
The Case for a Lender-of-Last-Resort Role for the IMF

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The concept of a lender of last resort (LLR) stems from a central banking principle dating back to Walter Bagehot (1873, 48 and 51) more than a century ago. The principle holds that in a financial panic the central bank should stand ready “to lend freely . . . whenever the security is good.” This precept implies that during a financial crisis there exists a multiple-equilibrium situation and that the good outcome can be secured and unnecessary real economic damage avoided by providing temporary liquidity to those entities that are fundamentally solvent.

Application of the LLR concept to sovereign financial crises requires the judgment that the same principles apply when lending is across borders and largely devoid of tangible collateral. This difference from domestic LLR lending underscores the importance of making the right judgment that the sovereign in question is politically willing and able, given enough time, to secure the resources that ensure it is solvent solely on the basis of full faith and credit. In both the domestic and international contexts, a central assumption of LLR lending is that after confidence is restored a reflow of private lending will materialize and the central bank (or International Monetary Fund) will be repaid promptly. International experience sug-

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gests that this process can take much longer for sovereign cross-border crises than for domestic financial crises.¹

The LLR concept and the idea of providing new lending to avoid default when countries are deemed solvent but illiquid were important in the international strategy initially adopted to deal with the Latin American debt crisis in the 1980s. Concerted lending by major international banks was the main mechanism rather than large loans by the IMF (which instead played a catalytic role supported with moderate lending). By the late 1980s and early 1990s the strategy transited to Brady Plan forgiveness of debt overhangs. Those governments seeking forgiveness (most governments in Latin America excluding Colombia and Chile as well as those of Nigeria and the Philippines) implicitly acknowledged that they had been insolvent after all, typically because of the “internal transfer problem” of fiscal insufficiency rather than the more tractable “external transfer problem” of insufficient foreign exchange. By the early 1990s, success of Brady restructurings and cheap money internationally set the stage for a renaissance of the international capital market for developing-country borrowers, based increasingly on bonds rather than bank loans.

The first major crisis in the resurgent emerging capital markets of the 1990s was the Mexican “tequila crisis” of late 1994 and 1995, which was largely the consequence of an outsized current account deficit but whose timing reflected the rise in US interest rates and two political assassinations. Bank rescheduling and concerted new lending were not options because the debt in question was short-term Mexican treasury paper held widely in the market. In a massive LLR operation, the US treasury provided \$20 billion in support and the IMF \$17.8 billion in standby support (IMF 1995), enabling Mexico to avoid default and carry out fiscal and external adjustment.

As the new emerging capital markets survived this key test and as global credit conditions again became highly favorable (as shown by a decline in US high-yield bond spreads), by 1996 and early 1997 large financial flows went to a long list of middle-income countries. However, excessive short-term borrowing combined with weak domestic banking systems ignited the East Asian financial crisis in 1997–98, and Russia’s default

1. I prefer the term “lender of last resort” over the alternative “lender of final resort” used in chapter 15 by Gregor Irwin and Chris Salmon. As discussed in chapter 21, the term “final resort” coined by Michael Mussa applies to all IMF lending, including plain-vanilla programs well below country quota ceilings. Instead, the focus here is on large packages designed to prevent default caused by a liquidity crisis. Although some of Mussa’s points are valid qualifiers of IMF support (the IMF lends to individual countries and does not “pump in large amounts of general liquidity into global financial markets”; it applies conditions, which are absent given good collateral in classic LLR), the term “final resort” is “not part of the standard IMF lexicon” as he notes, whereas “last resort” has become familiar in discussion of sovereign crises (see, for example, Fischer 1999). Of course, the term must be understood as a broad analogy rather than an exact application of Bagehot’s principle for central banks.

in August of 1998 marked a more general deterioration that helped sweep Brazil into crisis by year-end. The period 1997–98 was an intense phase of international LLR operations, this time centered much more heavily in the International Monetary Fund, in part because of the revealed political unpopularity of the US bilateral LLR operation in the Mexican case.² Even the institutional machinery changed to accommodate the new reality, with the creation of the Supplementary Reserve Facility in the IMF, allowing much higher volumes of lending relative to a country's IMF quota. The interest rates were higher and maturities shorter in this new facility, as befitted an LLR instrument. A subsequent surge of LLR lending in even larger volumes but concentrated in fewer countries occurred in 2001–02 as Argentina, Brazil, and Turkey experienced financial crises associated in considerable part with political developments, including the prospect of election of a leftist government in the case of Brazil.

LLR Lending and Repayment

It is sometimes argued that the IMF cannot be a lender of last resort because, unlike domestic central banks, it cannot print money and hence does not have unlimited resources. In practice this distinction has not been relevant so far. The question of adequacy of IMF resources to carry out the LLR function did become increasingly germane, however, as a large share of the IMF's resources came to be concentrated in loans to just Argentina, Brazil, and Turkey. This phenomenon in turn has reflected the difficulties of ensuring that one of the LLR principles—prompt repayment upon revival of private flows—is observed in international sovereign LLR operations. The longer the repayment is delayed, the more the IMF's lending capacity is tied up in outstanding loans.

Despite this concern, the broad picture is that the IMF's LLR operations have eventually led to successful repayment, albeit on a time scale of years rather than days or weeks as might be the case for classic domestic LLR lending. Table 14.1 reports the outstanding exposure of the IMF to each of the eight large recipients of emergency lending over the past dozen years: Argentina, Brazil, Indonesia, Korea, Mexico, Russia, Thailand, and Turkey. The data are in billions of SDR and refer to year-end amounts outstanding.³ For 2005 through 2007, the amounts are based on end-2004 levels and the "expectation basis" schedule of principal payments in 2005 through 2007 (IMF 2005a).

