INTERNATIONAL LENDING OF LAST RESORT
AND
SOVEREIGN DEBT RESTRUCTURING

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Financial crisis—that is, the interruption of normal access to financing—is a serious and growing threat to economic development in developing countries that are financially integrated with the rest of the world. The crisis experience of the past two decades and the unrelenting pace of financial globalization in the developing world point to an increasing need for an international lender of last resort (IILR) prepared to act when no other lender is capable or willing to lend in sufficient volume to deal effectively with financial crises.

Progress in establishing an effective ILLR has been slow and unsatisfactory for the most part. It is time to take advantage of the momentum created by the empowerment of the International Monetary Fund (IMF) to address the global crisis and the new multilateral impetus associated with it. The proposal in this chapter supports and builds on recent initiatives by the IMF concerning precautionary facilities. In particular, it brings debt restructuring under the ILLR umbrella.

Crisis experiences since the Brady debt restructuring in several countries show that modern international finance is volatile and crisis prone. The financial crises of emerging countries are becoming important sources of lessons for an ever wider set of countries with access to borrowing from commercial sources. The recent global recession and attendant public debt expansion have dangerously weakened solvency in a number of countries, advanced and emerging alike. Jamaica's debt restructuring in 2010 may be the first in a new wave after the dust of the global crisis settles.[1]

Although progress has been made in response to the crisis (IDB 2010), multilateral safety nets for financial crises remain full of holes.[2] Despite proposals to reform the international financial architecture to address liquidity crises and financial contagion in the new financial order that have been advanced for more than a decade, liquidity facilities remain inadequate. [3] Furthermore, no multilateral framework exists to deal with sovereign debt restructuring. In the past decade restructurings have found their way, sometimes amicably, sometimes acrimoniously but always unpredictably and in ways that enrich imaginative lawyers (Panizza, Sturzenegger, and Zettelmeyer 2009).

This chapter discusses the intrinsic limitations on current ILLR facilities growing to become a generic solution to the problem of financial crises in emerging markets. It proposes instead an integrated system of specialized ILLR facilities that builds on existing institutional machinery and creates tiers to accommodate countries with different capacities. Such a system

makes use of existing multilateral instruments to provide a transition path from liquidity to adjustment to debt restructuring depending on the circumstances as financial crises evolve and morph. The multilateral ILLR system proposed in this chapter would allow the international financial architecture to deal with country financial crises in a robust and consistent way despite the typical confusion as to whether liquidity, adjustment, or debt restructuring is necessary or sufficient to resolve the crisis.

The chapter is organized as follows. The first section characterizes the construct of ILLR, taking the traditional doctrine of lending of last resort in the domestic arena as a starting point. Based on the review of the limitations of this model in the international arena, the second section proposes a feasible ILLR framework that integrates liquidity provision with potential adjustment and debt restructuring. The third section goes one step farther, exploring how legal reform to establish an international bankruptcy institution for sovereign creditors would substantially improve ILLR capacity to manage financial crises involving adjustment and debt restructuring. The fourth section discusses the supporting role of multilateral development banks in an ILLR system. The last section provides some concluding remarks.

<<A>>Modeling ILLR after the Traditional Doctrine of Lending of Last Resort (LLR)

It is natural to try to model ILLR on the basis of the traditional doctrine of LLR in the domestic context, which deals with both the prevention and the mitigation of financial crises of domestic institutions.[4] In this section, we characterize the traditional doctrine and then discuss the limitations of such a model in the international context (see Fernández-Arias 2010 for a more detailed analysis).

The traditional doctrine makes a critical distinction between liquidity and solvency crises. In the case of a liquidity crisis—that is, a financial crisis faced by solvent borrowers—there is a coordination problem: the provision of normal lending would result in a perfectly satisfactory outcome for all, but panicked or constrained lenders massively withdrawing financing creates real adjustment costs and ultimately insolvency, thus self-validating the withdrawal. This kind of crisis is avoidable. By contrast, in the case of a solvency crisis—that is, a financial crisis suffered by an insolvent borrower—the mere disposition to lend or provision of liquidity by LLR will not restore normalcy and avoid the crisis. In this case, there is a single crisis equilibrium in which the

LLR can help only by mitigating the adjustment costs of insolvency and adjudicating losses in an efficient, sustainable way.

<<*B*>>*Traditional Lending of Last Resort*

To obtain the desired effects in liquidity crises, speed, certainty, and power are critical to bridge the financial gap and remove unwarranted lack of investor confidence. Bahegot (1873) and subsequent researchers have proposed a number of principles for LLR for liquidity crises, which can be summarized as follows:

- Lend against any marketable collateral valued at its value in normal times.
- Lend in large amounts (on demand) at terms steeper than market terms in normal times.
- Establish the above principles ex ante and apply them automatically.

Because liquidity crises are characterized by the existence of multiple equilibriums (the good equilibrium is attainable by avoiding self-fulfilling expectations of lack of creditworthiness), the principles of LLR are calibrated to prices in normal times (that is, the good equilibrium). Penalty terms are applied to ensure that the capital of LLR is not used beyond the period of financial distress.

