Whither IMF Reform?

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With the eruption of financial crises in Argentina and Turkey, the IMF is back in the news. So too, predictably, is the debate over whether that institution does more to enhance or undermine financial stability. The issues are familiar, by now almost painfully so. How will the controversy develop from here?

The big news, from the point of view of these discussions, is obviously the inauguration of a new U.S. administration. Compared to Clinton's Treasury Department, the Bush Administration will be less willing to support financial rescues of crisis countries. It takes seriously the moral hazard critique -- that IMF rescues weaken market discipline by encouraging investors and governments to believe that they will be bailed out in the event of difficulties. The Administration has links to the Meltzer Commission, whose report to the U.S. Congress last year argued for a reduced role for the IMF. (Lawrence Lindsey, Bush's chief economic advisor, previously sat down the hall at the American Enterprise Institute from two members of the Meltzer Commission.) Bush's people will be looking for an opportunity to demonstrate their determination that governments should be forced to live with the consequences of their policies and that investors should suffer the full consequences of their portfolio decisions. They will do so by finding a crisis in an emerging market where they can insist that the IMF, rather than extending a bailout loan, should stand aside and let events run their course.

What will happen next? The next Argentina or Turkey will then have to approach the markets about providing additional money. If they refuse, it will have to temporarily suspend payments. It may have to declare a standstill or impose Malaysian style controls to prevent problems with its sovereign debt from spilling into its banking system. It will then attempt to negotiate a restructuring and a debt exchange.

These events will give new visibility to two reforms of the international financial architecture that have been on the table now for some time: officially sanctioned standstills and collective action clauses. Both are intended to provide alternatives to IMF bailouts. Under the proposal for standstills, the IMF Board would take a decision or the IMF Articles of Agreement would be amended to specify the circumstances under which the Fund would endorse a standstill. The IMF's endorsement would prevent resort to a temporary standstill from tarnishing a country's reputation in international financial markets, the argument goes, while the need to secure IMF sanction will prevent governments from using the measure opportunistically. If the Fund's power to sanction a standstill is given legal force in the courts of IMF member countries, then the debtor will be sheltered from disruptive legal action by its creditors.

Some prominent policy makers have lent their names to this idea, including Juergen Stark of the Bundesbank, Paul Martin of the Canadian Finance Ministry, Mervyn King of the Bank of England, and Laurent Fabius of the French Ministry of the Economy. (Full disclosure requires me to acknowledge that I recently wrote a report on these proposals for the Swiss Federal Finance Ministry and presented it to a seminar hosted by the Swiss National Bank in Zurich just this week.) The proponents reason by way of analogy with the automatic stay provision in countries' bankruptcy laws. There needs to be a mechanism, they argue, to prevent creditors from engaging in a disorderly and socially costly scramble for assets. Therefore, there needs to be an entity analogous to a bankruptcy judge to authorize activation of the mechanism and at the same time to prevent its opportunistic use by the debtor. Given protection from the scramble for assets by panicked investors and shelter from disruptive legal action, the debtor and his creditors will then be able to pursue restructuring negotiations in an orderly way.

Although this might seem like a radical argument, it is a logical response by those who take seriously the moral hazard created by IMF bailouts and who therefore wish to limit the financial role of the Fund. Moreover, investors should like the idea, their reasoning goes, because it renders predictable and transparent the conditions under which the measure will be imposed.

Notwithstanding the considerable support it enjoys in Canada, Europe, and in Japan and the rest of Asia, this idea is unlikely to go anywhere. For one thing, there are sound objections to the notion that standstills should be made more predictable. In particular, the knowledge that a country can resort to a standstill with IMF sanction will only precipitate additional crises if investors flee a country in order to avoid being locked in, as seems likely. In order not to cause more crises than it solves, this measure needs to be applied with "constructive ambiguity" -- that is to say, with discretion. And the Bush Administration would clearly oppose giving such considerable discretion and decision making power to the IMF.

None of this is to deny that countries will have to resort to standstills more often in the future if they receive multilateral assistance less frequently than in the past. But they will do so unilaterally. To be sure, the IMF will be able to signal its approval, but only verbally and by lending into sovereign arrears. In fact, these are things that it is already authorized to do. In other words, there will be no decision by the Executive Board on "new modalities for standstills." There will be no amendment to the IMF Articles of Agreement.

The other idea that will enjoy a renaissance if the Bush Administration attempts to limit the role of the IMF is collective action clauses. Collective action clauses provide mechanisms and specify the conditions under which the financial terms of bond contracts can be changed. If we are going to have fewer financial rescues, then we clearly are going to see more restructuring by crisis countries. Investors will want assurances that those restructurings will take place in orderly and predictable ways. People who trade debt instruments want to be able to price restructuring risk. Collective action clauses that specify how and when restructurings can take place allow them to do just that.

The two major developments in the restructuring arena in recent months, in Ecuador and Peru, point in this direction. In Ecuador's case, some clever legal eagles devised an ad hoc mechanism, the exit consent, for binding in dissenting investors and thereby permitting the country to push through an exchange offer acceptable to the majority of its creditors. (They weakened the nonfinancial terms of the old bonds to make their exchange for new bonds more attractive.) But Ecuador's use of this device was a surprise, and it is not clear whether it will work the same way the next time it is tried. Investors prefer to know how any restructuring will work when they buy their bonds, as opposed to only finding out how clever lawyers intend to engineer it at the last moment. Hence, the use of exit consents in Ecuador is likely to increase support, on the trade side of the major financial institutions in particular, for contractual provisions governing how restructurings will take place.

Then there is Peru, where Elliott, a distressed debt investor (or vulture fund), won a judgement order which included payments on Brady bonds through the fiscal agent (Chase) and the clearing houses. Only time will tell whether the precedent stands -- whether the courts judge Elliott as good law or bad. (As yet, there is no precedent, because the Elliott case was settled out of court.) But for the time being at least, the case has strengthened the hand of the vultures (if vultures can be said to have hands!) by enabling them to attach assets and disrupt the attempt of a government and the majority of its creditors to reach an agreement on partial payment. In turn, this will induce the vast majority of bondholders to push for majority voting clauses in bond contracts as a way of allowing them to cram down terms on the vultures.

By way of conclusion, it is worth recollecting how this discussion differs from the debate over IMF reform when it kicked off several years ago. The argument that some of us were making then, that the magnitude and frequency of IMF bailouts needed to be reduced in order to limit moral hazard, has since become conventional wisdom. But the inference many of us made then — that the financial role of the Fund could be reduced only if other means for resolving crises, like collective action clauses, were first put in place — has been turned on its head. As a result of the U.S. election, it is likely that the financial role of the IMF will in any case be reduced. My prediction is that the markets will respond by investing in alternative mechanisms for resolving crises such as collective action clauses. Investors didn't need these provisions so long as they could count on bailouts. But this is no longer the case.

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