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20-13 Sovereign Debt Restructuring: The Centrality of the IMF's Role

Sean Hagan

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ABSTRACT

Over the past 40 years, the International Monetary Fund (IMF) has played a central role in the sovereign debt restructuring process. Accordingly, in the event that the COVID-19 pandemic leads to a significant wave of sovereign debt distress, this role will come under close scrutiny. This paper analyzes how IMF policies have evolved to shape the incentives of sovereigns and their creditors at each stage of the sovereign debt restructuring process. It also identifies a number of issues that will be of particular relevance in the current circumstances, including (1) the assessment of sustainability in a macroeconomic environment of considerable uncertainty, (2) the treatment of official bilateral creditors, and (3) the potential benefit—and challenges—of introducing additional incentives designed to maximize creditor participation in any debt restructuring operation.

Sean Hagan is a senior nonresident fellow at the Peterson Institute for International Economics, visiting professor at Georgetown University Law Center, and former general counsel of the International Monetary Fund.

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Debt, debt distress, and debt restructuring are facts of life for individuals, companies, financial institutions, and, on occasion, sovereign states. What makes sovereign debt unique is that it is the only type of debt for which the restructuring process is not guided by some form of legislative framework. Rather, a review of experience over the past 40 years reveals that the process is often shaped by the International Monetary Fund (IMF).

As with the restructuring of corporate debt, it is possible to stylize the sovereign debt restructuring process as comprising three stages:

- *Initiation stage*, when the key issue is the selection—and application—of the criterion to be used to determine whether and when a debt restructuring is needed.
- *Negotiation stage*, when the sovereign and its creditors discuss the detailed terms of the debt relief that is needed.
- *Closing stage*. when the sovereign seeks to ensure maximum creditor participation in the negotiated agreement.

The IMF has an impact at each of these stages. A key determinant as to whether and when a debt restructuring is initiated is the IMF's assessment of debt sustainability. And, precisely because a debt restructuring entails costs, the IMF often finds itself under pressure to be as optimistic as possible about the country's debt dynamics (IMF 2013a). During the negotiation stage, IMF policies—including both the design of the country's adjustment program and the Fund's "lending into arrears" policy—play a critical role in defining the leverage of the debtor and creditors during discussions about the extent of debt relief that is needed. Finally, with respect to the closing stage, the IMF attempted to introduce reforms almost 20 years ago to address free rider problems through an amendment to its charter. In the absence of adequate support for this proposal, the IMF has become a strong advocate for the inclusion of contractual provisions that address these issues.

In the event that, as a result of the COVID-19 pandemic, the international community is faced with a significant wave of debt distress, the IMF's role in the sovereign debt restructuring process will come under considerable stress. Accordingly, in addition to providing a general analysis of the evolution of the IMF's policies in this area, this paper identifies a number of issues that the IMF will likely need to address in the current environment. These include application of the debt sustainability criterion in an environment of considerable uncertainty, the treatment of official bilateral creditors, and the potential role of more robust measures to maximize creditor participation in debt restructurings.

1. INITIATION STAGE: CRITERION OF SUSTAINABILITY

While each stage of a debt restructuring has its complexities, there is little doubt that, in the sovereign context, the initiation stage has proven to be the most problematic. And, because of its role as the lender of last resort, it is often the IMF that has to deal with this problem.

When a country begins to lose market access and, as a result, loses the ability to refinance its debt obligations, it will often approach the IMF for the financing it needs to avoid a default. Presented with this request, the IMF effectively has two options: (1) it can provide financing (sometimes in very large amounts) in support of an economic adjustment program that catalyzes a return to market access, enabling the country to continue to service its debt obligations (these are often referred to as "catalytic" programs or, more unkindly, "bailouts"); or (2) it can approve a program on the condition that the sovereign approach its creditors to secure a restructuring of its debt.

Approximately 20 years ago, there was a vigorous debate as to what criterion should guide the IMF in making this choice. There were those who emphasized the importance of relying on quantitative metrics: the IMF should normally provide financing only up to a certain amount (perhaps measured as a percentage of its quota in the IMF). Under this approach, if a country needed more financing to meet its financial needs, there would be a presumption that it should approach its creditors for debt relief.[1] This was motivated by a concern that the increasingly large financial packages approved during the 1990s were generating moral hazard: what were generally referred to as bailouts were perpetuating reckless lending and future crises.

