be difficult and likely is not worth pursuing. However, we believe strongly that the contractual approach can still be effective without aggregation—this should not be an excuse to avoid pursing the contractual approach. In addition, we believe that efforts to provide for aggregation in any sort of mechanism are likely to be strongly resisted by many in the private sector.

On voting thresholds, careful consideration will need to be given to how voting thresholds are set. It may be appropriate to use existing market practice or to let the market make the determination.

We strongly agree with the staff's proposal to track use of CACs more aggressively in its surveillance activities. In addition to the options suggested in the Fund paper, the Global Financial Stability Report could be used to highlight which emerging market countries have been using CACs.

We believe there should be strong presumption that countries wishing Fund access, particularly exceptional access, should endeavor to put clauses in their new debt. We also support making use of CACs in any new bond issuances, including any bonds issued in connection with a restructuring, a condition for receiving Fund lending while the sovereign is in arrears to private creditors.

We support further research into the Fund providing countries additional access through a new facility to encourage an exchange of existing debt. A new facility would need to be established to address special balance of payments problems.

Industrial countries have the option of putting these clauses into their own debt as an additional option to promote the use of clauses. However, as noted in the paper, there is no evidence that the use of these clauses, in, for example, the United Kingdom and Canada, has encouraged emerging markets to use the clauses. Further, the objective of this initiative is to address a gap in the crisis resolution framework for emerging market issuers. The best option is for the official sector to work closely with the market participants and emerging market sovereign issuers to emphasize the utility of the clauses and encourage their use.

We strongly disagree with the staff's assertion that the contractual approach will be of minimal use unless existing debt is also treated in the near term. An incremental approach can be effective. Nonetheless, when emerging market countries are considering debt exchanges, we could support strong official sector encouragement for the use of CACs. We would not support proposals that would require a country to exchange all its existing debt before receiving a Fund disbursement.

The staff asserts that official exhortation for greater use of these clauses will not be effective because similar efforts have been unsuccessful in the past. We would argue that there are several important differences between previous efforts and the current efforts, including the greater receptivity on the part of the private sector and a commitment from many in the official community to pursue the contractual approach.

The "first mover" issue is an important consideration and will require special attention in the coming period. Some additional incentives may be necessary to address the uncertainties that exist as this process is getting off the ground.

Mr. Zoccali and Mr. Pereyra submitted the following statement:

We thank staff for a comprehensive set of papers on the design of collective action clauses and on ways to promote their use. Staff's well-documented analysis of the characteristics of the international bond market reasonably allows as a first conclusion that the main obstacle to the widespread use of collective action clauses (CACs) is the difficulty in overcoming the rigidity of market practice in some of the major financial centers, most notably New York and Germany. As staff note, the use of CACs depends on the accepted "norm" in a given market. As a consequence, emerging market borrowers seeking to tap financing from investors who typically purchase bonded debt in a given jurisdiction find it difficult to diverge from long-standing prevailing market practice. The fact that there is no clear legal reason why bonds governed by New York law could not include CACs, begs the question of why market practice has been so reticent to incorporate what would seem to be a Pareto improvement for the long-term functioning of markets.

The staff report on Encouraging Greater use of Collective Action Clauses in Sovereign Bond Contracts provides a helpful background regarding the reasons for resistance to change. In this regard, suffice it to note, first, that short-run costs for borrowers are likely to increase given today's lack of market acceptability of such changes in documentation, until the markets become accustomed to the new practice. Second, evidence points to investors regarding CACs as signaling a future need to seek a restructuring, despite the fact that where the use of clauses is already the market standard these do not seem to signal future credit difficulties. Third, a given market practice tends to be driven by inertial behavior, reflected in the preference for "off-the-shelf" language in bond documentation. In sum, while inertia and short-run costs are clear obstacles to the use of CACs, they are by no means the only ones.

Additionally, the concern of a permanent increase in borrowing costs if the introduction of CACs is seen as a demand of emerging market issuers, should not be downplayed, given the resistance shown by dedicated emerging market portfolio managers in New York. Staff might wish to comment further on the validity of their perception that CACs would not significantly improve debt restructuring procedures, and that "creditor rights" would be weakened because of the chances that domestic investors could eventually end up representing a large proportion of debt holders and be subject to moral suasion by the sovereign.

We acknowledge the difficulty of establishing econometrically that the use of CACs would systematically raise borrowing costs. At the same time, sovereigns who have issued bonds governed by English law, including by countries in this constituency, have not consistently paid a premium relative to issuers of bonds governed by New York law. Consulted rating agencies also seem to suggest that they did not consider the governing law of a bond issue among the risk factors affecting bond ratings. From this angle, it should not be subsumed that lack of use of CACs in some jurisdictions responds to an inherent reticence on the part of emerging market borrowers.

We associate ourselves with the view that only majority restructuring and majority enforcement provisions could be germane to the workout process. Regarding representation clauses and their intended role of facilitating early contact between a debtor and its creditors, we have serious doubts as to whether the trustee is empowered to effectively become instrumental in discussing and deciding a modification of contractual terms. Under these circumstances, the use of an intermediary could, as some market participants point out, ultimately end up delaying a restructuring process; and the time factor plays a critical role in the restoration of creditworthiness of the sovereign, as well as of private sector borrowers in the country. Similarly, while the concept of a "cooling-off" period in initiation clauses could hold some attractiveness, this objective could be better served by means of a majority enforcement clause. Aggregation provisions, intended to address the limitation of majority restructuring and majority enforcement clauses to a given bond issuance, seem to be a non-starter given market participants' firm negative views. Consequently, we consider these "new provisions" as going against the guiding notion that any modification of international sovereign bond documentation must take into consideration prevailing market sentiment in order to avoid misinterpretation of the sovereign's intentions and, as importantly, to ensure a more orderly and lower cost debt reprofiling process.

In order to foster a more favorable market environment in support of CACs that encompasses institutional investors as well as the buy and sell sides, we consider critical that any widening of the use of CACs be limited to the issuance of new debt. Concerning the voting threshold required in majority restructuring clauses, English law suggests that lower levels in the order of 66/75 percent, are operationally meaningful. Nevertheless, there might be scope to move to a somewhat higher threshold in the context of a more broad-based approach to secure CAC acceptability. In this connection, staff also raise the possibility of resorting to exit consents to modify non-payment terms through a lower majority, a technique used by Ecuador in its debt restructuring. We would welcome, however, some additional comment regarding the effectiveness of this construct in light of Elliot vs Peru and subsequent market attitudes.

Regarding ways to enable the Fund to promote the use of CACs, the expectation of uniformity in application would provide some scope for more active surveillance in the form of tracking and technical assistance, as a way of increasing awareness among the membership of the benefits of CACs. However, we are opposed to making the use of CACs a condition for access to Fund resources, given the probability, in the current circumstances, that this give rise to inappropriate signaling or even to the interruption of Fund support in the event that a perfectly justified bond issuance does not include CACs due to market resistance. Additionally, conditioning eligibility for exceptional access on the use of CACs could result in a denial of Fund support solely as result of the inability of the country concerned to meet this condition, thus introducing a further constraint for its return to financial viability.

As for the use of CACs in new debt issued under a program as a requirement for access to Fund resources, we concur with the objections raised by staff. As already suggested above, it is precisely the countries in need of Fund support that have the greatest difficulty in accessing international capital markets. Such conditionality would further complicate their situation, given that the introduction of CACs in those circumstances is most likely to require payment of a premium or reduce the availability of private market financing. As significantly, the eventuality that CACs end up associated only with countries in financial distress, therefore signaling potential insolvency and resulting in their stigmatization, should be a general concern. In general, we concur with staff that introduction of CACs should not serve to discourage demand for Fund arrangements and that the start of a Fund-supported program would not be the right time to insist on CACs in new issues or on changes in the legal terms of debt documentation.

We also strongly oppose the suggestion that the Fund could promote the use of CACs by making it a condition for its lending into arrears. Such a strategy clearly establishes the link to stigmatization. Moreover, such a condition would impose a clear negative externality for the member concerned, in terms of the eventual costs that may be imputable to a prolongation of the restructuring process or to the higher premium for securing CAC acceptability. Alternatively, the loss of confidence that could be associated with outright lack of program compliance if market acceptance proves elusive would negate the benefits of Fund support. The creation of a special facility to finance the additional balance of payments need generated by the retirement of existing debt that does not include CACs, would, by definition, not necessarily improve the country's debt profile, which should remain the overriding aim of the exercise. We are, thus, of the opinion that such Fund-promoted incentive schemes, as well as the alternative of amending the Articles of Agreement, would not only pose difficulties, but also be less effective than a cooperative approach to adapt market "standards" within the membership.

In closing, official exhortation or conditionality on a reduced group of borrowers is unlikely to alter market practice. We strongly encourage prudently advancing the use of CACs in bond issues through a cooperative and more broadly based effort that includes: increased use of such provisions by industrial country borrowers, as well as investment grade emerging market issuers to contribute to setting a new market standard. We also see merit in complementing such efforts, by way of U.S. securities registration and European listing requirements so as to destigmatize the use of CACs by making majority restructuring and enforcement provisions standard in major financial centers.

The Deputy Director of the Policy Development and Review Department (Mr. Allen), in response to questions from Directors, made the following statement:

Mr. Low asked whether the reason sovereign issuers are reluctant to include collective action clauses (CACs) in their bonds is that it is not market practice to include such instruments or whether they have more fundamental economic concerns. The staff sees this primarily as an issue of overcoming the inherent conservatism of the market to any changes in existing practice, although there are also first mover cost issues associated with issuing CACs.

On a related point raised by Mr. Zoccali, while the market concerns that creditors' rights would be significantly weakened if domestic debt holders held a large share of an international bond issue should not be exaggerated—as it would be unusual for domestic creditors to reach the supermajority of 75 percent required for the approval of a restructuring if the English practice were to be adopted by other financial centers—such a possibility can not be completely ruled out. There are probably cases of some individual international bond issues which are largely held by domestic investors, which could be a genuine concern. These concerns probably underlie the proposal by the Emerging Market Creditors Association (EMCA) and other market participants that a supermajority of at least 95 percent should be required for the approval of debt restructurings, but in the staff's view this threshold would be too high for CACs to be used effectively.

Mr. Mirakhor asked whether the staff believed that the fastest way to get these clauses into bonds is to change listing requirements in major jurisdictions, particularly in New York. Certainly, we believe that would probably be the single most effective measure that could be taken in this area. However, I note from Ms. Lundsager's preliminary statement that the U.S. authorities see problems with this approach. Turning to Mr. Palei's related question about the feasibility of introducing mandatory requirements for the use of CACs in major jurisdictions, while this would be feasible, it would probably require changes in legislation in some of these jurisdictions.

On Mr. Kelkar's questions about the effects of an international common strategy on the costs of funds and on market developments, the staff's view is that applying the English practice of including CACs in bonds issued under New York law would have little effect on such costs once the initial obstacles had been overcome.

> Regarding Mr. Portugal's question as to how higher access levels to the Contingent Credit Line (CCL) or the Supplemental Reserve Facility (SRF) could encourage the use of CACs, taking into account that these facilities do not have access limits, we agree that the terms of these facilities would have to be revised if they were to be used effectively as an incentive for the use of CACs.

Mr. Portugal observed that the option of allowing higher access to CCLs and SRFs should not be presented as a positive incentive for the use of CACs if this option would require the introduction of access limits in these facilities.

The staff representative of the Legal Department (Mr. Hagan), in response to questions from Directors, made the following statement:

> Messrs. Portugal and Palei asked for specific examples of maverick litigation prior to debt restructurings, and for the value of the initiation clause in that context. Based on the existing experience, the staff generally agrees that the risk of litigation is higher after the restructuring has taken place because vulture funds can at this point enforce their claims without a risk of having to share the benefits with other bondholders of the same issue. Having said that, there are examples of maverick litigation prior to debt restructurings, and the most recent one has taken place in the case of Argentina. While the motives of the creditor that has sued the authorities are still unclear, the implications are interesting because he has not only sued on his own behalf, but also on behalf of a class which represents outstanding debt of $30 billion under the 1994 Fiscal Agency Agreement. Nevertheless, it is not clear exactly how this will play out, as it has only been filed recently and a number of questions have arisen. First, it is unclear to what extent this creditor represents the interests of the other creditors that he claims to represent, and many of these creditors might decide to opt out of the class. Second, the court needs to decide if this creditor in fact represents the interests of the other creditors within the meaning of the Federal Rules of Civil Procedure which define class actions. The authorities are currently reviewing their legal strategy, and it is too early to draw any conclusions, but this is certainly an example of maverick litigation.

> Regarding the issue of initiation clauses, Directors have asked if these are needed given the limited instances of maverick litigation prior to restructurings. The staff paper explains that the effectiveness of such clauses depends on how they are drafted. If the clause provides for an automatic stay on litigation after a default, it is probably not useful, and there are other provisions already contained in bond contracts that allow for a majority of creditors to impose a stay on maverick litigatio. However, to the extent that it is designed to allow for a grace period after an instance of nonpayment, it could delay the declaration of a default and consequently acceleration. In addition, it would also help defer the activation of the cross default provisions

in other bond issues. The latter appears to be the most promising avenue for an initiation clause.

Mr. Portugal asked if there were any specific examples of bondholders acquiring a blocking position in bond issuances. We have no empirical evidence, but there is anecdotal evidence with respect to Argentina. There are rumors that a vulture fund is acquiring blocking positions in many of the orphan bonds left over in the "mega swap" of 2001, and many investors and the Republic of Argentina are extremely concerned about this.

On Mr. Zoccali's question about exit consents and recent market developments, the staff has been cautious about proclaiming exit consents as a panacea for outstanding bonds that do not have CACs. Exit consents allow a simple majority of creditors to agree to the amendment of nonpayment terms of debt contracts. Judging from comments received from the EMCA and from a variety of securities industry representatives in the recent letter to the Secretary of the U.S. Treasury, Mr. O'Neill, the market reaction to exit consents has been negative. It appears that market participants intend to respond to any attempts to increase the use of exit consents by moving some of the nonpayment provisions into the category of payment provisions which require a higher majority, as was the case with the negative pledge clause used as part of the exit consent amendments in the case of Ecuador.

Mr. Portugal asked about the status of legislation proposed by practitioners to clarify the legal framework in Germany and about the additional steps that could be taken to clarify whether or not an individual bondholder could initiate litigation under Japanese law. While the authorities of Germany and Japan are the most qualified to answer that question, the staff's intention in the staff paper was to obtain the input from the private sector as to what they considered to be acceptable and viable within these jurisdictions. In the case of Germany, the leading law firms surveyed by the staff were unable to provide firm opinions on the viability of these practices because they had concerns regarding possible uncertainties in the German legislation. The staff cannot conclude whether those concerns are valid, and is just transmitting the views expressed by these practitioners. In the case of Japan, the uncertainty appears to relate to the fact that the commission company of bondholders, which is the Japanese equivalent to a trustee, does not have the ability to constrain bondholders' rights to initiate litigation, so the question is whether or not that could change without changing the current legislation.

Mr. Mirakhor asked about the promise that making the use of CACs a registration or listing requirement would promote the use of CACs. As the Deputy Director of the Policy Development and Review Department (PDR) has indicated, while there is certainly some promise in this, it also raises some difficulties. If this approach were to be adopted, it would probably need to be

> done in a coordinated fashion to overcome collective action problems among national regulators. This would likely require legislative changes in the U.S. and in Europe. In the U.S., the Securities and Exchange Commission's (SEC) mandate appears to be limited to disclosure and it does not refer to the underlying terms of the contract. The relevant European directive also appears to be addressed at disclosure rather than at identifying specific terms that need to be included. For the moment, we have focused in the staff paper on the actions that the Fund could take within its own financial and legal powers to promote the use of CACs, without going into a detailed analysis of possible changes to national legislations.

