Crisis Resolution:
Why We Need a Krueger-Like Process to Obtain a Taylor-Like Result[1]

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Those who see the need for new approaches to resolving financial crises take seriously the moral hazard created by IMF financial operations. A regular pattern of rescue loans, in this view, allows investors to escape losses, which in turn encourages them to lend without due regard to the risks. Repeated rescues thereby weaken market discipline. Furthermore, IMF support permits governments to cling to unsustainable policies for longer than they would otherwise. This permits financial vulnerabilities to build up, in turn leading to more severe fallout at the time of the eventual economic and financial collapse.

Traditionally, academic investigators have tended to emphasize investor moral hazard rather than borrower moral hazard, because they see it as both more plausible and easier to test.[2] Since the Argentine crisis, however, the concept of borrower moral hazard has made something of a comeback. The worry is not so much that the promise of IMF support packages leads elected officials to consciously assume additional risks, but that it may encourage them to cling for longer to unsustainable policies to which they are already committed and on whose

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[1]Prepared for the Institute for International Economics Conference on "Sovereign Debt Workouts: Hopes and Hazards." I owe the subtitle of this note to Michael Buchanan (Goldman Sachs 2002). These remarks draw on my book, *Financial Crises and What to Do About Them,* forthcoming from Oxford University Press.

[2]To be sure, the results of existing tests are inconclusive. Zhang (1999) and Spadafora (2001) are two statistical studies that take broadly similar approaches to testing for the existence of moral hazard but reach strongly incompatible conclusions. Sarno and Taylor (1999) and Chang (2000) both conclude in favor of moral hazard, while Kamin (2001) concludes against.

continuation their political survival is dependent.[3]

Gazing around this room is enough to remind one that not everyone agrees with this diagnosis. Not a few members of this audience will insist that the risk of moral hazard has been over-sold. They will argue that evidence for it is weak. Emerging market spreads have widened since the Asian crisis, the event that occasioned the IMF's unprecedentedly large support packages. The interest-rate reward enjoyed by investment grade countries has become more pronounced. Portfolio capital flows have not exactly been flooding into emerging markets since the Mexican rescue of 1995. These facts are not obviously consistent with the overwhelming importance of moral hazard.

At an instinctual level many members of the international policy community still feel that the tendency for the IMF to respond to the latest financial problems with yet another package of financial assistance is part of what has rendered the international financial system accident prone. But the preceding should remind us that moral hazard is not the only problem facing the stewards of the international financial system. Initiatives to address the moral hazard problem should be accompanied by complementary measures to counteract other distortions that stifle the flow of finance to emerging markets.[4] These complementary measures include stronger policies and creditor protections (bankruptcy and insolvency procedures, rights for minority investors) in emerging markets. But they also include regulatory reforms in the money centers to buttress the stability of global financial markets, thereby making emerging-market borrowing and lending

[3]The effects of the IMF's decision to provide further assistance to Argemtoma in August 2001 are frequently seen in this light (e.g. Mussa 2002).

[4]As emphasized by Calvo (2002).

more attractive. Restrictive covenants that require pension funds and insurance companies to sell into falling markets, aggravating volatility and crisis risk, are part of the problem. So too are revisions in the Basle capital standards that strengthen the tendency for international banks to engage in positive feedback trading.[5] But that is the topic of another paper. My point is that there is no necessary inconsistency or conflict between the initiatives needed on both fronts.

The alternative to yet more financial assistance for a country with unsustainable debts is for the international policy community to stand aside -- to resist the temptation to provide more financial assistance and instead to insist on a restructuring. Why don't we see more frequent resort to this alternative if it is the obvious solution to the moral hazard problem? Why are governments prepared to impose extraordinary hardships on their constituents to avoid it? Why is the international policy community so reluctant to see restructurings occur?

The fundamental reason is that market-based debt restructurings are difficult, messy and, above all, uncertain. These facts reflect the existence of information asymmetries between lenders and borrowers. They reflect the inability of borrowers to commit to a credible rehabilitation plan. They reflect the threat of litigation by rogue creditors. They reflect the existence of a variety of other collective action problems for investors in an age of securitized finance.