In the end, however, a quantitative metric was not relied upon as the primary criterion. Rather, the IMF adopted the approach that, because debt restructurings involved significant costs, they should be avoided if possible—even if that meant providing a large amount of IMF financial support. The costs of a debt restructuring that were—and continue to be—a source of concern include the following:

- For sovereign debtors, the costs are potentially numerous. Apart from the reputational damage and, by extension, the country's ability to reaccess markets in the medium term, a restructuring may have immediate economic and financial costs. This is particularly the case, for example, in a country where the domestic banking system holds a significant amount of the debt to be restructured. In these circumstances, a debt restructuring may cause widespread insolvency in the banking system, resulting in both a contraction of credit and large fiscal costs arising from the subsequent recapitalization.
- There is also the cost of contagion, which can take a number of forms. When banks in other countries hold the debt of the sovereign in question, bank insolvencies will not stop at the border. And, of course, there is the psychological dimension of contagion—a restructuring announced by one country can trigger indiscriminate creditor withdrawal from a group of countries, prompting a more generalized crisis.[2]
- Finally, for creditors the costs are obvious: faced with a choice between getting repaid in full or only in part, a creditor will clearly opt for the former.

Nevertheless, there are circumstances where the costs of a restructuring are outweighed by the cost of *not* restructuring. For the IMF, this situation arises when debt is judged to be unsustainable. Much has been written on the concept of debt sustainability and an exhaustive discussion of the concept is

1 See, for example, Haldane and Kruger (2001).

2 For a discussion of the IMF's perspective on the various forms of contagion, see IMF (2015b).

beyond the scope of this paper.[3] However, it should be emphasized that, while unsustainability is often equated with insolvency, the comparison is imperfect: a company is judged to be insolvent—rather than simply illiquid—when the value of its liabilities exceeds the value of its assets. For a sovereign state, the value of its assets is—at least theoretically—inexhaustible, given the government's taxing power. However, there does come a point when a country's debt-to-GDP ratio is so high that the exercise of that taxing authority becomes counterproductive (since it undermines growth) and there are no feasible economic policies that will prevent debt levels from continuing to rise without some form of debt relief. Judgments regarding sustainability are always probabilistic (for example, perhaps a valuable natural resource will be found) and the determination is further complicated by the fact that the assessment needs to take into account the political—not just the economic—capacity of the country to undertake adjustment programs.

As complicated as the concept is to apply, it is understandable that, given its mandate, the IMF uses sustainability as the key criterion to determine when it will make its financing conditional on a debt restructuring. Under the Articles of Agreement, the IMF is required to lend only if it has determined that its resources will be used to support policies that will resolve the country's balance of payments problems.[4] If debt is unsustainable, IMF financing without a debt restructuring makes matters worse for the country, not better, since—and this is the crucial point—it enables the country to delay a debt restructuring that is effectively inevitable. And delaying the inevitable creates its own set of costs. A government may increase its borrowing from its banks—which will exacerbate the recapitalization needs when the day of reckoning comes. Or it may engage in desperate adjustment measures that further undermine growth. And finally, IMF financing that facilitates the delay will make it even more difficult for the sovereign to secure debt relief from its creditors: as debt owed to the IMF replaces debt owed to commercial creditors (who are paid in full under the program), the preferred creditor status of the IMF effectively means that more relief will have to be extracted from fewer creditors when the restructuring eventually arrives.

Indeed, for this last reason, when debt becomes unsustainable, the perspective of creditors also begins—or should begin—to shift. For creditors whose claims are about to fall due, a delay that is facilitated by IMF financing will enable them to exit unscathed. But for creditors with longer maturity terms, the IMF's preferred creditor status means that further delays will make the inevitable restructuring of their claims more painful.

A central problem has been that, as logical as it is to use debt sustainability as the key criterion, the IMF has often struggled to apply it. The problem is not just because judgments regarding sustainability are, well, judgments. It is also because the IMF often comes under enormous pressure from its members (who are represented at the Executive Board, the decision-making body) to make optimistic—indeed sometimes heroic—assumptions to support a conclusion that debt is sustainable, even when probabilities clearly point in the other direction.

