

Crisis resolution in emerging market economies – challenges for the international community

Since the mid-1990s a number of emerging market economies have experienced severe capital account crises. These crises displayed new features in comparison with earlier balance of payments crises in developing countries. Their causes were broader than in the past, including not only macroeconomic imbalances but also balance sheet weaknesses in the private financial and corporate sector. Moreover, contagion across countries was initially facilitated by the increasing integration of domestic capital markets into the global financial system, the securitisation of debt and a larger range of debt instruments. These crises unfolded very rapidly, manifesting themselves through sudden shifts in the financial account of the balance of payments. They also involved a broader set of actors as regards both debtors (sovereign and private borrowers) and, to a larger extent, creditors (holders of various financial instruments such as bank loans, bonds and foreign direct investment claims).

The recent crises have therefore posed new and difficult challenges in terms of crisis management. Debtor countries, private sector creditors and international financial institutions have all been called upon to adjust their role to the specific circumstances of individual crises. In this context, the IMF has since the late 1990s introduced a number of new instruments and procedures with which to respond to these new challenges. In addition, several policy measures have been adopted or are currently under consideration in each of the three main components of crisis resolution, i.e. domestic adjustment, official financing and private sector involvement. One of the challenges in this ongoing work on crisis resolution is to balance, on the one hand, clarity in the formulation of policy principles and efficiency in the design of instruments, and on the other, flexibility to address the specific circumstances of each crisis.

I Introduction

The recent crises in emerging market economies, including Mexico in 1994-1995, East Asia in 1997-1998, Russia in 1998, Brazil and Turkey during the period 1999-2001, and Argentina since 2001, share a number of important common features. They were characterised by a sudden reversal of foreign capital inflows and heavy domestic capital flight, pressure on the domestic currency to devalue or depreciate, large adverse movements in domestic asset prices and financial variables, banking crises¹ and a contraction of domestic output. As the crises had their origin mainly in the financial account (formerly known as the capital account) of the balance of payments, they are usually referred to as capital account crises, as opposed to earlier crises that were typically triggered by adverse current account developments.

The high costs associated with these events – as presented in Section 3 – both for the economies directly concerned and the world economy at large, have raised awareness

among the international community of the need for both better crisis prevention and better crisis resolution. The international community has responded by reviewing existing prevention tools and developing a number of new instruments. For example, closer IMF surveillance of the financial sectors in borrowing countries, the development of early warning systems, enhanced transparency of the IMF's activities, and the promotion of standards and codes have all contributed to more effective crisis prevention.²

Similarly, the experience with these crises has led to a discussion of ways to improve the resolution of crises. The specific nature of capital account crises implies that determining how best to ensure that macroeconomic and financial stability and

¹ A notable exception is Brazil, where a banking crisis was avoided thanks to hedging through foreign currency futures and dollar-indexed government securities.

² The article "Recent developments in international co-operation" in the February 2002 issue of the *Monthly Bulletin* discusses some of the crisis prevention issues.

internal and external sustainability are restored in crisis countries in a timely and orderly manner, in full respect of creditors' rights, is not a straightforward matter. This has necessitated reforms of several of the most important crisis resolution tools.

Orderly crisis resolution is of particular relevance for the ECB because crises in emerging market economies may have significant macroeconomic and financial effects

on the euro area. Moreover, the ECB is involved in discussions on improving crisis resolution through its role in the process of international monetary and financial policy cooperation. Against this background, this article reviews the challenges raised by the recent capital account crises (Section 2) and discusses the policy measures already implemented or under consideration to improve crisis resolution (Section 3).