The severity of these difficulties is disputed. Some observers insist that their gravity has been exaggerated by the proponents of far-reaching institutional reform. But it is not necessary for there to be agreement on their severity in order for such considerations to shape policy. A

[5]Thus, reforms that would more sharply increase the capital charge associated with sub-investment-grade assets would strengthen the incentive to close out such positions when emerging markets suffer rating downgrades, amplifying positive feedback effects.

significant risk of an undesirable outcome will be enough. Elected officials are risk averse. Faced with these uncertainties, they will be inclined to leave the solution to the moral hazard problem to another day. Faced with the latest crisis, they will be inclined to back down, yet again, and lend, and to minimize the adverse consequences for market discipline and government behavior.

This implies the need to rectify the deficiencies in existing mechanisms for restructuring problem debts. If such mechanisms are seriously deficient, then any new financial hardheadedness on the part of the Fund may create serious disruptions in the crisis country and jeopardize the stability of the international financial system. Awareness of this danger may prevent the IMF from addressing the moral hazard problem in the first place. At a minimum it will diminish the credibility of IMF claims that the institution intends to limit the magnitude of rescue packages and instead to rely more heavily on market based restructurings. In the absence of institutional reforms to limit the underlying uncertainty, neither markets nor governments will see declared commitments to clear presumptive limits on the size of IMF packages as credible or time consistent.[6]

If this is the problem, then the solution is institutional reforms that reduce these uncertainties. This much is easy to say. But what reforms, exactly? Here I see the options and their proponents as falling into three camps.

The first I call the "no reform" camp. Its members see no need to do anything further aside from showing more resolve not to throw official money at emerging-market financial

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[6]I return below to proposals for ameliorating the moral hazard problem through the declaration of presumptive lending limits.

problems.[7] Market participants, with the support of their legal and financial advisors, are fully capable, in this view, of resolving debt crises themselves. Ten years of experience with the bond market has taught them how to use debt exchanges to restructure problem debts and to limit the threat of litigation by rogue creditors. Market-based debt exchanges have a track record of success when countries engage constructively with their creditors. Even when things go seriously wrong, creditors have shown themselves able to form representative committees in order to pursue negotiations with the debtor, and their negotiations have been quick to produce results when both parties show good faith.[8] Investors are prepared to accept a significant reduction in the face value of their claims when they are convinced that a country has serious problems but also that it is making a good-faith effort to put corrective policies in place.

Rogue creditors, for their part, are unlikely to use litigation to hold up the process. Institutional investors have an ongoing relationship with the crisis country, often as debt underwriter as well as creditor. Commercial banks have franchise value to protect in the form of good will and licenses to operate in the crisis country. Rather than filing suit, they have an incentive to pay off holdouts to prevent the latter from using legal means to disrupt the exchange. For all these reasons, true vultures are few in number. They can be bought off by other creditors or the debtor. Their bargaining power can be undercut by legal devices like exit consents. Countries adopting these strategies can put their debt problems behind them, and, when they do,

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[7]Among the more articulate proponents of this view are Roubini (2000, 2001).

[8] Counterexamples like Russia in 1998 and Ecuador in 1999 are instances where governments failed to pursue good-faith negotiations and simply announced their debt restructuring as a fait accompli, antagonizing investors. Other countries have learned from their mistakes.

they can begin regain market access.

The recommendation of members of this camp is to stop tinkering with the mechanism and to more stoutly resist the temptation to throw official finance at emerging-market financial problems. The difficulty of restructuring problem debts, in this view, has been exaggerated. The IMF and its shareholders have nothing to fear but fear itself. They should disregard warnings that market-based restructurings are difficult and that they can create problems for the crisis country and the international financial system. Recent events appear to have reinforced optimism about the resilience of the global financial system; in particular, the pressure to intervene may be even less now than in the past to the extent that contagion has grown less virulent. The international financial system's "architects" are thus preoccupied by a non-problem. They are generalizing excessively from the cases of countries that have done it wrong. If the IMF and the international financial community simply display more backbone, then the rest will take care of itself.

At one level this advice is appealing, since it dismisses as superfluous an entire range of questions regarding institutional redesign, along with the question of whether there exists the political will to implement significant changes. But it begs the question of why the IMF and its shareholders have felt such pressure to extend financial assistance intended to minimize recourse to payments suspensions and restructuring negotiations.