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3 The underpinnings of the IMF's analytical framework with respect to debt sustainability can be found in IMF (2011). Another concise treatment is in Debrun et al. (2019).

4 IMF Articles of Agreement, Article V, Section 3(a), online at www.imf.org/external/pubs/ft/aa/pdf/aa.pdf.

First and foremost is the pressure from the government of the country requesting assistance. Even when it is necessary, government officials are often reluctant to initiate the process out of fear of immediate economic and political repercussions, preferring to “gamble for resurrection,” often through reliance on desperate measures to generate the necessary foreign exchange to meet the next debt payment. And given the importance of ensuring adequate country ownership of any program that it supports, the IMF is under tremendous pressure to go along.

Perhaps the most dramatic example is the IMF decision to provide financing without a restructuring to Argentina in the fall of 2001, even though, as pointed out in a report of the IMF’s Independent Evaluation Office (IEO) in 2004, senior IMF staff gave the program only a 20–30 percent chance of success (IMF 2004). Several months after the financing decision was made, Argentina defaulted and there is little doubt that the measures taken during the period of delay made the restructuring process more difficult. Moreover, and somewhat ironically, the IMF concern about ownership—which led to the decision to finance—was followed by a political backlash against the IMF when a new government took over after the default.[5]

Pressure can also come from other countries, particularly where there is a fear of contagion. This was certainly the primary reason why the IMF did not require a debt restructuring as a condition for its assistance to Greece in 2010. Although there were concerns in the IMF about the sustainability of Greece’s debt at the time, other euro area countries were concerned that a restructuring decision would not only damage the soundness of European banks that held Greek debt but also trigger outflows from other euro area countries that were perceived to have debt vulnerabilities. By the time the debt restructuring occurred in 2011, a significant amount of the private claims had been replaced by IMF credit, which further complicated the debt restructuring process.[6] Perhaps most importantly, IMF staff concluded, ex post, that the delay had not really mitigated contagion because of the uncertainty that persisted in the market about the sustainability of Greece’s debt (IMF 2015b, paragraph 37).

In the face of these difficulties, the IMF has sought to develop analytical tools to make the determination of debt sustainability as predictable and as transparent as possible. Most notable among these tools is the Debt Sustainability Analysis for Market-Access Countries, used to assess countries’ debt vulnerabilities in the context of the annual Article IV Consultation reports (IMF 2013b). However, it is important to be realistic about how robust these tools can be in the face of the pressures on the IMF because of fears concerning the immediate costs of restructuring. Accordingly, as a separate means of reducing the pressure to delay a debt restructuring, the IMF has sought to make the debt restructuring process, once initiated, more predictable. As Stanley Fischer (2002) noted, the IMF will be more hesitant to initiate the process if there is uncertainty about how it will unfold. The following sections focus on the policies that the IMF has put in place to reduce this uncertainty.

5 For a comprehensive analysis of this episode, including the desperate measures taken by the authorities to avoid a restructuring, see Mussa (2002).

6 The IEO also completed a very critical evaluation of this decision (IMF 2016).

2. NEGOTIATION STAGE: DEFINING THE LEVERAGE

It is one thing to determine that a debt restructuring is needed; it is another to put in place a framework that ensures that a debt restructuring agreement is actually reached. Here again, the Fund plays a central role in supporting the negotiating process in at least two respects. First, the design of the IMF-supported adjustment program effectively determines the overall amount of debt relief that the debtor will need to secure from its creditors. Second, the IMF's policy on "lending into arrears" makes clear to creditors that the Fund is prepared to continue to provide financial support to the debtor even if creditors do not reach agreement on terms consistent with the program and the sovereign therefore decides to default and arrears emerge. Both of these elements, discussed below, define the leverage of the actors in the negotiations, a critical ingredient to successful agreement.

Determining the Balance of Financing and Adjustment

A natural corollary of the determination that debt is unsustainable is the assessment of how much debt relief is needed to make it sustainable. Since the IMF's mandate is to assist a member in resolving its balance of payments problem, this assessment is critical as overindebtedness is typically a large part of the member's problem.

