Reformed management of international financial crises

By Ola Melander
Ola Melander is studying at present at the London School of Economics.

The international financial crises in recent decades started a widespread debate about how different types of crises should be handled. Since the presentation in 2001 of the International Monetary Fund's proposals for improving the management of sovereign solvency crises, the debate has become more intense. The author describes a variety of motives and suggestions for reforming the management of liquidity and solvency crises.

Current problems and issues

The international financial crises in recent decades started a widespread debate about shortcomings in the international community's handling of countries in crisis.

The international financial crises in recent decades – from the Latin American debt crisis in the 1980s to the ongoing crisis in Argentina – have evoked a widespread debate about shortcomings in the international community's handling of countries in crises and possible ways of tackling the problem.[1] It is not least the issue of private sector involvement (PSI) that has been discussed. PSI is a concept with no generally accepted definition and is used in several different senses. Broadly speaking, the PSI issue is about the possibility, when a country is in a crisis, of maintaining private financing in the form of lending or debt reduction. The appropriate forms for PSI depend on whether the crisis concerns liquidity or solvency (a temporary or a permanent inability to pay).[2]

There are two motives for reforming crisis management: the problem of coordinating private creditors and the problem of moral hazard among lenders

[1] For surveys, see Eichengreen (1999), Kenen (2001) and Rogoff (1999).
[2] Financial crises can also be subdivided into debt, banking and currency crises, or combinations of these.

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and/or borrowers. The former problem has to do with the conflict in a crisis between individual incentives and the creditors' collective interest. For instance, the individual creditor wants to be paid in full but in a solvency crisis it may be more advantageous for creditors as a group to agree to a general writedown of claims; this may enhance the country's growth potential and thereby its ability to pay in the longer run. The problem of moral hazard arises when public financing protects private creditors from losses (creditor moral hazard) and reduces the country's costs (debtor moral hazard). In that they reduce the expected cost of taking unsound risks, both types of moral hazard increase the probability of future crises.

The question of how to improve crisis management should be addressed in the light of an economic analysis of the existing arrangements. What are the problems and market failures? How do different proposals for reforms aim to tackle the problems? Would the proposed reforms have negative secondary effects? This paper begins with a brief account of the current framework for the management of international financial crises. A distinction is then made between liquidity crises and solvency crises, with the focus on various kinds of problems with the co-ordination of private creditors, and the problem of moral hazard is discussed. Political demands for a fair distribution of the burdens are considered. Finally, various proposals for a reformed management of crises are described and analysed.

The current framework for the management of international financial crises

The starting point is that a country which faces a financial crisis needs additional financing because incomes do not suffice to finance expenditures. There are three different but, in practice, complementary ways of handling the financing problems: economic adjustment (decreased spending), loans from the International Monetary Fund (IMF), other international organisations and/or countries (increased income), and private financing (increased income).

The IMF adopted a framework in April 2000 for the Fund's approach to countries facing financial crises.

In April 2000 the IMF's policy committee adopted a framework for the Fund's approach to countries facing financial crises. Much of the framework was based on earlier work

by the IMF and the G7[3] and G10[4] countries. The approach allows the IMF to be highly flexible in adapting its actions to the conditions in a particular case. The framework envisages that the approach is to be chosen in the light of the IMF's assessment of the particular country's underlying payment capacity and its prospects of regaining access to the international capital market. In simple terms, an assessment is made in each case of the extent to which the crisis concerns liquidity rather than solvency. A liquidity crisis where there is a good chance that a combination of IMF catalytic lending[5] and the country's implementation of a programme of economic adjustment will quickly restore access to the international capital market is not to be met with demands for compulsory PSI even if the financing requirement is large. Voluntary measures, for instance routines for supervising flows of private portfolio capital, may be required in certain cases to solve the problem of creditor co-ordination. When a country's debt is unsustainable in the longer run, on the other hand, so that the crisis is one of solvency, mandatory PSI, in the form of a re-negotiation of private claims, is to be a condition for obtaining IMF money.