It could be that officials underestimate the efficiency with which the markets can resolve debt problems. Perhaps they are swayed by creditors convinced that they will enjoy more favorable terms with bailouts than without them. But it is more likely, as argued above, that officials see involuntary suspensions leading to restructuring negotiations as difficult, messy, and risky. While the principals may arrive at a satisfactory resolution if left to their own devices, they also may not. The outcome is uncertain. There is some risk that default will cause severe economic, financial and political dislocations. There is some risk that it will have destabilizing repercussions affecting the stability of the international financial system. Risk-averse politicians are reluctant to have this experiment occur on their watch. Thus, their tendency to resort too frequently to financial assistance for crisis countries reflects more than lack of understanding or backbone. It reflects uncertainty about whether existing institutions and arrangements are up to the task. This in turn implies the need for institutional reform to reduce that uncertainty to acceptable levels.

This brings me to the second class of proposals, what I call "radical reform." Members of this camp reject existing arrangements as inadequate and propose to replace them, lock, stock and barrel, with new institutions and procedures for resolving debt crises. The leading ideas under this heading, the international lender of last resort and the international bankruptcy court, propose radical new approaches to dealing with liquidity and solvency crises. Given more space, I could discuss such schemes at length.[9] Suffice it to say that, absent considerable new powers for the multilateral financial institutions or some new global entity, I see these ideas as creating more problems than they solve. Endowing an international bankruptcy court or international lender of last resort with only some of the powers of its national counterpart but not others would only replace one form of moral hazard with another. In practice, of course -- and fortunately, in my view -- these proposals are non-starters. There is no political appetite for creating a new international entity with vastly expanded powers.

[9]Readers wishing such a discussion can find it in Eichengreen (2002).

This leaves the third class of proposals, which stake out a middle ground. None seeks to create new international institutions with the power to override domestic courts and contract law. But all acknowledge the need to modify the mechanisms used to restructure problem debts in order to render that process more predictable. At some level, they are all variations on the same theme. They envisage limited changes in financial contracts and practices designed to smooth the management of financial disruptions, thereby opening up an alternatives to large-scale official finance, but without contemplating an increase in the powers and prerogatives of existing or prospective international institutions. They would encourage crisis countries to resort more frequently to payments standstills. They would add put or rollover options to loan agreements. They would insist on the use of collective action clauses that rely on majority-voting and sharing to deal with the free-rider problems that complicate restructuring negotiations.[10] These limited changes would not ensure that sovereign debt crises could be resolved as smoothly as domestic bankruptcies, but that is not the point. To the contrary, some pain is essential to deter reckless lending and borrowing, even more than in the domestic setting, since there is no international body with the power to impose other sanctions to prevent opportunistic behavior.

The proposals in this category vary along two dimensions. First, they differ in whether they are best suited for addressing liquidity or solvency crises. Standstills and debt-rollover options are ideal for addressing liquidity crises, but other than creating a window of time they do nothing to facilitate the subsequent restructuring if one is necessary. Collective action clauses speak to the large-number and free-rider problems that complicate restructuring negotiations and

[10]Each of these options has been the subject of lengthy discussion an analysis. An invaluable synthesis and critique of this work is Kenen (2001).

are thus better suited for crises of debt sustainability.

Second, the proposals differ in whether they see a need for changes in domestic law or precedent to shelter debtors from litigation. Those who doubt that litigation is a threat question the need to amend national laws or the IMF's Articles of Agreement to give protection from legal action to countries declaring a standstill. Those who worry that litigation may be a problem insist on the need to write the relevant protections into each and every loan agreement and consequently on the need to amend national law to make this obligatory.

My own view is that is that most crises are rooted in fundamentals and that the threat of litigation cannot be dismissed.[11] I therefore prefer collective action clauses to rollover options on the first of these grounds and changes in national law or international treaty to facilitate their use on the second. To be sure, standstills are still needed as a first step when a country has a sustainability problem requiring it to restructure its debts. Regularizing the use of standstills would therefore play a useful role even if one thinks that few crises are of the pure liquidity type. But standstills do not address the more fundamental problems of transactions costs and uncertainty about the outcome of restructuring negotiations. In any case, collective action clauses, which address these problems head on, also include a de facto standstill provision, since they give the debtor some shelter from legal action when it halts payments by requiring a critical

