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Concluding Remarks by the Chairman on
Fund Policy on Sovereign Arrears to Private Creditors
Executive Board Meeting 98/20—February 27, 1998

Executive Directors welcomed the opportunity to have a discussion of the complex issues relating to the Fund's policy on sovereign arrears to private creditors, and considered that the staff paper offered a useful and timely contribution. They noted that the staff is working on a paper that addresses nonsovereign arrears to private creditors, and in that context, that the staff will reflect carefully on the views expressed by Directors today, and will try to begin to draw operational lessons from the crises in Asia. Directors underscored the importance of strengthening the international financial community's capacity to respond to crises in ways that do not encourage imprudent or unsustainable behavior by creditors or debtors.

Directors considered that a key outcome of today's discussion is the emphasis accorded to involving private creditors at an early stage of the crisis in order to ensure adequate burden sharing and to limit moral hazard. Directors observed that the recent experience of the Asian crisis attested to the importance of such an approach, and they pointed to the important role to be played in this regard by the country's strong and convincing adjustment efforts.

Directors reiterated that the Fund's primary role regarding sovereign liquidity crises focuses on prevention. Through the surveillance process—including at the regional level—the Fund encourages members to adopt sound macroeconomic, structural, debt management, and other policies that serve to minimize the risks of crisis. In this regard, Directors noted that the Fund, through its efforts to improve data reporting and dissemination, can reduce information asymmetries, thereby facilitating more efficient functioning of capital markets. In the period ahead, Directors will be carrying forward the growing agenda of issues relating to prevention in light of the Asian crisis.

Directors noted that the globalization of international capital markets and the improvements in market access have increased the importance of private capital as a source of external financing for many developing countries, but at the same time they have also increased these countries' vulnerability to shifts in market sentiment. This underscored the importance of taking early forceful measures in the face of emerging difficulties, and of holding both public and private foreign borrowing under appropriate restraint, particularly at the shorter maturities, and of adopting a cautious approach to the waiver of sovereign immunities, in particular by central banks.

Notwithstanding increased emphasis on prevention, Directors considered that members, including those with significant external debt in the form of sovereign bonds, will on occasion face a threat of balance of payment crisis. With forceful and prompt adjustment to emerging pressures, markets would be likely to support a country's adjustment efforts with new money, and thereby help countries to weather the storm. Directors recognized, however, that there may be cases in which members may not be able to avoid a default on sovereign bonds, even as appropriate adjustment efforts are introduced.

With little modern experience with defaults on sovereign international bonds, Directors agreed that it is difficult to predict with certainty how a default situation would unfold. Several Directors agreed that, in the absence of legal and institutional arrangements that have in the past helped to ensure that, as a general matter, relations with commercial banks remained relatively orderly, there is a risk that a sovereign bond default could become disorderly as a result of creditor litigation. They considered that the risk of litigation following a default on sovereign bonds could be nonnegligible, and that such litigation could complicate the task of economic management, and possibly result in a protracted stalemate in relations between a member and its private creditors. These uncertainties could also make it difficult for members to receive new financing. Other Directors, however, considered that the risks of litigation—although probably greater than in the debt crisis of the 1980s—may have been overestimated in the staff paper, and that such litigation would not be likely to pose a major impediment to policy implementation and the normalization of a member's relations with its private creditors. These Directors considered that the scarcity of attachable liquid assets available to satisfy a judgment, the costs of litigation, and the long delays likely to be involved would tend to discourage suits, and that bondholders should have an interest in an orderly settlement process. Moreover, the incentives for litigation against a sovereign would be further reduced if the debtor presented a credible and timely restructuring plan in the framework of a convincing adjustment effort.

Regarding the way in which the Fund could respond to a liquidity crisis that poses the risk of a member defaulting on international sovereign bonds within the existing legal and institutional frameworks, Directors noted that a balance had to be struck between promoting effective balance of payments adjustments and orderly debtor-creditor relations, on the one hand, and limiting moral hazard with respect to both creditor and debtor behavior, on the other. In such circumstances, the Fund, bilateral, and other official sources might consider that the provision of appropriate amounts of financing in support of strong adjustment efforts and for avoiding a default would be appropriate. Directors agreed, however, that concerns about the adequacy of the safeguards for the Fund's resources would, as a general matter, imply that the Fund would not be in a position to meet the whole of the member's financing need. Notwithstanding the possibly systemic implications of an interruption of debt service, Directors considered that there would be concerns that the provision of official financing in such circumstances would create moral hazard vis-à-vis creditors and debtors. Directors considered that official creditors would be concerned that an official "bailout" of private creditors could encourage imprudent behavior, and could increase the likelihood and potential magnitude of future crises.