Ms. Vtyurina asked for clarification regarding the usefulness of initiation clauses in preventing litigation before and after the declaration of a default on sovereign debt.

The staff representative of the Legal Department (Mr. Hagan) clarified that it was not clear that initiation clauses would make a critical difference in cases of litigation following an event of default, as provisions already contained in bond contracts would likely suffice to enable a qualified majority of bondholders to prevent maverick creditors from enforcing their claim. The staff's view was that majority enforcement provisions already contained in bonds governed by New York law allowed a majority of bondholders to rescind an acceleration. Regarding the second step of having an individual bondholder initiate litigation, the staff's view was that, to the extent to which bonds were issued under a trust deed governed by English law, existing provisions would allow a majority of bondholders to prevent such instances of litigation. On the other hand, initiation clauses could provide a useful breathing period upon nonpayment of a specific bond issue by providing a grace period that would delay the occurrence of the actual event of default, which would trigger cross-defaults in other bond issuances.

The staff representative from the International Capital Markets Department (Mr. Blitzer), in response to questions from Directors, made the following statement:

> Mr. Callaghan asked about the significance of investors that have been quoted in the staff paper as not purchasing instruments with CACs as a matter of policy. We do not think that a significant share of investors in emerging market debt—either dedicated investors or the increasingly important crossover investors—follow this policy, and we do not see any evidence that investors as a group are avoiding the purchase of bonds with CACs in significant numbers. In particular, Russian bonds are currently the third largest component of the emerging market debt universe and they currently include CACs. Investors have been investing heavily in these bonds over the past two years, and these have outperformed the market consistently over this period. Surveys of their clients' positions conducted on a monthly basis by large investment banks over this period show that a high percentage of investors are overweight in Russia, and the most recent survey showed that none of their clients had a zero weighting in these bonds. The lesson appears to be that

> there is often an inconsistency between what investors say and what they actually do with their investments.

Mr. Portugal said that it was comforting to note that there were no examples—beyond some anecdotal evidence—of holdout creditors acquiring controlling positions in a single bond even in the case of Argentina, which was the largest default by a sovereign debtor thus far. The available evidence backed Ms. Lundsager's point that the contractual approach to sovereign debt restructuring could function without the need for an aggregation clause whose main purpose would be to address instances of holdout creditors, which were almost non-existent, apart from the case of the small creditor that was currently suing Argentina for $30 million. This was also a good indication that the problem that the staff was proposing to address through the introduction of initiation clauses was not significant.

Perhaps the staff could analyze in a paper the merits of the suggestions presented by the Brazilian chair during the Spring 2002 IMFC meetings to address the concerns over holdout and vulture creditors without the need to introduce initiation or aggregation clauses, Mr. Portugal remarked. One option could be to extend to other European continental countries the immunity from prejudgment attachments for deposits of foreign central banks that already existed in the United States and England. Another suggestion could be to adopt rules to protect from attachments payments flowing in national clearing systems. These rules would be similar to domestic rules in the United States for private sector bankruptcies, which prevented attachments of funds being transferred between intermediary banks. It was the absence of such a rule for international sovereign defaults that had made the case of Elliot versus Peru possible.

Mr. Shaalan made the following statement:

> We welcome the set of staff papers presented to the Board and we find them useful in deepening our understanding of the difficulties involved in promoting a broader use of CACs. However, we are not optimistic that much success can be achieved in this endeavor, at least not within a reasonable time frame.
>
> The staff demonstrates the limitations of the contractual approach in their search for a needed mechanism that would facilitate a more orderly resolution of sovereign debt crises. While we could argue that a more widespread use of CACs would facilitate the process of restructuring sovereign debts, we are opposed to the use of any conditionality by the Fund in this direction for a variety of reasons. The shortcomings of a conditionality approach are well explained in the staff paper and have been elaborated on by many other Directors in their preliminary statements. We cannot be supportive of any policy that would link access to the use of Fund resources to the adoption of such clauses either in existing or in new debt instruments. Like other Directors, we find it rather ironic that we would be considering such a proposal while in the midst of an exercise aimed at streamlining and focusing conditionality.

Like Mr. Callaghan, our view is that the most promising and straightforward avenue to promote a broader use of contractual provisions in new sovereign debt issues lies in a coordinated effort centered around the modification of securities registration requirements in major financial centers. A coordinated approach to overcome the risk of regulatory arbitrage is the single course of action that has the most potential to significantly change market standards for emerging market bonds. We are fully aware that this approach would require legislative changes in the countries concerned where most bond issuances take place. Therefore, the legislators in these countries will need to be convinced of the importance of these changes, and this should not be an insurmountable obstacle when compared to the obstacles described in the staff paper with regard to other options. If the international community is determined to move ahead with the contractual approach, either as a substitute or more likely as a complement to a Sovereign Debt Restructuring Mechanism (SDRM), this appears to be the most effective way to achieve meaningful progress in promoting a greater use of CACs.

We are not convinced of the proposals put forward to bring about a change in the outstanding stock of sovereign debt, even though it is obvious that if that were possible it would have a great impact in achieving more orderly debt restructurings. As rightly noted in the staff paper, even if such exchanges are done in favorable market conditions they are likely to have a significant cost, and there is a clear risk that they would be interpreted as a signal of greater risk for future restructurings. As for the proposal to condition access to Fund resources on such an exchange, this would give bondholders an unacceptable degree of leverage over member countries seeking assistance from the Fund, and we would not be ready to accept any compromise that could result in such an excessive leverage. The proposal that the Fund provide additional financing through a special rate of charge or a special repurchase period to meet the balance of payments needs that would arise in the context of an exchange also has serious shortcomings that are well addressed in the staff paper. Again, even assuming that we can overcome the obstacles associated with such a policy, which include the difficulty of determining the precise level of the balance of payments need associated with the debt exchange, we do not foresee a rush by debtors to take part in this experiment.

Finally, we have no problem in principle with the strengthening of Fund efforts in the context of surveillance to encourage the broader use of CACs by Fund members, provided that we do not jump from surveillance to conditionality as we have a tendency to do. However, before introducing a major change in policy, particularly one that could entail additional resource costs, we have to analyze the costs of the new policy and ensure that the expected outcome justifies these costs.

Mr. Bossone made the following statement:

Our reactions to the staff papers will focus on the two main questions underpinning them:

Are Collective Action Clauses (CACs) an efficient or effective instrument to facilitate orderly sovereign debt restructuring?

Are there strong enough incentives to encourage the universal use of CACs?

But before I discuss these questions, let me first thank the staff for their contribution. Their papers offer us a much instructive analysis of the structure of CACs, a candid assessment of their possibilities and limits, and a number of plausible options to promote their use assessed against the background of current market practices and preferences.

Although, once in place, CACs would constitute an improvement on the currently prevailing ways to manage sovereign debt restructurings, they would still leave major problems unresolved. Also, noting that the time, effort and degree of coordination and will needed to introduce effective CACs universally would be very much comparable to those of a statutory solution, the relative merits of CACs vis-à-vis those of an SDRM seem quite modest.

With CACs in place, aggregation of claims will still be a significant problem. Even the adoption of meta-clauses may fail to address this problem adequately, since not even the use of identical language in legal documents would guarantee against them being interpreted and applied differently in different jurisdictions. Moreover, meta-clauses would require changes in domestic laws that currently do not provide for rights of minority creditors to be modified without their consent. And if we had to rely on persuasion, Madam Chair, as you yourself pointed our recently: how could we possibly hope to persuade markets to accept meta-clauses when they are reluctant to include even ordinary clauses in debt contracts?

In the absence of some kind of approach that would make CACs universal across jurisdictions and across types of contract, the risk of regulatory arbitrage and market distortions might not be negligible. Using selective incentives to push the process forward by leading some players to move first might give rise to negative signaling problems. Also, under selective incentives, introducing CACs ahead of crises would be discouraged by the debtor's prospect of incurring immediate sure costs against the expectation of uncertain future benefits. On the other hand, introducing CACs in times of crises would stigmatize them and discourage their diffusion.

The diffusion of CACs suffers from a significant coordination problem—a problem that the market alone is typically incapable of solving when facing uncertainty: no single player sees the advantage of moving first, and in fact all players believe they might lose by doing so. Those players who could easily move first are the ones who least of all would be expected to find themselves in a situation where CACs would be activated. Therefore, they would not set a meaningful example to be followed by others. It is not really a problem of having a first mover; it is rather one of having the right mover taking the lead or, alternatively, one of pushing all players to move forward at the same time.

This cannot be achieved by persuasion or selective incentives alone. And this is why our preference goes to those types of incentive that maximize the coverage of potential debtor countries and act on them simultaneously. We would favor changes in general legislation that would require CACs to be included in all foreign currency debt instruments issued within national jurisdictions, or that would remove legal impediments to their inclusion. We would be in favor of introducing meta-CACs, and even of studying the possibility of their retroactive application. For the same reason of maximum coverage and simultaneity, we would also be open to the idea of conditioning all GRA access to the adoption of CACs.

We favor, of course, incentives aimed at spreading better knowledge of CACs among market participants, for instance through the promotion of standard documentation for the inclusion of CACs, and more in general through various forms of engagement of the market players such as those suggested by Mr. Wijnholds in his preliminary statement. Similarly, we would support the idea of using Fund surveillance to monitor market progress. Obviously, though, these incentives would likely be much weaker and slower than the institutional or regulatory incentives discussed above.

We would be very cautious about the incentives through leading by examples. This type of incentive would provide adequate signals to emerging market debtors only if CACs were included in all debt securities by the official sector of the advanced countries, comprising those securities denominated in domestic currency and issued in domestic markets. Absent a strong commitment to do so by all major advanced countries, leading by example would simply be ineffective.

As regards the use of selective regulation, linking for instance stock-exchange listing requirements, investor portfolio requirements, or bank capital ratios to the introduction of CACs, we have serious reservations in that they would either risk to create an undue interference with the original objectives of the regulatory instruments or give rise to market distortions. (Indeed, it would be rather awkward if we went for a pro-market contractual approach and then interfere with the market with ad hoc measures.) We do have similar reservations on using incentives connected with the IFI lending policies.

In searching for an effective strategy to promote CACs and as a way to build consensus on it, an incremental approach could be worth considering whereby the official sector would commit to step up regulatory action incrementally, eventually leading to the implementation of a statutory solution, if not enough progress is accomplished by the markets over a defined time set. Of course, an incremental approach requires a lot of coordination among national authorities, their credible and steady commitment to it, and continuous progress monitoring.

The incremental approach at the international level is not without at least one significant precedent. When, in the mid-1990s, the central banks of the G10 became concerned with the risk associated with the settlement of foreign exchange transactions (at the time better known as the Herstatt risk), they designed a market-friendly strategy based on the banking industry designing its own risk-management set of policies eventually leading to the creation of a global payment-versus-payment settlement facility. Inducing an effective industry response was complicated by the fact that while remedying this type of risk involved significant costs for individual banks, protection from the risk depended on the banks acting together. There was a strong first mover problem, to be sure. Cooperation between the central banks and the commercial banks was fruitful and critical for producing a solution that would be acceptable to both regulators and the market players. But the key incentive that did move the banking industry was that the central banks indicated that in the absence of visible progress they would step up their action including eventually by building and running a public foreign exchange settlement facility. As the market preferred to find its own commercially-based solution, the central banks' threat—if I may use this term—proved enough to prompt the desired private-sector response.

In the case of sovereign debt restructuring, using as a credible threat an incremental approach culminating in a statutory solution would reinforce the Fund's commitment to study the SDRM in parallel with the contractual approach, with a view to making it operational should events require for it to be implemented at some point. I would note in this respect, and I conclude, that we have already evidence that the threat factor may be effective, observing that ever since the SDRM proposal has been flagged the market's distaste for it has prompted some reaction in the desired direction—although, of course, we still have a very long way to go. We thus need to make our strategy more credible and consistent if we want to accelerate that response.

Mr. Portugal agreed with Mr. Bossone that having only some industrial countries lead by example would not be effective in promoting the use of CACs, particularly as these countries would likely be those that least expected to find themselves in a situation where

CACs would need to be activated. While he agreed that this approach might be more effective if a wider group of industrial countries were to include CACs in their bond issuances, the available evidence was limited, as only Canada and the United Kingdom had thus far adopted such provisions in their bond contracts, and even within this small sample there were differences in the provisions adopted by each country. While Canadian bonds included both majority enforcement and majority restructuring provisions, British bonds appeared to include only majority restructuring provisions.

Mr. Brooke made the following statement:

> We continue to believe that CACs, if widely adopted, would make a significant positive contribution to our crisis prevention work. In particular, my authorities firmly believe that CACs would promote a more orderly and less costly debt restructuring framework.
>
> The main reason we have not seen much progress to date in the adoption of CACs is that we have not yet convinced enough of the creditors and sovereign bond issuers of the merits of CACs. As highlighted in one of the staff papers, the adoption of CACs in corporate bonds governed by English law came about as a result of the demands of bond holders, rather than from pressure from the authorities at that time.
>
> We fully agree with Mr. Yagi therefore that the most important step we need to take is to convince either the issuers or the creditors (and preferably both) of the merits of CACs.
>
> It is encouraging therefore that a growing number of investors are coming round to supporting CACs. Perhaps one good thing that will come out of the present difficulties in Argentina is a further realization by creditors that there must be a more efficient way to achieve debt restructurings than the current approach.
>
> Hence, we agree with others that the Fund and the international community need to step up their efforts to encourage greater take up of CACs. In this regard, we support: Mr. Portugal's and Mr. Palei's proposal of meetings between major issuers, major investors and major underwriters; staff promoting use of CACs to authorities in regular surveillance and program discussions; new issues and via swaps when they are being conducted for other purposes; monitoring of CACs in surveillance; greater efforts to promote CACs to bond holder groups and bond underwriters; greater advocacy to rating agencies (as suggested by Wijnholds); industrial countries should lead by example; support Wijnholds's call for IBRD and RDBs to lead by example; can support use of CACs as a qualifying requirement for exceptional access and for lending into arrears; Mr. Yagi made some interesting suggestions here that could be pursued; we can support making the link between CACs and the CCL a more explicit condition than it is at present. We

should continue to look at all creative options and incentives that may help to overcome the first mover problem.

We think that changes in listing requirements could be another very effective approach. If other options do not produce any positive results, we may need to come back to this option. We agree with Callaghan that the lack of take-up of CACs is largely a matter of market convention, hence happy for staff and authorities to recommend that all bond issuance should be in London.

On the design issues, we need an approach that commands the general support of market participants: we agree with others that to maximize chance of adoption it will be essential for IMF staff to keep in close contact with G10 and market participants; we think that majority restructuring and majority enforcement clauses will be essential; we strongly favor representation/trustee arrangements; in principle aggregation clauses would be beneficial. However, as staff highlight, there seem to be significant practical problems, here. Nevertheless, this should not preclude their further discussion with market participants; we agree with Messrs. Bennett and Callaghan that a 75 percent voting threshold looks reasonable. Suspect that EMCA's 95 percent suggestion is largely an initial bargaining position. We think CACs should also be included in syndicated bank loans.

As I said before, CACs will help with crisis resolution. However, given the problems with aggregation; legal interpretation in different judicial systems; and the likely length of time before they are fully adopted, we should not slow-up work on the statutory approach towards an SDRM. As noted before, the two are complementary and we would like staff to continue working on both approaches in parallel.

