



IMF Policy Discussion Paper

The New Approach to Sovereign Debt Restructuring: Setting the Incentives Right

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Office of the Executive Director for Italy, Greece, Portugal, Malta, San Marino, and Albania

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Abstract

The views expressed in this Policy Discussion Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Policy Discussion Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

The paper discusses key incentive-related issues of the sovereign debt restructuring mechanism recently outlined by the IMF First Deputy Managing Director. The structure of incentives in the mechanism should be consistent with the principle of favoring market-oriented, voluntary solutions to financial crises. The paper frames the mechanism in the context of involving the private sector in financial crisis resolution (PSI), and identifies the conditions for setting up an appropriate incentive structure. The paper explores issues relating to the functioning of the mechanism, including access policy on IMF resources; the power to activate the mechanism; its relation with intermediate PSI instruments; and its impact on investment in emerging markets.

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I. INTRODUCTION

A. The Original SDRM Framework

The new approach to sovereign debt restructuring (heretofore referred to as the Sovereign Debt Restructuring Mechanism – SDRM), presented by the First Deputy Managing Director of the International Monetary Fund (Box 1), is a welcome initiative.² The recent experience with sovereign debt crisis management in emerging market countries shows that the incentive structure under which creditors and sovereign borrowers currently operate is inadequate to encourage voluntary, cooperative resolutions of crises (voluntary PSI). This situation contrasts with the priority assigned to PSI by the official sector in the resolution of crises as an instrument to achieve a better sharing of the related financial costs and to reduce creditor moral hazard.

As of late, uncertainty on crisis resolution methods and the anticipation of high litigation costs have made voluntary PSI unattractive and involuntary PSI virtually impracticable.³ As a result, a wide gray area has fallen in between a purely catalytic approach by the IMF and the sovereign default, while the IMF has been put under severe and

² See A. Krueger, *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring*, speech delivered at the National Economists' Club Annual Members' Dinner, American Enterprise Institute, Washington D.C., November 26, 2001.

³ We see the difference between voluntary and involuntary PSI arising from the coercive element of the NPV reduction of assets, not from the existence of a haircut itself. Creditors can accept a haircut (i.e. a reduction in the NPV) in the context of cooperative negotiations with the debtor. PSI becomes involuntary as soon as the debtor imposes a haircut on the basis of its sovereign powers, or of a standstill mechanism sanctioned by a third party. While a haircut of this latter kind usually involves the creditors' declaration of technical default, creditors generally abstain from taking this formal step in the context of a cooperative solution.

conflicting pressures. On the one hand, the IMF has been pushed by the private sector and, often, by the sovereign debtor, to defuse the risk of default by extending exceptional financing far beyond traditional access limits. On the other, the IMF has been pressed by its main shareholders to increase PSI by making it, at the very least, a condition for exceptional financing.

A properly designed SDRM can fill the gray area in two major ways. First, it can provide a framework to enhance the possibility of voluntary PSI, and it may offer an appropriate setup to make involuntary solutions possible when cooperative attempts fail. Second, and no less important, the SDRM can allow for a more orderly debt restructuring, if this is needed, and can limit some of the economic and social disruptions suffered by the sovereign debtor.

The idea of the SDRM reflects the changed nature of the creditor-debtor relationship in recent years. If creditors are few, similar in type, and well organized (as was the case with banks in the Latin American debt crisis of the 1980s, or in Korea in 1997 and Brazil in 1998) and capital markets are relatively closed, a negotiated solution with the sovereign debtor can probably be found without standstill. However, if creditors are many, sparse, and diverse and the debt contracts do not carry collective action clauses, a cooperative solution to a debt crisis is much more difficult to reach. In this context, a standstill arbitrated by the IMF (as proposed by the new approach under the SDRM) would freeze the game, give time to implement an adjustment program with IMF financing, and allow the players to work on debt restructuring.

This paper takes on a number of key incentive-related issues of the SDRM framework. In our opinion, an incentive-based perspective is essential to ensure the

consistency of the SDRM framework with the recognized principle that crisis prevention and resolution should rely, as much as possible, on market-oriented solutions and on voluntary approaches.⁴ In other words, we believe that the SDRM should be intended as an integral part of the overall PSI strategy, and that its incentives should be designed accordingly. We also believe that the *economics* of the SDRM must be set right to avoid that wrong incentives lead to overuse or misuse of the instrument, or even make the instrument useless.