Simplifying somewhat, the framework accordingly means that large IMF loans may be obtainable in liquidity crises and that debt is to be restructured in solvency crises. Criticism of the framework has mainly focused on the lack of clear rules for the size of IMF loans and the absence of effective alternatives to large IMF loans.

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Problems with private creditor co-ordination in liquidity and solvency crises

For banks and other corporations there is a clear distinction, at least in theory, between liquidity and solvency crises.[6] The distinction is also applicable to sovereigns with the important difference that the actual size of payments is conditioned not only by the ability to pay but also by the political will. Even if it is economically feasible, using a large proportion of GDP to meet payment commitments may be out of the question politically. A liquidity crisis is characterised by a

[3] Canada, France, Germany, Italy, Japan, United Kingdom and United States.
[4] The G7 countries plus Belgium, the Netherlands, Sweden and Switzerland.
[5] Lending aimed at encouraging the inflow of private capital by demonstrating the IMF's confidence in the country's economic policy.
[6] See Eichengren & Portes (1995) and Paues (2001).

A liquidity crisis is characterised by a temporary inability to meet payment commitments, while the characteristic of a solvency crisis is that the country's debt is unsustainable in the longer run.

temporary inability to meet payment commitments with the incomes and liquid assets at the country's disposal. The characteristic of a solvency crisis is that, given the size of the country's debt and the prospects for future incomes, reasonable economic assumptions indicate that the debt situation is unsustainable in the longer run. The management of a solvency crisis accordingly requires that the present value of the debts is written down by reducing interest rates and/or repayments. The debtors' inability to pay is temporary in a liquidity crisis and more permanent in a solvency crisis.

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For a number of reasons, however, the distinction is difficult to make in practice, not least when time is short in a crisis and above all as regards sovereigns. A liquidity crisis often has to do with fears of future insolvency – otherwise the debtors ought to be able to obtain financing in the market – and can develop into a solvency crisis. Moreover, future payments are dependent both on the country's future economic policy, which affects the payments capacity, and on the political will to pay and these two factors are difficult to predict. Finally, sovereign insolvency is in fact applicable only to foreign currency loans, that is, when the burden of interest and repayment is too heavy in relation to exports. The burden of loans in the domestic currency can always be lightened by means of an expansionary monetary policy that reduces the debt through inflation.

The problem of co-ordinating private creditors may have to be handled in liquidity as well as solvency crises.

Both liquidity and solvency crises may entail a need to manage the problem of co-ordinating private creditors. This involves getting individual creditors to act in the collective interest of creditors as a group.[7] In a *liquidity crisis* the co-ordination problem is characterised by multiple equilibria. If a sufficient number of creditors expect that a sufficient number of other creditors will not renew their short-term loans, so that the country will no longer be able to meet its payment commitments, their expectations will be self-fulfilling. The result is a "bad" equilibrium. While it is in each creditor's interest to withdraw credit while the country still holds liquid assets, it would pay the creditors as a group not to do so at each other's expense. The short-run ability to pay declines and the liquidity crises may even develop

[7] The account of the co-ordination problem is based mainly on Bank of England (2002).

into a solvency crisis if the lack of liquidity damages the country's long-term payments capacity. If, on the other hand, creditors expect that others will renew their loans, no credits will be withdrawn and the potential liquidity crisis will not materialise. The result is a "good" equilibrium.

In a *solvency crisis*, individual creditors may likewise act in a way that conflicts with the majority's interest if, instead of accepting the debt reduction that a sustainable debt situation requires, they resort to litigation in the hope of obtaining payment under the loan's original contract. This can lead in several ways to a further reduction of the country's payments capacity, with the result that creditors as a group obtain less than they would have done without litigation. Above all, a disorderly and protracted re-negotiation of the debt exacerbates and prolongs the crisis, with negative consequences for GDP and thereby the country's payments capacity. In more theoretical terms, the threat of future litigation weakens the incentive to invest and implement an economic policy that strengthens the country's long-term payments capacity – there is a risk of any future surplus being sequestered by the courts.