Finally, we agree with Mirakhor and Palei that Crisis Prevention is more important than Crisis Resolution. In this regard, I agree with Bennett that further significant progress on crisis prevention will require more work on access limits, as well as improvements in our DSA, surveillance and transparency procedures.

Mr. Alosaimi made the following statement:

I join other Directors in thanking staff for a thoughtful set of papers. The papers clearly show that there are no easy answers on how to increase the role of the Fund in encouraging the use of Collective Action Clauses (CACs) in bond contracts. While a number of options are detailed, each option has its drawbacks. These difficulties indicate that while the Fund can play a useful role, a meaningful increase in the use of CACs would require concerted efforts by the international community. Let me add a few comments.

First, I endorse increasing the use of CACs in international sovereign bond contracts as it would facilitate future debt restructurings. However, CACs are not going to be a panacea. Therefore, working on CACs should not delay or derail the work on a Sovereign Debt Restructuring Mechanism (SDRM).

Second, the focus should be on inclusion of majority restructuring and majority enforcement provisions. Here, I agree with Mr. Callaghan that it is preferable to focus on standardizing and promoting existing practices with respect to CACs rather than attempting to incorporate new provisions. The focus should also be on incorporating CACs in new international sovereign bond issues for the reasons detailed in Mr. Portugal's statement.

Third, including CACs could have initial temporary costs as noted in the staff paper. Moreover, there could also be other costs. While studies on this issue are not definitive, there are indications that lower quality borrowers paid a premium for including CACs in their bond contracts. These findings would indicate that bond investors perceive that when the risks of default are not minimal, the drawbacks of bonds that include CACs outweigh the potential benefits. This perception could be due, in part, to the belief that the prospect of a more orderly resolution could reduce the available financing from the Fund as noted in Mr. Yagi's and Mr. Toyama's statement. Staff comments would be appreciated.

Fourth, it is clear from the staff papers that a concerted effort to change securities registration requirements, exemption rules, and listing requirements in all G-10 countries and Luxembourg would be the most direct and effective way to ensure the use of CACs in international sovereign bond issues. If these changes would not take place without legislation, these countries should enact the needed legislation.

Fifth, pending the passage of the required legislation, the industrial countries and the World Bank should lead by example as noted by Mr. Wijnholds, Mr. Mirakhor, and Mr. Brooke. For its part, the Fund should focus on trying to convince both bond issuers and investors of the merits of CACs. I do not however, support the use of conditionality for promoting the use of CACs for the reasons detailed in the staff papers as well as by Mr. Shaalan and other Directors.

Mr. von Kleist made the following statement:

I thank the staff for preparing a set of concise and informative papers on this important topic. The bad news contained in the papers is that little progress has been made in spreading the use of collective action clauses since the 1996 G 10-report and that it will probably take a considerable number of years before the bulk of the outstanding international sovereign bond stock will be equipped with CACs. The good news, however, is that the low acceptance of CACs largely reflects a first-mover problem and that—once this problem is overcome—CACs may be spreading faster. From this perspective, I sense that Staff's overall assessment of the prospects for CACs may be a bit on the pessimistic side. I shall return to the issue of encouraging the use of CACs below.

To begin with, it is worth recalling the overriding context of today's discussion, which is PSI. The various elements of the Prague framework should be considered as mutually reinforcing. For instance, if we make progress in establishing more consistent and credible access policies, this should, in turn, facilitate the promotion of CACs. The same holds for the SDRM, which should be a complement, not a substitute to CACs.

Turning to the various types of collective action clauses, I agree that majority restructuring and majority enforcement provisions are critical to the workout process—both from the point of view of debtors and creditors. As to the voting threshold for majority restructuring provisions, the 95 percent threshold proposed by the EMCA could make it extremely difficult to bring about an agreement. We would therefore favor a qualified majority threshold, say, between 66.6 and 75 percent, as is common practice under many domestic jurisdictions and in international bond documentation under U.K. law.

As to the possibility of trust deeds, we would agree that some form of collective representation could be a useful instrument to promote communication between the debtor and its creditors at an early stage. Also, a provision requiring an even distribution of proceeds from any litigation would indeed be another effective incentive for collective action. It is, however, a different matter whether such representation should occur via a rather heavy-handed trust structure or via a "lighter" instrument such as a representative. This question should be looked into further. With regard to initiation clauses, these should be weighed carefully. Finally, on aggregation provisions, there is little doubt about their helpful role in facilitating comprehensive debt restructurings. However, like the SDRM, they raise the difficult issue of verification of claims. It appears that aggregation provisions would require some authorized body of verification or at least some kind of international credit registry—a difficult task, but one well worth pursuing in the longer term.

Turning to the encouragement of the use of CACs, the key challenge—short of the difficult issue of changing regulatory requirements—appears to be to heighten the awareness among creditors and borrowers of the need and the potential benefits of CACs. Not very much has been done by way of persuasion thus far, which is certainly one reason for the limited progress in spreading the use of CACs. Incidentally, therefore, I am perhaps a bit more optimistic than Staff in terms of the prospects for purely voluntary approaches of promoting CACs.

As far as the Fund is concerned, a lot can be done to promote the use of CACs and I fully support the proposals on Fund surveillance and also on technical assistance made in Section IV.A of the related Staff Paper. I might only add that this work should be coordinated with any work that might be done by other bodies, such as the BIS or the Financial Stability Forum, so as to avoid duplication. I also join Mr. Wjinholds, Mr. Varela and others who call for more proactive efforts to persuade issuing houses and other market participants of the virtues of CACs.

With regard to the various proposals to make Fund lending conditional on the use of CACs, these are worth considering in detail, although the potential drawbacks and limitations, including signaling problems, need to be weighed carefully. Also, if this avenue is chosen, the Fund needs to be able to credibly commit itself not to support countries that are unwilling or unable to upgrade their debt contracts with CACs. The question is whether this really will be the case before some of the wide-spread reluctance to use CACs is overcome.

As regards the provision of additional Fund financing for the introduction of CACs, I am less convinced. In addition to the problems mentioned in paragraph 52, this proposal seems to be in contradiction with the prohibition under the Articles of Agreement to finance capital outflows.

On the possibilities outside the Fund to encourage the use of CACs, leading by example is certainly an important element in the efforts to overcome the first mover problem. The Staff reports make it rather clear, however, that such an approach will bear little fruit unless it is joined by investment grade emerging markets.

Finally, I have one remark to make on the drafting of the Staff paper on “The Design and Effectiveness of CACs”: the paper rightly mentions that the German Federal Government issued an statement in early 2000 on the admissibility of including CACs in foreign sovereign bond issues subject to German law. This statement aims to remove doubts among market participants as to the legal validity of CACs in Germany. It is true, as mentioned in Section 1 of para 17 in SM/02/173, that this has not affected market practice. We attribute that to the “first user” problem, not legal uncertainty. However, the second sentence in paragraph 17—while referring to the view expressed by some market practitioners—may give rise to the impression that the Fund calls the statement of the Federal Government on the admissibility of CACs in Germany into question. There is no factual basis for such doubts; and our legal experts certainly do not share the doubts of the quoted “practitioners”. I would, therefore, request to delete the second

> sentence in para 17 before publication of the paper, especially since the doubts of market practitioners receive adequate mentioning in para 15. Also, such a reference does not serve the purpose of promoting the use of CACs. To sum up, Madam Chair, we welcome today's papers and discussion as another step in the right direction in our general discussion on PSI and especially look forward to our discussion on access limits which from the point of view of the Fund is the pivotal issue.

Mr. Portugal observed that if Mr. von Kleist's reference to the need for coordination between the Fund and the Bank for International Settlements (BIS) in surveilling the use of CACs should be interpreted as meaning that the Fund would focus on surveillance of emerging markets and leave the surveillance of the use of CACs in industrial countries to the BIS, that would not be an acceptable course of action. As Mr. Mirakhor had already indicated, if it was decided that the use of CACs should be part of the Fund's surveillance, this should apply to the entire Fund membership.

Regarding the discussion on the use of CACs under the German legal framework, it would be useful if Mr. von Kleist could indicate if the German government would be willing to introduce legislative changes in order to clarify the situation and remove any remaining uncertainties, Mr. Portugal said. While the government's opinion appeared to be that the current legal framework did not impede the use of CACs, there appeared to be lingering concerns that the courts of justice could have a different interpretation of the current framework.

Mr. von Kleist responded that his comments on the need for cooperation with the BIS should not be seen in the context of the discussion of the geographical coverage of the Fund's possible surveillance of the use of CACs. His point had merely been that the Fund should make use of resources and knowledge that were already available in other institutions, like the BIS and the Financial Stability Forum.

Regarding the German government's opinion of the current legal framework, Mr. von Kleist observed that the government should not be expected to reinstate its opinion every time that a particular market practitioner called it into question. His authorities were confident that the current framework would allow the use of CACs based on the conclusions of the 1996 study by the G-10 and on comprehensive consultations with the legal community—including the constitutional court and legal experts—made in early 2000. While the current framework did not make the use of CACs mandatory, that was consistent with the sense of the current Board discussion, and the voluntary use of CACs was certainly plausible under the current German legal framework.

Ms. Lundsager agreed that the Fund's surveillance should be uniform across Fund membership, but that did not mean that it should be identical for all countries. As indicated during the recent review of the Fund's surveillance, the staff should focus in each country on those areas with more important issues. In that context, the value added of surveilling the use of CACs in industrial countries appeared to be limited, just like it would have little value added to focus during the surveillance of emerging or developing countries on certain areas that were more thoroughly covered in the surveillance of industrial countries.

Regarding the suggestion to introduce changes to the regulatory and legal environment in the United States, Mr. Lundsager considered that this option did not provide a practical way forward. As the staff had correctly indicated, the current system was based on the principle of disclosure with the aim of maximizing the amount of information available for investors to make their investment decisions. The approach of seeking legislative changes would be a lengthy process. For example, it had taken more than a decade to have the Gramm-Leach-Bliley Act, which repealed the Glass-Steagall Act, approved. It would be even more difficult to generate the momentum needed to complete a change that would not be oriented toward the domestic market but to foreign issuers. By the time these changes could be achieved, the general use of CACs would probably have already been achieved through the market-based approach. Therefore, efforts should concentrate on this approach, building on the positive reactions that had already been received from the private sector.

Mr. Portugal agreed with Ms. Lundsager that uniformity in surveillance did not preclude focusing on the relevant issues for each particular country. However, if an understanding was reached that it would be beneficial for the Fund's membership to take certain actions, and that the implementation of those actions should be monitored through Fund surveillance, then this should apply to its entire membership. Therefore, while he had some doubts that monitoring the use of CACs through Fund surveillance would be a positive step, if it were to be decided that this should be done, it should then apply to the entire membership. The staff would have to encourage the authorities to include CACs in their bond issuances, and it should report the responses from different authorities back to the Board. In fact, an understanding had already been reached at the G-10 and G-22 that industrial countries should lead by example in this area—as reflected in a number of IMFC communiqués and Board summings up—and bonds issued by the British and Canadian authorities already contained CACs.

Mr. Kiekens made the following statement:

> Your proposals for a Sovereign Debt Restructuring Mechanism (SDRM) have already induced some private creditors to act "in the shadow of the draft law," as you foresaw seven months ago. In a joint letter sent on June 3 to U.S. Treasury Secretary O'Neill, the heads of six major private creditor organizations expressed strong belief in the usefulness of collective action clauses for easing the resolution of sovereign financial crises. This is in stark contrast to the agnosticism which had been their most positive reaction to the idea of such clauses before you published your proposals last fall.
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> How now should the international community react to this sudden enthusiasm for collective action clauses in the community of private creditors?
>
> First, the Fund should continue its detailed exploration of the feasibility of a statutory SDRM. Without this light to cast the shadow of such a draft law,

private creditors might forget that they want to introduce collective action clauses voluntarily in jurisdictions where it is not yet standard practice.

Second, the international community should take advantage of this declared enthusiasm to enlist the collaboration of private sector representatives in designing model collective action clauses to be introduced into international sovereign debt instruments. Today's staff paper on existing collective action clauses and possible new provisions in sovereign debt instruments can contribute much to such an effort. All the provisions it covers deserve further consideration. The G-10's last communiqué announces its formation of a working group of legal experts who will work with private sector lawyers to draft model clauses. This working group will submit its findings to the G-10 Ministers and Governors during the Annual Meetings in September. At the same time we should verify the validity of these model clauses in various jurisdictions.

Third, now that private creditors are convinced that it would be useful to introduce collective action clauses into international sovereign debt instruments, it is time to convince the sovereign debtors as well. The industrial countries, investment-grade emerging market borrowers, the World Bank and other multilateral development banks should lead by example in order to persuade more sovereign borrowers to introduce such clauses in their bonds that are governed by foreign laws. With the exception of access to the CCL, linking access to Fund resources to the introduction of collective action clauses would have the undesirable effect of creating a false associating of such clauses with financial problems. Strengthening the link between the use of collective action clauses and access to the CCL would only be useful to the extent that such access truly represents a mark of excellence in the minds of private creditors.

Fourth, an obvious way of keeping collective action clauses from being identified with less creditworthy sovereign borrowers would be for the most important jurisdictions to make the inclusion of collective action clauses in external sovereign debt instruments compulsory by law. This avenue of making CAC's compulsory by law would also require the legislation to specify which clauses are acceptable and which are not, and provisions declaring bonds invalid if they do not include the required clauses. Admittedly, all this goes far beyond the market-led contractual approach for solving sovereign financial crises that the Board is supposed to discuss today.

Making collective action clauses a requirement for listing or registration in the major financial centers is seen by the staff as one of the most promising avenues. Indeed, I suggested this idea years ago. But now I have become skeptical about its political feasibility. Listing and registration requirements are intended to protect investors, by assuring that they receive comprehensive and reliable information. They also aim at protecting the rights of minority shareholders or creditors. Listing and registration requirements are not intended to restrict, per se, the type of contracts that can be traded. It would be directly contradictory to stress on the one hand, a strong belief in contractual freedom and parties' ability to decide for themselves what kind of contracts they can enter into and trade among themselves, and on the other hand to make collective action clauses a requirement for sovereign bonds to be traded on the market.

If legislators recognize that a legal framework is needed to organize relations between creditor and sovereign borrowers in case of payment difficulties, it would be more straightforward to organize such a framework by law and at the international level, rather than providing legislation at the national level forcing parties to agree on any such mechanism in line with specifications spelled out by national laws which would not necessarily be coordinated among jurisdictions.

The same can be said about a new provision in the Fund's Articles of Agreement making the use of collective action clauses in countries' foreign debt contracts a condition of membership. If such an amendment were politically feasible, it would be much more efficient for the Articles of Agreement to establish a Sovereign Debt Restructuring Mechanism directly instead of adhering to a supposedly "contractual approach," that would equally depend on amending the Articles.

Mr. Wei made the following statement:

At the outset, let me join other speakers in thanking staff for their tremendous efforts in preparing the papers for the Board to continue discussing the establishment of a mechanism for the restructuring of international sovereign debt in facilitating crisis resolution. We appreciate the opportunity to discuss the use of the collective action clauses (CACs) as one of the approaches in addressing the sovereign debt restructuring mechanism. While the staff paper extensively discusses the initiative and practical ways for greater use CACs, like others, we feel more work needs to be done in order to make further progress on this matter.