[11]The most widely-cited if controversial illustration of this risk is the Elliott Case against Peru. Here, it is argued that the Elliott Case does not set a precedent, since that case was settled out of court, and it in any case it reflected an erroneous interpretation of pari pasu provisions that would have been overturned by a higher authority. Still, the legal implications of this case are unclear precisely because it was settled out of court. And although Elliott does not set a legal precedent, it surely sets an economic one --the fact that the debtor chose to pay off a litigious investor surely increases the likelihood of future legal action. Moreover, Elliott's success in attaching payments to other creditors, even temporarily, increases the likelihood that signs of holding out by vulture funds will cause future restructuring negotiations to unravel.

mass of investors to agree before litigation can be initiated.[12]

To maximize the benefits, changes in national law mandating the inclusion of collective action clauses in all loan agreements would have to be adopted by all IMF countries. This would be essential to prevent some debtors and creditors from attempting to substitute, say, quasi-sovereign for sovereign obligations or private placements for publicly-issued debt securities.

Collective action clauses are not a new idea. They already exist in the UK market, and their more widespread use has been recommended by a long series of expert committees and official documents starting with the Rey Report (Group of Ten, 1996). Unfortunately, progress on their more widespread adoption has been slow, reflecting what Buccheit and Gulati (2002) refer to as "drafting inertia." Experience has shown that relying on the markets to see the light is unlikely to solve the problem in real time.[13]

The issue therefore is how to promote the more widespread adoption of these provisions. Economists have a natural preference for incentives. Thus, Taylor (2002) has suggested that access to IMF facilities, or the price at which such access was granted, could be made contingent on the adoption of collective action clauses.

In the strong version of this recommendation, only countries that had already incorporated collective action clauses into their international loan agreements would be eligible for IMF

[12]Some (e.g. Kenen 2001) would advocate both collective action clauses and an international standstill mechanism. While I do not disagree in principle, in practice I am inclined to argue that the international policy community should husband its scarce political capital and concentrate for the time being on pushing for what is essential, namely, collective action clauses.

[13]In addition to the sway of convention in financial markets, the spread of restructuring-friendly provisions may be slowed by the recognition that investors can expect bailouts under the status quo. This both limits the need for restructuring-friendly provisions and raises the danger that adopting them may limit the extent of official assistance.

assistance. However, this is unlikely to influence the substantial (and, hopefully, growing) class of investment-grade countries that do not contemplate having to negotiate an IMF program. At a more fundamental level, this approach again amounts to assuming a solution to the Fund's time-consistency problem. The IMF's Executive Directors can aver their reluctance to lend to countries that have not embraced the relevant contractual reforms, but when the crunch comes and a crisis looms they will feel pressure to back down and lend to countries whose loan contracts lack these provisions and which therefore create a particular risk that an involuntary restructuring will be difficulty, messy and uncertain. And knowing that the IMF has an incentive to disburse anyway, countries will have little incentive to alter their habits in response to incredible threats of being denied access.

The idea that access at preferential interest rates could provide an incentive to alter contractual provisions may also be problematic. When a country is in the throes of a crisis and desperately requires IMF support, the interest charge it faces is not exactly the first thing on its mind. Differential interest rates on IMF packages for crisis countries, in other words, are blunt instruments for encouraging changes in habit.

This approach would also have to overcome serious legal obstacles. As I understand the IMF's Articles of Agreement, they guarantee comparability of treatment. Hence, they require the institution to extend access to individual facilities on comparable terms to all member countries. That means, among other things, not discriminating in terms of interest charges. This principle is compatible with the existence of different facilities bearing different interest rates for countries with different kinds of loan contracts. The Fund's Executive Board has already acknowledged that the use of CACs is one factor that might be considered when pre-qualifying a country for a

Contingent Credit Line. But the Contingent Credit Line has not exactly been a resounding success. Requiring a country like Mexico to first exchange its outstanding debt instruments for new ones featuring CACs will not exactly encourage it to rush to sign up for a CCL.