Individual creditors can act in a solvency crisis in a way that conflicts with the majority's interest.

One of the basic problems in crisis management is that of achieving a co-ordination of creditors, in liquidity as well as solvency crises, so that individual creditors are persuaded to act in the common interest. This amounts to prolonging short-term loans in liquidity crises and accepting necessary debt reductions in solvency crises. The importance of co-ordination has grown since the debt crisis in the 1980s, when the IMF called on the private sector to contribute to the country's financing requirement. In those days, private financing was facilitated by the countries' creditors being a homogeneous and relatively small group of international banks whose financing mainly consisted of medium- and long-term syndicated loans.[8] The losses creditors incurred from the re-negotiation of debt in the 1980s and early 1990s was a major reason why the syndicated bank loans were replaced to a growing extent by sovereign bonds, which for a long time were seen as a form of borrowing that was safer for the creditors. In the 1980s sovereign bonds were usually excluded from re-negotiations both because the amounts were comparatively negligible and on account of the difficulties that

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[8] A syndicated bank loan is a loan arranged jointly by a number of banks that guarantee to lend the principal.

re-negotiation posed. In recent years, however, there have been a number of bond loan re-negotiations. The large number of bond holders today, compared with the number of banks involved in lending to countries in the 1980s, has made co-ordination in the event of debt restructuring considerably more of a problem.

Moral hazard – a problem?

It is mainly concern about what could happen if creditors are not forced to take the consequences of imprudent decisions that has left its mark on the crisis management debate.

The problem of moral hazard does not concern conflicts of interest between private creditors. The conflict in the present context is between the private creditors and other parties – the international community (creditor moral hazard) and the debtor country (debtor moral hazard). A major feature of the crisis management debate has been concern about the creditor moral hazard that arises if, instead of being forced to take the consequences of imprudent decisions, lenders are protected from losses when countries are granted large loans from the international financial institutions, primarily the IMF.

Debtor moral hazard has not been discussed to quite the same extent.[9] It is conceivable in theory that, by mitigating the economic consequences of a financial crisis, IMF loans weaken the incentive for a country to pursue a policy whereby financial crises are avoided. But even with IMF loans, a crisis is always costly for the country in question, not least in terms of lost GDP. Debtor moral hazard would be a problem, however, if the cost of financial crises were to be unduly low for the country concerned.

IMF loans ought not to support an economic policy that does not promote the country's long-term interests.

The IMF's former chief economist Mussa (2002) considers that the problem of creditor moral hazard in particular has been greatly exaggerated in the debate. IMF loans are for the short term, have to be repaid with interest and presuppose economic reforms. Even with IMF financing, financial crises generally entail considerable economic costs for the country in question as well as its creditors. However, Mussa admits that moral hazard may be a problem in the future if security policy considerations are involved in decisions on IMF loans.[10] Another problem he mentions is that a government may have interests that differ

[9] An exception is, for example, Lipworth & Nystedt (2001).

[10] The primary example of this is Russia in the late 1990s, when market agents talked of "the moral hazard play" (investment in Russian treasury bonds) on the assumption that the country was "too big and too nuclear to fail".

from those of the country's inhabitants. IMF loans may enable a government to implement an imprudent, short-sighted economic policy that postpones the crisis and renders it more serious. The basic problem lies in the government's time horizon possibly being shorter than that of the electorate, perhaps extending only as far as the next election.[11] IMF loans ought not to support an economic policy that does not promote the country's long-term interests.

While the problem of moral hazard should be taken seriously, the effects of IMF lending need to be studied in a wider perspective. The IMF borrowing facility is a form of insurance whereby loans are granted, subject to conditions, to countries that are in economic trouble. This, like all forms of insurance, involves some degree of moral hazard but the question is whether this outweighs the IMF loans' positive consequences. The possibility of IMF loans for a country in crisis encourages economic and financial openness, which benefits not just the country in question but other countries, too, by enlarging the opportunities for international economic exchange.