2 Challenges for the resolution of capital account crises

The resolution of the recent capital account crises has been particularly challenging due to a number of features that distinguish them from previous balance of payment crises. First, unlike in the 1980s, the 1990s crises were characterised by the highly significant role played by private financial and corporate institutions in borrower countries, which has made it necessary to monitor closely not only macroeconomic but also financial stability indicators. In addition, these capital account crises were closely related to changes in international financial markets and to the channels for cross-border contagion that such changes produced. They were accompanied by a growing integration of emerging market economies into the global financial system, which was made possible by the removal of restrictions on capital movements in the countries concerned. These developments were part of what came to be known as the "Washington consensus",³ a wave of measures to liberalise international transactions which took place in the first part of the 1990s, partly as a result of the lessons learnt from the sovereign debt crises of the 1980s. Moreover, the liberalisation took place against the background of a general increase in global financial flows and the development of new financial instruments. Such integration, although still imperfect, is beneficial since it promotes a better international allocation of savings and investment. At the same time, capital market integration and the associated wider use of marketable and liquid instruments increased vulnerability to sudden

stops and reversals of capital flows and reinforced the potential for contagion among countries. Only more recently has this potential been reduced as markets have become more transparent and investors better able to discriminate between borrowers, and as domestic reforms have been carried out in borrowing countries.

A second characteristic of the recent crises is the more substantial involvement of the private sector, both on the creditor and on the debtor side. During the 1980s, crises were mostly confined to sovereign debt and involved a small number of lending banks in mature economies, as the most widely used instrument for borrowing was the syndicated loan. After the debt restructuring at the end of the 1980s with the use of Brady bonds and the ensuing creation of an international market for bonds issued by emerging markets, most emerging market borrowers were able to use bonds alongside bank loans. In addition, the liberalisation of domestic and international capital markets in line with the

3 The term "Washington consensus" was first used by John Williamson to describe the dominant view in the late 1980s and 1990s that economies should increase their reliance on markets. The recommendations made included, in terms of domestic policies, privatisation and deregulation, and in terms of external policies, the opening of highly regulated domestic markets to cross-border transactions. The latter idea was based on the view that market-based economies should participate in the global economic and financial system in order to benefit from enhanced competition. A view became established that the current account should be liberalised first, as this measure was easiest to implement, and that this could then be followed by a relatively rapid liberalisation of the capital and financial accounts.

Washington consensus gave private sector borrowers access to international capital markets. This led to an increase in the number of issuers, as well as in the number of buyers, which included investment funds and retail investors. From the late 1990s, greater use of an additional instrument, foreign direct investment (FDI), further increased the role played by private lenders. On the borrower side, however, sovereign borrowers were still involved in the recent crises on two accounts. First, widespread crises in the corporate and banking sectors led to the involvement of public authorities as providers of a safety net to mitigate the macroeconomic implications of financial instability. Second, a larger role for the private sector in a debtor country does not preclude that the government, owing to unsustainable fiscal and/or monetary policies, may still be the primary counterpart of foreign lenders and the main source of the crisis. As a by-product of the increase in the number of actors involved in emerging market financing, of the liberalisation of cross-border capital flows since the late 1980s and of the securitisation of international debt, the current stock of emerging market debt differs significantly from the roughly homogeneous stock at the end of the 1980s. The stock of debt is now composed not only of syndicated bank loans and official financing, but also of bonds and FDI, with the last component increasing substantially since the late 1990s.

As a result of these specific features, the resolution of capital account crises has become particularly challenging. One of the challenges is related to the speed with which the crises unfold. By contrast with current account crises, which usually build up over time, capital account crises may occur rapidly because capital is highly mobile. Therefore, such crises often require more rapid policy responses on the part of the domestic authorities and the international financial community. Additionally, the increased size of cross-border capital flows made possible by the liberalisation of the late 1980s produces much higher volatility in macroeconomic and financial variables in times of crisis. Loss of market confidence in

the policies or the fundamentals of a country can have such a powerful effect on the price of sovereign and corporate debt, on exchange rates and on interest rates, as to make them swing abruptly and overshoot their new long-term equilibrium level.

A further complication relates to the role played by financial institutions and financial deepening in borrowing countries. In the recent episodes of capital account crisis, assessing the size and the causes of a crisis was complicated by, *inter alia*, the process of financial deepening, which is still bank-based in emerging market economies. Specifically, the liquidity transformation carried out by banks is likely to make the assessment of the payment capacity of borrowers much harder. Moreover, a combination of maturity and currency mismatches significantly aggravated the weakness of banks, as partial dollarisation exposed them or the firms to which they lent to sudden and for the most part unhedged exchange rate movements. Another layer of complication was added where the government of a country acted as guarantor of its financial stability, leading to government involvement in the bailout of domestic banks. Finally, with a banking crisis, instability in the financial sector can spread to the real side of the economy, which can then be cut off from capital inflows. Given the role that banks play as intermediaries, bankruptcies in this sector have a multiplier effect that makes the cost of crises both higher and more difficult to evaluate.