2. For the United States this unpopularity led to congressional restrictions on use of the US Department of the Treasury's Exchange Stabilization Fund for financial rescue purposes that were still in place at the outset of the East Asian financial crisis.

3. The SDR was worth \$1.37 at the end of 1993. It peaked at \$1.49 at end-1995, fell to a trough of \$1.26 by the end of 2001, and then rose to a new peak of \$1.55 by the end of 2004.

Table 14.1 IMF debt of eight LLR countries, 1993–2007 (millions of SDR)

Year ^a	Argentina	Brazil	Indonesia	Korea	Mexico	Russia	Thailand	Turkey	Total
1993	1,682.8	221.0	0.0	0.0	3,485.0	1,797.3	0.0	0.0	7,186.1
1994	2,562.4	128.0	0.0	0.0	2,644.0	2,875.6	0.0	236.0	8,446.0
1995	4,124.4	95.2	0.0	0.0	10,648.1	6,469.8	0.0	460.5	21,798.0
1996	4,376.0	47.0	0.0	0.0	9,234.5	8,698.2	0.0	460.5	22,816.2
1997	4,349.3	23.3	2,201.5	8,200.0	6,735.2	9,805.9	1,800.0	440.4	33,555.7
1998	3,865.1	3,426.8	6,455.8	12,000.0	5,951.5	13,732.0	2,300.0	275.8	48,007.0
1999	3,262.6	6,431.0	7,466.8	4,462.5	3,259.2	11,102.3	2,500.0	648.9	39,133.3
2000	3,880.3	1,356.8	8,318.0	4,462.5	0.0	8,912.8	2,350.0	3,205.3	32,485.6
2001	11,121.1	6,633.9	7,251.7	0.0	0.0	5,914.9	1,337.5	11,232.9	43,492.0
2002	10,547.5	15,319.6	6,518.1	0.0	0.0	4,767.3	287.5	16,245.7	53,685.7
2003	10,446.2	19,056.5	6,915.1	0.0	0.0	3,411.2	0.0	16,212.8	56,041.8
2004	9,073.1	16,116.7	6,237.0	0.0	0.0	2,293.8	0.0	13,848.3	47,568.8
2005 ^b	8,038.7	10,032.9	5,849.6	0.0	0.0	0.0	0.0	10,900.8	34,821.9
2006 ^b	7,038.7	7,785.5	4,834.0	0.0	0.0	0.0	0.0	7,808.5	27,466.6
2007 ^b	6,038.7	1,903.1	3,474.3	0.0	0.0	0.0	0.0	6,326.8	17,742.9

LLR = lender of last resort

SDR = special drawing rights

a. Year-end data.

b. Based on end-2004 levels and the “expectation basis” schedule of principal payments.

Sources: IMF (2005a, b).

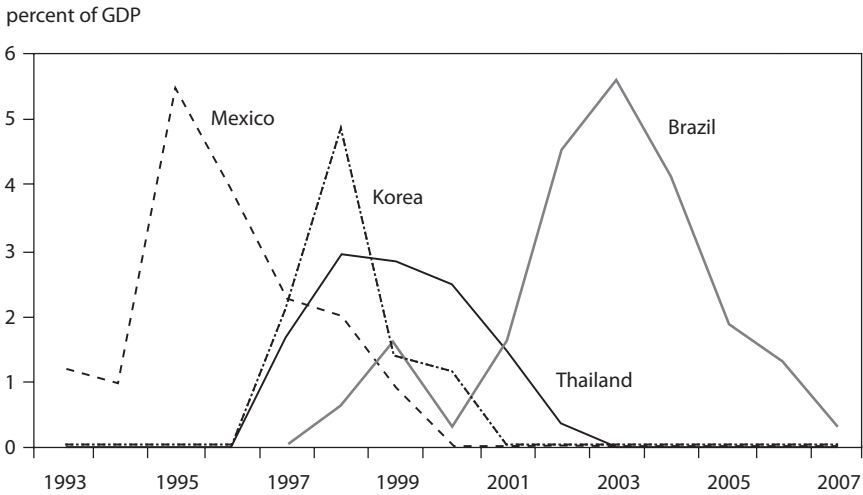
The total amount outstanding of IMF lending to these eight countries surged from SDR 8.4 billion at the end of 1994 to about SDR 22 billion in 1995–96. With the East Asian crisis it rose to SDR 48 billion at end-1998. The total then eased to SDR 32 billion by end-2000 before reaching a new peak of SDR 56 billion at end-2003. However, the total should be back down to SDR 35 billion by end-2005 and only SDR 18 billion by end-2007 as examined below.

Figures 14.1 and 14.2 show the same data normalized as a percent of GDP.⁴ The record of outstanding debt to the IMF provides a test of the principle that LLR lending should be promptly repaid. A steep, narrow inverted V would be the ideal pattern confirming this outcome. There is indeed such a pattern for one key case—that of Korea. Debt to the IMF surged from zero in 1996 to SDR 12 billion at the end of 1998; it was back down to about SDR 5 billion the next year and down to zero by 2001. Even so, dating from 1997 when the initial surge of lending occurred, it took four years to reach complete repayment. A more rapid effective repayment occurred in the first Brazil episode. The initial surge in IMF lending was in 1998, and Brazil had largely repaid the Fund by 2000.

The repayment process took longer for Thailand (five years), Mexico (five years), and Russia (seven years). For Brazil’s second episode (emergency lending in 2002), the chances are good for nearly complete repay-

4. Dollar GDP series and forecasts through 2006 are from IMF (2005c).

Figure 14.1 Debt to IMF by Brazil, Korea, Mexico, and Thailand, 1993–2007



Note: For 2005 through 2007, the amounts are based on end-2004 levels and the “expectation basis” schedule of principal payments in 2005 through 2007.