These problems could be solved by amendments to the IMF's Articles or by an agreement on the part of its shareholders to create a range of new facilities with tiered interest rates for countries with and without collective action clauses in their bonds. But a proliferation of new facilities would undermine much of the progress that has been made recently in streamlining and simplifying IMF lending procedures. In any case, if there is going to be an amendment to the Articles, why not consider an amendment that would address the key issues? I have in mind an amendment mandating the inclusion of a uniform set of clauses in all new loan agreements of IMF member countries. The core provisions would allow a 75 per cent vote on restructuring terms to bind all bondholders, require at least 25 per cent of the bondholders to agree before legal action can be initiated, require the proceeds from such legal action to be shared with the entire class, and renounce the right to attach the proceeds of any new financing provided during negotiations. This could be usefully supplemented by an initiative to devote some of the resources of the World Bank and the regional development banks to underwriting the costs of market based debt exchanges designed to retire old issues lacking these provisions.

Policy makers, U.S. policy makers in particular, have an evident distaste for mandating changes. They prefer incentives to mandates. In the case of the U.S., they also do not wish to see their own future bond issues included. One suspects that Administration officials do not want to be obliged to submit the relevant changes to approval by the Congress. But there is no avoiding a mandate if we are serious about the need for rapid progress. There is no finessing the need for Congressional support. At a minimum there will have to be changes in SEC regulations governing what kind of provisions are required of issues admitted for listing on U.S. markets.

One widely-heard criticism of the IMF-Krueger proposal for orderly debt restructuring is that it would require amending the Articles of Agreement, which would be difficult politically. The preceding discussion, while not inconsistent with this observation, suggests that the problem is not specific to the Krueger proposal. If the international policy community is serious about implementation, direct political action will be needed whether officials opt for the Krueger proposal or for more limited reforms. It will be needed whether they opt for an amendment to the IMF's Articles or for changes in U.S. securities regulations and laws. It is widely said that the time has come to move from contemplation to action. My conclusion is that this means action to amend the treaty obligations and domestic securities regulations of the United States (and the other advanced-industrial countries), like it or not.

Another widely heard objection to the collective-action-clause solution is that these measures would have to be added to all loan agreements, not just to sovereign bonds. The point is correct, but I do not see it as a problem. International bank loans already include equivalent provisions. In many countries, so do private bond issues. Trade credits and other obligations would also have to be addressed, but I do not see this challenge as insurmountable.

Perhaps the most fundamental objection -- or at least the one that most clearly differentiates CACs from the Krueger proposal -- is that CACs would apply thresholds for majority voting and litigation to individual loans and not to the debts of the government as a whole. Even the IMF's "contractual approach" -- its intermediate option which would place most decision making power directly in the hands of the creditors and the debtor -- would allow for majority voting by the creditors across issues, rather than issue by issue. Thus, those who choose between the two options implicitly take a position on the difficulty of aggregation.

How serious is this aggregation problem? Here it is important to distinguish aggregation for litigation from aggregation for accepting restructuring terms. It could be argued that litigation will be easier if minimum participation is defined issue by issue, since it will be easier for a vulture fund to accumulate the requisite fraction of an individual issue than that fraction of a country's entire debt. While this is true, the logical response is to raise the fraction of bondholders who must agree before they can instruct the trustee to litigate from 25 to, say, 75 per cent of the issue.[14] In addition, the use of sharing clauses requiring those who litigate to share the proceeds of any settlement with the entire class of investors would reduce the incentive to pursue disruptive action. It is important to recall that the goal here is not to make litigation impossible, only to make its pursuit by vulture funds more difficult and costly.

Turning to restructuring, it might be argued that provisions for majority voting issue by issue, as opposed to majority voting by all classes of creditors simultaneously, will create coordination problems. No one group of bondholders would be prepared to vote an agreement to restructure, one could imagine, if the holders of other issues insisted on better terms and continued to hold out. In the presence of this kind of first-mover problem, the entire agreement could unravel. In practice, creditors have shown themselves to be able to solve this collective-action problem by coordinating across issues -- by forming, inter alia, the Argentine Bondholders' Committee made up of the holders of divers claims. The recommendation of such

[14]While 25 per cent has been the norm, nothing requires it to remain the norm in the future.

a committee would provide a focal point for the creditors' decision of whether to accept or reject the proposal by the debtor, ameliorating their coordination problem. This would not solve the coordination problem entirely, but that is not the point. The goal of reform is not to make restructuring smooth as silk, since doing so would go too far in the direction of weakening the bonding role of debt, only to reduce somewhat the severity of the obstacles.