While we are in favor of exploring the benefits of greater use of CACs further, we have two basic concerns. First, we are not so sure of the underlying risks contained in the proposed move toward the uniform and almost universal use of CACs. To include CACs in sovereign debt contracts could affect countries asymmetrically. Countries with lower credit quality are more likely to face increasing rather than decreasing financing costs. Given the weak fundamentals and already high interest rate spreads in a number of developing countries, introduction of CACs will increase their borrowing cost although they may play the role of facilitating crisis resolution. Actually, even countries with relatively sound fundamentals could also face uncertain results from the introduction of CACs, depending on a number of factors. Our feeling is that we still do not have enough knowledge about the risks of introducing CACs under various conditions. We encourage staff to do more research in this area. The second concern arises from the initiative to include not only new bonds but also bond stock in the adoption of CACs. We are mindful that the vast majority of international sovereign bonds lack CACs and the staff projection shows it to be a difficult and lengthy task. The time horizon alone, estimated to be several decades, challenges the feasibility of the universal use of CACs as the sovereign debt restructuring mechanism we are going to pursue. Furthermore, replacing the current stock of international sovereign bonds that do not contain CACs with bonds with CACs could be very expensive not only for individual countries but also for the international community assuming we will agree to subsidize the cost. Even if the international community could provide a certain amount of financial assistance, the replacement could still be very expensive and complicated for low-income poor countries with large stocks of debt in relation to their fiscal strength and institutional capacity. Since more than half the stock of international sovereign bonds will mature in the next five years, the cost of swapping them for new bonds with CACs has to be taken into account. Mr. Portugal is right in that the initiative at present to widen the use of CACs should be limited exclusively to new international sovereign bonds.

On the issue of whether CACs should be included in conditionalities, like Mr. Wijnholds and many others, we cannot support incorporating the use of CACs in the conditionality of Fund-supported programs. The paper makes such a proposal on the basis of the assumption that "there is a strong relationship between the introduction of CACs and the objectives of the policies that govern the use of the Fund's resources". First, we rarely see the critical relationship between the use of CACs and the macroeconomic objectives of Fund-supported programs. The de facto status of the Fund as the preferred creditor also helps secure Fund resources. Second, as Mr. Portugal states, if staff deems it necessary to adopt CACs as they envisage the need for debt restructuring during the program or repayment period, it means that the program is not sustainable. Third, usually a country coming up to the Fund for a program is in an adverse situation. If the country is required to use CACs as a condition, the move could have a significant impact on market confidence and in turn create a more difficult environment for commencing the program. Clearly, it is not wise for individual countries to move to the introduction of CACs when their market situation is shaky. The timing for the authorities to make the move should be carefully considered and determined by individual authorities rather than by such IFIs as the Fund.

On the scope of use of CACs, we share the view that to include domestic public debt and private external debt is unnecessary since these instruments are already governed by certain domestic laws and regulations to deal with the so-called "vulture creditors" and extending the use of CACs to these domestic instruments could pose additional cost.

Regarding the development of new clauses, such as the representation clause, initiation clause and aggregation clause, as indicated by the staff, there has been significant resistance and reluctance by both debtors and creditors to accept what has not been the established market practice. The incorporation of new clauses will also probably cause at least short increase in borrowing costs. And the evidence that there will not be a permanent rise in cost is weak and limited. Therefore, we do not see the merit of introducing new clauses beyond the majority restructuring clause and enforcement clause, at least at the current stage.

With respect to the way of promoting the use of CACs, we believe that it is up to the authorities of individual countries to decide whether and when to incorporate CACs in their international sovereign debt contracts. Like others, we are not convinced that it is necessary to make the policy move mandatory either by setting conditions or by amending the Articles of Agreement. Also, at present, we believe that the developed countries, which have more favorable conditions than the developing countries to widen the use of CACs, should take the lead by adopting CACs more extensively in their issuance of international sovereign bonds.

Mr. Duquesne made the following statement:

The staff papers provide a comprehensive view of the existing framework and they give a fair picture of the stakes involved in the attempt to encourage greater use of CACs. Clearly the introduction of CACs can have benefits, and even though we are in favor of generalizing their use, we must continue to work on the SDRM in the absence of a strong commitment by bond issuers and creditors to use CACs. In fact, it is clear that CACs alone will not be sufficient, and that work on the SDRM has to advance in parallel. I have some comments on promoting the use of CACs.

First, a standard needs to be defined that will be acceptable to both buyers and issuers, and a common understanding on the design of CACs needs to be reached if we want to encourage their greater use. In this exercise it is critical to take into account the views of the private sector, but the official sector is finally in charge of the broader responsibility of ensuring that markets work smoothly. This mechanism must not unduly give advantage to either the creditor or the debtor. In that regard, private sector acceptance of the mechanism is important, and priority must be given to the efficiency of CACs in facilitating an orderly restructuring when necessary. In this context, the majority requirement proposed by the private sector is excessively high, as it is so unbalanced that it would defeat the purpose of CACs. Attention should also be paid to the work of the G-10 toward standardizing CACs and we look forward to the conclusion of this work. The definition of a standard would also be useful in alleviating the concerns that currently preclude a broader use of CACs, as it could reduce the first mover costs and signaling effects associated with its use by providing market participants with a common reference.

Second, on the specific design of CACs, we support a broader use of the existing restructuring and enforcement provisions. As far as enforcement provisions are concerned, the trust deed seems to be the most efficient system. We note that there is no legal impediment to its use, even under New York law. Also the private sector appears to regard it favorably, so it should not be too difficult to promote its use.

We also support the development of new clauses, particularly the engagement and initiation clauses. The engagement of a representative will be useful, at least as a channel of communication, and this could even be empowered to negotiate directly with the debtor, provided that the final decision remains with the creditors through an ex post vote or the possibility of minority opposition.

The initiation clause is critical, as it will reduce uncertainty during the phase when the debtor approaches his creditors for a possible restructuring. This is the only clause that would give some leverage to the debtor and this is necessary since the current practice gives excessive leverage to the creditor, whereas the debtor can only use the threat of default.

We also see favorably the gradation clause, which would allow for comprehensive treatment of the debt and ensure intercreditor equity. For these reasons, it should be further explored, although it will be difficult to make this clause operational outside a broader SDRM framework. This confirms that further work is deserved on this mechanism, and that CACs and the SDRM are more than complementary.

I noted Mr. Cippà's argument that the Fund's discussion on the SDRM might have triggered the private sector's recent interest in the development of CACs, albeit in a restrictive manner. If that is the case, that should be an encouragement for the Fund's work on the SDRM, as the whole purpose of this proposal is to clarify the framework in order to encourage both debtors and creditors to find a solution without using this instrument, which should remain an instrument of last resort.

Third, on the role of the Fund in promoting a larger use of CACs, a balance between positive and negative incentives should be found if the risk of stigmatizing CACs is to be avoided. In that regard, we cannot support making the use of CACs a condition for access to Fund resources or, even less, for Fund membership. On the other hand, the Fund could adopt standards and amend guidelines on debt management to encourage their use. It could also monitor their use in surveillance activities on a universal basis, and give the appropriate publicity to its findings. Further, analytical work on the potential costs and benefits should also be conducted.

Regarding financial incentives, the proposals relating to pricing are not very convincing. We tend to favor proposals in terms of increased access. We consider that, as a best practice, there could be a presumption that a country could be asked to include CACs in international sovereign bonds in order to facilitate access to the SRF.

In the same vein, we could further study the amendment of our lending into arrears policy to require the use of CACs in restructured bonds. We note, however, that this approach will affect only a handful of countries and that it bears the risk of associating CACs with countries that have defaulted.

Finally, since the measures that can be taken at the Fund level remain limited, the staff should continue its dialogue with partners outside the Fund. Regulators in the main financial centers should be encouraged to take the necessary measures to help promote the use of CACs, as this should help improve the markets they supervise. Also, developed countries could lead by example by including CACs in their international bonds.

Let me conclude by saying that the reluctance of the private sector to move forward more cooperatively is surprising, since market participants were supposed to prefer this approach to a more formal SDRM. All other concerns seem to be overstated, since CACs are already of rather common use in London, and since they are the result of market practice and not law, so they should be acceptable as market friendly. If this approach is not successful, the SDRM will be the Fund's solution to this problem.

Mr. Barro Chambrier made the following statement:

Since my views are similar to those of Messrs. Portugal, Mirakhor, Shaalan and Alosaimi, I will be brief.

CACs appear to be useful tools to ease and speed up debt restructurings by reducing the risk that holdout creditors can pose to this process. However, they have not gained market acceptance, and they need further promotion. Majority restructuring and majority enforcement clauses are the only clauses that already exist and have proved to be effective in some cases. They should be given priority to gain market confidence before considering the promotion of other clauses discussed in the staff papers. For the moment, I agree that domestic debt should also be excluded from the process, and the issue of a voting threshold should be considered on a case-by-case basis.

The Fund can play an important role in promoting the use of CACs in international sovereign bond restructurings. As many Directors have indicated, this will have to be a coordinated initiative that takes fully into account the private sector. However, the Fund should not force member countries to use these clauses, and the use of CACs should not be included in the scope of Fund conditionality. In this regard, I share the convincing arguments put forward by Messrs. Portugal and Callaghan.

Positive incentives outside Fund conditionality should be explored further, since only the acceptance by the market can guarantee the success of CACs in the long run. Here Mrs. Lundsager's and Mr. Ralyea's statement seems to give some evidence that the market's opinion is changing, and I would like the staff to elaborate more on this new element.

Mr. Rustomjee made the following statement:

We thank staff for the very useful documents that outline the rationale for a wider use of collection action clauses in sovereign bond contracts, as a method providing for greater stability in the relationship among sovereign debtors and creditors. There are aspects of the proposals, which should be supported by both debtors and creditors. In our view, there is a clear first mover problem and we concur with many Directors who urge that industrial countries should consider taking the necessary legal steps to facilitate the greater use of collective action clauses in bond contracts. We also concur with the view that the Fund can and should play an important role in encouraging member countries to adopt the use of these clauses in bond contracts, and we find a few ideas presented in the staff paper useful. The main attractive idea in this regard, is the use of Fund surveillance, but like Mr. Portugal, Mr. Callaghan, and many others, we would not support the creation of new conditionalities to encourage member countries to include these clauses in their contracts.

Potential Resistance to Change

*Different legal practices.* There appears to be some resistance to change to a generalized framework of including collective action clauses in bond contracts, based on current legal practices in major different jurisdictions, i.e. differences exist in the legal practice of including CACs in the United States, Germany, the United Kingdom, and Japan. Nevertheless, despite the fact that it is not legally required in the United States to include CACs in bond contracts, it is already a practice by some institutional investors to hold dollar denominated debt in accordance with the practice of English law. It appears therefore that the legal practices in major jurisdictions regarding the inclusion of CACs in bond contracts would not seem too difficult to overcome.

As with many colleagues, we have concerns regarding a number of aspects of the proposals. Firstly, the costs associated with replacing the stock of debt to include CACs would be very significant indeed. Accordingly, while we are in principle in favor of having CACs in bond contracts, we would support a proposal to include CACs only in newly issued sovereign debt, particularly to avoid imposing unnecessary costs on debtor countries. In this regard, we also support the views expressed by Mr. Portugal that the use of CACs should be limited to sovereign debt, since extending its use to domestic public debt and private external debt will increase the cost to emerging economies, and could undermine the development of national capital markets.

*Regarding the voting threshold for majority restructuring.* This is clearly an important consideration to promote the greater use of CACs in bond contracts. In this regard, the EMCA has proposed a threshold of 95 percent, as opposed to the threshold according to English law, which is also widely accepted in the market. We do not favor this proposal. A too high threshold will not be workable, and would frustrate the efforts of the majority to engage with the debtor, since the very small minority creditors could refuse to cooperate. Faced with a choice, we would therefore support the current practice according to English law.

Role of the Fund

*As regards Fund surveillance*. We support an increase in Fund surveillance of the use of CACs in member countries. This would allow for improved information on the use of CACs by member countries. As others have proposed, such surveillance should explicitly be understood to be even handed and applicable to all members and not only to emerging market members. We see this as important, as the responsibility for crises prevention we take to be a universal responsibility.

*Fund conditionality.* We are clearly not favor of making the use of collective action clauses a condition for the use of Fund facilities. We can also not support a proposal that would make the adoption of CACs in all outstanding bonds as a condition for disbursement. We hold the same view in the case of lending into arrears. Adding conditionalities in these manners would run in our view contrary to the Fund’s recently adopted approach of streamlining conditionality. In the case of new arrangements, CAC conditionality may also complicate the member’s access to financial markets. We would therefore not be in support of this proposal.

*On eligibility for exceptional access.* We would find it unduly discriminatory if exceptional access to Fund resources particularly the CCL and the SRF facilities, were made conditional on the member adopting CACs, and again we would not be able to support this. At the same time, we would not be able to support the proposal for the levying of a special rate.

*Obligations of Membership.* The proposal that membership to the Fund should be made conditional on the usage of CACs in bond contracts would require a change to the Articles of the Fund. We cannot support such a change to the Articles solely for this purpose.

The Way Forward

In conclusion, while we are supportive of the use of collective action clauses in bond contracts, we would support the inclusion of such clauses into new sovereign bonds. We also see a need for the major industrial countries to consider the needed legal changes to accommodate the inclusion of such CACs in future bond contracts. Furthermore we support the view that the Fund could encourage the use of the CACs during Fund surveillance, but should not make the use of Fund resources conditional on the inclusion of CACs in existing or new debt. Finally, we believe that early and appropriate cooperation with the institutional investors should be fostered to ensure a more widespread use of CACs in bond contracts.

Mr. Bennett made the following additional statement:

While it is still early to celebrate a wider adoption of CACs, long-term advocates of the use of CACs should welcome the substantial progress made in the current discussion. I would just like to cover two or three points that arise out of the discussion.

Mr. Kiekens has cautioned us not to veer too far to the statutory approach and amend laws because that would prejudice the contractual approach. I think it is important that we should not foreclose the amendment of particular laws. Establishing an appropriate legal framework is entirely consistent with the contractual approach, defining the right one is always a challenge, but I do not think that amending a law to allow for CACs or to facilitate them means abandoning the contractual approach. Rather, it is defining the parameters within which the contractual approach can be put in place.

Ms. Lundsager cautions us not to wait for the U.S. Congress to change the laws to foster the use of CACs, and she is probably right in that we should definitely get on with it and explore all possible avenues. However, we should not rule out changing laws. Even if it took ten years to change the Glass-Steagall Act, at the end of the day it was a worthwhile endeavor, and we should not rule out changing laws in those jurisdictions where it is important to do so.

Mr. Portugal's comments advocating that CACs be examined in Fund surveillance for the entire membership are a positive development. He and other Directors have rightly pointed out that industrial countries have a

> responsibility to lead by example, and this chair certainly encourages other countries to adopt CACs. Indeed, when I was listening to Mr. Duquesne, I thought that he was on the verge of announcing France's decision, but I suppose he is saving that for another Board discussion.
>
> Messrs. Wei and Rustomjee have valid concerns about the cost that the use of CACs can impose upon borrowing countries, and the staff should work with the G-10 and other expert groups working on model clauses on possible ways to reduce these costs. The main point that we should take from the current Board discussion is that momentum is building for a wider adoption of CACs, but the question is how fast and how efficiently this can be achieved. The staff has done a tremendous job in the staff papers presented to the Board, and it should continue to work aggressively to answer the remaining questions.

Mr. Portugal clarified that his position regarding Fund surveillance of the use of CACs was that Fund surveillance was already overburdened and that the benefits of surveillance in this additional area would likely not outweigh the costs involved. However, if it were to be decided that CACs should be covered under Fund surveillance, then this should apply to all countries accessing international capital markets.