Sources: IMF (2005a, b, c).

ment after five years.⁵ For Indonesia, in contrast, it is likely that by 2007, nearly a decade after the onset of its crisis, the amount outstanding will still be about half the total reached in 2000. Indonesia is the one country of the big eight recipients that fits more comfortably in a category of long-term lending to a poor country than the category of LLR lending designed as a bridge back to market access.⁶

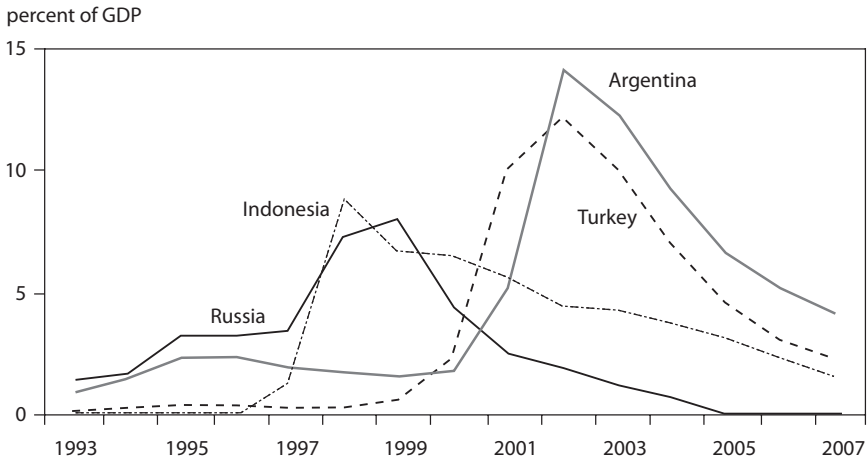
Argentina and Turkey are the prime cases that pose the question of whether the IMF has stepped into a quagmire of large exposure for an unduly long time as a consequence of emergency lending. Turkey’s debt to the Fund reached about SDR 16 billion in 2002 and will still be about SDR 11 billion at the end of 2005. The projections for 2006–07 assume that SDR 2 billion due in each year is effectively rolled over, leaving outstanding debt at about SDR 7 billion at end-2007.⁷ Argentina has had an even slower repayment process. From peak debt to the IMF of about SDR 11 billion

5. Brazil accelerated payment to 2005 of about \$5 billion that was due in 2006.

6. Note that neither Brazil nor Indonesia currently has an active IMF program, and both are in the repayment phase. Although Argentina and Turkey do have programs, they too are paying down IMF debt.

7. The country report for Turkey mentions that the authorities are considering “requesting an extension” that “would postpone almost US\$4 billion beyond the peak repayment period” (IMF 2005d).

Figure 14.2 Debt to IMF by Argentina, Indonesia, Russia, and Turkey, 1993–2007



Note: For 2005 through 2007, the amounts are based on end-2004 levels and the “expectation basis” schedule of principal payments in 2005 through 2007.

Sources: IMF (2005a, b, c).

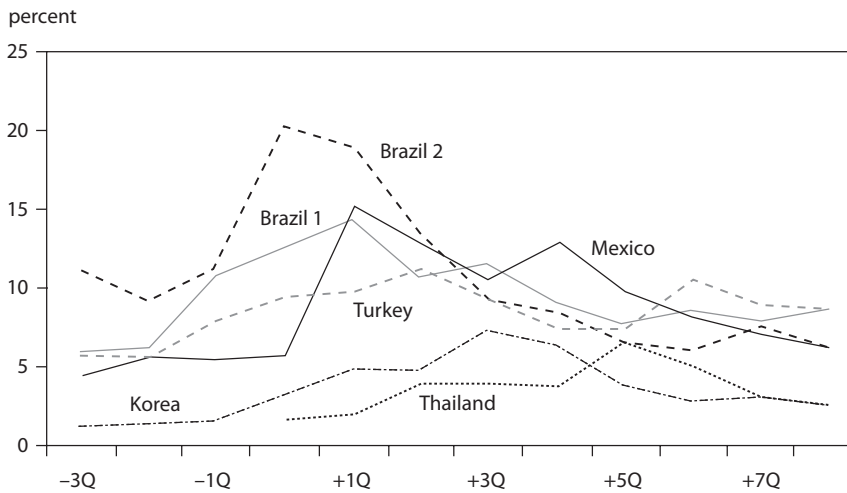
at end-2001, its debt will still stand at about SDR 8 billion by end-2005. If the IMF relends SDR 1 billion in 2006 and again in 2007, by end-2007 Argentina will still owe the IMF about SDR 6 billion. As discussed below, Argentina is of course the prime case of failure of the LLR process.

Experience shows, then, that LLR lending tends to be repaid within about four to five years in successful cases and threatens to persist much longer in some cases that are nonetheless arguably successful (Turkey, Indonesia) and, especially, in cases of failure (Argentina). Should the persistence of LLR debt on a scale of five years for countries instead of days or weeks for a domestic bank lead us to conclude that the application of the central banking principle of LLR to countries is mistaken? I do not think so. For the country and for the system, the benefits of avoiding default are still present. The principal question is whether the prospect of having IMF emergency support money tied up for an average maturity of about two and one-half years (that is, repaying approximately half the funds within that period) should warrant rejection of such lending. This question turns on whether doing so poses a serious risk that the IMF will run out of resources.