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Turning now to empirical tests of the occurrence of moral hazard, Lane & Phillips (2000) have examined how market interest rates in emerging market countries have been influenced by events that have a bearing on the future possibility of obtaining IMF loans. Examples of such events are additions to the Fund's financial resources or the granting of large lending packages. There is no clear evidence to support the moral hazard hypothesis but testing it empirically is difficult.

Distributing the burden – a political problem

The problem of moral hazard concerns, as mentioned, the distribution of a crisis burden between the international community, borrower countries and private lenders. If the chief problem is creditor moral hazard, then the private creditors should shoulder a larger burden, while borrower countries should do so if the main problem is debtor moral hazard. So reforms to alter the burden's distribution should aim to rectify economic shortcomings (moral hazard) in the present system.

[11] A similar phenomenon may occur among banks and/or other companies if the management adopts an imprudent strategy in an attempt to eliminate problems with solvency (gambling for resurrection).

It is in the long-term interest of borrower countries that default and debt reduction continue to be costly.

Some advocates of reform supplement the economic analysis with a more political perspective and call for debt reductions in order to achieve a "fair" distribution of the burden.[12] The idea here is that the burden on the borrower countries ought to be eased at the lenders' expense. However, such a system would be perceived as arbitrary and would greatly reduce the emerging markets' possibility of borrowing in international capital markets. A politically motivated redistribution would benefit debt-burdened countries in the *short run* but would have serious consequences for their future borrowing. Consequently it is in the *long-term* interest of borrower countries that default and debt reduction continue to be costly.[13]

While the IMF often shoulders a major part of the financing burden in the short run, in the longer run a larger share is covered with private capital.

Another politically sensitive issue is that in the short run private actors reduce their exposure to countries in a financial crisis while the international community, primarily the IMF, provides large-scale financing. The lower interest rate on IMF loans is taken to mean that the international community carries a cost in the form of interest subsidies. This imbalance has led to demands that the private sector must carry a larger share of the burden. However, there is an important difference between these two types of loan: whereas private loans are not always paid back, the IMF has so called preferred creditor status. Countries give priority to the repayment of IMF loans and the lower interest rate is a token of the lower credit risk.[14] Another important aspect of the burden's distribution is the time profile: in the short run the IMF often shoulders a major part of the financing burden but in the longer run a larger share is covered with private capital. So a short-term comparison between official and private financing is somewhat misleading.

Proposals for reforming crisis management

Concern about growing problems with private creditor co-ordination and the problem of moral hazard accordingly lie behind various proposals for improving

[12] See e.g. Raffer (1990) and Pettifor (2002).

[13] This is not meant to imply that debt reduction is undesirable for the poorest and most heavily indebted countries. Such reductions are already being handled under the HIPC initiative. The present article is concerned instead with crisis management in emerging markets with access to international capital markets.

[14] The special status of the IMF reflects the fact that its financing benefits not only the borrower country, where access to private capital is very limited in a crisis, but also other countries and private creditors in that international trade is facilitated and the country's payments capacity is increased.

the management of liquidity and solvency crises. A selection of the most important proposals is presented below, starting with the IMF's proposal for a sovereign debt restructuring mechanism (SDRM). A mechanism for handling liquidity crises – an international lender of last resort (LOLR) – is then described, followed finally by two proposals for the management of both types of crisis; the first is confined to IMF loans combined with payment standstills and the second uses collective action clauses (CACs) in loan contracts to facilitate the re-negotiation of debt.

Proposals for reforms stem from concern about growing problems with private creditor co-ordination and the problem of moral hazard.