BOX 1. A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING

In a speech delivered last November 26, 2001, at the National Economists' Club in Washington DC, IMF First Deputy Managing Director Anne Krueger indicated the main lines of a possible new approach for countries with unsustainable debts. The new approach (modeled on corporate bankruptcy law) would allow sovereign debtors to seek legal protection from their creditors while they renegotiate with them. A country would come to the IMF and request a temporary standstill on its debt – lasting a few months – while the country negotiates a rescheduling or restructuring. Extensions would require IMF approval. According to Anne Krueger, the approach might require the imposition of temporary exchange controls to stop money from fleeing the country. The primary objective of the new approach would be to create a formal mechanism whereby debtors and creditors would have an incentive to reach agreement on their own accord, so that the mechanism would rarely need to be used. A formal sovereign-debt restructuring mechanism would need to be built on four principles: *i)* creditors should not be allowed to disrupt negotiations by seeking resources in the own national courts; *ii)* debtor countries would need to provide assurances that they were negotiating in good faith and treating all creditors equally; *iii)* private creditors would be encouraged to lend new money by receiving some guarantee that they would be repaid ahead of existing private creditors; and *iv)* once agreement on a restructuring had been reached by a large enough majority of creditors, the rest would be bound to accept the terms. There are important technical issues to be considered, such as: how to provide a legal basis for the mechanism; who should operate it; how the standstill would be formally activated; how to ensure the debtor country behaves appropriately during the negotiations; and to what types of debt the standstill should apply.

⁴ This principle was endorsed by the International Monetary and Financial Committee at its meeting in Prague in September 2000, and was established out of consideration that official financing is limited, that debtors and lenders must bear full responsibility for their decisions to borrow and lend, and that contracts must be honored to the fullest extent possible.

B. A Limited Role for the IMF

The paper starts from a conception of a limited role for the IMF in the SDRM, consistent with our belief that debt sustainability analysis is inherently unreliable as the key instrument for the IMF to decide on SDRM activation. This is for two main reasons. First, even taking into account the extremely high quality of IMF staff work, the evaluation of debt sustainability must necessarily rely on macroeconomic projections and assumptions on policy behavior including structural reform. Such assumptions, in turn, largely depend on future political developments and the policy credibility of the country, variables that are notoriously difficult to predict. Also, the analysis can hardly assess the country's willingness to pay or the attitude of the investors toward the country. Furthermore, information could be asymmetrically distributed between the IMF staff, the authorities, and the market, thereby increasing the possibility of errors or incorrect predictions. It could be replied that this sort of projections and assumptions are routinely used by the IMF staff. This is certainly true, but it is done in the context of programs built in cooperation with the national authorities. By contrast, in the SDRM context the IMF is requested to behave as an impartial and omniscient arbiter of the macroeconomic situation of a sovereign debtor.

Second, and more intrinsically related to PSI, the amount of resources available to repay creditors has been so far endogenous to the resolution of crises, in the sense that official financing, haircuts and fiscal adjustment have been jointly determined to achieve some way of closing the financing gap. Even assuming—as we do—that it is possible to credibly bound official resources (including from the IMF), the country can decide to adjust more or less strongly and consequently generate different amounts of resources to pay creditors in the restructuring process. This has two implications. One is that sustainability

analysis cannot be used as a bullet-proof basis for activation decision (although, of course, it can refine the information set available to the players).

The other is that the distinction between liquidity and solvency crises becomes blurred. Indeed, in some cases in the past, what had been considered liquidity crises (where the IMF could apply the catalytic approach) eventually turned out to be solvency crises, and the inevitability of debt restructuring became apparent to everybody. It could be argued that it is in such situations of high uncertainty that the SDRM as a coordination device can be especially useful to prevent crises from precipitating further; yet it is precisely in such situations that debt sustainability analysis is most unreliable.

Our approach, therefore, departs from Anne Krueger's original proposal on the SDRM in that it envisages a relatively limited role of the IMF both in deciding when and on what basis the mechanism could be activated and in actually activating it (see Section V).

C. Work Plan

With this scheme in mind, and leaving aside the important legal and institutional problems surrounding the construction of a workable SDRM, the paper discusses how the mechanism's cost (payoff) structure should be designed both to avoid a weakening of the market discipline effect associated with costly default and to ensure that creditors and debtors have an adequate incentive to reach voluntary agreements before activating the mechanism. In this respect, the paper discusses the relationship between the SDRM, involuntary PSI, and default, arguing that the SDRM represents a form of "*improved default*". The paper then argues that, in order for the SDRM to be successful, creditors and debtor should face an increasing cost structure in moving across an operational sequence where the SDRM stands between voluntary PSI and all-out default, and identifies the conditions to achieve an

increasing cost structure. The paper finally highlights a number of important issues relating to the functioning of the SDRM. First, the establishment of the SDRM is likely to affect investment in emerging markets both through price and composition effects. Second, credibility of IMF access limits remains a central issue for a functioning SDRM. Third, the power to activate the SDRM should be left to the sovereign debtor, since assigning it to the IMF brings about serious signaling problems. Lastly, the instruments of intermediate PSI—such as collective action clauses, exit consents, and the like—should be seen as complementary, not alternative, to the mechanism.