LLR Results

There have been nine cases of LLR lending to the eight countries shown in table 14.1 (the repeat country is Brazil). Of these nine cases, we can re-

Figure 14.3 Country risk spreads in LLR crisis episodes deemed IMF successes



EMBI Global = Emerging Markets Bond Index Global
 LLR = lender of last resort

Note: Shows average EMBI Global spreads for each of six crises (Mexico, Brazil 1 [1999], Brazil 2 [2002], Turkey, Thailand, and Korea); data are quarterly averages before, during, and after the quarter of the outbreak of the crisis.

Source: JP Morgan (2005).

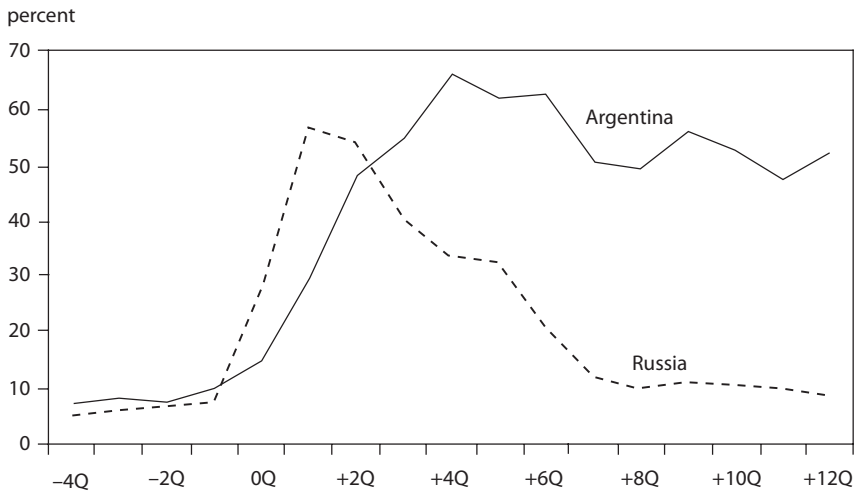
sonably exclude Indonesia, partly because it is closer to an aid problem than to an LLR problem and partly because the debt in jeopardy was private instead of government. Of the remaining eight cases, arguably there were five clear successes (Mexico, Brazil 1999, Brazil 2002, Korea, and Thailand), one probable success (Turkey), and two clear failures (Russia and Argentina). So, broadly speaking, the success rate has been about three-fourths.

The simplest measure of success is whether the risk spread on international lending returns to normal after the crisis period. The JP Morgan (2004) Emerging Markets Bond Index Global (EMBI Global) provides data that can be used for such a test. Figure 14.3 reports the average EMBI Global spreads for each of the six crises just designated as a success (including Turkey). The data are quarterly averages before, during, and after the quarter of the outbreak of the crisis (quarter zero [0]).⁸

It is evident in figure 14.3 that all six cases exhibited a pattern of a surge in the risk spread associated with the outbreak of crisis and an eventual

8. The outbreaks are dated as follows. Mexico: 1994:4; Brazil 1: 1998:4; Brazil 2: 2002:3; Thailand: 1997:2; Korea, 1997:4; Turkey, 2001:1.

Figure 14.4 Sovereign spreads in the Argentine and Russian crises



Note: Shows average EMBI Global spreads for crises in Argentina and Russia; data are quarterly averages before, during, and after the quarter of the outbreak of the crisis.

Source: JP Morgan (2005).

return of spreads to levels about the same as before the crisis. The principal exception was Thailand: Eight quarters after the crisis the spread was lower than at the peak but nonetheless slightly higher than in the quarter of the outbreak (in this case, the first quarter with data available).

An intriguing pattern in figure 14.3 is that the outbreak quarter is not usually the quarter of peak spread. The peak occurred in the outbreak quarter only in Brazil 2. The peak spread was in the first quarter after the outbreak in Mexico and Brazil 1, in the second quarter after outbreak in Turkey, in the third quarter in Korea, and in the fifth quarter in Thailand. Once again this suggests that sovereign crises require more time for LLR lending to restore confidence than would be expected in a domestic banking panic. The recovery lag is somewhat overstated where the announcement of the LLR package is itself delayed (for example, in Korea in the “first quarter after,” 1998:1).

The country spread also helps measure LLR failure. Figure 14.4 shows the same sequence of spreads for the cases of Russia and Argentina.⁹ Spreads remained at a remarkably high 30 percent in Russia fully five quarters after the crisis outbreak, and even after eight quarters spreads were still at a relatively high 1,000 basis points despite the oil bonanza.¹⁰

9. The outbreak quarter is set at 1998:3 for Russia and at 2001:3 for Argentina.

10. World oil prices more than doubled from 1998 to 2000 (IMF 2005b).

The explosion of spreads, and persistence at high levels, was even more dramatic for Argentina, where they remained at about 5,000 basis points three years after the crisis outbreak.

The Resources Issue

Suppose we accept as a stylized fact that LLR action has been successful in three-fourths of the cases where it has been tried. At least three basic questions about its advisability would still arise. First, does it create moral hazard? Second, does it pose meaningful risk of large losses to the IMF? Third, does it unduly preempt IMF resources and divert them from other important uses?

Moral Hazard

I have argued elsewhere (Cline 2004b, 73–74) that concern about moral hazard problems from LLR programs has been seriously overstated. Several formal statistical tests have rejected the moral hazard hypothesis (Zhang 1999, Lane and Phillips 2000, Kamin 2002). More to the point, after the historic Argentine default and unilaterally imposed deep forgiveness on its bonds, it is simply implausible *prima facie* to argue that private creditors can be expected to overlend because they think there is no risk in emerging-market capital markets thanks to IMF LLR operations.