In solvency crises, bankruptcy proceedings incorporate the principles of applicable LLR, which can be summarized as follows:

- Provide or arrange emergency financing as a senior lender on an interim basis (in lieu of lending freely against collateral at penalty terms) to avoid the costly interruption of operations.
- Temporarily suspend rights of stakeholders to coordinate crisis management and debt restructuring while the insolvent institution is reorganized or liquidated.
- Establish the above principles ex ante and apply them automatically.

A practical difficulty in applying these principles is determining whether the crisis is a liquidity or a solvency crisis. The condition of illiquidity merits a temporary diagnosis, to be reversed if the provision of liquidity does not produce the expected normalization results. In

addition to the risk of LLR financial losses, the natural tendency of beneficiaries to avoid restructuring and bet for resurrection suggests the need to err on the side of caution.

A less obvious cost of the difficulty of diagnosing the type of crisis is moral hazard. Moral hazard is not an issue in the case of lending into liquidity crises, but becomes relevant if a solvency crisis is misdiagnosed as a liquidity crisis (Fernández-Arias 1996). Moral hazard would also justify erring on the side adjustment rather than financing.

<<B>>Applying the traditional doctrine to the international context

In crossborder LLR to sovereigns or ILLR, the consolidated public sector (including the central bank) replaces the domestic institution as the beneficiary of LLR.[5] The key difference between domestic LLR and ILLR is that ILLR is subject to sovereign risk. Sovereigns are not bound by laws enforceable in foreign courts. Because multilateral creditors are "preferred," however, the risk for a multilateral ILLR is smaller than for other creditors. Another difference connected to sovereignty is that a multilateral ILLR ought to take into account international linkages that may create important repercussions outside the beneficiary country and hold the key to solving financial distress in other countries. ILLR interventions in a specific country may be justified because of their international spillovers; LLR interventions are based only on the national interest.

In a liquidity crisis, the above principles could be applied by and large mutatis mutandis. Although in common practice sovereign collateral is not posted, such failure is immaterial provided that ILLR is applied in the presence of adequate financial safeguards ("sufficient implicit collateral"), because the provision of collateral serves the purpose only of ensuring that the LLR will not suffer financial losses at the expense of the beneficiary.

In a solvency crisis, the very concept of solvency needs to be redefined. Sovereign insolvency should be interpreted not as the ability to pay in a financial sense but as willingness to pay in an economic sense. Furthermore, the concept of bankruptcy reorganization needs to be redefined more specifically as the economic adjustment and policy reform needed to regain solvency, which may or may not include the debt restructuring typical in corporate bankruptcies. These differences are arguably not fundamental, in that the question of how to deal with a solvency crisis in an efficient way—which in the sovereign case means appropriate adjustment and debt restructuring—remains.

The traditional principles of ILLR are fundamentally inapplicable for a different reason: in the sovereign context, there is no equivalent to a bankruptcy code or a court to ensure enforcement of ILLR determinations limiting the property rights of stakeholders. In the absence of a bankruptcy-like institution, existing lenders have the right to flee, which opens the possibility that ILLR financing is siphoned off (a lenders' bailout). Furthermore, ILLR makes it difficult to catalyze new lending in the absence of granting seniority protection, which compromises the financial soundness of the rescue effort. [6] Finally, the ILLR cannot play a crisis management role; the same "equity holders and management" need to be retained.

The prudential regulation used in the traditional doctrine to limit moral hazard is also infeasible in the sovereign context, because of unenforceability. Lending conditionality appears as a natural substitute (Cordella and Levy-Yeyati 2005). ILLR can only add to what stakeholders agree to do unilaterally (for example, adjustment and reform) or under bilateral agreement (for example, market debt restructuring); its only power is to condition financial support on certain actions of stakeholders, such as policy conditionality (for example, with respect to country's adjustment). The role of ILLR is constrained to the selective use of carrots and sticks concerning its own financing depending on the country's behavior.

Another key dimension in need of adaptation from the traditional doctrine of LLR to the international context is private sector involvement. The inability of granting senior status protection to fresh lending is a fundamental impediment to restoring the confidence of the private sector. ILLR could catalyze private sector lending in a financial crisis within the existing legal framework by using sufficiently powerful multilateral guarantees, but such a remedy would be prohibitively risky and costly. ILLR could encourage countries to contract insurance or insurance-like credit lines, perhaps triggering contingent credit lines when ILLR acts, but doing so would require the country's willingness to pay a substantial up-front premium (see Fernández-Arias 2007).

Impeding capital outflows may be a more effective way of securing additional financing. The Bretton Woods system conceived the use of capital controls to deal with capital flows precisely to ensure that capital mobility would not provoke financial crises (Fischer 1999). Insurance-like controls on capital outflows triggered by certain agreed-upon events in financial markets, such as a generalized "sudden stop" certified by the ILLR, could also be stipulated

contractually and be part of the set of tools used to bail in private creditors in financial crises. Of course, being market friendly, it would also entail an insurance premium cost.[7]

In all cases, ILLR needs to be expeditious. The need for speed is explicit in the case of preventing a liquidity crisis from developing into a solvency crisis. Speed is also critical in the case of adjustment and restructuring to prevent the economy from stalling for lack of an adequate arrangement among stakeholders.