II. NATURE OF THE SDRM

A. The SDRM Framework as “Improved Default”

It should be recognized that, by bringing about a standstill on payments, the SDRM involves an element of partial default, in that the freeze on payments determines creditor losses in terms of a lower net present value of their claims on the sovereign (however temporary the agreed suspension of the debt service is). Such losses take place even if the terms of the debt were to remain unchanged after the standstill is revoked (i.e., no formal debt restructuring takes place).⁵

At the same time, the SDRM provides the space for a last-ditch voluntary PSI solution, or if needed for a debt restructuring, but saves the sovereign the high economic and social costs of an all-out default. It also saves on the costs of transactions and uncertainty

⁵ From a formal point of view, a legal default can be avoided in two cases. First, and as often happens even now, the parties to the debt contract may agree not to declare a legal default to avoid consequences such as cut-off from certain kinds of official financing and triggering cross-default clauses. Second, the international community could agree that the legal component of the SDRM framework inhibits a declaration of default in the standstill phase.

typically associated with a debt workout under disorderly default, and may help debtors recover market access sooner than under all-out default.

The SDRM framework, however, must leave the possibility of an all-out default open, for example in the case that no agreement with the creditors can be reached, or if the country is not willing to carry out a IMF-sponsored program with its stringent conditionality. Also, the SDRM should not imply a bailout of private creditors from the official sector, nor should it reduce the cost of default to a point where either the creditors or the debtor would behave strategically so as to induce its activation instead of engaging in voluntary PSI. The SDRM can therefore be seen as a mechanism for an “*improved default*,” one step short of an all-out default and one step beyond a fully cooperative solution of a crisis.

B. The SDRM and Involuntary PSI

To understand the close association of the SDRM with involuntary PSI, it is useful to go back to the oft-invoked parallel between the SDRM and corporate bankruptcy. The critical difference between the SDRM and the bankruptcy procedure is that, in the latter, creditors know that there is a reasonably certain recovery value from the liquidation of corporate assets, in case the corporation is shown not to be viable despite the infusion of new capital and the suspension of debt service. Creditors know that if the law is applied, and if there is no asset stripping, they will be entitled to their share of assets.

On the other hand, sovereigns do not have a liquidation value. In case of sovereign default, creditors expect their recovery value to depend on the sovereign’s foreign exchange reserve holdings and its capacity to generate future reserves, but they have no guarantee of what they will actually get. Indeed, the recovery value is endogenous to the solution of the crisis. The amount of reserves depends on the depth of the country’s economic adjustment,

on the availability of official financing, and on the creditors' willingness to stay engaged and finance the country. All these elements interact with the determination of debt sustainability and, as noted in the Introduction, make the debt sustainability analysis inherently problematic. In the absence of a credible coordination device, or before one is activated, such an uncertainty does not allow creditors to make reasonable predictions about their recovery value and about the sovereign's return to financial viability.

C. An Important Trade-Off

In a situation where creditors are atomistic, markets are liquid, and there are no capital controls, creditors (especially those holding liquid instruments) may have a strong incentive to head for the exit when they anticipate the activation of a standstill, especially if they expect to be forced into restructuring, or more in general if they expect to lose out in the SDRM phase.⁶ Accordingly, the risk posed by the existence of a credible SDRM framework is that an investor pullout would happen as soon as the trigger variables reached the point of standstill activation, or when investors form a reasonable expectation that this will happen. This resembles the typical dynamics of a bank run or the bursting of a bubble⁷. The more credible and strictly enforced the involuntary solution is expected to be, the earlier in time the pullout begins, caused by the backward induction solution to the game. The SDRM, thus,

⁶ The expectation—or the assumption—of losing out from resorting to the SDRM standstill is a crucial aspect of the mechanism. See below.

⁷ The parallel with bank runs should of course be qualified. A bank run involves many (or all) depositors simultaneously demanding their assets. Foreign creditors, by contrast, would only in extreme situations be in the position of trying to liquidate their assets all together. A more typical situation would involve the decision to renew credit lines or bond holdings. Here a “run” would be reflected in a rapid deterioration of roll-over ratios. However, in a country with a very open capital account, a full-fledged run can take place if holders of domestic currency-denominated deposits panic and try to convert deposits in foreign-currency denominated assets.

seems to suffer from the very central problem of involuntary PSI: the possibility of it taking place leads the investors to flee the country.