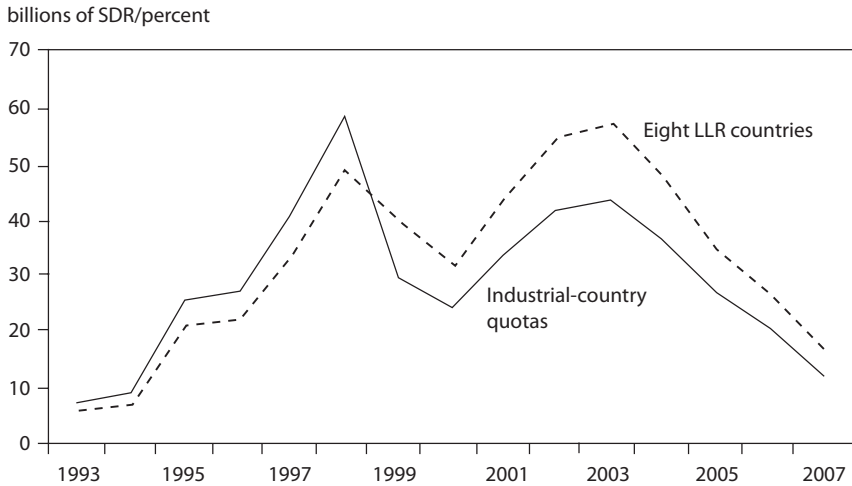
Meaningful Risk of Large Losses to IMF

So far experience has borne out the validity of the IMF's preferred-creditor status. Thus, Russia repaid all of its IMF debt even though it imposed sharp forgiveness on treasury bills owed by the government to private creditors. In the most extreme sovereign default to date, that of Argentina, so far the government has honored its obligations to the IMF. So the answer to the question of risk of loss seems to be in the negative.

Preemption and Diversion of IMF Resources

A more plausible concern is that a proliferation of LLR lending, especially to slow-repayment countries, could monopolize available IMF resources and constrain the IMF from carrying out its more normal programs in a wide array of countries not involved in LLR-type crises. Indeed, it is a popular view that, regardless of the merits of the LLR argument, the IMF cannot afford to carry out this function in the future because it is already seriously overexposed in lending to a handful of countries that have ben-

Figure 14.5 Aggregate IMF loans outstanding to eight LLR countries, 1993–2007 (billions of SDR and percent of total industrial-country IMF quotas)



LLR = lender of last resort
SDR = special drawing rights

Notes: The eight LLR countries are Argentina, Brazil, Indonesia, Korea, Mexico, Russia, Thailand, and Turkey. For 2006–07 the figure assumes constant IMF quotas.

Sources: IMF (2005a, b).

efited from large emergency lending in the past. A closer look suggests, however, that this concern is exaggerated.

Figure 14.5 returns to the eight LLR countries examined earlier and aggregates the amount of their outstanding debt to the IMF. The figure also shows this aggregate as a percent of the total amount of industrial-country quotas in the IMF. Industrial-country quotas provide the core lending base of the institution. These countries hold about 62 percent of total quotas. The total quota base for the Fund is reviewed every five years. The current total of SDR 212 billion dates from the 11th review in early 1998; the previous total of SDR 135 billion was in place during 1991–98 following the 9th review in 1990 (IMF 2000). Therefore the core lending base stood at about SDR 84 billion in 1993–98 and SDR 131 billion in 1999–2004. For 2006–07 the figure simply assumes constant IMF quotas.

Two key patterns stand out in figure 14.5. First, despite the growing concern in recent years that the IMF has become unduly vulnerable to large claims held on a few countries, the share of loans outstanding to the eight LLR countries in the core lending base of the Fund has not returned to its peak of nearly 60 percent in 1998 (it peaked more recently at about 45 percent in 2003). Second, already by end-2005 this share should be rel-

atively moderate (at about 35 percent), and by end-2007 it should be down to only approximately 15 percent. The reality, then, is that by end-2005 the share of outstanding LLR debt in core Fund lending capacity will already be back down to where it was a decade ago, and this share is likely to fall by about half again by 2007. In part this favorable situation can be attributed to a period of benign conditions in international financial markets associated with robust global growth and low US interest rates. The IMF should be in a relatively strong resource position to extend future LLR support if needed. This would be even more true if IMF resources were increased to keep pace with the scale of the world economy.

The Global Environment in the 1990s Versus Today

In one important regard, the case for LLR is weaker today than it was during most of the past decade. In 1994 the collapse of the capital market for Latin America was still in the recent past. A default by Mexico would have been a major shock to the nascent bond market for emerging-market economies. The renewed health of the capital market based on the success of the Brady Plan would have been highly vulnerable to relapse. Similarly, by the late 1990s, there were major systemic risks. The Russian default and the collapse of the Long-Term Capital Management (LTCM) hedge fund coming on the heels of the outbreak of financial crises in hitherto largely immune East Asia meant that international capital markets were susceptible to a severe loss of confidence.

The most direct gauge of systemic risk was in “contagion,” as revealed in increased risk spreads even for emerging-market economies not directly involved in crises. Contagion from Russia and LTCM played a major role in dooming the fixed exchange rate regime in Brazil and triggering its first post-Brady financial crisis. Argentina too faced a surge in spreads from about 450 basis points in the second quarter of 1998 to 760 basis points in the third quarter. In a context of substantial potential for global contagion, during 1998–99 the provision of LLR support to Korea, Thailand, and later Brazil made sense in part because there were systemic benefits in addition to those for the individual countries themselves.