International mechanism for managing solvency crises

The IMF proposal for a new international procedure – the Sovereign Debt Restructuring Mechanism – for the management of sovereign solvency crises was presented in the autumn of 2001 and draws inspiration from national laws on corporate insolvency, primarily Chapter 11 of the United States Bankruptcy Code.[15] The aim, as at national level, is to handle the problem of creditor co-ordination in a predictable, orderly and prompt process and thereby maximise the borrowers' capacity to repay debt. The introduction of an international bankruptcy mechanism has not been feasible to date because of certain differences between sovereigns and corporations. Sovereigns cannot be wound up or taken over in the event of insolvency and their ability to pay is partly dependent on the willingness to pay. The IMF proposal recognises these differences and does not mean that sovereigns would be subjected to an international law court.

The IMF proposal for a new international mechanism, SDRM, for the management of sovereign solvency crises was presented in the autumn of 2001 and draws inspiration from national laws on corporate insolvency.

In the original SDRM proposal the mechanism was to be activated only after an application from the crisis country. The activation was to be approved by the IMF provided the debt situation was unsustainable and the country had or was negotiating an IMF programme. The proposal has three components that come into force when the mechanism has been activated. The *first* component is a

[15] For a more detailed account of the proposal see Krueger (2001, 2002c). For an early variant, designed for both liquidity and solvency crises, see Sachs (1995) and for a historical survey of the idea see Rogoff & Zettelmeyer (2002).

temporary stay on creditors taking legal action against a country that has suspended payments, provided the country fulfils certain requirements to do with economic policy and its treatment of creditors. The *second* component is that countries, under IMF surveillance, are enabled to issue new bonds with priority over existing debts. Today, bond contracts protect the interest of earlier investors and aim to obstruct such new borrowing. The *third* component is the possibility for a majority of creditors to bind a minority to a reconstruction of the country's debt. The proposal envisages that the conditions for a reconstruction would be negotiated by the country and its creditors and could be approved by the IMF but the Fund would have no formal power over them.

The central decisions would be made by a majority of the creditors and the role of the IMF would be limited.

The initial SDRM proposal has been modified after the United States and others opposed the IMF's central role.[16] A majority of the creditors would be responsible for making the central decisions about activating and prolonging the stay on litigation, issuing priority debt and conditions for a restructuring of debt. As at present, the conditions for restructuring debt would be approved informally by the IMF granting loans as a contribution to financing the country's capital requirement.

The IMF – an international lender of last resort?

Some observers consider that the IMF already functions as an international lender of last resort (LOLR) for countries, in keeping with a national LOLR for financial institutions. Others argue that this is not the case at present but that the IMF ought to be developed in this direction.

An international LOLR has a role to play in international financial crises.

In the event of a threat to the stability of the financial system, a national LOLR is able to provide unlimited short-term loans for financial institutions that are solvent but lack liquid assets.[17] The ideal case calls for a high interest rate, to prevent abuse, and collateral, as a safeguard against loan losses, but this is seldom feasible in practice. A national LOLR may not be in a position to manage an international financial crisis because this requires liquidity in foreign currency. So an international LOLR may have a role to play here. Fis-

[16] For the revised versions of the proposal see Krueger (2002a, 2002d).

[17] Note that central bank LOLR lending is restricted to situations that threaten the financial system's stability. Central banks also supply the banking system with liquidity under normal circumstances but they then require eligible collateral.

cher (2000) considers that with the increased possibilities of granting large short-term loans in a crisis, the IMF is developing into an international LOLR.

There are a number of differences at present between the IMF and a national LOLR.

At present the IMF differs from the theoretical national LOLR in a number of respects. Its lending potential is limited by the organisation's resources, neither can the provision of bilateral supplementary loans be guaranteed in advance. Unlike a national central bank, the IMF is not in a position to issue currency in unlimited amounts. The timing of loan payments is tied to economic reforms by the country in question. Loans with a relatively long maturity are needed in many cases in order to restore the confidence of financial markets and obtain a sufficient respite for reforms. High borrowing rates may threaten the sustainability of sovereign debt and are therefore used with some caution.