While the predictability of the SDRM can prompt uncooperative behavior, thereby precipitating a crisis, its existence can remove from the system a key incentive to creditor cooperation during a crisis. In a crisis situation, the incentive for creditors and the sovereign to stay engaged and find a cooperative solution through voluntary PSI derives from the concrete risk of a disorderly and costly default, and from the belief that cooperation can stave off default and allow a return to sustainability. Insofar as the SDRM makes the default process orderly and less costly, it may weaken the incentive to voluntary PSI. This effect may be reinforced if, in addition, creditors believe that exceptional financing may be forthcoming under the SDRM and therefore consider a bailout from the official sector during the SDRM to be a likely possibility.

The design of an incentive-compatible SDRM therefore involves a critical tradeoff. On the one hand, the SDRM payoff to creditors must be low enough to encourage (or at least not to discourage) voluntary PSI in the pre-SDRM phase, and to mitigate debtor and creditor moral hazard. On the other hand, if the expected payoff to creditors is not rewarding enough, a rush for the exit, and the consequent precipitation of a crisis, cannot be ruled out, most crucially from cross-over, short-term oriented creditors, who are not motivated to shelter durable relationships with the debtor country. This would happen if creditors expect the SDRM to be activated and anticipate to lose out from a forced restructuring.

Solving this critical tradeoff optimally does not seem to be possible. Indeed, it will be seen that the SDRM incentive structure discussed below protects from the first type of risk (i.e., that creditors and debtors may not be motivated enough to reach a voluntary solution in

the pre-SDRM phase, while the increasing structure of costs for creditors that we advocate does heighten the risk of run for the exit.)

In this context, the challenge of an incentive-compatible SDRM is that of setting up an institutional framework that facilitates the collective representation of creditors, without suppressing the incentive associated with the risk of default. By freezing market activity and blocking legal actions, the SDRM should prepare the ground for a last-ditch, private-sector cooperative participation to debt sustainability in the context of an orderly debt restructuring process, but only once all voluntary attempts from the players to cooperate under normal market conditions have failed to bring results. Ensuring that the SDRM fulfils this condition bears implications for how to design its incentive structure.

III. OPTIMAL INCENTIVES IN THE SDRM

One instrument can only attain one objective. In the case of the SDRM framework, this requires a choice, or at least a prioritization, of the two above mentioned objectives, i.e. containing default costs and promoting a voluntary PSI solution. We believe that the main objective of the framework should be to induce a cooperative PSI solution. The limitation of default costs should be seen as a constraint, not as an objective. Indeed, from our previous arguments it is clear that costs play a central part in structuring the incentive of the players in reaching a solution. The SDRM should be activated only after attempts at voluntary PSI have failed. The costs of resorting to the SDRM should be structured accordingly.

A. Role of an Increasing Cost Structure

Sovereign default brings about costs to all players concerned. The sovereign suffers the loss of reputation and market access, and the costs of economic, social, and political disruption. Creditors suffer the recovery losses and the deadweight costs from dealing with a

disorderly default process.⁸ Other countries, and the international community, suffer the costs deriving from the systemic effects of the default (in the form of contagion or spillovers).⁹

While a high default cost is necessary both (ex ante) to contain debtor and creditor moral hazard and (ex post) to stimulate voluntary PSI once a crisis event has occurred,¹⁰ the disruptive consequences of all-out default may outweigh the incentive effect.

The SDRM framework aims, inter alia, at reducing the costs from default. Yet, for the framework to be successful from the point of view of a cooperative solution to the crisis, the structure of costs facing creditors and the debtor should be increasing at each step of the process—from normal market conditions to the SDRM standstill, and finally to all-out default—so that they have an incentive to reach a cooperative solution early in the process.¹¹

In other words, in order for the SDRM neither to prompt uncooperative behavior (i.e., early exits or runs on the debtor), nor to pre-empt cooperative solutions, it must be a *last-resort* and *costly* instrument to activate: as a form of involuntary PSI, the SDRM should be regarded by all players as the last step to be resorted to after all other attempts at voluntary

⁸ Although creditors generally recover less from a default than from a cooperative solution, not all creditors lose out necessarily from a default. Vulture funds, indeed, aim to gain from disorderly debt restructuring.

⁹ This broad definition of the cost of sovereign default provides a rationale for undertaking public action aimed at reducing the social welfare costs associated with it.