Four unequivocally desirable characteristics of a feasible ILLR are similar to those inspiring the traditional doctrine:[8]

- *Power*: Sizeable support that is sufficient to meet short-term financial obligations and prevent a collapse (of either demand or supply) in a liquidity crisis or inefficient adjustment in a solvency crisis
- *Speed*: Timely, immediate disbursements to prevent crises rather than cure their consequences or, if already underway, mitigate and resolve them at minimum cost
- *Certainty*: Automatic (nondiscretionary) financial assistance according to prearranged mechanisms and conditions with adequate repayment period to match extraordinary financial needs (uncertainty undermines confidence that the ILLR will do its job and fosters crises)
- *Focus*: Low or no commitment fee, to incentivize the preventive use of the facility, and substantial charges on delivery without prepayment impediments, to disincentivize the use of facilities outside a financial crisis.

Four distinctive characteristics of a feasible ILLR must be borne in mind:

- *Financial safeguards*: In the absence of actual collateral or legal senior creditor status, ILLR financial safety needs a satisfactory country risk assessment.
- *Catalytic action*: In the absence of an international liquidity issuer and a bankruptcy framework to grant seniority to fresh money, a powerful ILLR function may need (prearranged) financial collaboration with official lenders and private sector involvement to configure a coherent and sufficiently large interim financial crisis package.

- *Prudential conditionality*: In the absence of legally binding prudential regulation, the ILLR needs to resort to satisfactory prior compliance with prudential conditionality.
- *Adjustment (and debt-restructuring) conditionality*: In the absence of an enforceable bankruptcy system to reorganize stakeholders claims in an efficient manner, the ILLR needs assurances from countries and lenders that solvency-related conditionality will be fulfilled.

<<A>>An Integrated System of International Lenders of Last Resort

In contrast to domestic legal provisions, sovereign conditionality cannot be enforced. The system therefore needs to define what to do if a conditionality is not met or will likely not be met to an acceptable standard. To the extent that the fulfillment of certain prerquesites is critical for successfully addressing a financial crisis, the ILLR needs to define standards for country eligibility.

The need for prudential and adjustment conditionality may involve both ex ante conditions of eligibility and ex post conditions of approval that deserve closer examination.

Conditionality on economic adjustment, policy reform, and debt restructuring would stipulate the needed conditions to resolve a solvency crisis. Because ex post conditionality implies negotiating conditions of approval that collide with the principles of speed and certainty, it should to be used only when the required adjustment or debt restructuring would otherwise be expected to be ignored or delayed and the solvency crisis left to drag on. Prudential conditionality is of little effect when applied ex-post, after "the horse left the barn." Conditionality is better applied ex ante in lieu of missing regulation and bankruptcy code. Therefore ILLR would ideally define standards for eligibility preconditions to the maximum extent possible.

Ex ante country eligibility—on the basis of preset conditions of country economic health, as measured by the soundness of fundamentals, the quality of the policies in place, and the degree of commitment to sustain them, including conditions pertaining to multilateral financial safety—covers both prudential conditions and conditions related to economic adjustment or

restructuring. A policy framework aimed at promoting stability and quality adjustment could include the following features:

- frameworks for financial system stability based on international standards
- prudent macroeconomic liquidity policies, such as low short-term debt.[9]
- prudent fiscal policies, such as fiscal rules consistent with fiscal and public debt sustainability
- sound monetary, fiscal, and exchange rate policy regimes to respond efficiently to shocks
- constructive relations with official and private lenders and investors
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Given the element of sovereign country choice in ILLR, setting conditions, either ex ante or ex post, is far from equivalent to setting legally enforceable regulation or bankruptcy frameworks. The most favorable case is one in which the country's fundamentals and policy framework comply with desired prudential standards and are so strong that the country can be presumed to be willing and able to react appropriately to adverse shocks autonomously. In this case, the ILLR could dispense with undesirable ex post conditionality. This situation is arguably the case of the recently established (FCL), which is based entirely on ex ante conditions of eligibility. The FCL is a substantial improvement over its predecessors and in many ways an approximation to the principles of a feasible ILLR outlined above. However, it is available to only the strongest countries. If eligibility conditions are sufficiently strict, a large number of countries would choose to remain outside the system rather than reform to meet the standard, something that is not consistent with an optimal ILLR system.

For all the benefits brought by providing incentives to countries to improve their fundamentals and policy frameworks to a high standard in exchange for ILLR qualification, there is the cost of denying ILLR to countries achieving lower standards. Because a fully powerful ILLR needs to be highly selective in terms of target countries, it would leave most countries unprotected; an ILLR protecting most countries would offer unnecessarily low protection to well-deserving countries. A menu of facilities catering to countries' capacities is thus needed to provide the best protection overall.

At the same time, ILLR features depend on the type of shock. At one extreme—the case of a global liquidity crisis—a widely available ILLR (subject to basic financial safeguards and possibly conditioned on internationally friendly policies) could greatly benefit most countries,

even if their policy frameworks are substandard, at least if they do not require substantial adjustment to the shock, as is typically the case. In this case, the costs of exclusion are substantial. At the other extreme—the case of a financial crisis in an individual country, possibly prompted by concerns about its fundamentals and possibly requiring adjustment—stringent standards for eligibility may be needed to ensure that the resources are used effectively to solve the underlying problems. In this case, higher standards are needed.