By 2005 the evidence increasingly seemed to suggest that the emerging capital markets (let alone industrial-country capital markets) had become sufficiently sophisticated (or simply inured enough) to reduce substantially the risk of contagion. Thus, despite Argentina’s default at the end of 2001, Mexico’s EMBI Global spreads were lower on average in 2002 (at approximately 320 basis points) than they were in the fourth quarter of 2001 (360 basis points).¹¹ Net foreign private credit flows (bank and nonbank)

11. There was Argentine contagion to neighboring Uruguay, however, and the long-predicted nature of Argentina’s default likely meant its spillover was smaller than would have been the case for a large surprise default.

to emerging markets were actually higher in 2002 than in 2001 (inflows of \$7 billion versus outflows of \$19 billion), and outside Latin America the upswing was greater (to inflows of \$21 billion compared with outflows of \$13 billion). These net flows to emerging markets as a whole rose further to \$88 billion in 2003 and \$114 billion in 2004, despite the specter (and eventual reality) of a punitive Argentine restructuring (IIF 2003, 2005a). In short, there are grounds for concluding that one decade after a financial rescue of Mexico led by the US Department of the Treasury, global financial markets have become much more resilient to major developing-country crises. If this judgment is correct, the systemic component of the case for LLR action has declined substantially, even though the country-specific case remains.

The Impact of Argentina

At the end of 2001 Argentina announced the largest sovereign default in history, involving approximately \$100 billion including interest arrears. It is paramount in determining international LLR policy to make the proper diagnosis of the implications of Argentina's default.

The first lesson to draw from the default is that it would be wrong to conclude LLR operations should terminate because the LLR program for Argentina failed. Fortunately, the international community did not adopt a simplistic interpretation along these lines and, instead, once again responded to the LLR challenge just a few months later when Brazil's electoral campaign began to show likely victory by the leftist candidate, inducing a temporary financial panic. Surely Brazil (and probably the world economy) is better off for the success of the 2002 LLR support and would have been worse off if there had been a knee-jerk reaction of "no more rescue operations" on grounds of failure in the Argentine case.

The second lesson is the crucial importance of political sustainability in determining the fate of LLR efforts. A key feature of Argentina's default has been its essentially punitive terms of restructuring, driven by populist politics. The default itself and the subsequent terms demanded were by a different regime from the one that signed the various LLR agreements with the IMF, even though the formal presidential term of office of the earlier government of Fernando de la Rúa had not expired. Instead, the president and finance minister resigned from office after street riots that, by some accounts, had in part been instigated by segments of the opposition party.¹² Ideally, in the third quarter of 2001 when the IMF gave its last large loan to Argentina, Fund authorities would have foreseen that the de la Rúa government would either fall or at least be unable to deliver on its

12. Mariano Tommasi (2002, 42) called the riots "largely due to the mobilization of violent protests by the peronist machinery of the Province of Buenos Aires."

“zero deficit” fiscal pledge. A hard lesson of the Argentine case would thus seem to be that, in the future, LLR operations should insist on a higher threshold of confidence in the sustainability of the government’s political ability to implement its adjustment program than might have been required in the past.

Political considerations appear to have driven Argentina’s workout as well as its default. The Argentine restructuring essentially gave privileged terms to other debt that had been restructured in late 2001 and was largely held by domestic citizens and pension funds. This left a smaller resource base to service the remaining debt. Even so, the eventual forgiveness of 70 percent in present value terms far exceeded that of any other middle-income country’s debt restructuring and was close to terms for heavily indebted poor country (HIPC) workouts. In Cline (2004a) I estimated, using debt-servicing projections by the government and plausible assumptions about growth and the exchange rate, that Argentina instead could have afforded to pay some 55 cents on the dollar.¹³ The nature of the strategy followed has tended to reduce funds available to service debt through maintaining an undervalued exchange rate that unduly shrinks the dollar magnitude of GDP and the primary surplus. Fundamentally, however, the restructuring reflects policy driven by a populist political agenda. It is no coincidence that the same environment has yielded a squeeze on direct foreign investment properties of a nature not seen in the region since the “obsolescing bargain” expropriations of the 1970s. Similarly, such decisions as the asymmetric conversion of dollar loans and deposits to pesos (favorable for domestic debtors, unfavorable for the banking system) reflected the populist imperative.

A third lesson is that the challenge in debt restructuring can turn out to be a “rogue debtor” problem rather than a “rogue creditor” problem (Porzecanski 2005). The restructuring process was marked by minimal government consultation with representatives of private creditors. In contrast, organizing the massive number of bondholders turned out not to be much of a problem. The eventual acceptance ratio of about three-fourths for the restructuring deal was much lower than the 90 percent or so usually achieved, reflecting the sense of many creditors that the deal offered

13. Some argue that Argentina’s seemingly high postrestructuring ratio of government debt to GDP, at about 70 percent after reasonable accounting for treatment of holdout debt and some correction in the undervalued exchange rate, is evidence that Argentina could not have afforded to pay more. Quite apart from the point that the asymmetry of treatment among creditor classes meant deeper forgiveness for the holders of the \$81 billion external bonds (not counting another \$20 billion or so in interest arrears), it is essential to recognize that Argentina’s postswap nominal debt burden is illusory. Low interest, for example on the 40-year par bonds paying only 2.1 percent in the first five years, means that, like many African nations dependent on concessional assistance, Argentina’s effective debt burden is much smaller than its nominal burden. Indeed, the postrestructuring government interest burden at only 2 percent of GDP is much lower than the 7 percent in Brazil and even the 2.7 percent in Mexico (UBS 2005).

much less than Argentina was capable of paying. The acceptance ratio among non-Argentine creditors was far lower, probably less than two-thirds, given the reportedly near-complete participation of domestic holders (which included pension funds and domestic banks subject to government influence).