¹⁰ A high expected cost of default, also, lowers the equilibrium debt coupon and therefore increases the probability of debt repayment. See G. Lipworth and J. Nystedt, 2001, “Crisis Resolution and Private Sector Adaptation”, *IMF Staff Papers*, Vol. 47, Special Issue (Washington DC: International Monetary Fund): 188-214.

¹¹ For simplicity we avoid considering the role of the default costs for other countries and the international community.

PSI have failed. Moreover, it should be structured in a way that retains the incentive effect associated with the costs of default.

B. Costs for the Sovereign Debtor

In light of the above, it is necessary to look more in detail at the cost structure for the sovereign debtor and for the creditors. As regards the sovereign, it can reasonably be assumed that its costs are strictly increasing over the steps of SDRM and all-out default. Under the SDRM, the debtor country would have to undertake or continue a IMF program with strengthened conditionality. Also, as stressed above, the partial default nature of the SDRM ensures that market access will be much more difficult for some time in the future. The expectation of strong IMF policy conditionality and of market-access loss following SDRM-activation would leave sovereigns hard-pressed to seek successful voluntary PSI. It is equally reasonable to assume that moving on to an all-out default—due to the impossibility of reaching a cooperative solution with creditors, or to the loss of support from the IMF—would carry even higher political, economic, and social costs.

It must be noted that the above assumption of increasing costs for the debtor is weakened by the possibility that a debtor reject a rollover offer, i.e. voluntary PSI is not obtained, in the expectation of better terms (a larger haircut) under the SDRM. In this case, the existence of the SDRM would cause debtor moral hazard. While this is a relevant aspect, two mitigating considerations are in order. First, any advantage to the debtor from a larger haircut would always have to be compared to the costs arising from the disruption linked to the “improved default” component of the SDRM. It can be expected that this comparison would generally point to a net cost for a debtor of moving up to the SDRM phase. Second, to

the extent that an improvement in debtor payoff is a concrete possibility, this negative incentive can be avoided by binding the SDRM payoff structure (see below).

C. Costs for the Creditors

In contrast with the sovereign's case, an increasing cost structure on the creditors' side is not obvious. Leaving aside those creditors actively exploiting the worsening of the situation, such as vulture funds, the majority of creditors would probably expect to lose out from an all-out default option. For the SDRM framework to be successful, creditors should expect to lose out from the SDRM, but not so much as from an all-out default. It is reasonable to assume that creditors would regard the SDRM standstill as a partial default. However, and consistently with the debtor moral hazard discussed above, it should be ensured that the terms of the renegotiated debt under the SDRM fell somewhere between those asked by the creditors and those offered by the sovereign during voluntary PSI (*payoff constraint*), a point further explored below.

D. Enforcing a Strictly Increasing Cost Structure for the Private Sector

Once the SDRM is activated, the amount of resources available for repaying creditors depends on the sovereign's future capacity to generate foreign exchange resources. To induce creditors to cooperate under voluntary PSI, and not to rely on the SDRM as a first-resort solution, they would have to assume that they would not get more after the activation of the SDRM than what they were offered before, in line with the payoff constraint above.¹² Admittedly, finding a system to ensure this condition seems difficult. There are three possible alternative options to this purpose.

¹² Assuming for simplicity that this offer can be measured, for example, in terms of net present value reduction of the debt instruments.

The first option is to bind total official financing (including that from the IMF) during the SDRM to a limit that would not be larger than under the pre-SDRM phase. This would impose a cap on the resource transfer from the official to the private sector.¹³ This option raises issues concerning the adequate determination of such credit limits, as well as credibility issues as to the official sector's effective ability to comply with pre-announced credit limits. On the other hand, if applied credibly, the option would deprive the international financial community of the power to use exceptional financing even when its use would provide an optimal response to a crisis. Finally, it must be noted that limiting official financing during the SDRM phase does not fully ensure against the possibility that the debtor would use the official financing and the net foreign exchange savings from adjustment to repay creditors at better terms than under the pre-SDRM phase (thus violating the payoff constraint).¹⁴

The second option, which is part of Anne Krueger's original proposal, provides that the official financing extended to the debtor country after the restructuring would be limited to the amount necessary to help the country rebuild its reserves and pay for essential services and imports, and would not be used to help finance payments to creditors on the restructured

¹³ The sovereign could still improve on the creditors' terms, but would have to do it out of its own resources, say, by tightening the adjustment (*super-adjustment*). This possibility would have to be permissible, since it would be part of the sovereign-creditor relationship and would not involve bailing out the private sector with public money.