The upshot is that a feasible ILLR, designed to address any type of shock generating a financial need, needs to be based on generic eligibility preconditions and minimal structure. The FCL is a perfect example. For a global liquidity shock, such as the generalized "sudden stop" to emerging markets after the Russian crisis, FCL standards or the eligibility conditions cited above would be too stringent. The recent global financial crisis came close to that situation. In fact, the economic downturn in emerging markets was strongly associated with the liquidity profile of the countries' liabilities (Blanchard, Faruquee, and Das 2010). For most countries, standards weaker than those required for a FCL would have been enough for successful ILLR. For a few countries, the global recession that followed the crisis affected them so severely that they are now in need of substantial adjustment and perhaps debt restructuring, which may require ex post conditionality.

In summary, eligibility conditions and operational characteristics of ILLR ought to be contingent on the type of shock or financial crisis in order to avoid inappropriate or excessive conditionality. A noncontingent ILLR is bound to lead to rigid, excessive conditionality in the case of widespread liquidity shocks of the kind seen repeatedly in the new global financial economy. A fully front-loaded ILLR is bound to be very selective and require excessively strong eligibility, leaving out countries that a weaker ILLR with more ex post conditionality may help.[10] What is needed is an integral system of specialized facilities that reflect the contingency prompting the financial crisis and allow for a transition path as country circumstances change, so that the system provides appropriate treatment to countries at all times. Such a system may look complex, but a simpler system is bound to be ineffective, in terms of protection power, country coverage, or both.

Fernández-Arias, Powell, and Rebucci (2009) group economies requiring ILLR into three categories:

- economies with only liquidity problems, where little or no adjustment is needed

- economies in which adjustment and reform are needed to regain solvency but debt restructuring is not expected
- economies that require both adjustment and debt restructuring to regain solvency.

In what follows, I describe the specialized facilities envisioned for these three types of situations.[11] I propose an integrated system of specialized ILLRs or pillars, each designed to address a type of financial crisis or contingency and structured in tiers to accommodate countries' conditions and capacities. Upper tiers, with more stringent eligibility requirements, entail stronger automatic support and weaker ex post conditionality. When one or more of the contingencies is triggered, each country would have access to the ILLR facilities in its tier.[12] Certification of the right contingency entails a judgment that may be impaired by political economy reasons if it is not based on objective indicators. To the extent possible, objective indicators would therefore serve as presumptive evidence of the contingency triggers, barring explicit countervailing justification.

<<B>>Liquidity Facility

One important contingency that merits special treatment is widespread liquidity turmoil or a generalized sudden stop, which could be certified by the ILLR on the basis of indexes such as the overall Emerging Markets Bond Index . This liquidity facility, which would be activated by a systemic liquidity crunch, as measured by these indexes, would liberally provide financing on an emergency basis. A basic tier, with minimal eligibility requirements, would cover all countries in good standing (that is, countries that are involved in IMF Article IV consultations and not in arrears), granting them automatic access to certain quotas (at steep rates to discourage unnecessary use of scarce funds except for the emergency at hand). A higher tier, with additional eligibility requirements related to solid fundamentals and policy framework (and low multilateral credit risk), would screen out countries at risk of developing solvency problems (Fernández-Arias and Hausmann 2002). Countries in this tier would have access to larger amounts of financing up front. Countries able to pledge marketable international collateral (for example, sovereign wealth fund assets) could receive additional liquidity. The establishment of this liquidity facility would reduce individual country's incentives to accumulate excessive

international reserves as self-insurance, a practice that is financially costly and systemically destabilizing.[13]

International financial safety nets fail to protect against a generalized liquidity crisis: facilities are mostly geared toward the possible need for adjustment in individual countries rather than the liberal provision of financing in the event of a systemic liquidity crunch. The recent global recession gave rise to the FCL that provides unconditional financing to a handful of countries but is not specifically designed to address liquidity crises. The main novelty of the proposed liquidity facility lies in its ability to provide widespread automatic financial support triggered by objective indicators of systemic liquidity crisis.

It is difficult to ascertain whether a financial crisis can be solved solely by providing liquidity; although it may be worthwhile trying this noninvasive recourse, the liquidity facility ought to consider the possibility that it may fail to solve the crisis and that solvency strengthening may be required. Weak fiscal sustainability indicators would inform such a presumption. If liquidity is not the solution, adjustment will be needed.