A fourth lesson is that one of the arguments against LLR lending—that it creates a huge bloc of senior debt and thereby forces private creditors to take even larger losses as a result—is spurious. Argentina’s outstanding debt to the IMF never exceeded \$14 billion, or just 10 percent of total government debt of \$144 billion at end-2001. HIPC-depth forgiveness was not caused by an overhang of IMF debt.

A fifth lesson is that IMF LLR lending does run the risk of placing the Fund in the “lender’s trap,” wherein there is an incentive to roll over loans coming due in order to avoid default. The parallel risk for the IMF is that it is placed in the dilemma of choosing between violating the rules for lending into arrears—which hold that the IMF should not make new loans to countries that have defaulted and are not making good-faith efforts to negotiate with their creditors—and precipitating debtor default to the IMF. On this issue, there should probably be a higher threshold for debtor behavior toward creditors if there is to be net new IMF lending than there is for mere rollover (and, especially, less than complete rollover) of debt coming due to the Fund. In the Argentine case, the only question has been how complete the rollover would be, not whether net new IMF money should be lent.

The Sovereign Debt Restructuring Mechanism

The complement of LLR is debt restructuring with forgiveness. Ideally countries in crisis would be clearly solvent or insolvent, and for the latter the appropriate response would be negotiated workout. For a time, especially in 2002, there was considerable momentum behind the idea that the IMF should be central to such workouts, and the Fund’s First Deputy Managing Director Anne Krueger formally proposed a mechanism for this purpose (the sovereign debt restructuring mechanism [SDRM]).¹⁴

The SDRM initiative stalled for several reasons. It probably lost a key champion when the US secretary of the treasury was replaced.¹⁵ The ini-

14. See Anne Krueger’s speech, “International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring,” at the National Economists’ Club Annual Members’ Dinner, American Enterprise Institute, on November 26, 2001, in Washington. Available at the IMF’s Web site at www.imf.org (accessed on September 9, 2005).

15. Note, however, that the Treasury Department may have cooled on the idea even earlier. On April 2, 2002, Under Secretary John B. Taylor in a speech at the Institute for International Economics on the subject of sovereign debt restructuring pointedly ignored the SDRM and instead called for collective action clauses.

tiative faced opposition from the private sector, which feared that the Fund would seek to impose workout terms that for political reasons might be tilted in favor of debtor countries and argued that, as a senior creditor itself, the Fund could not be impartial. The SDRM was also opposed by such key debtor countries as Mexico. Substantively, it became clear that the mechanism was designed to address a problem that had been relatively rare: coordinating dispersed creditors in order to ensure negotiations and helping discipline unreasonable holdouts for workouts on foreign bond debt. In practice most of the crises had not been driven by foreign bond debt (Truman 2002); nor did organizing creditors turn out to be a problem (Roubini and Setser 2004).

Ironically, the Argentine experience has revealed that a forceful position by the IMF on what would be reasonable terms would likely have been to the benefit of the creditors. The Fund instead took a hands-off stance, arguing that the terms should be decided strictly between the Argentine government and the private creditors.

It seems unlikely, nonetheless, that calls for the SDRM will be revived. The major crises are sufficiently few and distinctive that it is a better strategy to deal with each crisis individually on a more ad hoc basis. In the future, however, the IMF could usefully make clear its own views on the amount of debt forgiveness it believes is needed; this should be done in a manner that does not seek to dictate the terms of restructuring.

There are two basic problems with the IMF determining repayment capacity. The first is that, as a key creditor itself, it has a potential conflict of interest that structurally gives it an incentive to understate capacity to repay private creditors. IMF officials may or may not be saints who would ignore this incentive, but it is present. Second, the IMF is ultimately a political body, and its guidance is inherently subject to political influences. Its key decisions are, and should be, consistent with the views of the Executive Board. There would be an inevitable tinge of politicization in an IMF-announced set of terms for restructuring. Private creditors would rightly fear that major IMF shareholders' interests in maintaining good political relationships with the debtor country could bias proposed terms toward deeper forgiveness.¹⁶ Conversely, debtor governments could fear that undue Group of Seven (G-7) influence in the IMF, combined with the interests of their constituent private investors, could tilt the terms in the other direction.

One solution to this conundrum might be the following: In a sovereign workout, it would be expected that the IMF would remain peripheral to the workout negotiations. However, the IMF would be expected to publish

16. In the case of Argentina, Eric Helleiner (2005, 951) argues that "US policy makers even went out of their way to express support for the Argentine government's tough negotiating stance" because of "strategic goals, neoliberal ideology and conservative anti-internationalist sentiments."

a technical report indicating three plausible scenarios for repayment terms: high, central, and low. The negotiations would then be left solely to the debtor and its creditors. This approach would have the merit of setting some notional bounds for what would be a fair outcome. Holdout creditors that insist on better terms than in the high scenario would presumably have a more difficult case to make in eventual litigation. Similarly, debtor governments unilaterally imposing deeper forgiveness than in the IMF's low scenario could anticipate greater future difficulties in making their cases in court as well as greater opprobrium in capital market perceptions. At the same time, countries seeking to maintain their credit reputation by avoiding substantial forgiveness would be on notice that there would be limits to the extent to which the resulting deal would be indirectly paid for by new IMF lending.¹⁷

Collective Action Clauses, Codes, and Private-Sector Involvement

The private sector has responded with its own approach to workout mechanisms in part, no doubt, prompted by the specter of an SDRM that might prove unfriendly. Collective action clauses in new bond issues for sovereigns have become the industry standard since Mexico broke the ice in 2003 by issuing bonds with these clauses and suffered no discernible pricing penalty. These clauses facilitate restructuring by a qualified majority of bondholders, overcoming the impasse that can otherwise be caused by rogue creditors.