¹⁴ The existence of creditor moral hazard could be contested by pointing out that if debt is unsustainable (which is the only situation when the original SDRM is envisaged to apply), creditors anticipate a haircut, and cannot expect to gain more in the SDRM phase if official financing is bounded. This argument however rests on the possibility of clearly distinguishing solvency from liquidity crises – and it was argued earlier in this paper that this is often not the case. By consequence, creditors do not have perfect information on the needed haircut.

debt. The problem with this option is that identifying the official financing needed for reserve targeting and basic imports requires that official financing, debt haircuts, eventual new money, and fiscal adjustment be all jointly determined: unless the IMF sets a credible limit to its financing, the flexibility needed to adapt access to the financial needs of the country (including to sustain its fiscal adjustment effort and its debt repayment capacity) could at the very least weaken the credibility of the access limits and easily induce creditors and the debtor to push for a larger IMF involvement, very much like the present situation under the catalytic approach.

The third option is the introduction of a legal constraint that would prevent creditors from recovering more than their last offer during the pre-SDRM phase. In practice, if the pre-SDRM phase takes place but does not bring forward to an agreement, the creditors and the debtor should know the last terms asked and offered by them, respectively, which could serve as benchmarks for negotiations under the SDRM. A legal constraint would ensure that the new terms to be negotiated under the SDRM would neither be superior to those requested by the creditors nor inferior to those offered by the debtor. Designing such constraint, obviously, raises issues of feasibility, implementation, and enforceability, which would have to be explored carefully

E. A *two-sided* moral hazard?

The increasing cost structure of the SDRM is designed to ensure that neither the creditors nor the debtor have a temptation to hurry to the SDRM phase before exhausting all possibilities of a voluntary PSI solution. The argument could be made that, even in the absence of an increasing cost structure, it is not possible to have both creditor and debtor moral hazard at the same time (*two-sided* moral hazard), and that moral hazard is possible

only on one side of the market. Indeed, two-sided moral hazard is not possible only under perfect information and rational expectations: in this case, the parties know beforehand what the solution of the game is and both cannot expect simultaneously to gain more from the SDRM than from the pre-SDRM phase, since the payoff from the SDRM phase will only be to the advantage of one but not the other. However, under the conditions of uncertainty and asymmetric information that typically characterize a crisis, the parties do not know the solution and both may have reasons to believe that each will gain more from the SDRM phase than from the pre-SDRM one.

In this case, two-sided moral hazard is possible and it is important that it be ex ante excluded through a credible SDRM cost structure. If the parties anticipate strictly increasing costs along the sequence of steps, none would have an incentive to skip one step for the next.

IV. OPTIMAL SEQUENCE FOR THE SDRM

In light of the preceding, let us examine the working of the SDRM in a stylized sequence of events. When the sovereign debtor enters a critical payment situation, a dialogue with the creditors is initiated. If the repayment difficulties arise only from a temporary liquidity problem, the dialogue may simply end with a re-profiling of the debt obligations that affords more breathing space to the debtor.

In the event of more serious payment difficulties, a negotiating phase can be initiated (voluntary PSI) with the objective to agree on a debt-restructuring plan. Contractual clauses can be activated to avert early exit or runs and to facilitate cooperation among the creditors, and between the creditor and the debtor. During the pre-SDRM phase, no exceptional financing is extended by the official sector.

If PSI negotiations fail, the sovereign may invoke the SDRM and a time-bound standstill on all outstanding debt contracts can be sanctioned by the IMF, or a third party, if conditions so justify. The mechanism would provide a last-resort opportunity for an orderly restructuring process whereby:

- a. The country and the IMF would negotiate a new program with strong conditionality, or strengthen the conditionality of the ongoing program;
- b. The IMF would evaluate the need for extra financing, on the basis of a thorough debt sustainability analysis. Extending exceptional financing should be evaluated with a view to preventing the sovereign debtor from using the funds to repay creditors at better terms than in the pre-SDRM phase. Also, the IMF would have to ensure that the debtor would not obtain renegotiation terms superior (a larger haircut) than it would have obtained in the pre-SDRM phase. As noted in Section III, a violation of these conditions would weaken the incentive to voluntary PSI;
- c. The creditors would be called on to agree on new debt terms. The new terms should offer to creditors lower recovery ratios than those requested by the creditors during the (failed) pre-SDRM negotiations;
- d. In light of enhanced intervention by the IMF, the creditors would also be called on to reconsider the continuation of financial support. New money would carry seniority, it could be subject to program outcomes, and would be more expensive than under successful PSI.