Related to this problem is the fact that it is difficult to assess the capacity and willingness of a borrower country to honour payments to its creditors, which complicates the choice of appropriate policy response. In a capital account crisis, the widening of borrowing spreads, pressure on the exchange rate and an increase in domestic interest rates usually lead to problems for the sovereign debtor in honouring its external payment obligations. In principle, the most appropriate policy response to such payment problems should be determined on the basis of the debt sustainability situation. If the crisis is triggered

by a temporary lack of funds but economic fundamentals are sound and debt remains sustainable (a liquidity crisis), the most appropriate response is to provide additional financing only or to reschedule the debt such that its net present value is maintained but payments are temporarily delayed. In this context, a case can be made for short-term financing from the official sector to provide the additional liquidity needed during the crisis, thus helping the country to smooth its payment obligations over a longer period of time. By contrast, if the crisis is linked to an unsustainable debt burden (a solvency crisis), it is more appropriate to seek a debt restructuring, involving a reduction in the net present value of debt. In times of crisis, however, it often proves extremely difficult to make a firm judgement on debt sustainability, given the difficulties in evaluating the precise nature of a capital account crisis and the fact that events may unfold particularly rapidly.

As a final challenge, coordination among creditors has become more complex with

the use of novel financial instruments and a widening creditor base. During the debt crises of the 1980s, it was relatively straightforward to organise coordination, because the creditors were not numerous and had largely converging interests. Sovereign creditors coordinated their actions through the Paris Club, and commercial banks set up informal coordination mechanisms through the London Club. The increasing number of creditors and financial instruments has now made it much more difficult to achieve coordination, preserve creditors' rights and avoid discrimination between creditors. In addition, when the domestic financial sector owns part of the country's debt, a satisfactory balance has to be found between inter-creditor equity, which implies the full involvement of domestic creditors in a rescheduling or restructuring of debt, and the preservation of domestic financial stability, which may require a more limited involvement of domestic creditors.

3 Policy measures to promote orderly crisis resolution

The experience with recent capital account crises has raised awareness and highlighted a need to reflect on the actions and policies of the different actors involved. Crisis resolution efforts have delivered mixed results, as can be seen from the varying degrees of success in containing their medium-term macroeconomic and financial effects. In a majority of cases, economic growth picked up very rapidly after the crisis, but in some instances a full reversal of the associated output loss was only possible after several years (see Table I). Similarly, high volatility in financial variables, such as interest rates, exchange rates and equity prices, was brought down at a pace that varied from country to country; in some cases market turmoil continued over a prolonged period. Where the external debt situation proved to be unsustainable, the return to a more sustainable path was uneven across countries

and sometimes required lengthy and difficult negotiations. Moreover, the restoration of financial and corporate sector balance sheet health implied, for most countries, heavy fiscal costs and widespread structural reforms involving short-term costs.

One of the main policy challenges to arise throughout these crises was to find an appropriate balance between the three main components of crisis resolution. The first component is domestic adjustment, i.e. the set of policy measures taken by the debtor country to address the causes of the crisis and to restore debt sustainability. The second component is private sector involvement (PSI), i.e. financial flows from private creditors, which may include, in very specific cases, a restructuring of debt with a reduction in net present value. The third component is official financing, i.e. extended by the official

Table**Real GDP growth in selected emerging market economies***(annual percentage changes)*