Ms. Vtyurina, following up on Mr. Bennett's comment regarding the cost implications of CACs, stressed the importance of collecting more information about these implications. As other Directors, like Messrs. Wei, Portugal and Zoccali had observed, this was an important aspect of the current discussion. Therefore, it would be helpful if the staff could indicate if there was any evidence that creditors had been focusing more on the use of CACs—perhaps requiring additional markups on countries issuing bonds with CACs—in the recent period when the discussion on the use of CACs had gathered additional momentum. Also, a more important question would be if there was any evidence on cost implications of the introduction of CACs in cases of debt swaps or restructurings in the context of recent sovereign defaults. The case of Pakistan, for example, would not provide relevant evidence, as the stock of bonds outstanding before the swap already included CACs, but it would be interesting to know what had been the cost implications of changes in bond contracts in the cases of Ukraine and Ecuador.

Regarding the case of Russia, Ms. Vtyurina continued, it was interesting to note that the majority of international bonds were Eurobonds which included CACs, and that they were performing extremely well. While it would be interesting to know more about the specific provisions included in these bonds, and an actual breakdown of Russian bonds would be needed to asses the authorities' strategy, the widespread use of CACs was likely not a hedging strategy for the future, but merely the result of standard practices by underwriters in European markets. Such considerations notwithstanding, the swap of domestic bonds for international bonds carrying CACs after the default on domestic debt did not appear to have had a significant effect on spreads. Factors like performance, relations with creditors and credit quality were more important for the determination of spreads than differences in provisions included in bonds.

Ms. Lundsager agreed that the case of Russia provided evidence that implications of CACs in terms of additional cost of debt should be extremely limited or non-existent, as Russia would surely not issue bonds with CACs under English law if this option entailed higher costs. It would be interesting if staff could provide a sample of countries that issued bonds both under New York and English law to see if there were any significant differences in terms of costs—obviously, a perfect sample would require having simultaneous issuances by the same country in both markets, which would probably be a rare instance, but some indicative conclusions could probably be drawn from a less perfect sample. While concerns from Directors regarding countries on the verge of default were understandable, cost concerns for normal balance of payments financing during the course of a year and in the absence of crisis situations appeared to be less justified.

Mr. Kiekens observed that the SDRM or an increased use of CACs should benefit both debtors and creditors if these initiatives were to be worth pursuing. Therefore, the evidence required to justify the increased use of CACs should be that bonds with such clauses were less costly for sovereign issuers than bonds without those clauses. As long as such evidence were lacking he would remain skeptical of a purely market-led contractual approach for solving sovereign financial crises. On a related note, Mr. Bennett's comment on the need to consider changes in national legislations to ensure the use of CACs implied that the so-called contractual approach would in the end not be radically different from the statutory SDRM approach. The additional benefit from an SDRM would be that this uniform framework would avoid the problems of coordination between national legislators. Therefore, the use of CACs and the SDRM might not only be complementary but even converging approaches, as they would both in the end require legislative changes to facilitate a fair decision-making process by creditors and an orderly resolution of payment problems.

Mr. Yagi remarked that the changes in national regulations presented as a possible option in the staff report were not in principle consistent with the objectives of securities regulatory agencies. However, this should not be interpreted as meaning that any kind of changes in national regulations would be rejected by his chair, as changes that could be required for the introduction of the SDRM could be considered at a future stage if an agreement could be reached on the introduction of this framework.

Mr. Mirakhor suggested that the case of Tunisia could provide a good example of a country that had issued bonds under New York, English and Japanese law, and the analysis of cost differentials among those issuances could provide some useful information on the cost effects of the use of CACs.

The Acting Chair (Ms. Krueger) informed Directors that several staff papers on the general subject of debt restructuring would be coming to the Board before the 2002 Annual Meetings, including a paper on furthering the Fund's work on the SDRM, on lending into arrears, and on access to Fund resources in capital account cases. As already mentioned, the G-10 was also working on the design of CACs, and the Fund would certainly look at work by this and other interested groups to make a more effective use of its scarce resources. The staff would consider the interesting suggestions put forward by many Directors during the current discussion, although the focus over the next several months would likely be on completing the forthcoming papers mentioned, given the existing resource constraints. At some point toward the end of the stream of Board discussion on those staff papers, the staff would have to do a stock taking exercise of the conclusions reached and of the work done by other institutions like the G-10 group.

The Deputy Director of the Policy Development and Review Department (Mr. Allen), in response to questions from Directors, made the following additional statement:

> On the issue of cost implications of the use of CACs, as reported in the staff paper, the various studies on this issue provide little evidence of any differentiation between the pricing of bonds issued with CACs, mainly under English law, and bonds issued without CACs, mainly under New York law.
>
> As far as recent debt restructurings are concerned, the restructured debts of both Pakistan and Ukraine contain CACs in their bonds, whereas the restructured debt of Ecuador does not.
>
> Messrs. Yagi, Alosaimi and Barro Chambrier have asked whether the market's possible reluctance to demand bonds with CACs could be related to the fear that any measures that promote a more orderly resolution of debt problems implies that less access to Fund resources will be provided. First, as already mentioned, we do not know how bonds with CACs issued under New York Law would be priced. The reactions received from market participants indicate that there would be some effect on costs, but these statements should be viewed with caution, as they could be somewhat self-serving. In a rational world, one would expect that bond prices would depend on the expectation of recovery of the loans by the person purchasing the bond. While the issuer's access to Fund resources would obviously affect this, so would the speed at which any restructuring could take place and its terms. It is not clear what sign the sum of these two factors would have.
>
> We are currently observing a cautious reaction from market participants that see themselves giving up an actual right to sue for the potential benefit of a speedy resolution, which is hard to value. This is a natural reaction, but it is quite possible that if an adequate issuer and a creative issuing house decided to issue bonds with CACs with the moral support of the trade associations, the penalty on these bonds would be minimal, if any. However, we cannot know with certainty until this takes place.

The staff representative of the Legal Department (Mr. Hagan), in response to questions from Directors, made the following additional statement:

> Just one point on Mr. von Kleist's concerns about the reference in the staff paper to the German government's statement on the use of CACs under their national legal framework. It was clearly not the staff's intention to

> express the view that the statement of the German government had no legal force. Rather, we intended to convey the view of practitioners in the market. We thought that the language was clear in that respect, but we will look at it again to make sure that there is no misunderstanding, and we will get back to Mr. von Kleist bilaterally before it is published.

The staff representative from the International Capital Markets Department (Mr. Blitzer), in response to questions from Directors, made the following additional statement:

> As the issue of CACs has come to the fore of the discussion, there is no evidence that the use of these clauses should have any effect on pricing of bonds. While no definitive econometric studies are yet available, we have anecdotal evidence from trade publications which as a matter of course provide descriptions of new bond issues, together with assessments of the marketing strategy of the underwriters, together with comments from investors. We have not noticed comments in these publications of problems in placing or pricing bonds because they have been issued under English law, or on decisions to issue bonds under New York law to avoid having to include CACs.

Ms. Lundsager asked if it would be possible to receive some additional information—beyond the ongoing work on the forthcoming staff papers—on concrete steps to be taken by the Fund to promote the use of CACs in bond contracts. It would be useful to know if the staff were planning to start gradually monitoring the use of CACs in the context of Fund surveillance, and promote the use of CACs in a more active manner. It would also be useful to know the staff's reactions to the suggestions put forward by Directors during the current Board discussion.

The Acting Chair (Ms. Krueger) explained that the staff would focus on completing the three forthcoming papers before the 2002 Annual Meetings, which represented a significantly heavy workload. There was also the intention to continue advancing discussions with market participants on some of the issues raised in the current Board discussion. The Research Department was working on new ways to obtain evidence from the market on the consequences of the use of CACs. There would clearly also be discussions with different Fund members on their willingness to use CACs. At this stage, these were probably the only additional actions that the staff could commit to take until the three staff papers mentioned had been completed. As mentioned earlier, the stock taking exercise expected to be undertaken toward the end of the Board discussions of these papers would shed more light on the following steps in this area. At that stage, additional information on the use and market acceptability of CACs would also likely be available.

The Acting Chair made the following summing up:

> Executive Directors welcomed the opportunity to discuss ways to encourage greater use of collective action clauses in sovereign bond contracts,

and the design and effectiveness of those clauses. There was broad agreement that existing collective action clauses could play a useful role in the orderly resolution of crises and provide a degree of predictability to the restructuring process. A number of Directors noted the complementarity between efforts on collective action clauses and the Fund's ongoing work on a statutory framework for debt restructuring, and they looked forward to the forthcoming discussion on Fund access policy, which is an important element of the Fund's framework for crisis prevention and resolution.

Design and Effectiveness of Collective Action Clauses

Directors agreed that the most useful collective action clauses are majority restructuring and enforcement provisions such as those now existing in many international sovereign bonds. They noted that the voting threshold is critical to the design of the majority restructuring provisions, and most expressed the view that a 95 percent threshold—as has been recently proposed by an investor organization—would be excessively high. Some Directors observed that British-style trust deeds contain an even more effective majority enforcement provision and could serve as a useful model for future issues. Some others, however, expressed concern that the increased costs of using trust deeds may outweigh the benefits.

Regarding the inclusion of innovative provisions in international sovereign bonds, many Directors noted that it is too early to draw conclusions, as a number of design features of these provisions are still unclear and the preliminary market reaction has been mixed. Several Directors made the point that representation clauses could potentially contribute to an orderly and speedy restructuring process by establishing a channel of communication between the debtor and bondholders early in the restructuring process. They saw merit in the further study of the feasibility of including such provisions in future bond issues. Many Directors were of the view that designing and implementing initiation and aggregation clauses would be more difficult, particularly in light of the initial market reaction, but some did not rule out the possibility of progress in this area, particularly in relation with the ongoing work on the SDRM.

Encouraging Greater Use of Collective Action Clauses

Executive Directors expressed disappointment that, despite broad agreement in the official community on the merits of collective action clauses, official calls for their broader use have had little impact on market practice to date. However, some Directors noted that recent communication from major private sector organizations suggests growing support for the use of restructuring clauses with high majority thresholds in sovereign debt contracts. Furthermore, many emerging market issuers have issued in jurisdictions where the use of such clauses is the norm, indicating that they do not see a problem with the clauses per se. While the evidence remains inconclusive, the available information on existing collective action clauses suggests there is not a significant price advantage to making use of a particular governing law and jurisdiction. On this basis, Directors considered that there could well be a first mover problem in adopting clauses in jurisdictions where this is not yet the market practice. However, there is less evidence that use of clauses would add significantly to costs once a new market practice is established.

Turning to actions that the Fund might take to encourage the use of collective action clauses, most Directors agreed that it would be useful for the Fund to encourage more strongly the use of such clauses through its multilateral and bilateral surveillance processes, and to monitor the use of these clauses both in new bond issuances and in the outstanding debt stock. A few stressed that surveillance of this area should be exercised over the entire Fund membership.

Many Directors were strongly opposed to the idea of conditioning access to Fund resources on the use of collective action clauses in new bond issues, but some supported the creation of a presumption that countries seeking access to Fund resources would include CACs in their bonds. It was noted that most countries tend to draw on the Fund when they are experiencing difficulties in accessing private financial markets. It was generally agreed that countries facing such difficulties were not in a strong position to change market practice, given the signaling problem. In addition, there is a risk that requiring program countries to adopt clauses would stigmatize the use of such clauses. Some Directors noted that the connection between collective action clauses and safeguarding Fund resources was weak. Others noted that the link between the use of clauses and the macroeconomic objectives of most programs was weak, and requiring the use of clauses would not meet the test of focusing conditionality on measures that are critical to the success of the member's program. Many Directors also considered that withholding resources from a member that was otherwise willing to implement a strong adjustment program would be difficult.

Furthermore, many Directors commented that establishing a presumption for the use of clauses in the event of exceptional access to Fund resources would be difficult to implement consistently. Most Directors indicated that the cost to emerging market countries of a comprehensive exchange to retire existing debt that lacks collective action clauses would be excessive, and considered that introducing collective action clauses in new issues alone would be more realistic.

Most Directors felt that making CCL approval contingent on the use of collective action clauses would reduce demand for this facility. Some

Directors, however, noted that a link to the CCL would be consistent with the CCL's aim of promoting best practices in debt and reserve management.

Most Directors were supportive of conditioning the Fund's willingness to lend into arrears on a commitment to use collective action clauses in a comprehensive debt restructuring. This would avoid the difficulty of requiring a country that is not in default to seek a comprehensive change in the legal terms of its outstanding stock. Other Directors, however, were opposed, given the difficulties of securing CAC acceptability and their associated costs for members in such circumstances. They also noted that this approach would risk making the use of clauses the mark of a previous default, thus potentially stigmatizing their use.

Most Directors made the point that the inclusion of collective action clauses could not, in and of itself, provide a legal basis for the Fund to offer lower charges or longer repurchase periods. While Directors did not on balance support the creation of a special facility with lower charges or longer repurchase periods to finance those needs that would arise in the context of a swap to retire existing debt that lacks collective action clauses, some Directors encouraged the staff to continue exploring possible incentives for debt swaps. Directors also did not support amending the Fund's Articles to require that members of the Fund use collective action clauses.

There was general agreement that any efforts to encourage the use of clauses would be most effective if supported by intensified efforts outside the Fund. Most Directors agreed that a concerted approach that resulted in consensus among issuers, major issuing houses, and institutional investors on the need to change the market standard in key jurisdictions would be the least costly way of promoting the use of clauses, but several noted that such consensus might remain elusive. Many Directors reiterated the desirability of having industrial countries lead by example, though some questioned whether this would produce much practical effect. Several Directors saw merit in exploring whether securities registration and listing requirements in major jurisdictions could be changed so as to require the use of collective action provisions. This was viewed as potentially the most effective means of changing market practice, although the difficulties of such an approach were also recognized. In particular, some Directors noted that this would fall outside the mandate of regulators and would require changing national legislation. Coordination among the major financial centers would also be important to avoid regulatory arbitrage.

## 2. REPUBLIC OF LITHUANIA—REVIEW UNDER STAND-BY ARRANGEMENT

Document: Second Review Under the Stand-By Arrangement (EBS/02/105, 6/14/02)

Staff: Alonso-Gamo, EU2; McGuirk, PDR

Length: 1 hour

The Acting Chair (Mr. Sugisaki) remarked that the current review coincided with Lithuania's tenth anniversary of Fund membership. Lithuania had become a member in April of 1992, and had enjoyed an excellent relationship with the Fund since that time.

Mr. Isleifsson and Mr. Kropas submitted the following statement:

> The period of the second review of the Stand-By program coincides with the ten-year anniversary of Lithuania's membership in the Fund. Our authorities are very pleased with the results of cooperation and want to thank the management and the staff for their continuous support of the country's economic reform efforts. Lithuania is a small, open economy with fixed exchange rate arrangements, and a fully liberalized capital account. The high capital account deficit, which has been a feature of the country's economy, has resulted from the need for financing its transformation process. Lithuania may have been more vulnerable to external shocks, if we did not have IMF arrangements in place in the different phases of transformation to a market economy. The country also went through several changes in the exchange rate arrangements, starting from the introduction of a national currency, a period of currency float, the introduction of currency board arrangements, the modification of arrangements, the reorientation of the anchor currency, and the preparation to EU accession. The Fund's advice was always helpful.
>
> The authorities were pleased to join the Nordic constituency in the Fund. It has been one of the first concrete forms of cooperation and policy coordination, contributing substantially to developing a more comprehensive framework for regional integration, which has now become an important source of wealth creation. The countries of our constituency contribute well above 50 percent of Lithuania's FDI. The strong presence of high-quality Nordic companies in the financial, telecommunications, media, retail, and other sectors contributes positively to the business environment and facilitates advanced market culture. Lithuania's economic relations with its Baltic neighbors Latvia and Estonia have grown to a historically unprecedented level. Lithuania's exports to Latvia and Estonia constitutes now 15.6 percent.