Over the past 40 years, private creditors have generally relied on the IMF's assessment of the limits of economic adjustments and, by extension, the residual amount of financing to be borne by creditors in the form of debt relief. Although creditors have sought to have greater input into the IMF's debt sustainability assessment, the IMF has resisted, recognizing that the determination of the appropriate balance between financing and adjustment is a public good that cannot be delegated.

To be clear, there is a mantra in the IMF that it should not micromanage the negotiation process, and it is true that IMF staff avoid giving views on the terms of individual instruments. But the size of the overall "restructuring envelope," determined by the design of the program, plays a dominant role in the negotiations. That is why, during the negotiation process, IMF staff are often asked by the country to participate in meetings with creditors to explain the economic and financial assumptions that underpin the program that the Fund is supporting.

Lending into Arrears Policy: A Critical Backstop

When the IMF supports a program that is designed to restore sustainability through debt relief, current policy does not require that the relief be provided prior to the approval of the financing arrangement that supports the program. While this allows flexibility, it also creates risk: what happens if negotiations with creditors on the needed debt relief break down? Continuing to make payments on the original—unrestructured—obligations would be inconsistent with the program's financing parameters and would not restore sustainability. In these circumstances, the parameters could be respected by the member country only if it defaulted and went into arrears to these creditors, which creates its own risks to the member's ability to regain access to the capital markets. During most of the 1980s debt crisis, the IMF was unwilling to take these risks. Accordingly, approval of arrangements was conditional on the debtor securing agreement with a critical mass of commercial banks for the necessary debt relief.

Over time, however, commercial banks began to drag their feet, resulting in considerable delays in the approval of arrangements. In light of these delays, the IMF decided in 1989 to adopt the "lending into arrears" (LIA) policy, which has had a profound effect on the sovereign debt restructuring process (IMF 1989a, 1989b, 1989c).The IMF is now prepared to support a program where upfront debt relief has not yet been secured. In the event that negotiations break down because creditors refuse to provide the debt relief assumed under the program, the IMF is prepared to continue to provide financial support, even if the country defaults on its debt. In the event of a default, the arrears effectively provide the necessary financing to ensure that the parameters of the program are adhered to (IMF 1989a, 1989b, 1989c).

It is important to underscore that the IMF never encourages a member to default. On the contrary, the IMF policy is to encourage the member to reach a collaborative agreement on a restructuring that avoids default. However, if creditors are unwilling to provide the necessary relief (i.e., relief that is consistent with the parameters of the program), the IMF is prepared to continue its financial support if the sovereign decides that, because of its desire to restore sustainability through the program, it is prepared to default (i.e., incur arrears). And this has an important impact on creditor incentives. At the time of the approval of the program, private creditors, being aware of this policy, understand that if they hold out for restructuring terms that are inconsistent with the program, they risk a default, which will undermine the value of their claims. Accordingly, the LIA policy provides a critical backstop to the negotiations even in circumstances where arrears have not yet emerged. It effectively gives the debtor greater leverage in the debt restructuring process.

Treatment of Arrears to Official Bilateral Creditors

An issue that may be of particular relevance in the context of the COVID-19 pandemic is the treatment of official bilateral creditors. When the LIA policy was proposed in 1989, the staff wanted it to apply to both private and official creditors. However, the IMF's Executive Board limited its application to private creditors, with the result that Fund-supported programs that anticipated restructurings of official bilateral claims could proceed only with the upfront consent of these creditors (IMF 2015a). For many years, this asymmetry in the treatment of official and private creditors did not actually have an adverse impact on the ability of the IMF to move rapidly when debt was judged to be unsustainable. This is because the restructuring of official bilateral claims took place under the auspices of the Paris Club, which generally made commitments of debt relief at the outset of the program. Over time, however, the number of official bilateral creditors that are not part of the Paris Club has grown in importance and seeking their consent in advance of the approval of an arrangement has become increasingly problematic (IMF 2015a).