If the official community is not willing to provide sufficient support to prevent the emergence of arrears on sovereign bonds, the debtor would need to seek a restructuring of these obligations. In formulating an approach to assisting such countries, a few Directors considered that one option was for the Fund to apply the pre-1989 arrears policy and withhold financial support until agreement in principle had been reached on a restructuring with private creditors. However, many Directors held the view that this might lead to a protracted delay in the promotion of effective balance of payments adjustment and hamper efforts to mobilize concerted financing. These Directors believed that it would be appropriate for the Fund to give further consideration to extending the scope of the 1989 policy of providing support for a member's adjustment efforts, on a cautious and case-by-case basis, after the emergence of arrears, but before agreement in principle had been reached with bondholders and other private creditors, as suggested by the G-10 Deputies.

These Directors underscored that early Fund support by "lending into arrears" should be limited and provided only in cases in which (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; (ii) negotiations between the member and its private creditors on a restructuring have begun; and (iii) there are firm indications that the sovereign borrower and its private creditors will negotiate in good faith to agree on a debt restructuring plan. Directors noted that all purchases under a program with a member with sovereign arrears to private creditors will need to be subject to financing reviews to allow the Executive Board to monitor closely unexpected developments—including any litigation—in creditor relations. However, some Directors did not favor a policy of lending into arrears, at least in the absence of further protection, as this strategy would carry the risk of aggressive litigation by individual creditors, thus adversely affecting safeguards on the Fund's resources.

Directors noted that the toleration of arrears to bondholders and other private creditors under Fund-supported programs may be seen by market participants as lowering the cost of a default to debtors, and thereby creating debtor moral hazard. Directors considered, however, that even under a policy of lending into arrears, the cost to debtors of default would remain substantial, and that Fund conditionality would provide an effective limitation on debtor moral hazard.

Directors gave preliminary consideration to three suggestions for possible improvements to existing mechanisms for resolving sovereign liquidity crises. Regarding modification of the legal provisions of bond contracts, a number of Directors considered that the introduction of sharing provisions, collective representation of bondholders and qualified majorities to alter the terms of bond contracts could make an important contribution to facilitating the orderly resolution of liquidity crises. Such provisions would apply to "new" bonds, but would not affect the stock of "old" bonds. The introduction of such provisions could, over time, diminish the risk of litigation and increase the likelihood of reaching early agreement on a restructuring. Directors noted, however, that there had been no market response to the G-10 Deputies' proposals in this area, and that progress is, therefore, likely to require some form of official action, possibly in the form of leadership by major industrial

country borrowers in introducing such provisions into their own bond offerings. Several Directors observed that this approach might raise borrowing costs, but noted that this would permit a better reflection of underlying risk premia than heretofore. Regarding a sovereign bankruptcy mechanism, most Directors continue to believe that proposals for establishing a formal international debt adjustment mechanism were cumbersome and impractical—and considered that it would not be worthwhile to pursue this option further.

Finally, Directors gave preliminary consideration to the possibility of a modification of Article VIII, Section 2(b) so as to allow the Fund to sanction a temporary stay on creditor litigation, thus providing members with protection from litigation in the context of the Fund lending into arrears. Such a modification—which would be a major step—would be intended to require creditors to exercise the same degree of forbearance that official creditors and commercial banks exercised through the debt crisis of the 1980s. Directors were of the view that this raises complex issues—including the legal procedures and interpretation—which will need to be considered further in the context of the Fund's policy on nonsovereign arrears to private creditors.

Several Directors considered that the temporary stay could make an important contribution to the orderly restructuring of distressed debt, and could help to provide the necessary financing assurances to allow the Fund to play an effective role in promoting balance of payments adjustment and catalyzing support from other creditors. Furthermore, this policy would help reduce creditor moral hazard. These Directors considered that the imposition of a "cut-off" date for loans affected by the temporary stay could help facilitate access to private financing during the debt renegotiation, while requiring a qualified majority in excess of 50 percent of the voting power for the sanctioning of the stay would ensure that such a stay was sanctioned only with broad support among the membership. A number of Directors considered that this approach offered an alternative solution and merited further discussion; however, given the complex nature of the issues involved, a final assessment would have to await a more in-depth discussion of the approach.

Opinions differed on whether such a mechanism could be designed to strike an appropriate balance between solving the immediate liquidity problems of a particular country and ensuring that international capital markets operate efficiently. Some Directors noted that such a mechanism would diminish the cost of default to debtors, which would introduce moral hazard and impede the efficient operations of capital markets. Some Directors were also concerned that allowing the Fund to sanction temporary stays raised a conflict of interest between the Fund's role as a regulator and its position as a creditor. Some Directors were of the view that such a mechanism was not necessary when lending into arrears on sovereign bonds, as they considered that the risk and likely consequences of litigation would not be significant.

Directors encouraged the staff to continue its work on the resolution of nonsovereign liquidity crises. We will return to the topic of orderly work-out mechanisms, including issues discussed today, and the general issue of private sector participation in resolving crises on a later occasion.