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 ¹⁾
Argentina	5.8	-2.8	5.5	8.1	3.8	-3.4	-0.8	-4.4	-10.9	5.5
Brazil	5.9	4.2	2.7	3.3	0.1	0.8	4.4	1.4	1.5	1.5
Indonesia	7.5	8.2	8.0	4.5	-13.1	0.8	4.9	3.4	3.7	3.5
South Korea	8.3	8.9	6.8	5.0	-6.7	10.9	9.3	3.1	6.3	2.5
Mexico	4.4	-6.2	5.2	6.8	5.0	3.6	6.6	-0.2	0.7	1.5
Russia	-12.7	-4.1	-3.6	1.4	-5.3	6.3	10.0	5.0	4.3	6.0
Thailand	9.0	9.2	5.9	-1.4	-10.5	4.4	4.6	1.9	5.3	5.0
Turkey	-5.0	6.9	6.9	7.6	3.1	-4.7	7.4	-7.5	7.8	5.3

*Source: IMF, World Economic Outlook, September 2003.**Note: Figures in bold indicate the year(s) in which a capital account crisis occurred.**1) Figures for 2003 are projections.*

sector, notably the IMF, the World Bank, the regional development banks, and, in some cases, bilateral official creditors. These three components are closely related and mutually reinforcing. A quick return of financial flows from private creditors is desirable to limit the costs of the crisis. Without this, domestic asset prices and financial variables may be subject to disruptive developments, thereby making a successful adjustment process less likely. Domestic adjustment is a precondition for effective PSI, since the restoration of market confidence hinges on a sustainable correction of domestic imbalances. Official financing also plays a crucial role, as it may help to reduce the cost of a crisis by providing new money at a time when access to capital markets is difficult. At the same time, such financing should only be extended if there is an appropriate degree of domestic adjustment, since only the correction of macroeconomic imbalances and balance sheet mismatches can provide assurances that the pool of IMF resources will remain available for potential use by other member countries.

In response to these challenges, the international official community, notably the IMF, has continuously reviewed its experience with crisis management, on the basis of both internal and external reports. The Independent Evaluation Office, which was set up by the IMF to provide an objective and

independent evaluation of IMF-related issues, may also be called on to play an increasingly important role in this review process.

The IMF has introduced a series of measures to enhance the timely and orderly resolution of capital account crises. The remainder of this section discusses specific measures that have been taken or are currently under discussion for each of the three components of crisis resolution. At the outset, however, two remarks applicable to all three components should be made.

First, the measures to enhance crisis resolution should strike an appropriate balance between rules and discretion. On the one hand, clear rules are needed to facilitate the coordination of the different parties' expectations and behaviour, as the absence of such rules is likely to lead to an inappropriate structure of incentives for risk-taking behaviour. On the other hand, some degree of discretion is required to tackle the specific problems and challenges of each crisis and to avoid an overly prescriptive and detailed framework that could hinder timely and suitable decisions.

Second, an important criterion by which to determine the most appropriate combination of these components is the debt sustainability situation. If debt is unsustainable, a

combination of domestic adjustment and debt restructuring will be needed. If debt is sustainable, a combination of strong domestic adjustment and ample, but temporary, official financing may facilitate renewed access to private financing and help to stem the crisis. This implies that an adequate assessment of debt sustainability is a key prerequisite for successful crisis resolution. In recognition of this, the IMF has made substantial efforts to improve the techniques used in its debt sustainability assessments and has started to include such assessments more systematically in the documents submitted to its Executive Board. While it should be recognised that the determination of medium-term sustainability is intrinsically a judgemental exercise, and its analytical basis may be subject to wide margins of error, the IMF's continuing efforts to increase the accuracy of the exercise are to be welcomed. In this regard, sustainability analyses should also provide different scenarios reflecting alternative hypotheses for macroeconomic variables and financial flows, so as to give an indication of a potential worst-case outcome. In addition, the IMF has agreed to increase transparency by publishing debt sustainability assessments, thus fostering accuracy in their preparation.

Domestic adjustment

Domestic adjustment is the cornerstone of crisis resolution, as it is a key prerequisite for the restoration of confidence and the resumption of financial inflows. The primary responsibility for such adjustment lies with the policy-makers of the country suffering the crisis. It is in the country's own interest to address the weaknesses that have led to the crisis and to ensure a timely return to macroeconomic and financial stability and debt sustainability. However, the occurrence of capital account crises necessitates a review of the nature of domestic adjustment. Specifically, the novel characteristics of the recent crises, as discussed in Section 2, imply that adjustment measures should not be targeted exclusively at macroeconomic

weaknesses, such as current account deficits and fiscal imbalances. They should also address underlying vulnerabilities in private or public sector balance sheets, such as currency and maturity mismatches, as well as possible weaknesses in the regulatory or supervisory framework. A specific challenge for domestic adjustment is to combine urgent policy action, which may be needed to contain the immediate effects of a crisis, with long-term structural reform, which is required to maintain the long-term growth potential of the economy.