If the SDRM fails, all-out default is the next and last step of the sequence. The SDRM is an occasion to allow creditors and the sovereign a new negotiation process whereby adjustment policies, new money options, and debt restructuring terms are

considered together under orderly conditions. All players should know, however, that nothing guarantees the success of the SDRM, and that all-out default remains a concrete possibility at the end of the SDRM period. Also, all players should be aware that no bailout would be possible from the official sector in the event that the SDRM fails.

It should be noted that the sequence above ensures a core condition of incentive-compatibility, that is, that the costs to all the players increase at each step of the sequence.

V. SOME IMPORTANT ISSUES

A. Credibility of Access Limits

The official sector should not be gamed into voluntary PSI. If the official sector does not credibly commit to limiting its financing in a crisis, both the creditors and the sovereign have an incentive to limit (strategically) the terms of their offers for negotiation, since they anticipate that the official sector will eventually step up its intervention in the attempt to stave off the crisis. Under such circumstances, the payoffs to the creditors and the sovereign depend on the choices of the official sector, and it always pays for them to push for more official financing. As a result, the incentive to voluntary PSI is weakened.

One way to eliminate this perverse incentive could be to constrain any exceptional official financing to the debtor prior to the activation of the SDRM, beyond some predetermined access limits.¹⁵

¹⁵ Mohan Kumar and Marcus Miller make a similar (though somewhat weaker) point in “Bail outs, Bail ins and Contracts: Strategic Aspects of the New Architecture”, in G. Underhill and X. Zhang (eds.), *Global Financial Crisis: What is to be done?* (Cambridge, Mass: Cambridge University Press, 2002, forthcoming), where they suggest that the IMF’s intervention should be subject to *strategic ambiguity* for the prospect of bail-out to be marred by the risk of an all-out default. Taking into account the practical difficulty for the IMF to embark credibly on strategic ambiguous behavior, our recommendation goes as far as suggesting the imposition of a strong rule on access limits before the SDRM is activated.

Moreover, while access limits to IMF resources could be applied flexibly during the SDRM (under the payoff constraint), they would have to be used rigidly after the SDRM (i.e., if the SDRM fails) so as to avoid bailout expectations through official financing that would alter the incentive compatibility of the sequence and weaken (ex ante) the probability of success of the SDRM. In other words, ensuring the time consistency of the use of IMF resources throughout the whole sequence is a key condition for making the SDRM incentive compatible.

B. Activation

According to the approach outlined by the IMF First Deputy Managing Director, the IMF would be responsible for deciding on whether or not to sanction a standstill under the SDRM, once a member has submitted a request. Such a role for the IMF is predicated on the basis that the IMF has the information to carry out the debt sustainability analysis to ascertain the actual payment capacity of the sovereign, and that it can therefore ascertain the sovereign's good faith.

Having the IMF activate the SDRM raises significant problems. There is, first of all, a signaling problem. Whatever the reasons for denying a request for a standstill, a denial would impact negatively on the market reputation of the sovereign, even if the reasons for the denial would be fully explained to the market. A denial could in fact further precipitate an ongoing crisis and *de facto* abort any possible PSI solution. These risks might be such that the expected cost of the SDRM could even outweigh that of an all-out default (thus violating the

optimal incentive criteria discussed in Section IV). This would discourage countries from resorting to the SDRM even when this would in fact be a good option.¹⁶

For its part, the IMF might not be willing to take on the responsibility of denying a request, even if the denial were motivated by a full-fledged, reliable debt-sustainability analysis. On the other hand, the IMF might base its decision on an inadequate debt sustainability analysis and deny the standstill when there would be reasons to grant it. Furthermore, once a country requests for a standstill, it might be close to impossible for the players to keep the request from becoming public. If the request were made public, thereby triggering the related signaling effects, a crisis could hardly be kept from deteriorating during the time between the country's request and the IMF's issuance of a judgment.

In view of all these problems, it might be simpler and neater to let the sovereign decide when to activate the standstill according to its own judgment and interest (and have the IMF, or a third party, sanction the standstill automatically on request from the sovereign). Markets would know that this is an option for the sovereign, and would value such an option ex ante when making their investment decisions. On the other hand, the sovereign would be well aware of the relative costs of exercising the option. Provided that the incentive structure of the SDRM is right, the risk that this option would make it easier for a sovereign to call a standstill, or allow it to halt payments when in fact it is in a position to pay, would be minimized: a rational debtor would not activate a standstill if the cost of doing so would outweigh the associated benefits. In the end, if markets believed that the sovereign was not

¹⁶ These issues are similar to those raised by the activation review of the IMF's Contingent Credit Line Facility.

acting in good faith, they could always make the SDRM fail and push the sovereign into all-out default.