It was for this reason that, in 2015, the IMF took the step of reducing the leverage of individual official bilateral creditors by adopting a policy that enables it to lend into arrears to official bilateral creditors (the LIOA policy). Given that this policy is relatively recent, it is not yet clear how it will be applied if a significant number of countries engage in the restructuring process because of the pandemic and there is substantial exposure to official bilateral creditors (including China). Critically, the LIOA policy does not result in official bilateral creditors being treated exactly like private creditors: official bilateral creditors enjoy greater leverage (although not the degree that they enjoyed prior to the introduction of the policy). The rationale for this asymmetry is that, unlike private creditors, official bilateral creditors provide critical financing for Fund-supported programs in the context of a crisis; when the new policy was being considered, there was a concern that any decision to lend into the arrears of official bilateral creditors could undermine their willingness to provide such financing in the future (IMF 2015a).

Accordingly, under the new policy, while the Fund may, as a general matter, lend into official arrears when they arise from the unwillingness of an official creditor to provide relief consistent with the program assumptions, it may not do so in a particular case if a judgment is made that doing so "would have an undue negative effect on the Fund's ability to mobilize official financing packages in future cases" (IMF 2015a). The policy identifies two factors to provide guidance for applying this rather general exception: size and track record. With respect to size, the IMF would "normally" not be able to lend into arrears when the creditor accounts for a majority of the total financing contributions needed from official creditors during the period of the program. Second, the IMF would "take into consideration" the creditor's track record of providing contributions in past debt restructurings under Fund-supported programs—a good track record would make the IMF less willing to lend into the arrears of that creditor (IMF 2015a).

While these are important limitations, the above-quoted language of the policy nevertheless reduces the leverage of individual official creditors. Specifically, although the IMF is required to "take into account" the past track record of a creditor and is "normally" precluded from lending into the arrears of a "majority," this language is designed to give the Fund a degree of flexibility. Going forward, a critical issue will be the extent to which this flexibility is used. In this respect, two points are worth emphasizing. First, as was recognized when the LIA policy was introduced in 1989, the IMF has to engage in a risk-balancing process. If the official creditor is very large, the risk of undermining the future availability of credit—a legitimate concern—has to be balanced against other risks, including the Fund's inability to provide support or—just as problematic—the Fund being excessively optimistic about the member's debt situation and lending without any restructuring. Second, as with the original LIA policy, the new policy can be applied as a backstop. If the program contemplates debt relief, the Fund can continue to assume that the preferred approach will play out and the relief will be secured through a collaborative agreement; arrears would arise—and be tolerated—only if the agreement were not secured.

3. DEALING WITH UNCERTAINTY

As noted earlier, making judgments regarding sustainability is always difficult given the specific circumstances of the country, including its economic and political capacity to deliver the needed adjustment. Because of the pandemic, the challenges surrounding the determination of sustainability are further complicated by uncertainties in the current external environment. As highlighted in a PIIE Briefing chapter I coauthored with Anna Gelpern and Adnan Mazarei, this uncertainty arises from a number of factors, including (1) the path of the pandemic, both within the territory of the member and beyond; (2) the depth and length of the slump in global economic growth shocks; (3) the projected path of inflation, interest rates, and commodity prices (especially for oil); and (4) the future behavior of global financial markets (Gelpern, Hagan, and Mazarei 2020).

Because of this uncertainty, there may be a significant group of countries whose debt is neither clearly sustainable nor clearly unsustainable, a situation that would place the IMF in a difficult situation (Gelpern, Hagan, and Mazarei 2020). On the one hand, making IMF approval of a program conditional on a debt restructuring that is sufficiently deep to restore sustainability unequivocally can (for the reasons discussed above) generate considerable costs for the member, its creditors, and—through contagion—other countries, costs that may be unnecessary if the overall environment improves quickly. On the other hand, treating the pandemic as a temporary problem poses its own set of risks: if private creditors' claims are simply paid in full and the external and domestic environment continues to deteriorate to the point that a country's debt clearly becomes unsustainable, the available pool of private debt that can absorb a debt restructuring will have become smaller, while the magnitude of the country's (senior) debt to the IMF will have grown larger.

To address this dilemma, Gelpern, Mazarei, and I suggested, for this category of "uncertain" countries, that the IMF make its resources conditional on a *standstill*, a debt restructuring that would give the country breathing space for perhaps one to two years, but would not involve a significant net present value reduction in creditor claims. If the problem does indeed turn out to be temporary, an unnecessarily costly debt restructuring would have been avoided. However, if problems persist to the point that the debt is clearly unsustainable, the standstill would ensure that there would continue to be claims of private creditors to absorb the needed debt relief. We noted that such an approach would be consistent with the reforms introduced in the Fund's exceptional access framework in 2015: these reforms effectively preclude an exit by private creditors in circumstances where a member's debt was considered sustainable, but not with high probability (IMF 2015b).