Leading institutions representing the private sector also called for a code of conduct for emerging-market lending that includes guidelines for restructuring (EMCA et al. 2003). After a joint effort among private-sector representatives and officials in some leading emerging-market economies (particularly Brazil, Mexico, and Turkey), in late 2004 a set of principles spelling out the code of conduct was released (IIF 2005b). These include clear procedures for dialogue with private creditors, exclusion of bonds controlled by the debtor government from voting in restructurings, equal treatment for all holders (by implication, foreign and domestic), and comparable forgiveness by bilateral creditors. The principles also provide for commercial banks and investment houses to consider maintenance of short-term credit lines during crises in the presence of a convincing, IMF-supported program, while at the same time they call for exclusion of short-term trade credit from general restructurings. The principles endorse continuation of the case-by-case approach to debt restructurings.

17. In such a case the political bias in the IMF's incentives would tend to be absent because the Fund's shareholders would not be fostering but instead eroding ties to the government in question by pushing for deeper forgiveness.

The Group of Twenty (G-20), which includes major developing countries as well as the G-7 industrial countries, issued a statement that “welcomed” the principles, which it “generally” supported (IIF 2005b, 5). It seems unlikely, however, that the G-7 actively supports some of the principles, especially reverse comparability.¹⁸ Overall, these principles represent common-sense endorsement of such precepts as transparency, good-faith cooperation, and fair treatment. They are strictly voluntary. Their endorsement by the G-20 (excluding Argentina, which chose not to attend the meeting in question) does seem to have sent a signal that most key borrowing nations sought to distance themselves from the unilateral approach adopted in the Argentine restructuring. Implicitly, the principles also send a signal that the key developing countries are not keen on the development of an SDRM or other formal mechanism that tends toward institutionalization rather than case-by-case treatment.

For its part, private-sector involvement is a concern that today has the ring of a relic from more innocent times. The massive losses of private creditors in Argentina’s restructuring *de facto* mean that the private sector has already “given at the store” for some time to come. Opponents of LLR support from the IMF cannot credibly argue that the private sector has escaped without losses on poor investments because of public-sector largesse. To be sure, private-sector involvement will remain appropriate, for example, in temporary arrangements to maintain short-term credit lines (as even the private sector’s own code has now endorsed). Private-sector involvement should continue to be implemented on the basis of keeping private refinancing arrangements as voluntary as possible while being consistent with successful crisis resolution (Cline 2004b).

Principles for Future Policy

I have previously formulated the decision for LLR support in terms of a diagram showing the volume of LLR lending on the vertical axis and the probability of insolvency on the horizontal axis, with a curve that is relatively high over half or more of the graph but then quickly falls toward zero as the likelihood of insolvency rises (Cline 2001). I argued that the official sector should be prepared to give the benefit of the doubt to solvency (implying provision of LLR support even if the probability of insolvency is somewhat greater than 50 percent) because the economic damage of default can be so severe and because the IMF itself has preferred creditor status and is likely to be repaid in any event.

What Argentina has shown is that the decision to extend LLR support must weigh even more heavily than one might have thought previously

18. “Comparability” is the Paris Club’s principle of seeking debt reductions by private creditors when reductions are being granted by bilateral donors.

the political sustainability of a government's adjustment program. Hind-sight shows that Argentina's political conjuncture in mid-2001 was on the verge of forced regime change that made adherence to the promised fiscal adjustment unlikely. In contrast, the IMF took the right decision in mid-2002 to provide LLR support to Brazil after the leftist candidate made it clear that he would pursue responsible fiscal policies.

More specifically, there should probably be greater emphasis than in the past on ensuring that the fourth rule for the exceptional access under the policies adopted in 2003 is in fact met. The fourth rule (IMF 2003) requires that "[t]he policy program of the member country provides a reasonably strong prospect of success, based in part on an assessment of the government's institutional and political capacity to implement that program."¹⁹

In short, borrowing nations should continue to have access to IMF LLR support when they have credible adjustment policies and political institutions that make it likely they can deliver on their commitments. The litany of usual reasons to end LLR support is not persuasive (especially moral hazard and preemption of IMF resources). Moreover, even though the systemic stakes for avoiding defaults may no longer be as high as they were when the emerging capital market was much less mature, some systemic risk remains; and the economic damage to the country itself from forced default continues to be sufficient reason in itself for the international financial system to use its principal institution in a manner that includes performance of the LLR function.

An important operational implication for the IMF is that, in cases of debt restructuring following default, the International Monetary Fund should make public its analysis of the amount of postrestructuring debt it considers sustainable after debt reduction (if any) and rescheduling, and the Fund should indicate high, central, and low variants. This would send a signal to both the creditors and the debtor as to the range of outcomes the IMF would consider plausible and balanced while it would avoid a heavy-handed role for the Fund as absolute arbiter of the amount of any write-offs.

The unfinished business today has more to do with the workout process than with LLR policy. The experience of Argentina may suggest the need for a more active role for the IMF in setting out its own views on prospective payment capacity of the country but in a fashion that in no way dictates the terms. The unfinished business in this area probably also includes mechanisms for strengthening the scope for legal recourse of creditors that have in effect faced repudiation through a unilateral exchange offer far below a country's underlying ability to repay. These might include, for

19. The other three rules for exceptional access state: "[There are] exceptional balance of payments pressures that cannot be met within the normal limits; . . . a rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable; [and] . . . [t]he member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding. . . ." (IMF 2003, 3-4).

example, a proscription on continued Bank for International Settlements shielding of reserves of a country in default that has clearly failed to conduct good-faith negotiations with creditors after an extended period of time and after the courts have awarded a judgment against it.

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