C. Other Instruments to Facilitate Voluntary PSI

The chances of successful voluntary PSI rest crucially on the net cost of cooperation among creditors, and between creditors and the sovereign debtor. Large coalition costs and a high risk of free-riding from dissident creditors impede cooperation. The cost of cooperation can be reduced through the use of instruments that inhibit the incentives to dissident behavior, such as collective action clauses, exit consents, credit enhancements, universal rollover options, credit enhancements, and rules for the sharing of proceeds among creditors. Thus, investigating the SDRM option should not diminish the official sector's effort to explore these other PSI instruments. Instrumental in enhancing cooperation could also be the creation of standing committees (conceptually similar to the Paris Club or the London Club) for all sovereign non-bank debts to the private sector, where creditor representatives and sovereign debtors would convene to negotiate restructuring agreements at times of payment difficulties. The operation of such committees could help accumulate experience, information and expertise on past sovereign financial crises that could prove useful in future circumstances.

D. Implications for Investment in Emerging Markets

At the margin, the trade-off between making the SDRM attractive to creditors and scaring them away with the threat of default (albeit improved) could have important economic benefits, to the extent that it would induce better market discrimination between different creditor types. To see why, note that, by creating an additional possible outcome in between voluntary PSI and all-out default, the existence of the SDRM would likely decrease

the *ex ante* probability of the latter, the costliest option for creditors. At the same time, the non-zero probability of an “*improved default*” outcome, implying higher costs than voluntary PSI, would at the very minimum not decrease the *ex ante* probability of some sort of default.

The reduced perspective of a disruptive outcome, and the presence of a coordination device in times crisis, might attract long-term investors to emerging markets. These investors not only are interested in minimizing the size of a haircut on the assets they hold, but seek to gain from the long-term wealth-generation capacity of a country and are interested to protect their long-run relationship with the country. On the other hand, the existence of the SDRM would be a source of rigidity for cross-over investors with a short-term horizon and a strong liquidity preference, and would likely lead them to incorporate in their risk calculation the possibility of being *locked in* into unwanted positions.

As a result, the impact of the existence of the SDRM on the cost of financing for emerging markets would be differentiated. While the cost of patient money might become cheaper, the cost of short-term funds would tend to rise. This would not necessarily be a bad outcome, since it would reflect an overall improved risk and investment environment.

VI. CONCLUSION

This paper sought to identify the core incentive structure for the SDRM to be successful and consistent with a limited role of the IMF as a third-party agent between the creditors and the sovereign debtor. The need for a limited IMF role arises from the assumption that, in general, debt sustainability analysis cannot be relied upon as a firm basis for a third-party agent to decide on the activation of a standstill on payments. The paper argues for an increasing shape of costs both to creditors and the sovereign debtor as they

move across a sequence from normal market conditions to voluntary PSI, to intermediate PSI, farther to the SDRM, and eventually to all-out default if nothing else has worked. The paper also attempted to clarify the nature of the SDRM in relation to involuntary PSI and default, and explored a number of related issues.

While the principle of an increasing cost structure is central to the analysis of the paper, it should be stressed that the principle would work only if a series of not-quite-so-ancillary assumptions hold. The problematic nature of these assumptions shows the limits of the analysis, and suggests that important problems remain to be solved before the conception of the SDRM expressed in the paper can be considered viable. First and foremost, the actual feasibility of an SDRM is taken for granted in the paper, in the face of the obvious political and technical (mostly legal) difficulties arising, principally, from the supranational nature of the instrument.

Second, full credibility of IMF access limits is indispensable to push creditors to cooperate with the debtor country in all the steps of the sequence. However, since—for good and bad reasons—the shareholders of the IMF cannot agree to respect the access limits they themselves set up, the issue of the time consistency of the use of IMF resources is not solved at the moment. This currently represents the main problem in addressing PSI, and it is doubtful that it would be more easily solved in a SDRM world.

Third, the increasing cost structure for the creditors hinges on finding a way to constrain the payoff they can receive in the SDRM phase, compared to what they were offered during the pre-SDRM phase. We discussed three alternative options including a ceiling on total official resources available to the debtor during the SDRM, provisions limiting the debtor from using official financing to pay its creditors (as in Anne Krueger's

proposal, and a legal constraint). We concluded that none of the options are waterproof or necessarily feasible.

Fourth, the incentive compatibility of the SDRM and the chance of success of a SDRM phase depend also on the credibility of a costly all-out default, as the last option of the sequence when the SDRM phase has failed. Expectations of a bailout from the public sector after the SDRM failure would reduce the anticipation of costly default and weaken (ex ante) the SDRM. This brings us back once again to the limits on the use IMF resources and, more in general, to the role of the official sector in crisis resolution.