What about the domestic-currency debts of the sovereign? What about non-sovereign debts? Whether domestically-issued sovereign debts have to be restructured will depend on the nature of the claims and the nature of the crisis. If restructuring them is viewed as too difficult -- which is not obviously the case, since the national authorities may simply be able to alter the value of its domestic claims through unilateral action, as did the U.S. government, for example, when abrogating the gold clause in its domestic debts in 1933 -- then they too could usefully include the relevant restructuring-friendly contractual provisions. But good-faith negotiations are preferable to unilateral restructurings. Mexico's *tesobonos* were denominated in domestic currency (though indexed to the dollar). Had the government not received a massive IMF-U.S. Treasury bailout, it would have had to restructure them. Given the structure of debt contracts as they stood, the only alternative to a bailout was unilateral action by the debtor, and unilateral action is not something that appeals to the creditors or is good for market stability, as we learned from Russia in 1998. Collective action and collective representation clauses would have been helpful for opening up an alternative. Thus, my preference would be to include CACs in all sovereign loan obligations, not just foreign obligations or foreign-currency obligations. Here I differ from Taylor (2002).

Corporate debts, for their part, can be restructured via domestic insolvency proceedings.

Admittedly, this presupposes a relatively strong and efficient bankruptcy and insolvency system, something whose development could be more aggressively promoted as part of the effort to strengthen the international financial architecture. In the event of a systemic crisis, the government may have to take special steps to develop a structured process to encourage pre-packaged agreements in the shadow of the court. Where there exist large amounts of external or otherwise hard-to-restructure debt, the inclusion of majority restructuring clauses in the relevant debt contracts will smooth the process of getting the creditors to agree on restructuring terms and ease fears that foreigners will end up owning disproportionate shares of the reorganized enterprises.

Then there is the transition problem. Limiting CACs to new loan agreements coming onto the market would imply a transitional period, since many bonds currently in circulation lack the relevant provisions. This transition could be shortened by exchanging these old issues for new ones. These transactions would have to be voluntary; otherwise they might be regarded as constituting an event of default, trigger acceleration and cross-default provisions, and lead to litigation. Voluntary debt exchanges are now something with which market participants have considerable experience; there is no obvious reason to doubt their viability. To be sure, some borrowers would have to pay a premium to induce their creditors to voluntarily exchange the old debt securities for new ones.[15] This premium would be a particular burden for developing countries with low credit ratings and could be usefully subsidized by the multilaterals.

Collective action clauses are not a panacea. They leave important issues unresolved.

[15]The econometric results in Eichengreen and Mody (2000) point to the relevant group of (sub-investment-grade) countries.

They may not move far enough in the direction of orderly workouts. But a contractual approach has obvious advantages over a bureaucratic one. Moreover, an incremental approach has the merit of not overshooting the target. If CACs without an IMF-activated standstill or an independent tribunal are not enough, then these further elements can be added later.

This last comment provides a sense of where I place Dr. Krueger's proposal. The Krueger proposal identifies the problem correctly. It moves in the right direction in terms of reform. My fear is that it goes several steps too far.

- It goes too far in sheltering debtors from litigation. While collective action clauses also prevent isolated creditors from litigating (since they require a critical mass of bondholders, typically a minimum of 25 per cent, to agree before suit can be brought), in contrast to the Krueger proposal they do not preclude the creditors as a class from suing. Banning litigation entirely is a more radical abrogation of creditor rights. This has already excited the representatives of the creditor community, which in turn threatens to raise borrowing costs for sub-investment-grade borrowers.[16] In it most recent incarnation (Krueger 2002), the proposal envisages banning litigation for only a limited period -- say, 90 days -- and turning over the decision of whether to extend the stay to a committee of creditors. This is a step in the right direction -- it is the most significant development in the evolution of Fund thinking on this issue. Moreover, one still worries that creditors will still regard the dilution of their legal rights as excessive, resulting in significant

[16]Given that no international tribunal would possess the entire range of powers of a domestic insolvency court.

increases in borrowing costs for emerging markets as a class.[17] Their worries are understandable, given unanswered questions like the following. How would such a committee be constituted? Would it be representative and therefore respectful of the range of creditor interests?[18]