The international official community also plays a role in domestic adjustment through the conditionality of IMF financial programmes. Conditionality ensures that IMF financing is used to resolve the debtor's economic difficulties and that the country will be able to repay the IMF at the end of the programme. It also plays a crucial role in restoring market confidence, as it provides assurances to private creditors with regard to the quality of domestic adjustment. Over the last few years, experience with capital account crises has led the IMF to review a number of elements of its approach to conditionality. First, following the Asian crises of the late 1990s, the IMF increasingly adapted conditionality to ensure it was tailored to the specific problems and needs of the country concerned. Its focus was broadened from macroeconomic policies to include areas such as financial sector policies. While this allowed the structural factors underlying a crisis to be addressed, it was subsequently acknowledged that in certain cases there had been some "overshooting" in the widening of scope. The IMF therefore decided to streamline conditionality by focusing on issues of critical relevance to the resolution of a crisis. Second, there has been increasing consensus that conditionality can only be effective if national authorities have the administrative capacity and the necessary determination and political support to implement corrective action. The IMF has thus increasingly fostered country ownership in programme design.

Official financing

The shift from current to capital account crises has made it more difficult to determine the appropriate role for official financing. Recent capital account crises have been characterised by very significant external financing needs in the public and private sectors of the debtor country which could not be met in full through available official reserves. The international official community has responded by supplementing these reserves with large financial packages. This approach has led to a debate on the appropriate role for official financing, focusing on the question of whether it could function as an international lender of last resort, along the lines of the role played by central banks in a domestic context. Notwithstanding its appeal, the analogy is subject to a number of limitations. First, a lender of last resort requires very large resources, whereas the resources of international financial institutions are limited. This contrasts with the domestic context, where central banks have – since they can issue their own fiat money – unlimited resources to assist private credit institutions facing liquidity problems. Second, the extension of large packages may lead to increased exposure of the international institutions, mostly the IMF, vis-à-vis a few large borrowers, resulting in an unwelcome concentration of IMF credit and an unacceptable degree of credit risk for the IMF and, indirectly, the international community. Third, in a domestic context the assistance offered by central banks to troubled banks may be accompanied by mandatory changes in corporate governance, including the substitution of incompetent management. In an international context, IMF conditionality may be used to correct unsustainable domestic policies, but its effectiveness is likely to be more limited. Fourth, although practical difficulties in distinguishing liquidity from solvency crises also complicate the performance of a lender of last resort function in a domestic context, they are bound to be more significant at the international level, as balance sheet information is much more difficult to compile

and assess for an entire country than for an individual credit institution.

In view of these limitations, the performance of an international lender of last resort function is likely to be subject to policy errors. Specifically, there is a risk of generous financing being provided to a country that is perceived to have a sustainable debt situation, which subsequently proves to be unsustainable. Over time, performing this function carries the risk that, in the event of a gradual deterioration from a sustainable to an unsustainable situation, the international official community will ultimately have little choice but to roll over its own financing. Finally, moral hazard may arise if official financing distorts the functioning of market discipline, i.e. the incentives that private creditors provide to a debtor country to pursue sound policies in order to generate the required repayment capacity. This may occur if borrowers and lenders perceive that official financing offers some form of free insurance. In this case, borrowing countries may find it less costly to pursue unsustainable policies (debtor moral hazard) and investors may pay less attention to credit risk when making investment choices (creditor moral hazard). Although moral hazard is not specific to international lending and empirical evidence is sparse, large official packages to borrower countries should remain exceptional and should be supported by a strong case. The possibility that moral hazard may be a bigger concern in an international context follows from the fact that, at times of crisis resolution, transferring a share of the costs resulting from unsustainable policies to creditors is more difficult if the creditors and borrower do not fall under the same jurisdiction. In addition, sovereign debt seniority structures tend to be more complex and less clearly defined than those of private institutions.