Recent Economic Developments and Prospects

Last year the Lithuanian economy experienced growth that exceeded the most optimistic forecasts and macroeconomic conditions improved further, with the trade and current account deficits narrowing relative to the previous years. Growth was driven by exports but also by domestic demand, in particular investment.

Positive trends continued in early 2002 with business confidence and external vulnerability indicators improving substantially. Rating agencies upgraded Lithuania's ratings and outlook.

Real GDP grew by 4.1 percent in the first quarter of 2002, in line with the authorities' expectations. While export growth was slower due to the slowdown in EU, domestic demand is recovering after three years of stagnation. Strong retail sales and investment growth in the first quarter of 2002 indicates that domestic demand is becoming an increasingly important engine of growth. It is also expected that export growth may pick up towards the end of the year due to the expected recovery in the EU and reasonably strong growth in neighboring markets. Strong domestic demand is likely to lead to a widening of the current account deficit this year, which to a large extent is to be financed by inflows of foreign direct investment.

Despite commencing EU accession negotiations almost two years after the first wave of accession candidates, Lithuania has now provisionally closed 28 chapters of the acquis. The discussion on the remaining chapters is well advanced and Lithuania is well posed to conclude negotiations with the first group of EU candidates.

Staff emphasis in the report on competitiveness is much welcomed. Productivity and corporate sector profitability trends and wage flexibility indicators confirm the authorities' views that competitiveness remains strong despite the appreciation of the exchange rate. The much faster growth in 2001 of small and medium sized companies seems to support this proposition.

Fiscal issues

A tight overall fiscal stance has contributed strongly to the stabilization of the economy. In 2001 the fiscal stance was in line with the MEP. In the first quarter of 2002, public finances continued to improve with revenue performance being stronger than projected which resulted in the general government deficit being lower than planned. Important progress has been made in recent months in improving HIF finances as arrears clearance and cost-cutting measures have been implemented. The authorities are committed to implementing the remaining envisaged measures to balance HIF's budget without accumulation of new arrears.

Earlier this year the government successfully launched a Eurobond issue of 10-year maturity. Further financing needs will rely on domestic market as interest rates on longer-term securities have converged to EU level. In March, the government issued the first 10-year domestic treasury bond with the Maastricht standard yield, establishing a benchmark for longer-term securities and a 10-year yield curve. The debt composition has improved further, which is evidenced by the decreased short-term and foreign debt shares in the overall debt portfolio. Our authorities look forward to work on further implementation of the Data and Fiscal Transparency Reports on Observance of Standards and Codes. These will be the last modules of the comprehensive set of standards and codes, strengthening ongoing improvements of fiscal and debt management practices.

However, our authorities agree with staff that further measures are needed to strengthen municipal finances, as evidenced by increased arrears. They are committed to taking further comprehensive regulatory measures to strengthen financial discipline of the municipalities and to reinforcing new principles of financial relations between the state and municipal budgets, including stabilizing municipal revenues, streamlining spending, strengthening financial discipline and providing stronger incentives for municipalities. The regrettable occurrence of marginal state budget arrears resulting in the nonobservance of the benchmark was due to technical difficulties, which occurred within a framework of ongoing improvements of treasury operations. The authorities are making further efforts to achieve a revenue neutral tax reform package.

Exchange rate and monetary policies

The monetary environment has became more conducive to strong economic growth. The recent smooth repegging of the national currency—the litas— from the U.S. dollar to the euro supports further convergence with the EU. The new peg has established a steady exchange rate relationship vis-à-vis the majority of Lithuania’s trading partners. The reorientation has induced a wider use of the domestic currency in financial transactions and led to a substantial increase in litas deposits. Real estate is now largely priced in litas.

Low inflation and nominal interest rates have led to further monetization. Intensified competition among commercial banks and other private financial institutions has lead to an increased efficiency of financial intermediation as well as a higher supply of high-quality financial services. Domestic credit has been growing significantly mainly due to increased business confidence and the dynamism of recently privatized banks. This goes along with the improvement in the quality of the banks’ credit portfolios and rapid growth of deposits. The authorities will continuously monitor developments in this area to preserve soundness of the banking system.

Consistent with the policy of harmonization with ECB standards, the required reserve ratio was reduced to 6 percent in May and the new rules of calculation comparable to the ECB standard were introduced. No further changes in the reserve ratio are envisaged in 2002. We would like to thank the staff for their substantial contribution to the debate on Lithuania's exchange rate strategy while preparing for participation in ERM2 and the eventual adoption of the euro. The ongoing bilateral consultations with the staff contributes substantially to a formulation of economic policies and preconditions needed for the success of the long-term strategy of the authorities.

Financial sector policies

The sale in February of the last state-owned Agriculture bank completed the privatization and restructuring of the banking sector. The authorities have benefited from the FSAP and an EU peer review, which was successfully completed in 2002. Both reviews provided comprehensive analysis of the financial sector in Lithuania.

Some of the recommendations of the FSAP report have already been implemented. The BOL approved stricter monthly requirements for banks on their shareholdings. AML practices in insurance and capital markets have been strengthened by reorganizing and increasing responsibilities of FCIS and by amendments of the law on prevention of AML which extends responsibilities for implementation of AML legislation, and preparing regulations on detection and reporting of suspicious activities.

Concerns regarding insurance supervision have already been taken into consideration by an amendment of the current law on insurance and by putting in place FSAP recommendations concerning corporate governance, consumer rights, and auditing. Furthermore, in the supervisory work in the period ahead, special focus will be placed on implementation of recommendations outlined in the EU peer review final report, which is expected to be issued soon.

Structural reform issues

Reform and preparation for privatization in the largest infrastructure sectors require careful consideration and discussions between political partners and society, and might be a reason for some delays in the initial privatization agenda. However, steady further progress has been reached in recent months in the energy sector and pension reform.

The successfully completed restructuring of Lithuania's power company and improved regulatory transparency led to a positive revision on its rating outlook. The energy sector has reduced its operational risks and introduced a transparent pricing system, which provides some tariff-setting flexibility to cover costs. After the sale of the initial stake to a foreign strategic investor, privatization of the Lithuanian Gas is about to be completed and the sale of a second stake to suppliers is expected by the end of 2002. The finalization of the agreement on long-term oil supply and sale of the stake in oil refinery to a supplier paves the way to facilitate modernization and expansion. In May, the Seimas endorsed a plan for pension reform incorporating a voluntary second pillar based on supplementary matching government contributions and tax incentives.

Unemployment is currently on a downward trend. In April, it fell for the third consecutive month to 11.8 percent from 13.1 percent. The authorities take note of staff's suggestions on ways to improve the business environment to make it more conducive to employment creation. As mentioned in the report, they have been working further on a measures package. The new labor code is expected to increase minimum wage flexibility for certain categories of workers and regions. These measures, together with the unemployment insurance law are expected to be passed this year, targeted job-training programs and an improved social safety net will enhance the functioning of the labor market and increase protection of the unemployed.

Mr. Wei submitted the following statement:

From staff's well prepared report and Mr. Ísleifsson and Mr. Kropas's informative statement, we are pleased that, following the first review in January 2002, Lithuania has continued its path of implementing sound macroeconomic policies and pressing ahead with structural reforms in a number of areas and has achieved a sound economic performance. Real GDP grew by 4.1 percent in the first quarter of 2002 (according to Statistics Lithuania). The repegging of the litas from the dollar to the euro proceeded successfully in February. All performance criteria set for end-December 2001 and end-March 2002 have been met. In light of these developments, we fully support the completion of the second review under the Stand-By Arrangement.

Looking ahead, due to robust domestic demand—a strong rebound in private investment and increasing demand for private consumption—the growth outlook for the remaining months of 2002 seems favorable, although higher import growth may enlarge the current account deficit. We agree with staff that the program will remain on track if there are no sizable external and internal shocks and are glad that the authorities are vigilant of the posed risks ahead.

I would like to emphasize three points for further discussion—current account sustainability and the currency board, fiscal policies and structural reforms.

First, on current account sustainability and the currency board, it is encouraging that now over 75 percent of the current account deficit was financed by FDI and that the country can access the international market on favorable terms. Obviously, this is very helpful in bolstering confidence in the currency board arrangement (CBA). Nevertheless, given the relatively low national savings together with the rapid growth and huge amount of investment required by the convergence with EU countries, Lithuania will, to a large extent, depend on foreign savings. According to staff estimates, the current account deficit will remain around 5 percent of GDP in the next five years (Table 5), which will have important implications for the soundness of the CBA. The first measure in this context is to increase national savings—now below 15 percent. As suggested by staff, the public sector could be a main channel to increase national savings by 2 percent per year. Secondly, maintaining the competitiveness edge—brought about by low labor costs and the flexible labor market as mentioned in Mr. Ísleifsson and Mr. Kropas's statement—through further improving productivity and labor skills is another important task, especially when the litas—pegged to the euro—is forecast to appreciate against the U.S. dollar in nominal terms by an annual average of 8 percent in 2002 and 2003. Due to recent exchange rate movements between the dollar and the euro, staff could probably comment on the impact on competitiveness for the country's production sector. Thirdly, it is also essential for the authorities to improve the environment for foreign investment and better manage their external debt.

Second, on fiscal policy, we think that the current fiscal consolidation is the right move to strengthen the credibility of the CBA and agree with staff that the authorities should be ready to tighten the fiscal stance when adverse external developments emerge. However, this is not an easy task. The authorities need to accommodate the fiscal demand originating from EU accession and maintain adequate services and social expenditure. Therefore, how to stabilize fiscal revenue and rationally relocate expenditure is critical. The undergoing tax reforms should proceed to help arrest the decline in revenue collection and the municipal finance reform should firmly stem the localities' continued fiscal problems.

Third, on structural reform issues, it is encouraging to note the substantial progress made in enhancing the efficiency of the energy sector and other sectors mentioned in Mr. Ísleifsson and Mr. Kropas's statement. On private sector development, given the neutral stance of fiscal policies in the medium term, the private sector ought to become the major engine of economic growth as well as the main arena in absorbing the excess labor force. Privatization has promoted the formation of dynamic and competitive domestic markets and contributed to private sector development. However, domestic credit obtained by the private sector is still very low. Figure 5 in the report shows that, from 1997–2001, both the average growth of bank credit to the non-government sector and the ratio of credit to the non-government sector to GDP in Lithuania were the lowest among the Baltic countries. However, it is noteworthy that in the first part of 2002 credit to the private sector picked up. We hope this trend will proceed together with the careful portfolio management adopted by banks.

With these remarks, I wish the authorities every success in the implementation of the economic program and on their journey to EU accession.

Mr. Portugal and Mr. Tombini submitted the following statement:

We would like to commend the Lithuanian authorities for their country's impressive track record during the current stand-by program, and also we would like to praise staff for an excellent and candid report. Messrs. Isleifsson and Kropas's very helpful statement provides additional evidence of the very positive results obtained in Lithuania under the current arrangement.

The ongoing efforts of Lithuania's authorities towards the adoption of appropriate policies have already generated rewards. Real GDP accelerated to a remarkable 5.9 percent and is expected to remain at high levels despite the slowdown in the euro area. Investment and exports, especially supported by strong demand from CIS countries, have driven growth. Structural reforms have allowed productivity to improve at a brisk pace, and inflation remains under check. Unemployment, however, remains high at 12 percent, and is unlikely to decline markedly over the medium term. In fiscal terms, the numbers show a better performance perhaps as a result of high GDP growth rate. Also notable is the smooth repegging of the litas from the dollar to the euro though one could argue, with the benefit of hindsight, whether the timing—and the exchange rate of $0.8632—was appropriate given the recent trend in the euro against the dollar.

The external current account deficit, however, remains high at 4.8 percent of GDP though much narrower than the levels observed in the recent past. Staff projected that it would widen to 5.9 percent in 2002, but half of such a deficit would be financed by foreign direct investment. External financing terms have improved allowing the coverage of the external gap. Spreads against German benchmark instruments have been consistently cut and just crossed below the psychological barrier of 100 basis points. These developments seem to be produced by market expectation on the proximity of the accession to the EU, which will imply an automatic elimination of the foreign exchange and country risk. Therefore, it is important for Lithuania to continue in its effort to join the EU in the first wave in 2004.

On the monetary front, broad money and credit to the private sector grew by 21 percent year-on-year at end-March. We agree with the staff that the expansion of these money aggregates needs to be monitored closely—despite starting from a low base—as they could exacerbate the deterioration in the external imbalances. Therefore, in a CBA arrangement, it is essential to strengthen the bank's prudential regulation and supervision to preserve the financial balance.

The fiscal discipline remains key, especially in the context of the CBA. We welcome the progress in the tax reform with the approval of the new corporate income tax and VAT. According to staff, tax revenue can be bolstered reducing inadequate exemptions, as seems to be the case in the new VAT. Such exemptions undermine tax reform objectives without benefits to the economy as a whole.

Moreover, problems regarding the municipalities need to be addressed promptly while they are still manageable. Strict enforcement of borrowing limits and better budgeting and planning procedures are yet to be implemented in Lithuanian cities. Experience has showed that provincial and municipal fiscal disarray can be very damaging and even help trigger crises, even when the central government shows clear signs of restraint, the latter seeming to be the case in the country.

On balance, Lithuania is in a good position to persevere in the reform path and overcome any eventual difficulty that may arise along the program, possibly due to exogenous conditions. The recent economic performance of the country and its already impressively positive track record on structural reform encourage our chair to fully support the current program.

The staff representative from the European II Department (Ms. Alonso-Gamo) made the following statement:

I would like to update the Board on some recent developments. In the last couple of weeks, we received some additional data. Real sector developments point to a continuation of positive trends. Non-energy exports for January-April grew by 14 percent year on year, and May CPI was slightly below the December level. First quarter wages were virtually unchanged when compared with the fourth quarter of last year. Unemployment declined to 11.1 percent at the end of May, almost two percentage points below the level at the beginning of the year.

Revenue performance continues to be strong, and the four-month deficit of the general government is in line with program projections. The state budget revision, which is mentioned in the supplementary memorandum and the staff report, had its first reading in Seimas on June 25th. Structural reforms advanced with the passage of the new labor code, and the sale of a 27 percent stake in the Mazeikiu Nafta Oil Company to the supplier, Yukos, was completed.

Mr. Kropas then informed the Board that the authorities had decided to publish the staff paper.

Mr. Harzer made the following statement:

> We support the conclusion of the second review under Lithuania's Stand-By Arrangement, and welcome the authorities' intention to continue to regard the arrangement as precautionary. The authorities should be commended for the successful conduct of adjustment policies. It is more than noteworthy that, despite less favorable circumstances in major trading partners' economies, almost all macroeconomic targets have been met, some with comfortable margins. However, as always, there is no room for complacency, especially against the background of the upcoming presidential elections. We urge the authorities not to relax in their reform efforts, but to actively address the remaining challenges like the comparably high level of unemployment.
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> As we broadly concur with staff's assessment, I will confine my comments to only a few points. First, we would have preferred using the increased headroom that resulted from the favorable revenue performance during the first quarter for a slight tightening of the fiscal stance. Instead, the revised budget for 2002 introduced to Parliament in June provides for a slight expenditure increase. Uncertainty regarding the revenue performance for the whole of 2002, as well as emerging expenditure on the eve of the presidential elections would have warranted the buildup of a fiscal cushion. Notwithstanding the impressive fiscal consolidation so far, ensuring a sustainable fiscal position remains challenging. Financing of the essential social infrastructure, as well as necessary expenditure related to preparations for EU accession limits the flexibility of the budget's expenditure side. At the same time, compensatory measures must be identified to make sure that the envisaged tax reform will be revenue neutral.
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> Second, the fragile financial situation of the municipalities has, unfortunately, led to an increase of payment arrears. In this context, we support staff's call for strict expenditure cuts, improvements in the budget planning process, tight credit limits, and strengthened incentives to reduce payment arrears.
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> Third, thanks to well designed preparations, the changeover from the U.S. dollar peg to the euro has been very smooth. This changeover is a logical step in Lithuania's journey to EU membership. As mentioned in earlier discussions, however, the current exchange rate of the litas under the peg should not be regarded as a breach of prejudice for its reference exchange rate when joining the ERM2 mechanism later on.