<<B>>Adjustment Facility

I start with the case in which debt sustainability indicators suggest that adjustment and reform will be sufficient to ensure solvency, so that no debt restructuring is expected. Disregarding the need for debt restructuring requires a minimum standard of fundamentals and a policy framework compatible with the level of indebtedness. At one extreme, the Adjustment Facility could include a top tier in the spirit of the FCL, designed for any adverse shock and granting ample financial support only on the basis of strong precondition requirements, with no ex post conditionality. A lower tier could be available to all countries exceeding some satisfactory standard of fundamentals and policy framework as eligibility requirement. This tier would feature more limited automatic support up front and complementary ex post conditionality concerning economic adjustment and policy reform (always under the expectation that debt restructuring will not be needed). More than one lower tier could be created, with the level of the automatic up-front support dependent on the strictness of eligibility requirements. This tiered approach has the advantage of providing breathing space to most countries not qualifying for the top tier to receive automatic support up front and then seamlessly arrange a traditional

stabilization program with ex-post conditionality. [ED: this was in the original and I think it is important; why not? Please keep]

Adjustment facilities have made considerable progress in increasing access to a first unconditional tranche for preselected eligible countries. The debate over how to formalize precautionary contingent lines to supplement the FCL appears to point in this direction of combining up-front financial support with ex-post conditionality. This proposal supports this trend and highlights the importance of a tiered structure for such facilities.

The system may also consider specific contingencies that would trigger additional lending on top of the previous facilities. For example, a supplementary facility may be associated with contingencies in which the predominant shock is exogenous to the country in question (for example, a collapse in terms of trade). This facility could give access to additional up-front drawing rights, to distinguish it from the case in which the financial crisis is triggered by internal events more likely associated with an inadequate policy framework. Such a facility would recognize that under this contingency, ex post conditionality is probably less necessary for the country to adequately adjust to the shock. The new element this proposal brings to this point is that facilities need to be designed not only for countries' capacities but also for the type of shock leading to financial need. Of course, facilities specialized in specific contingencies like this could also be organized in tiers.

Whether debt restructuring is needed to regain solvency is difficult to ascertain, but it usually becomes clearer as information on adjustment performance comes in and the market reacts to the country's developments. If the market expects debt restructuring, it is paramount to move quickly, before the financial situation unravels. In practice, debt restructuring usually takes too long to be implemented. A multilateral facility is therefore needed to help countries with unsuccessful adjustment programs to transition to debt restructuring.

<<B>>Debt-Restructuring Facility

Finally, a Debt Restructuring Facility is needed. Debt restructuring and "bankruptcy protection" may be triggered by countries asking for protection from the ILLR against lenders and other claimants (and at the same time relinquishing access to the other facilities). Often, however, countries incur costly delays in restructuring debt. Weak debt sustainability indicators and a

negative review of the prospects of sensible adjustment and reform to avoid debt restructuring under the previous facilities would also prompt a switch to this facility.[14]

Eligibility for this facility ought to be as wide as possible, leaving out only countries unable to work under multilateral ILLR rules (for example, countries severed from Article IV consultations). Under this facility, the ILLR would establish whether debt restructuring is needed and manage interim financing, adjustment, and debt restructuring using the power of conditionality. The certification that debt restructuring is justified and underway would amount to a declaration of "excusable default" (Grossman and Van Huyck 1988), which would reduce the reputational cost of nonpayment or temporary controls on capital outflows or even eliminate these costs if these actions are part of ILLR conditionality.

The novelty of this facility is that it brings debt restructuring under the ILLR umbrella and deals with it by financing a justified debt workout rather than pretending that adjustment is always a feasible solution to regain solvency and leaving to the market to sort out insolvency if it is not. This proposal calls for a reconsideration of the debate that led to the abandonment of the Sovereign Debt Restructuring Mechanisms (SDRM) announced by the IMF in 2001, this time in the context of an ILLR certifying and financing a justified debt workout.

A practical system of ILLRs needs to confront a number of practical implementation problems. One class of problems has to do with political pressures on the ILLR to be more flexible with certain countries with political clout. In this regard, elements of automaticity and objectivity—rules rather than room for discretion—are helpful (Obstfeld 2009). A particularly difficult problem of this nature is how to disqualify a country that ceases to comply with eligibility criteria (for example, a FCL country after a negative semiannual review). Although the signaling value of such determination is unavoidable, the gradual removal of privileges (for example, through lower caps, steeper charges, or both) may help the transition. The tiered approach proposed could also help solve the problem of exit or disqualification by providing a smoother transition to a lower tier.

Another problem that has plagued this kind of facilities is the stigma of joining a program designed to provide emergency financing. Fear of signaling weakness by doing so led to the total failure of the Contingent Credit Line (CCL) and subsequent predecessors of the FCL, all of which could otherwise have prevented crises, to attract clients. Although the FCL is by design accessible to a select group, which helps reduce the stigma problem, and has attracted three

countries (Colombia, Mexico and Poland), countries with the strongest policy frameworks have not joined, and it is not clear that the stigma issue has been overcome. Currently, countries are confidentially invited to make an informal application whose result would be communicated privately, so that there is no loss of reputation attached to being rejected (unless there is a leak at some point in the process). However, unless the strongest countries decide to apply, this system allows the stigma problem to persist. A system announcing the criteria used for eligibility would inspire more confidence and probably be an improvement, but it would not change the fact that the strongest countries would still presumably not participate. An alternative, transparent system would be to officially produce and disclose a list of eligible countries—that is, prequalify countries unilaterally—making sure that the strongest countries are included. By proactively producing the list of eligible countries in each tier based on set criteria, this alternative would reduce or eliminate the stigma problem. Such a system would also, however, publicly identify countries unqualified for each tier, suggesting that, although superior to the current system, it would not be unanimously acclaimed.