As a result, it has been recognised that an international lender of last resort function is to a large extent neither feasible nor desirable. The notion that official financing should be subject to clear rules, including

strict access limits, so as to minimise potential distortions of market functioning, should therefore be considered a positive development of this debate.

This view is reflected in the IMF's framework for exceptional access. Under this framework, IMF financing should not, as a rule, go beyond predefined access limits, which are determined as a function of the quota assigned to each IMF member country. As a rule, the amount of financing in any given year should not exceed 100% of the quota (the annual access limit) and the total amount of outstanding IMF lending should remain below 300% of the quota (the cumulative access limit). However, in some cases, the IMF may decide to grant exceptional access by extending financing above these limits. Until March 2003, this was possible in "exceptional circumstances", which were not spelled out in more detail, or through the use of the Supplemental Reserve Facility (SRF), which was not subject to limits (the SRF can be used in cases where the risk of contagion could pose a threat to the international financial system). Since 1995, nine countries – Argentina, Brazil, Indonesia, South Korea, Mexico, Russia, Thailand, Turkey and Uruguay – have benefited from access beyond statutory limits. Moreover, such lending above limits constituted the bulk of total IMF lending in that period.

In March 2003, the IMF decided to strengthen its access policy framework by specifying a number of procedural requirements and substantive criteria for exceptional access. In terms of procedure, the programme documentation is now required to include a more detailed justification of the proposed amount of official financing, the IMF Executive Board has to be consulted at an early stage, and a systematic *ex post* evaluation of programmes supported by exceptional access is expected. The criteria are the presence of exceptional pressures on the financial account of the balance of payments that cannot be met within normal limits, a high probability that debt will remain sustainable, good prospects that the country will regain market

access, and a strong likelihood of the adjustment programme being successful. The exceptional access policy was further strengthened in June 2003, when the IMF agreed on mandatory publication of the reports prepared for decisions on exceptional access from July 2004 onwards, a measure intended to exert a disciplining effect on its decision-making process.

The inclusion of a criterion on debt sustainability could be seen as an element of a lender of last resort function for the IMF, since it means that more substantial amounts may be granted to a country facing a pure liquidity crisis. However, even with this provision, the IMF's role cannot be regarded as that of a lender of last resort as the amounts of official assistance are not open-ended, even in exceptional access cases. The amount of financing is always required to be justified in relation to certain indicators, for instance GDP and the financing gap.

Private sector involvement

Private sector involvement (PSI) is defined in this article in a broad sense and encompasses not only situations where debt is restructured (implying a reduction in net present value, or "haircut") but also where private creditors renew existing or extend new credit without a reduction in net present value. Seen from that broad perspective, PSI constitutes a key element in all crisis cases, for two main reasons. First, it is needed because private financing accounts for the bulk of the external financing of emerging market economies. The other two components of crisis management, domestic adjustment and official financing, are insufficient to cope with the large financing needs that arise in capital account crises. This is because domestic adjustment tends to produce effects mostly over the medium term and may therefore not always deliver immediate results, and because official financing is capped by resource constraints. Second, the participation of private creditors is important in view of moral hazard considerations. As discussed in relation to

official financing, markets can only exert their disciplining function when creditors are encouraged to internalise the risks related to their investment choices. This can only happen if, in the event that these risks materialise, investors are forced to bear at least part of the associated costs.

However, involving the private sector is made difficult by the general challenges discussed in Section 2, such as the speed of unfolding market developments and, more importantly, coordination and information problems. Coordination problems arise when the optimising behaviour of each individual creditor leads to a sub-optimal solution. For example, in the case of a proposed restructuring, each creditor may have an interest in declining the offer and seeking full repayment, in the hope that other creditors will participate in the restructuring and bear the burden (free-rider behaviour). If all creditors pursue the same free-rider strategy, the end result may be disorderly and inferior to a coordinated solution. Information problems relate to the aforementioned difficulties in assessing the actual payment capacity of sovereign debtors, as well as their strategies in the process of debt restructuring. As a result, the negotiation process is surrounded by a considerable degree of uncertainty, which may make private creditors reluctant to accept their involvement in the resolution of a crisis.