Box 1 of the staff paper shows that there is still a need to align the denomination of debit and credit positions of small enterprises and households, in order to reduce exchange rate risk.

Lastly, like staff, we see the need to address the remaining structural agenda in order to ensure Lithuania's international competitiveness, and to deepen the credibility of the currency board arrangement.

Mr. Lissovolik made the following statement:

Lithuania's economic performance under the program has been strong, as is reflected in the vigorous economic growth rate of 5.9 percent in 2001. Structural reforms are proceeding expeditiously, whilst both fiscal and monetary policies are prudently geared towards maintaining economic stability. At the same time we agree with the staff that the impressive achievements of Lithuania should not give way to complacency, given that there do remain areas of vulnerability on the economic landscape. In particular, we note a relatively high current account deficit as well as a high level of unemployment, which necessitate further structural reforms and fiscal moderation.

In the monetary sphere the operation of the country's CBA thus far has been successful and conducive to macroeconomic stability. We agree with Mr. Portugal and Mr. Tombini that the expansion of monetary aggregates albeit from a relatively small base will need to be closely monitored in order to ensure the continued effectiveness in the operation of the Lithuanian CBA. We also agree with Mr. Wei that one of the key measures in ensuring the soundness of the Lithuanian CBA is raising national savings, with the fiscal sphere playing a key role in rationalizing the economic policy mix.

On the fiscal front we agree with Mr. Portugal and Mr. Tombini on the need for streamlining the country's VAT through eliminating inadequate exemptions. On the expenditure side of the budget we concur with the staff that careful prioritization of expenditure is key for fiscal soundness in view of the imminent EU- and NATO-related commitments. Revenue performance could also be further improved through strengthening tax administration. Also, as Mr. Portugal and Mr. Tombini note in their preliminary statement there is a need to address the fiscal problems at the municipal level and in this respect we take note of the commitment expressed in the helpful statement by Mr. Isleifson and Mr. Kropas to address the fragilities in the sphere of municipal finance. The emergence of state budget arrears resulting in the nonobservance of the program's benchmark signals the need for fiscal prudence at all levels of government.

On the structural front we welcome the progress attained thus far in reforming the country's utilities as well as in boosting the reform of the financial sector, whose soundness is yet another key ingredient in the CBA framework. In this respect we welcome the fact that, as noted in the statement by Mr. Isleifson and Mr. Kropas, some of the recommendations of the FSAP report pertaining to banking supervision and the reform of the country's insurance sector have already been implemented. Another important challenge in the structural sphere resides in curtailing the sizeable unemployment in Lithuania, which until recently exceeded 13 percent. We welcome the list of reform initiatives in this sphere as specified in the statement by Mr. Isleifson and Kropas and hope that the downward trend in unemployment observed thus far in the course of the year 2002 continues.

Finally, Mr. Chairman, I would like to comment briefly on Lithuania's foreign trade. Russia is Lithuania's leading trading partner and it is gratifying to note that Russia's share in trade with Lithuania has been steadily increasing in the past years. I was particularly struck by the fact that according to the Lithuanian Development Agency in 2001 exports from Lithuania to Russia increased by 84.3 percent, which no doubt had a palpable contribution to the country's economic growth, showing thereby the considerable potential in the multilateral approach to trade pursued by Lithuania. We hope that this multilateralism will continue to prevail in the future as the country further integrates into the EU.

With these remarks, Mr. Chairman, we support the proposed decision and wish Lithuania continued success in economic reform.

Mr. Yeritsyan made the following statement:

The Lithuanian authorities should be commended for the implementation of sound macroeconomic policies, and for the significant advances towards a fully functioning market economy and integration into the EU. The program has been successfully implemented and the overall macroeconomic outlook in light of the authorities' commitments under the arrangement remains strong. On this basis I support the proposed decision.

I also welcome the staff's lucid report and support the well-focused staff appraisal, which along with advice towards more sustainable policies concentrates on medium term macroeconomic risks. Further I will elaborate on some of the issues raised in the staff report.

First, I agree with staff that improving tax collections should have priority over other types of adjustments to achieve sustainable deficit targets in the medium term. I would support policies to improve tax administration and the tax base under unchanged statutory tax rates. It also seems that there are problems in the fiscal management area, which does not fit into the impressive macro-picture. I would stress the need for resolving the issue of arrears, for achieving a rule based policy framework and for greater transparency and accountability. I hope this would be accomplished far before the EU accession. In addition to staff's comments on government's external borrowing I would also like to stress that the already compressed budget expenditures do not leave room for higher interest payments.

Secondly, I think that the authorities' communication to the public about the new exchange rate arrangement and the whole process of the preparation of the re-pegging could be considered as one of the best practices of communicating a major change in policies. The re-pegging to the euro will make it easer to integrate into the European economies. Nevertheless, the authorities should closely follow the competitiveness indicators and target a more ambitious improvement of the external balance. Two new factors could become a possible cause of concern: the possible appreciation of the euro would further facilitate the appreciation of latai; and there are no convincing reasons to believe that an increase in wages relative to productivity could not be reversed. Furthermore, productivity growth in the tradable sector could moderate.

Third, I share staff's view that the rapid growth in monetary aggregates can be absorbed, as they start from a low basis and Lithuania has the lowest monetization ratio compared to its neighbors. However, more analysis driving the money demand function and identifying the factors that will make this trend sustainable would be important and interesting. In addition to staff's thoughts about surged bank's credit to the private sector, I would also pay attention to the ratio of short-term loans in total loans, which has declined substantially in the last two years (a sharp decline in the first half of 2001). Along with positive outcomes, this trend would also raise new credit risk challenges and create maturity mismatches as long term deposits do not grow at the same pace as short-term loans. Finally, it would be interesting to hear staff's view on the banking system's exposure to foreign exchange denominated loans and deposits, which has remained on a somewhat upward trend.

Fourth, the progress in bringing the current account deficit down to more sustainable levels is satisfactory. I also think that the medium term fiscal policy framework under the program is appropriate. However, I would stress that more reduction in the current account deficit is needed through facilitation of structural reforms and an increase in export oriented private sector activities.

As a final point, labor market developments and challenges in developing social infrastructures in Lithuania, namely in HIF and pension reform, suggests a comprehensive analysis of full applicability of similar systems in the EU countries, which could be certainly expended to the other two Baltic republics. Such an analysis would help the authorities to develop more mobile labor markets and, at the outset, to implement sustainable and financially sound social infrastructure. I see a more active role of the Fund in this issue, as this would have long-term fiscal implications in Baltic countries.

I would like to ask staff's view on the recent press release that the Lithuanian authorities will reopen their negotiations with the EU with regard to the ownership of farmland. They want equal treatment with other neighboring participants in this negotiation process.

Mr. Santos made the following statement:

The Lithuanian economy continues to perform fairly well, reflecting to a great extent the sound policies implemented under the current Stand By Arrangement. This is particularly important as it will allow Lithuania to make the most of the opportunities that will be provided by EU and at a later stage EMU membership.

We agree with staff's assessment of economic developments and policy performance as well as with policy recommendations, and we would just like to elaborate a bit more on exchange rate developments, particularly on the effect of the sharp appreciation of the Euro since the switch of the peg from the U.S. dollar to the euro last February.

No doubt, this was a move that had to be made as in the run-up to EU and EMU membership economic and financial integration with the EU have increased substantially. As for the timing of this move, ex ante, February 2002 sounded as good a time as any other to switch the peg. However, ex post, we cannot help feeling that the timing of the switch has revealed a little unfortunate in view of the strong appreciation of the euro vis-à-vis the U.S. dollar since then, about 13 percent, which follows a 20 percent appreciation of the lita in real effective terms over the past three years, reflecting the strong U.S. dollar over that period of time.

It is true that the sizeable weight of euro-denominated transactions in Lithuania's foreign trade means that the appreciation is less severe measured in nominal effective terms. Furthermore, as stressed in the report, the economy has been able to weather the appreciation of the REER in recent years, with wage moderation and strong productivity gains. The question is to what extent it will be possible to sustain such wage and productivity trends in the near future, so that declining unit labor costs continue to secure external competitiveness.

This clearly puts at a premium structural reforms that deliver dividends in terms of productivity growth and of a consequent appreciation of the fundamental equilibrium exchange rate that parallels the actual appreciation of the lita and hence prevents an erosion in external competitiveness to materialize. As for wage policies, it will be a challenge to avoid some increase in wages after two years of moderation. This is particularly the case because labor market slack is less than indicated by the still high unemployment as most of it is of a structural nature and not cyclical unemployment that could keep wage demands in check.

Moreover, we fear that financial losses incurred by holders of dollar denominated deposits, could be sizeable. The consequent wealth effect could have an impact in consumer spending, even if some adjustment of deposit denomination has taken place over the past months. According to the report that seems to be somewhat of a question mark.

Finally, let me clarify that all these concerns should be viewed in the proper perspective as the economy is strong and its current competitive position seems adequate. We just express these concerns as, all in all, we believe the economy would have been better served had the peg been switched without almost fully locking the gains of the dollar since the launching of the euro.

After adjourning at 1:00 p.m., the meeting reconvened at 2:32 p.m.

Ms. Ocampos made the following statement:

First of all let me thank the staff for the interesting report on Lithuania and Mr. Isleifsson and Mr. Kropas for their insightful statement.

Steady progress in improving Lithuania's economic conditions has been made since the last review. Prudent implementation of economic policies and structural reforms appear to have further strengthened macroeconomic fundamentals: economic growth will be even higher than envisaged driven by a strong rebound in private investment, the fiscal deficit is on track, and the repegging to the euro has successfully reinforced the Currency Board Arrangement (CBA). The authorities deserve to be commended for their skillful and prudent management and their commitment to macroeconomic consolidation and growth. In this context, EU accession negotiations have advanced rapidly, placing Lithuania in the forefront of accession candidates for the first wave in 2004. Given these developments, we fully support the completion of the second review under the Stand-by Arrangement.

Notwithstanding in the medium-term, like many other emerging economies, Lithuania is not free of adverse shocks that may jeopardize its strong fundamentals, as such, it is essential to maintain the reform momentum in order to buttress the progress achieved so far. Since we are in broad agreement with the staff appraisal we would like to concentrate our comments on a few aspects regarding fiscal consolidation and the CBA and structural reforms.

Strengthening fiscal consolidation

It is noteworthy that despite pre-election pressures the deficit target of 1.5 percent of GDP will be maintained by reallocating current expenditures and increasing capital expenditures. Moreover, the structural changes on the revenue side are also to be praised, since they set the grounds for a more solid and market conform revenue structure. The forthcoming elimination of exemptions is a welcome decision and we hope that the recent Seimas's introduction of new ones for selected activities could be reconsidered to preserve the effectiveness of the new tax policy.

On the expenditure side, we concur with staff that a medium-term strategy that increases budget management is crucial to promote growth and prepare Lithuania for the effective use of potentially large EU grants. In this regard, we are glad to know that the worrisome financial stance of the municipalities will be curbed by establishing strict principles of financial discipline and by reinforcing financial relations between the states and the municipality's budgets.

Reinforcing the CBA

We commend the authorities for the successful and smooth process of repegging to the Euro, which can be attributed to the sound economy and the confidence in the CBA, as well as to the high quality of central bank's staff who put in place a well-designed information strategy. The success of the CBA confirms the validity of this scheme if sustained by adequate policies particularly fiscal discipline. The repegging of the litas to the Euro will ease the way to accelerate EU accession and reduce exchange rate misalignments with the EU, its main trading partner, though -given the recent dollar trend- may affect competitiveness in dollar denominated trade. To strengthen the confidence in the monetary framework, besides consolidating the fiscal stance, the current solvency of the banking system needs to be preserved and reinforced if required. In this regard, given the low level of financial depth in Lithuania, we welcome the pick up in credit growth to the private sector. Nonetheless, as noted by Mr. Portugal and Mr. Tombini, although this increase is not concerning given the quality of credit portfolio, the supervisory authorities should keep a watchful eye on its development in order not to jeopardize the soundness of the banking system. In the same vein, we concur with Mr. Wei on the need to increase national savings and reduce the dependency on foreign savings that is widening the current account deficit.

Mr. Isleifsson and Mr. Kropas point out that the repegging has induced to higher preference for litas, including for real state transactions. Nonetheless, we are somewhat surprised that despite this process and that almost 50 percent of external trade is within the Euro Area, new loans and credits remain largely denominated in dollars, including household's deposits.

We wonder whether the repegging and the current dollar depreciation will gradually change the currency preferences in Lithuania. Staff comments on this issue would be welcomed.

Strengthening structural reforms

On the structural front, the need to underpin elements of the agenda is paramount to consolidate the economic and social advances reached so far. The process of privatization of the energy and transport sector needs to be speeded up and in the financial sector, the authorities need to implement the FSAP recommendations. We consider particularly relevant the strengthening of the banking supervision through more stringent prudential regulations such as the change of rules on large exposures to groups or affiliated companies.

Finally, given the high level of unemployment, which apparently is going to come down at a slower pace, we welcome the launch of measures to stimulate labor creation and allowing more flexibility in setting minimum wages across types of jobs and regions. In the same vein, the measures to protect unemployment reveal the authorities firm commitment to tackle social problems.

With these remarks, we wish the authorities every success in their challenging endeavors.

Mr. Dohlman made the following statement:

We broadly agree with the staff's assessment of Lithuania's priorities and vulnerabilities and are pleased to support completion of this review. We have a just a few points for emphasis.

First, maintaining a highly credible fiscal policy is doubly important under the currency board arrangement (CBA). We therefore join the staff in strongly emphasizing the need to maintain a tight fiscal stance, especially next year, and to maintain revenue neutrality strictly in the ongoing tax reform. Early action on revenue-enhancing measures, such as moving the declaration period, would avoid the need for such moves around elections.

Second, we were surprised to see the reemergence of central government arrears, though small, and would appreciate some clarification of the technical difficulties that led to this. The authorities have now missed this quantitative target in three out of the four quarters monitored so far. More worrying, however, is the much larger increase in municipal arrears. The disjunction between central government and municipal fiscal performance is jarring. In this regard, we are pleased to see submission of legislation to tie further transfers to municipalities to a reduction in arrears as a structural benchmark for end-September. We urge quick passage of this legislation, and follow-through on other staff recommendations in this area.

Third, we found the discussion in Box 1 regarding currency exposure of banks and corporations to be very useful and reassuring. However, like Mr. Harzer and Mr. Santos, we read with some concern about the household sector's currency exposure, which seems to be worsening. We wonder whether there is a means to encourage voluntary renegotiations with banks to address this imbalance. On a related point, does the staff view the continued dominance of dollar-denominated bank loans shown in Box 1 as reflecting inertia, or more structural factors? More generally, we would welcome development of a more systematic means of collecting net currency exposure by sector, an area of increasing interest to the Fund. This would have some value added in the case of Lithuania given the recent switch in the peg, relatively large gross financing needs, and dependence on FDI financing.