A key reason why countries have historically not relied on these facilities is mistrust that when funds are needed, there could be a last-minute impediment to disbursement approval, a last-minute push to extract (perhaps extraneous) conditionality. Preset eligibility for automatic up-front support for every ILLR tier would eliminate much of this worry for eligible countries (for all countries if prequalification for eligibility were proactive). Nevertheless, uncertainty about ex post conditionality would persist. The new top-tier FCL, based exclusively on ex ante conditionality and no additional activation clause, solves this problem for the handful of countries eligible for it. However, even countries eligible for a FCL may mistrust the criteria that would be used for recertification every six months and be concerned about losing their qualification. Despite added flexibility in the setting and verification of conditionality, ineligible countries still face most of the same uncertainties of the past. Trust can be built by increasing transparency and incorporating trusted institutions into the process (a possible role for multilateral development banks and other multilateral institutions).

<<A>>Radical Reform to ILLR: International Bankruptcy Court and Sovereign Debt Restructuring

The absence of stipulated and enforceable laws akin to those governing bankruptcy proceedings significantly limits the ILLR when solvency and debt overhang considerations are dominant. As in the case of a domestic institution going through bankruptcy, efficiency calls for appropriate adjustment and debt restructuring, but the ILLR cannot rely on the traditional legal instruments to produce these results. Country conditionality may steer crisis resolution in the optimal direction, but it does not guarantee the kind of resolution that would be feasible with bankruptcy-like legal power, as strong conditionality may fail to be fulfilled and weak conditionality is bound to have limited effect. Control over the behavior of private creditors appears even less powerful. The impediments to effective private sector involvement in ILLR are critical, because the sheer size of private sector capital flows makes them fundamental to containing liquidity crises and managing solvency crises.

Because of sovereignty, it would be naive to propose the creation and empowerment of an international bankruptcy court similar to its domestic counterpart. Even if sovereigns attempted to cede ex ante some sovereignty prerogatives by accord in order to bring ILLR country conditionality closer to a legal framework, the commitment to such submission would be unenforceable. However, international legal reform to empower ILLR with respect to international lenders along the lines of a bankruptcy framework appears feasible, either by treaty or contractually, and may bring substantial improvements.[15] Law may not bind governments, but it may bind private creditors.

The absence of an international bankruptcy system creates two critical limitations with respect to financing adjustment in an insolvency situation. First, lenders and other stakeholders with conflicting interests cannot be forced to collaborate. Beyond coordination, the ILLR cannot supersede the rights of creditors to free ride and cash in; it cannot force them to wait until a viable debt-restructuring arrangement is designed and agreed to under efficient rules (a standstill on debt payments). Coordination among lenders is necessary but not sufficient for efficient restructuring.

Second, it is difficult to obtain new lending during the reorganization process, because there is no court able to grant seniority priority to interim financing, making it almost impossible to attract fresh private sector financing to accompany ILLR (a point emphasized by Bolton and Skeel 2005). In the absence of legal power, ILLR is limited to indirect means of influencing private lenders, such as tying its financial support to their collective behavior and hoping that

they are able to coordinate a rational response, as in lending into arrears. Without any mechanism for catalyzing private sector participation, ILLR may thwart the whole effort.

> In this context, the SDRM proposal represented a moderate attempt to institute certain rules to facilitate creditors' collective action for debt restructuring to overcome these two limitations without impinging on creditor rights, such as in the imposition of a stay on payments and litigation or the imposition of junior status on old debt. It fell short of addressing effectively both limitations.[16]

As it stands now, countries can control financial flows in an insolvency situation only by using blunt and conflictive instruments, such as arrears and hastily arranged debt restructuring. True, the fear that impediments to collective action of post-Brady securitized debt holders would make sovereign debt-restructuring negotiations collapse and arrears permanent did not materialize, and debt exchanges were completed. Even in the best of circumstances, however, debt restructuring agreed upon on the basis of an offer that (some qualified majority of) lenders "cannot refuse" is a breach of contract, with nasty consequences for the future even in the absence of holdouts. Like arrears, the imposition of controls on capital outflows on the part of countries may be a way out in certain circumstances, but it may also carry enormous costs for the future if such controls poison the well of financial integration. ILLR can help diffuse the reputational cost of arrears by lending into arrears if a country is making a good faith effort at restructuring. It can also help by activating its lending and declaring the occurrence of certain financial contingencies that merit impediments on capital outflows, thus providing cover to countries exercising controls in those circumstances ("excusable" capital controls). However, all of these methods rely on individual countries' unilaterally breaching their obligations and living with the legal and reputational consequences.