To overcome the coordination and information problems, three broad groups of instruments have been proposed. One proposal, which gained attention in the aftermath of the Mexican crisis and was promoted in a report by the Group of Ten countries entitled "The resolution of sovereign liquidity crises" (May 1996), is to modify the contractual framework by including collective action clauses (CACs) in debt contracts (the contractual approach). More recently, the IMF explored the idea of establishing a framework in international law by creating a Sovereign Debt Resolution Mechanism (SDRM) (the statutory approach). And at present work is under way on a third

proposal, the development of a Code of Conduct (the Code-based approach). These three solutions, which are described in greater detail in the following paragraphs, are distinguished by the problems they set out to address and their contractual, statutory or voluntary nature. The contractual approach is mostly targeted at solving the creditor coordination problem. The statutory approach would address the problems of both creditor coordination and information collection and would be encapsulated in a legally binding framework. Finally, the Code-based approach would address both the coordination and information collection problems, but it would be of a non-binding nature.

The contractual approach is based on CACs, i.e. provisions in debt contracts that facilitate coordination among creditors. Notably, they lower the threshold for the approval of a debt restructuring from unanimity to a qualified majority, for example 75% of the amount of outstanding debt (majority restructuring provisions) and thus help to avoid situations where a minority of creditors blocks a restructuring agreement. They also limit the ability of a minority of creditors to initiate legal proceedings against the debtor that could disrupt the restructuring negotiations (majority enforcement provisions). Such clauses are legally possible under nearly all jurisdictions, but until recently had not been used in some key jurisdictions – mainly New York – due to prevailing market practices. It is estimated that, at present, only around one-third of the existing stock of international sovereign bonds includes CACs. Recently, however, significant progress has been made towards a more widespread inclusion of CACs: they have been incorporated in most of the new sovereign bond issues under New York law since March 2003. So far, their inclusion has not had a perceptible impact on borrowing costs, contrary to borrowers' fears that CACs might be perceived by creditors as facilitating undue recourse to debt renegotiations and therefore leading to an increase in risk premia. Progress towards a

broader inclusion of CACs has been helped by intensive work on model clauses in official and private sector fora, including the Working Group on Contractual Clauses of the Group of Ten, in which the ECB also participated. Furthermore, in an effort to lead by example, the EU Member States committed themselves in April 2003 to including CACs in their future bond issues under foreign jurisdictions.

All in all, this suggests that progress towards the broader inclusion of CACs is satisfactory. Nevertheless, the contractual approach alone may not offer a full answer to the challenges related to PSI. A first concern is that it may take many years before CACs are included in the entire stock of sovereign debt. Furthermore, CACs usually apply to one specific debt issue and thus do not provide for aggregation among holders of different issues. Nevertheless, there has been progress in achieving some degree of aggregation under a contractual approach. In particular, bonds recently issued by Uruguay include CACs that provide for a limited form of aggregation. However, including contractual provisions that provide for aggregation is not entirely straightforward and their design is still at a rather experimental stage. Finally, while the contractual approach helps to address problems of coordination among debtors, it may not offer an answer to other challenges raised in the context of crisis resolution, such as the need for a symmetrical information exchange between debtors and creditors. All in all, this suggests that further work and innovative solutions may be required to improve some aspects of this approach.

As an alternative solution, the IMF worked between 2001 and early 2003 on a statutory approach based on a legally binding procedure in the form of an SDRM. This approach was based on the idea that some elements of bankruptcy mechanisms applicable in the domestic context to private or public sector entities could be used in a sovereign context. Under the proposal, the SDRM would have been limited to cases where the debt situation of a country had become unsustainable. It

would have put all relevant debt of a sovereign borrower into a limited number of creditor classes and would have allowed a qualified majority of creditors in each class to agree on a restructuring plan. In addition, it would have been equipped with a dispute resolution forum, empowered to perform administrative functions (e.g. notifications to creditors, registration of claims, administration of the voting process) and to take certain judicial decisions to solve debtor-creditor and inter-creditor disputes.