The chief difference between the national and international levels is that sovereigns are not comparable to banks and other corporations.

The chief difference between the national and international levels as regards the distinction between liquidity and solvency crises is that, in the absence of an international bankruptcy court to which the world's countries are subordinate, sovereigns are not fully comparable to banks and other corporations. A country's future payments are dependent both on its future economic policy, which influences the payments capacity, and on the political willingness to pay. In the case of domestic currency loans, moreover, there is always the option of printing more money, so that insolvency is not possible for such loans.

These are not the only differences between countries and private borrowers. Collateral is often difficult to obtain from sovereigns, neither can a country be wound up or taken over in bankruptcy proceedings in the same way as banks and other firms. And while national authorities can dismiss bank executives, international organisations cannot do the same to a country's political leaders. There is no direct international counterpart to the possibilities that national supervisors have of overseeing and influencing the actions of banks.

But neither should the differences between countries and private borrowers be exaggerated. Although collateral is difficult to obtain, in practice sovereigns give the repayment of IMF loans priority over private loans. And even at the national level, adequate collateral is a theoretical concept in an acute crisis. Governments cannot be removed by the IMF but experience shows that financial crises often lead to a change of government. Finally there several similarities between the IMF and national supervisors. The Fund oversees the economies of

its Member States, above all through Article IV consultations, and is in a position to exert a direct influence on economic policy in borrower countries.

A continued development of the IMF in the direction of an international LOLR is recommended in the Meltzer Report.

The Meltzer Report to the United States Congress (IFIAC 2000) recommends that the IMF continues to be developed into an international LOLR by being enabled to provide larger loans, albeit with shorter maturities and higher interest rates than at present. Loans would only be made to countries that have already complied with certain conditions for financial stability and transparency. It is doubtful whether the proposals are feasible. A commitment to provide loans only for certain pre-selected countries can never be followed entirely objectively in every situation. Neither is it likely that IMF loans can be shorter and more costly without this having negative effects on market confidence and programme sustainability.

Limited IMF loans and temporary payment standstills

The combination of temporary payment standstills and limited IMF loans is intended for both liquidity and solvency crises.

The combination of temporary payment standstills and limited IMF loans is intended for both liquidity and solvency crises.[18] Standstills can apply either to sovereign debt or to all external debt via capital and/or exchange controls. In a liquidity crisis a standstill is an alternative to large IMF loans. Capital outflows are arrested for a time and there is a respite for economic reforms. The problem of co-ordinating private creditors is also handled. The liquidity crisis is resolved in that creditors are unable to reduce their exposures individually. In a solvency crisis a standstill is not a sufficient remedy because the debt is, by definition, unsustainable and has to be written down, but it can provide a breathing space while the debt is restructured. Both types of crisis call for a limited amount of IMF lending, not least as a contribution to temporary financing. In order to enhance the credibility of declarations that the IMF loans will be limited, greater clarity is proposed in rules and criteria for the granting of IMF loans in excess of the regular access limits. Exemptions from the rules would still be allowed in exceptional cases, for instance if international financial stability were to be threatened.

[18] See e.g. Haldane & Kruger (2001).

A number of potential problems are connected with a greater use of payment standstills. One risk is that at the first indication of a future standstill, creditors would withdraw financing, thereby making a standstill inevitable. Another problem is the risk of litigation. As a way of overcoming this problem, Buiter & Sibert (1999) propose the introduction of clauses for prolonging loans, a universal debt rollover option with a penalty (UDROP). The clauses would confer the right to prolong sovereign bonds and inter-bank loans, using pre-determined maturities and interest rates. The conditions would be written into loan contracts so that creditors and debtors will have accepted them in advance. Countries could choose to include UDROPs in their loan contracts, at least for loans in foreign currency. An advantage with this proposal is that it disposes of the need to protect against litigation because loans would be prolonged in accordance with the contract. One problem is the time it would take – even assuming that the clauses are included in all new contracts – before all the outstanding contracts without these clauses expire. The greatest problems, however, concern the effects on capital flows and interest rates, besides the lack of a simple way of inducing countries to adopt UDROPs.