- The Krueger proposal is problematic insofar as it removes the power to activate the standstill from the government of the crisis country, transferring it to the IMF.[19] This is a consequence of the fact that the standstill would prevent litigation. That investors would have no recourse if a government imposes a standstill opportunistically -- that is, if it has no problems of debt sustainability but simply wishes to avoid paying -- is a moral hazard for the national authorities. This would appear to be the rationale for assigning the decision to activate the measure to the IMF. But doing so will not appeal to developing countries, which will see it as diminishing their autonomy. It will not appeal to those who are already critical of the IMF for its expansive powers. Investors, for their part, will undoubtedly view placing this additional power in the hands of the Fund, itself a political animal, as adding uncertainty.
- The proposal goes too far in injecting official bureaucracy into the restructuring process.

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[17]In addition, Krueger (2002) appears to differ from its predecessor in no longer suggesting that a restructuring agreement would have to be approved both by the requisite majority of creditors and the Fund's Executive Board. This too is a move in the right direction; if the Fund believes that the restructured debt is still unsustainable, it can simply withhold its financial support.

[18]Presumably, the IMF would no longer renew the standstill, but it would recognize the creditors who were on the committee and therefore in the driver's seat.

[19]This is still a feature of the revised proposal in Krueger (2002).

The need for a third party to tabulate bondholder votes, guard against fraud, and determine when a qualified majority agrees to restructuring terms -- whether the IMF itself or an independent tribunal (the preferred option in Krueger 2002) -- is far from clear. The collective representation and collective action clauses in UK-law bonds are mechanisms by which bondholders themselves can do this for themselves. It is not obvious that creditors lack the capacity to count their own votes. And it is far from apparent that they would prefer having the responsibility for doing so delegated to an international tribunal instead of having it rest with their own trustee. Krueger (2001) also points also to need the for a mechanism to "adjudicate" disputes among creditors and between creditors and the debtor. The case for mediator like that used in labor disputes to facilitate sovereign debt restructuring negotiations has been made before (notably by Eichengreen and Portes 1995). Debtors and creditors may not trust one another's assertions about the value of the obligations outstanding and the country's capacity to service them. Disputes over facts can create an acrimonious atmosphere that prevents debts from being restructured smoothly and efficiently. An impartial mediator to audit the accounts of both parties, establish the facts, and maintain an atmosphere of civility may help to obviate these dangers. But if such a mediator is needed, there is no reason why the debtor and creditors cannot appoint one themselves. I see no reason for enshrining this as part of an international insolvency mechanism.[20]

I want to avoid being seen as throwing the baby out with the bath-water. The Krueger

[20]Here the Taylor proposal takes the right approach, in suggesting that questions of inter-creditor equity can be resolved by some kind of arbitral panel, if necessary, but that its appointment can be left to the markets.

proposal identifies the problem accurately. It moves in the right direction in designing a solution.[21] But it moves too far. A more limited contractual solution focusing on the addition of collective action clauses to loan contracts is a more logical and prudent first step.

But simply lauding the advantages of these contracts for the stability of the international financial system is not enough to ensure their rapid adoption. Their merits have been advertized now for nearly a decade, yet drafting inertia has prevented them from spreading rapidly through the market. Some observers suspect that the IMF and the G-7 will use Argentina's default and eventual restructuring to encourage their more widespread adoption; in other words, when Argentina eventually restructures its debt, they may make the incorporation of CACs into the new debt instruments a precondition for international support. But, given the formidable spreads that will be borne by Argentina's restructured debt, this will hardly set an example that other emerging markets are anxious to follow.

Thus, real progress requires a more serious commitment on the part of the international policy community. I am skeptical that modest incentives, in the form of encouragement to the IMF to lend more freely to countries with CACs, will suffice. At the end of the day, there is no alternative to mandating the incorporation of these provisions into all new loan agreements, including the obligations of the government of the United States, through an amendment to the IMF's Articles of Agreement. There is no alternative, in other words, to using a Krueger-like process to attain a Taylor-style result.

[21] It has also had an important role in prompting the U.S. government and the organization representing large institutional investors, the Institute for International Finance (IIF 2002), to go beyond their previously luke-warm endorsement of collective action clauses and advocate pecuniary incentives for their adoption.

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