Fourth, we welcome the authorities' progress in implementing the FSSA recommendations, particularly those relating to supervision and anti-money laundering.

Finally, we welcome the news from the staff regarding the latest unemployment figures, and passage of the labor code bill. We support the additional proposed initiatives (described in paragraph 19 of the staff report) to help reduce unemployment and urge the authorities to plan ahead to offset any increases in expenditures associated with these initiatives.

Mr. Al Azzaz made the following statement:

Lithuania's adjustment and reform effort has made further progress. The improvements are evident in the extent of fiscal consolidation, increase in external reserves, and significant structural reforms. The rapid advances in the EU accession negotiations and the smooth repegging of the litas from the dollar to the euro are also noteworthy.

That said, the challenge is far from over and continued pursuit of macroeconomic prudence and structural reforms is essential to place the economy on a high sustainable growth path and ensure a successful conclusion of the accession negotiations with the EU. The authorities' program, as outlined in the staff report, reflects a welcome commitment to that end. Here, I broadly agree with the staff appraisal and will only add a few brief remarks for emphasis.

The stress on maintaining fiscal discipline is appropriate. In this regard, I welcome the authorities' commitment to ensure revenue-neutrality of the tax reform package. Elimination of exemptions in a timely manner and a fundamental reform of the pension system are also important for success of the fiscal reform agenda.

> In view of the spending commitments related to joining the EU and NATO, the authorities need to be extra vigilant. Here, efforts should focus on containing other spending while minimizing cuts in basic services and social expenditures. In this connection, setting tighter priorities in the annual budget process is essential. The authorities' intention to strengthen the finances and reduce arrears of the municipalities and the Health Insurance Fund are also reassuring.
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> I welcome the progress made and the authorities' plan to press ahead with the implementation of measures to strengthen banking supervision in line with the FSAP recommendations. These efforts should increase efficiency and further enhance confidence in the financial sector.
>
> Timely implementation of the steps to further enhance competitiveness and the improvements of the business environment are crucial for the growth and employment outlook. In this connection, the authorities' strategy to address the unemployment issue, especially the focus on enhanced labor market flexibility and well-targeted training programs is a welcome step.
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> With these remarks, I support the proposed decision and wish the authorities further success.

Mr. Le Gal joined others in congratulating the authorities. He noted that the issue of arrears—particularly municipal arrears—was very important in this case. He also associated himself with Mr. Harzer's comments on the repegging of the litas to the euro, noting that this had not prejudged the exchange rate for Lituania's future adoption of the ERM2 framework. It was also noted that the staff should focus more attention on the ERM2 framework when dealing with countries moving toward EU accession; in this case, the staff paper had not even mentioned the EMR2.

The staff representative from the European II Department (Ms. Alonso-Gamo) made the following statement:

> The staff is satisfied that most of the chairs seem to share the assessment of the staff regarding Lithuania's good performance. We essentially wanted to emphasize medium-term risks, and outline that Lithuania is implementing sound policies at present.
>
> On the issue of repegging and the exchange rate. With the benefit of hindsight, it is easy to argue that the Lithuanian authorities could have waited a few months to benefit from the recent euro appreciation. Apart from the fact that no one could have known when, or even if, the euro would appreciate, the same way that we do not know now whether the current rate will be sustained, the most important consideration when preparing the repegging was to have a transparent process and inform the population, by letting agents prepare in advance. In that sense, the repegging was a success, as some chairs have said.

A surprise repegging might have led to instability, capital outflows, and large currency mismatches, likely more than wiping out the effects of an appreciating euro rate. In a small, very open economy, with sufficient labor market and price flexibility, fine-tuning the rate is less important than credibility. I think that the credibility of the repegging has been proved by the reaction of the markets.

Now we turn to the risks of the euro appreciation to the CBA. The main object of the repegging was to switch the peg of the litas to the euro. With three-quarters of Lithuanian trade geared toward the euro area, its Baltic neighbors, and other EU candidate countries, movements of the euro vis-à-vis other currencies have a mitigated impact on Lithuania's competitiveness. Given Lithuania's very low rate of inflation, it had actually gained competitiveness vis-à-vis its CIS trading partners despite the recent dollar depreciation. Let us not forget that a good portion of the dollar trade, which is now about 20 percent, is in oil and energy imports.

That said, a euro appreciation does lead to some erosion of competitiveness, but Lithuania starts from a position of very large absolute cost advantages, and a period of rapid growth in exports. In fact, non-energy exports to the EU in April were up by 14 percent over the previous year. Established niches in the export market, a track record of impressive gains in productivity, and a flexible labor market with a proven capacity to deliver declines in nominal wages when needed are all characteristic of this Lithuanian economy. Real wages are now lower than for the average of 1999.

Looking ahead, we have run some scenarios to see what the impact of different euro rates would be. Using the WEO assumptions about inflation and economic performance in trading partners, Lithuania would be able to withstand a euro appreciation on the order of 10 or 20 percent over 2002-2003. After that, the Lithuanian authorities have a credible exit strategy in their move toward ERM2 and the euro. As the French and German chairs emphasize, we are not prejudging the rate at which Lithuania would join the ERM2. This would be an opportunity to reassess competitiveness.

An appreciation of 30 percent during the same period—2002–2003—taking the euro back to its historic peak could be withstood without output loss, provided they maintain productivity growth levels of about 6 percent per year. This compares with an annual rate of productivity growth of 10 percent that was registered in 2000 and 2001. Growth of productivity in the tradable sectors in the last year was 14 percent. Of course, it all depends on Lithuania's ability to maintain this strength into the future. According to exporters, there is scope for such gains. There is still a lot of potential for productivity gains, especially through more capital-intensive investment. There would be a cost, however, in that export expansion and growth would materialize, but without much employment creation. If productivity gains were lower, then the output and employment costs would be commensurately higher. In any case, the staff would like to reiterate its emphasis on the need for fiscal discipline and continued structural reforms to support the credibility of the CBA, as well as on growth and employment creation. We share the view of some chairs that keeping an eye on competitiveness indicators will be critical over the next two years.

Turning to the fiscal side, we also welcome the Board's support of the staff's view that maintaining a credible fiscal policy is essential in the coming years. It would be difficult to find a staff member who would disagree with the view that the fiscal stance should be even tighter. In fact, we think that the 1.5 percent figure for this year is appropriate, and that the supplementary budget actually keeps the target where it is. There is a reallocation of expenditure of 0.2 percent of GDP in an election year, and we think that we may be too conservative regarding GDP growth this year given the current data update. It may turn out that the nominal target that we have this year could deliver a lower ratio to GDP fiscal deficit, but in any case, we did not think that given the uncertainty in Europe, and the sort of risks regarding municipal finance, that this was the time to tighten the target even further. Perhaps the better than expected revenue performance that we have had so far might be needed later in the year to make up for some shortfalls. Moreover, expenditure is fixed in nominal terms and cannot be increased unless parliament approves it, so if we turn out to have higher revenue later in the year, automatically the target would adjust.

We definitely share the view that it is important for the tax package to be revenue neutral, and to keep a very firm stance next year.

On the municipalities, we would like to put the problem in perspective. We are concerned, and we see a growing problem, but it is still manageable. That is why we want the authorities to tackle it right now. They have taken important measures, but we want them to go even further. I am happy to say that in the supplementary budget legislation that was submitted to the Seimas two days ago, there is a clause including a condition requiring that any additional money be transferred to the municipalities for the clearance of arrears. There will also be discussions in the coming month of a real property tax that would enhance municipal revenues. This could prove controversial, given the municipal elections later in the year.

The six million litas state budget arrears does not threaten macroeconomic viability. It is, however, true that there are problems in terms of management at the treasury level. That is why this target has been kept, as a signal that fiscal management has to improve. There has been a data ROSC mission recently. There will be a fiscal ROSC in July, and we hope the technical assistance provided by the Fund in that context would help them to further improve fiscal management.

On credit growth, we want to reiterate that credit starts from a very low base after two years of stagnation, and from talks with the bankers, we think that the current credit growth is small in absolute amounts. It is also our opinion that this credit is going to creditworthy customers, though we do share the view that one has to keep an eye when there is very rapid credit growth, and that enhanced banking supervision is necessary.

Several chairs raised the issue of the loans in euro, and dollars. We have some updated data since the issuance of the staff paper. Looking at new loans issued between February and April, about 45 percent are in euros, 33 percent are in litas, and 21 percent are in dollars. This corresponds more or less to the share of trade with the dollar area. We believe that the high levels at the beginning were because enterprises and individuals took some time to adapt.

The trend is somewhat less clear in deposits. About 55 percent of deposits in February-April are in litas, about 8 percent in euros, and about 37 percent remains in dollars. This is because a lot of individuals did not want to switch their deposits and risk early withdrawal penalties, and also I think that there is a psychological component of giving up currency that has been the anchor for the last ten years, and switching to what is, for a great deal of the population, a new and untested currency. Regarding the wealth effect, if losses are realized, then there will be a negative wealth effect, and that would probably offset some of the worrisome excess demand that other Directors have mentioned.

Turning to structural reforms, we fully support the view that the authorities need to continue with structural reforms, and that these are important as if high growth continues, it will have to be accompanied by employment creation. In terms of unemployment, while we welcome the measures that have been introduced by the authorities, I would like to caution the Board that unemployment in Lithuania does not have short-term solutions. There is a large structural component of older workers, especially in the rural areas, who are difficult to retrain, and it is important to address part of that as a social issue. That being said, the new labor code allowing for more flexibility in setting minimum wages, and differentiating between sectors will definitely help.

There was some mention of the danger of wage increases. As inflation has been incredibly low in Lithuania—with some actual deflation from January to May—pressures for wage increases are not apparent. However, we will continue to monitor inflation.

There was a question on the EU accession negotiations, and in particular on the possible reopening of the chapter on capital movements in view of the Lithuanian authorities' desire to renegotiate the transition period

> for the sale of land to foreigners. Lithuania has concluded 28 of the 31 chapters of the accession framework, including the very difficult energy and regional chapters. We do not think that reopening this chapter is going to be a major obstacle. Lithuania is simply requesting what other candidate countries have negotiated in terms of the transition period for the sale of land, as Lithuania had agreed to no transition period. There was intense political opposition to the needed constitutional revision, and in the discussions, Lithuanians felt that it was difficult to argue that they could not get similar terms to what every other candidate country had obtained.
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> Finally, on medium-term vulnerabilities in the savings rate, the Chinese chair mentioned the need for increasing the savings rate. It is true that Lithuania requires an investment level that will allow it to grow rapidly, and it also needs to keep its current account deficit in check. This means that it will need to generate more domestic savings. In our projections, we see further savings coming mainly from the public sector, and we have been extremely conservative in terms of our assumptions about the growth of savings from the private sector. However, we would expect that with both the new pension system in place, and with the benefit of greater stability from EU accession, that increased investment opportunities for savers would stimulate domestic savings. Moreover, both the level of the current account deficit, and how it is financed are issues. If Lithuania can continue attracting foreign direct investment, and these investments are directed toward export-oriented industries, the resulting increase in export revenue would be sustainable.

Mr. Kropas thanked Directors for their contributions and positive outlook. The general focus on fiscal policies was appropriate, as, given the exchange rate regime, fiscal policy stood as the main tool for macroeconomic policy, and a critical mechanism for securing external viability and ensuring the credibility of the currency board arrangement.

Many Directors expressed concern about the remaining arrears problem, Mr. Kropas noted. The authorities focused particular attention on the problem of accumulated arrears, and remained committed to their clearance as expeditiously as possible. The Fund should be commended for the constructive role it had played in Lithuania's' bid for accession to the EU.

The Acting Chair made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the successful implementation of economic policies in 2001, which led to the achievement of all the goals under the Stand-By Arrangement. Directors welcomed the continued favorable developments in the first quarter of 2002—noting, in particular, the strong growth of exports and improved fiscal performance. They observed that the smooth repegging of the litas to the euro in February reflected cautious policies, as well as extensive technical preparations and a fully transparent

approach. Against this background, Directors encouraged the authorities to continue to give high priority in the medium term to expanding employment opportunities, and sustaining growth through improvements in competitiveness.

Directors welcomed the authorities' commitment to a further strengthening of fiscal policy, and related reforms, in the remainder of 2002. They observed that the 2003 draft budget will offer an opportunity to signal policy continuity at an important juncture. Directors underscored that the planned comprehensive tax reform package should remain revenue neutral, in particular by eliminating exemptions and loopholes. They cautioned that it is also essential to resist preferential tax treatment for particular sectors—and thus ensure the neutrality, evenhandedness, and transparency required to promote private sector activity and growth.

Directors noted that some progress has been made in improving the financial situation of the Health Insurance Fund and municipalities. However, they expressed concern about the increase in municipal arrears in early 2002, and underscored the importance of further action to strengthen financial discipline in the municipalities. Key steps should include the streamlining of expenditure, improved budgeting and debt management, and mechanisms to ensure that additional transfers to municipalities are linked to concrete corrective measures and arrears reduction. The need to rationalize health expenditures was also noted.

Directors welcomed the broadly favorable assessment of the financial sector under the FSAP. However, a few Directors pointed to the possible risks from the expected strong growth of private credit in 2002. Directors commended the authorities' decision to implement the recommendations of the FSAP mission. They welcomed the planned tightening of prudential rules in the banking sector—including those governing large exposures and provisioning—as well as measures to strengthen insurance regulations, and combat money laundering and terrorist financing.

Directors commended the authorities for completing the privatization of the banking system. They also took note of the important steps being taken to restructure the energy sector and restore its profitability, which would help pave the way for privatization in that sector. Directors urged, however, that it was important that the momentum of reform be sustained in the coming months, and underscored the need for measures to improve the business environment.

Directors noted that, while the medium term outlook appears broadly favorable, there are risks to the authorities' strategy—associated, in part, with large external financing needs. They pointed to fiscal restraint, careful debt management, and structural reforms as being key to maintaining the credibility of the currency board arrangement, and establishing the basis for an orderly exit into ERM2 and the euro in due course.

Directors emphasized that it is essential to press ahead with reforms aimed at promoting greater flexibility in labor markets, boosting productivity, and maintaining competitiveness—a priority underscored by recent exchange market developments. These policies, together with an increase in national savings, would reduce the economy's vulnerability to domestic and external shocks, stimulate the growth of employment creation, and help ensure that Lithuania will be prepared to join the EU in the first wave expected in 2004.

The Executive Board took the following decision:

1. The Republic of Lithuania ("Lithuania") has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement for Lithuania (EBS/02/135, Sup. 1, 9/7/01) to review program implementation.

2. The letter from the Prime Minister and the Chairman of the Board of the Bank of Lithuania dated June 13, 2002, together with its attached Supplementary Memorandum of Economic Policies and Technical Memorandum of Understanding, shall be attached to the Stand-By Arrangement for Lithuania, and the letter from the Prime Minister and the Chairman of the Board of the Bank of Lithuania dated July 26, 2001, as modified, shall be read as supplemented and modified by the letter dated June 13, 2002.

3. Accordingly, the quantitative performance criteria referred to in paragraphs 3(a)(i) through (v) of the Stand-By Arrangement for Lithuania for September 30, 2002 shall be as specified in Table 1 of the Supplementary Memorandum of Economic Policies and in the Technical Memorandum of Understanding attached to the letter dated June 13, 2002.

4. The Fund decides that the second review contemplated in paragraph 3(d) of the Stand-By Arrangement for Lithuania is completed. (EBS/02/105, 6/14/02)

Decision No. 12780-(02/69), adopted
June 27, 2002

APPROVAL: September 24, 2002

SHAILENDRA J. ANJARIA
Secretary