A greater use of payment standstills raises a number of potential problems.

Facilitating debt restructuring with collective action clauses

Collective actions clauses (CACs) in a bond contract are a contract-based adjunct to the SDRM proposal. A basic difference is that while an SDRM is intended only for solvency crises, CACs can facilitate the management of both solvency and liquidity crises. In a liquidity crisis, CACs can simplify the problem of creditor co-ordination and thereby make it possible to postpone payments. In a solvency crisis, CACs can be used to achieve a necessary reduction of debt. So CACs have appreciable positive effects.

An SDRM is intended only for solvency crises, while collective action clauses can facilitate the management of both solvency and liquidity crises.

Today CACs are a routine feature of bonds issued under English law but seldom of bonds issued under United States law. At present there are four types of CAC:[19]

[19] For a fuller account see Dixon & Wall (2000).

- Collective representation clauses (for the appointment of a joint representative in the negotiations).
- Majority action clauses (a qualified majority of bond holders can bind a minority when restructuring debt).
- Sharing clauses (payments to one bond holder are distributed between all bond holders).
- Non-acceleration clauses (a minimum proportion of the bonds is needed in order to demand full payment after a country has suspended payments, that is, protection from litigation by individual creditors during the negotiations).

However, CACs pose a number of difficulties that make them an adjunct to an SDRM rather than an alternative. The principle difficulties are:

- The negotiations and voting proceed contract by contract rather than applying to the whole of the outstanding debt. Clauses for comprehensive negotiations have been proposed but would increase the risk of abuse. The sovereign could then issue new bonds to actors it controls and thereby exert an influence on the outcome of the negotiations. There could also be legal problems, with interpretations that differ from country to country.
- Experience shows that many emerging market countries are unwilling to introduce CACs lest they reduce capital flows and add to their costs.[20]
- Even if CACs were to be included in all new bond contracts, it would be a long time before all the outstanding contracts without CACs mature, leading to a considerable delay before the full effect of CACs materialises.

The political and legal conditions for introducing an SDRM are still not clear.

These problems could, however, be handled with an SDRM. The negotiations and voting would apply to the whole of the outstanding debt, while the prevention of abuse would be entrusted to an independent international legal organ.[21] The problem of implementation would also be resolved in that an SDRM would automatically and immediately yield effects corresponding to those of CACs. However, the political and legal conditions for introducing an SDRM are still not clear.[22]

[20] For empirical studies of CACs' effects on interest rates see Eichengreen & Mody (2000) and Becker, Richards and Thaicharoen (2001).
[21] For a fuller description of the functions of the proposed legal organ see Krueger (2002b).
[22] For a discussion of outstanding issues and difficulties to do with the introduction of an SDRM and CACs see Boorman (2002).

Conclusions

The proposed SDRM and clauses for handling co-ordination problems would be significant reforms for improving the management of international financial crises.

Both the problem of creditor co-ordination and the problem of moral hazard indicate that the international mechanisms for crisis management are probably not optimal. It is important, however, that reforms are based on economic analyses rather than on political considerations and that any negative secondary effects of different proposals are carefully assessed. To some extent the IMF already functions as an international lender of last resort but a further development of the organisation in that direction seems to be neither desirable nor politically feasible. Loans with relatively long maturities and interest rates that are not unduly high are often required in order to restore market confidence and pave the way for private capital inflows. It is also important that the IMF acts in the long-term interests of the debtor country and does not allow short-run political interests in the country to persuade the Fund to grant loans that only postpone and exacerbate the crisis. The proposed international mechanism for solvency crises and bond contract clauses for handling problems with the co-ordination of private creditors fill important economic functions and would be significant reforms for improving the management of international financial crises.

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