In some respects, our proposal is also consistent with the Debt Service and Suspension Initiative (DSSI) that was launched by the G20 on April 15, 2020.[7] However, it differs in two important respects. First, in terms of the category of countries that are eligible for such a suspension, while the G20 initiative would be limited to low-income countries, our proposal would be applicable to all countries that fall in the "uncertain" category described above. Second, under the G20 initiative, the standstill would be optional for both the sovereign and its private creditors: it would be activated only for countries that "request" forbearance from their creditors. With respect to private creditors, while the G20 "called upon" private creditors to participate, their participation was never made

7 Communiqué: G20 Ministers of Finance and Central Bank Governors, April 15, 2020, online at https://g20.org/en/media/Documents/G20_FMCBG_Communiqu%C3%A9_EN%20(2).pdf.

a condition for its implementation. Under our proposal, the implementation of the standstill would be made a condition for the use of IMF resources, at least for countries in the "uncertain" category.

For all the reasons that have been discussed in the earlier sections of this Working Paper, this latter difference—not making the standstill a condition for the use of IMF resources (i.e., allowing it to be entirely optional)—has an enormous impact on the overall incentive structure and the prospects of a standstill being implemented. If a country requesting IMF resources simply has the option of either asking its private creditors for a standstill or using IMF resources to repay its creditors, it may very well choose the latter: if it chooses a standstill, it will get only limited debt relief but may suffer in terms of its creditworthiness. Indeed, concerns about creditworthiness and credit ratings are one of the reasons why a number of low-income countries appear to have decided not to request the DSSI.[8] Similarly, for private creditors, if there is a choice between being paid on the original terms or agreeing to a deferral under the DSSI, it is difficult to understand why they would choose the latter.

If, however, implementation of the debt standstill is made a condition for the use of IMF resources, the incentives change and improve the chances of implementation. For a sovereign, it will now be a choice between agreeing to approach its private creditors for a standstill or being unable to obtain IMF resources to continue to service its debt obligations, resulting in a possible default. For private creditors, the choices also change: if they fail to agree to a standstill, they know that the program approved by the IMF will not provide for payments to be made to them during the standstill period, which will result in a default and application of the IMF's LIA policy. While implementation of the standstill in these circumstances may still adversely affect the country's credit rating, the stigma may not be as great: because it is a condition for the availability of IMF resources, the country will not suffer the stigma of being seen as "choosing" to avail itself of the standstill.

4. CLOSING STAGE: MAXIMIZING CREDITOR PARTICIPATION

Once a proposal has been arrived at that is likely to garner a critical mass of creditor support, the country's goal is to obtain participation from all affected creditors. If a significant number of creditors hold out, not only will this limit the debt relief that is obtained, it will also make it more difficult for other creditors—who would otherwise be willing to participate—to agree to the terms of the restructuring agreement. While this free rider or "collective action" problem has always existed, its dimensions have grown over the past 30 years because of the changing composition of the creditor community and, in particular, the shift from bank credit to sovereign bonds, the holders of which not only are numerous but also have diverse interests. The collective action problem has also been exacerbated by the fact that the holdout strategy has become more viable given legal developments that limit the protections that have typically been available to sovereigns (Hagan 2005).

8 *The Economist*, African Governments Face a Wall of Debt Repayments, June 6, 2020; online at www.economist.com/middle-east-and-africa/2020/06/06/african-governments-face-a-wall-of-debt-repayments.