The cleanest and safest way to achieve control over financial flows in a crisis situation while avoiding arrears or forced debt restructuring and capital outflow controls would be to endow the ILLR with legal powers to grant a standstill on international payments when a country's ability to service its debt is insufficient, based on rules similar to those governing standstill orders in a domestic bankruptcy court. In this way, the ILLR would provide a standard for "excusable" default. At the same time, countries not meeting the standard and unilaterally defaulting would be exposed as opportunistic in the judgment of the ILLR, increasing the reputation cost of frivolous default. Discriminating between justified and unjustified defaults and

debt-restructuring terms, so that low default costs apply only to ILLR–certified debt restructuring based on technical criteria, is fundamental to ensure that the ex post efficiency gains of an orderly workout managed by ILLR do not translate into incentives to default opportunistically (Sturzenegger and Zettelmeyer 2007).[17]

The ability to legally impose a standstill on payments and capital outflows provides the flexibility needed to restructure while keeping sovereign risk under control, because a multilateral ILLR is an honest broker not suffering from the sovereign's willingness-to-pay problem (Fernández-Arias and Hausmann 2002). Granting this authority would empower the ILLR, in three ways. First, it would enable the ILLR to disburse funds automatically, without concern that its lending translate into increased capital outflows and little real effects. Second, it would help coordinate lenders and investors and buy time for an appropriate debt restructuring under equitable conditions for all involved. Third, by conditioning the lifting of the standstill on an appropriate debt-restructuring agreement, it would give the ILLR an effective instrument with which to ensure that adjustment and restructuring will be successful. This point is worth elaboration, because it is one of the main benefits of this radical legal reform.

As in domestic bankruptcy, stakeholders need to agree on an overall proposal for adjustment and debt restructuring. The interest of the ILLR is to promote a reorganization that combines country adjustment (including policy reform) and debt restructuring in a way that serves the best interests of the country. There are many ways in which such combination may be faulty. Inadequate coordination by creditors may lead to chaos. Short-sighted governments may favor excessive debt reduction, hurting the country's prospects for future financing. Alternatively, debt restructuring may be negotiated too late, because governments do not want to face its political costs, preferring instead to "gamble for resurrection," which results in inefficient adjustment (Sturzenegger and Zettelmeyer 2007). Countries with unsound governments may engage in overadjustment followed by excessive debt reduction.

Even if creditors coordinate perfectly and governments maximize national welfare, debt reduction bilaterally agreed on by lenders and borrowers may be too shallow and fail to remove adverse debt overhang effects.[18] This is a distinct possibility if ILLR financing is perceived to depend on a country's postrestructuring financial needs, the typical case of a deep-pocketed third-party taken advantage in a bilateral negotiation. The ability to maintain the standstill on payments until a satisfactory package on adjustment and debt restructuring is found and lenders

agree, as well as the ability to remove such standstill if the country does not engage in adjustment and debt negotiations in a constructive manner, would provide powerful leverage to the ILLR on both adjustment and debt restructuring.

The other key element of legal reform is the ability of the ILLR to grant seniority to fresh interim lending. The alternatives to voluntary new financing reviewed earlier rely on substitutes of legal priority that are costly or difficult to obtain. If these substitutes are based on official guarantees, they are a contingent liability of ILLR and therefore costly. If they are based on insurance contracts or insurance-like provisions in debt contracts, they are difficult to implement and typically seen as too costly by short-sighted governments, for traditional insurance aversion reasons. More generally, new lenders may be unable to provide fresh money, because of legal interference by existing lenders in arrears. Legal seniority would resolve this issue by implicitly creating a built-in insurance mechanism. The country would implicitly pay for this (mandatory) insurance through higher spreads on account of the expected dilution costs of regular debt in the event of financial crisis, thus aligning the allocation of costs and benefits of the risk covered.

By creating the conditions for fresh voluntary market financing, this legal power would act as a strong catalyst, reducing the financial resources needed by the ILLR. In the extreme, the ILLR would be able to concentrate on its management role rather than financing. In the absence of legal power to grant seniority status to fresh money, it is likely that new money will always have to come from official sources and require political agreement to sustain sizable funds.

<<A>>The Role of Multilateral Development Banks in Supporting the ILLR

Official ILLRs include both multilateral and bilateral institutions. Unlike private sector lenders, which need to be granted substantial enhancements or somehow coaxed into lending into a financial crisis, multilateral development banks are natural components of an ILLR system, because they are guided by development goals that make them more willing to lend in riskier environments if social returns are high. At times of difficulty, or crisis, the risk of losses is high—but so is the corresponding social return of containing them. In parallel, given their preferred creditor status, multilateral development banks have a superior enforcement capacity to recover their capital at risk, which makes them more able to withstand risk. Both differences

between multilateral development banks and private lenders become dominant in high-risk situations, such as severe downturns or financial crisis.

These differences explain why private lending is procyclical and lending by multilateral development banks is countercyclical. The historical record and econometric analysis document that countercyclical lending by multilateral development banks replaces retrenching by private creditors (Fernández-Arias and Powell 2006; Levy-Yeyati (2010). In the typical developing country, the share of multilateral development bank disbursements relative to private disbursements increases significantly during growth downturns and decreases in upturns.[19] More to the point, in the typical developing country, the level of multilateral development bank disbursements is inversely related to the rate of economic growth.