The statutory approach would provide a strong framework for addressing information and coordination problems. Unlike CACs, it would provide for aggregation across debt contracts of different creditor classes. Moreover, it would be applicable, from the first day of its implementation, to all outstanding debt. It would also be legally binding, as it would be embedded in an international legislative framework, for example via an amendment to the IMF's Articles of Agreement.

However, at the IMF Spring Meetings in April 2003, it became clear that there was not sufficient political support for the creation of an SDRM. Emerging market borrowers were not willing to endorse it because of opposition from private sector creditors and concerns about a possible increase in borrowing costs. Some of the advanced economies were similarly sceptical. Accordingly, the development of the SDRM was put aside for the time being, but it was agreed to continue to study some of its features, which could be of general relevance to the orderly resolution of crises. Looking ahead, it will therefore be important to assess the extent to which these features – such as the enhancement of transparency and disclosure, aggregation across debt issues and the creation of a dispute resolution forum – could be replicated outside an international legal framework.

As a third solution, work is under way on a Code of Conduct, which would set out best practices and guidelines for the borrower,

the lenders and the international official community. Although these best practices would be non-binding, they could improve the process of crisis resolution. At present, a group of private sector representatives and officials from emerging market economies and creditor countries are involved in preparing the ground for such a code to be drafted. The Code would be based on a number of principles for sovereign crisis resolution, such as early consultation between creditors and debtors, early information-sharing and transparency, and fair treatment. Moreover, it would refer to a number of instruments to help implement these principles. The instruments could, for example, include information-sharing mechanisms, CACs and mechanisms to organise the negotiations between a debtor and its creditors. Finally, the implementation of the Code of Conduct

could be ensured through specific monitoring and review procedures.

The Code could help to improve crisis resolution as its policy principles would guide the actions of debtors and creditors and thereby help to address both coordination and information problems. It would also contribute to better crisis prevention, as it would encourage and facilitate ongoing dialogue between the relevant parties and thereby promote sound behaviour and early corrective action. At this stage it remains open whether the Code would include sufficiently strong instruments and incentives to be effective, given its voluntary character. Some observers have argued that such an approach could only be fully effective if it operates “in the shadow of the law”, i.e. if a fully-fledged institutional framework is in place as a fall-back solution.

4 Conclusion

This article has reviewed the recent experience with capital account crises in emerging market economies. These crises have proved very difficult to manage, as evidenced by the mixed results in terms of the economic costs and the speed with which confidence and stability have been restored in crisis-hit countries.

The international official community has already drawn lessons from the recent experience and has agreed on a number of measures to maximise the effectiveness of each of the three main elements of crisis resolution, i.e. domestic adjustment, official financing and private sector involvement. In addition to macroeconomic imbalances, vulnerabilities in a country's corporate and financial balance sheets are now recognised to be among the primary sources of instability, with the potential to lead to full-blown crisis. With respect to official financing, the IMF has launched a number of new initiatives, including the adoption, in March 2003, of a new framework to guide decisions on exceptional access to IMF funds during capital account crises, which should

contribute to enhancing accountability and transparency. Finally, in the area of private sector involvement, a number of new proposals have been put forward to address the coordination and information problems that may lead to disruptive market developments. However, no proposal is likely to offer a solution to all the issues that have complicated crisis resolution in the recent past. CACs have the advantage of being comparatively easy to implement, as shown by their widespread inclusion in recent international sovereign bond issues of emerging countries, and of helping to mitigate the problem of intra-creditor coordination. On the other hand, they fail to offer more information to investors and do not facilitate aggregation across different bond issues from the same country. The proposal to create an SDRM has been put on hold for the time being, since a number of interested parties perceived it as being comparatively heavy-handed in dealing with market imperfections. However, some of its elements may merit further consideration, given their potential contribution to solving coordination and information problems in protracted debt

restructuring cases. A third proposal, the preparation of a Code of Conduct, could also help to address both coordination and information problems, but its precise design remains open and its operation on the basis of voluntary best practices is still to be tested.

However, these proposals and their implementation may not exhaust the full range of solutions to be considered in the years to come. Although progress has recently been made in crisis resolution, further efforts are likely to be required on the part of the international community, given the remaining policy challenges.