Faced with these challenges, the IMF proposed, almost 20 years ago, an amendment to its Articles of Agreement that would enable a qualified majority of creditors to make an agreement binding on all creditors, a type of "cramdown" mechanism that is found in corporate insolvency laws: the Sovereign Debt Restructuring Mechanism (SDRM) (Hagan 2005). For a variety of reasons (including concerns relating to surrender of national sovereignty), there was insufficient support among the IMF membership to implement the proposal. Instead, the international community, including the IMF, promoted the inclusion of collective action clauses in sovereign bond contracts, which are now ubiquitous. Over the years, these clauses have been improved, most notably in 2014 when a feature was added that enables "aggregated" voting across different bond series, making it more difficult for holdout creditors to obtain a controlling position in a single bond series.[9] These bonds are clearly not a panacea, however. Those that have the most robust aggregation features are in only about 50 percent of the outstanding stock. Moreover, some of these aggregation features may not be available as a means of implementing a standstill by virtue of the fact that there is not a wholesale transformation of the maturity structure of the debt (Gelpern, Hagan, and Mazarei 2020). Finally, a significant amount of debt owed by low-income countries does not take the form of bonds and therefore does not include these provisions (Gelpern, Hagan, and Mazarei 2020).

For all of the above reasons, if there is a significant wave of sovereign debt restructurings, consideration may need to be given to a temporary legal enhancement of a legislative nature that will limit the leverage of holdout creditors. While the SDRM could address this problem, it is unlikely to garner adequate support and, in any event, would take too long to put in place. An alternative, and more practical, solution would be to focus on a modification of the laws that govern almost all international sovereign debt instruments: those of England and the State of New York. There is some useful precedent that can provide guidance.

The UK Parliament, in 2010, enacted a law that prevents creditors from suing sovereigns that participate in the IMF and World Bank's Heavily Indebted Poor Countries program (approximately 40 countries).[10] The United Kingdom could pass a similar law that extends the same protection to sovereigns that secured debt relief in the context of an IMF-supported program during a defined period. With respect to New York law, while legislation might be difficult (at either the state or federal level), Lee Buchheit and Mitu Gulati (2018) have pointed out that the same outcome may be achieved through an Executive Order, a device that was used to address potential litigation in the context of the restructuring of Iraq's debt in 2002.[11]

9 ICMA, Collective Action Clauses (2014), online at https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/primary-market-topics/collective-action-clauses/.

10 UK Debt Relief (Developing Country) Act (2010), online at https://services.parliament.uk/bills/2009-10/debtreliefdevelopingcountries.html.

11 Although this Executive Order was originally issued in the context of a United Nations Security Council Resolution that required countries to take action pursuant to Chapter VII of the UN Charter, Buchheit and Gulati (2018) point out that, in the case of Iraq, the Executive Order was extended even after the Chapter VII Resolution had lapsed.

In addition to the above "sticks," consideration can also be given to maximizing creditor participation through the provision of "carrots" (i.e., credit enhancements) in the context of the debt operation. At the end of the 1980s debt crisis, both the IMF and the World Bank played an active role in this area. Specifically, a portion of the financing provided by these institutions to an overindebted country was earmarked for the country's purchase of US Treasuries that were used to collateralize the new debt that it issued in the context of the debt restructuring. In the current context, the objective would again be to maximize participation by providing enhancements that, on the margin, would increase participation while not significantly undermining the debt relief provided. Clearly, the design of any enhancements would take into account developments in the capital markets since that time. Notwithstanding these developments, there will likely be different classes of creditors with different risk appetites—with some being willing to accept a new instrument that has a lower return but also, because of the enhancement, a lower risk (IMF 1989b, 1989c).

5. CONCLUSION

Over the past 40 years the IMF has become a central player in the international financial crisis resolution process. This is often a fraught task, largely because of the scale of the economic, financial, and political fallout of these crises. To avoid addressing them in a purely ad hoc manner, the IMF has adopted a number of policies designed to make its decision-making process more predictable. These policies, shaped by hard lessons learned over the years, now play a critical role in defining the incentives of both the sovereign debtor and its creditors.

Looking forward, in the event that there is a significant wave of debt distress, the design and application of these policies will come under scrutiny and further improvements may be necessary. Particularly sensitive areas include the assessment of sustainability, including in an environment of acute uncertainty, and the application of the recently established policy on arrears to official bilateral creditors. Whether the IMF can resolve these crises in a manner that minimizes the costs for all stakeholders will depend, to a large degree, on the ability of member countries to exercise sufficient self-restraint to allow the IMF to apply these policies in a manner that is fully consistent with the criteria that they have established.

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