Although the institution at the center of ILLR functions is the IMF, coordination with other ILLRs is important for success. The question is whether the active countercyclical role of multilateral development banks during downturns and financial crises would remain under the ILLR system proposed above. The answer is probably yes, on several counts:

- ILLR applies only in extreme financial situations. Multilateral development banks modulate specific development projects and policy reform to the economic circumstances of countries, including by helping devise effective countercyclical fiscal policies where there is fiscal space that can accelerate economic recovery or by limiting the size of contractions while ensuring development value.
- Under a number of scenarios, multilateral development banks may be called on to be a partner of the ILLR. Because multilateral development banks are willing to lend in a financial crisis and to do so long term, under normal operations they are implicitly partners of ILLRs. The IMF may fail to serve as the ILLR because it is not permitted to disburse sufficient resources to a particular country. Under such circumstances, countries could benefit from multilateral development banks as explicit partners. It is also possible that for small countries, the IMF may find it more practical to delegate ILLR functions to multilateral development banks, subject to its supervision (Fernández-Arias, Powell, and Rebucci 2009). The ILLR will also miss opportunities because of country ineligibility, stigma, or mistrust; in these cases,partnering with multilateral development banks may be

necessary to reach a constructive result. In particular, multilateral development bank participation may help build trust in ILLR adjustment and debt-restructuring views in solvency crises in particular countries.

- ILLR is critical for providing countries with a larger financial envelope to shape crisis policies; multilateral development banks are called upon in times of difficulty to participate in the actual reassignment of public sector activities within the available envelope. They contribute through project- and policy-based loans (including the reformulation of the loan portfolio). They support the development integrity of key aspects of the overall public expenditure framework, which may collapse under fiscal adjustment pressure; help design and protect social programs to contain the effects of recessions on the poor and future generations; and safeguard investment projects and policy reforms that may be victims of disorderly adjustment. Given the high volatility of economic activity in developing countries, which contributes to poor economic performance, these responsibilities are crucial for economic development. They cannot be addressed by an ILLR concerned only with macroeconomic balances. Participation of multilateral development banks would reduce the neef for ILLR adjustment conditionality.
- Times of crisis may create opportunities to pursue growth-enhancing reforms, including development-oriented structural reforms through policy-based loans, that would otherwise not be undertaken. The IMF is in charge of monitoring the budget envelope in the short run; multilateral development banks focus on reforms that generate better frameworks for fiscal policy. Multilateral development banks can design fiscal institutions that not only serve the purpose of fiscal adjustment under ILLR but also ensure fiscal sustainability going forward. Their participation would improve ILLR conditionality.

In all cases of extraordinary financing of this sort, the IMF and multilateral development banks need to act in concert to ensure that the ILLR function is performed efficiently, in the context of an overall lending program. It is especially important that multilateral development banks refrain from lending more leniently than the IMF under contingencies covered by its ILLR facilities, because such competition would undermine the ILLR system. (Of course, this is

equivalent to saying that the ILLR system is undermined if the IMF is harsher than multilateral development banks deem appropriate.) In the last analysis, an ILLR system needs to be agreed upon and coordinated by all multilaterals. For example, once an ILLR system is agreed upon, countries asking multilateral development banks for extraordinary financing may be required to ask for eligibility to ILLR facilities (if they do not already qualify for them), so that the ILLR assessment can be taken into account in determining the terms and conditions of such financing. This coordinated procedure would also strengthen membership in the ILLR system and secure prequalification, which is key for the success of a crisis prevention and mitigation tool in which speed and certainty are critical.

In a tiered ILLR system like the one proposed, the ILLR assessment is highly informative for an multilateral development bank willing to retain appropriate flexibility. For example, there should be a strong expectation that a country eligible for the top tier (for example, a country with an ongoing FCL arrangement with the IMF) could freely access extraordinary financing. In contrast, a country that would not qualify even for the lowest tier would be expected to be denied such financing. Without prejudging the overall conclusion on the part of the multilateral development bank, there would be a substantial burden of proof to overturn such presumptions on the basis of macrofinancial indicators and other relevant dimensions of the macroeconomic and structural policy framework as well as market-based indicators of country creditworthiness. For all other less clear-cut cases, ILLR status would be less decisive in forming the judgment of the multilateral development bank. The IMF's shorter-run focus and the market's exclusive concern with commercial credit risk mean that both may ignore longer-run sustainability and development issues that multilateral development banks take into account.

<<A>>Concluding Remarks

There is an increasing need for a system of international lending of last resort (ILLR) to deal with financial crises in vulnerable countries as financial globalization deepens and spreads. Multilateral progress to address liquidity and solvency crises has been inconsistent, with no meaningful distinction between the two; in particular, there is still no framework for sovereign debt restructuring. The proposals in this paper support and build on recent initiatives at the IMF to expand the facilities created in 2009 to address the global crisis on a permanent basis.

This paper follows the strategy of adapting the traditional institutions of lending of last resort and bankruptcy resolution in the domestic arena to what is today feasible for multilateral institutions to engineer as ILLR. The paper proposes an integrated system of specialized ILLR facilities to address problems of liquidity, adjustment, and debt restructuring as the situation evolves and the nature of the crisis morphs. Each facility is, structured in tiers defined by prequalification standards to cater to countries' capacity. In all cases, facilities provide sufficient automatic support up front as to be able to seamlessly arrange a country program, if needed, subject to minimum ex-post conditionality.

Country eligibility to facilities depends on both the strength of country's fundamentals and the nature of the financial crisis (e.g. liquidity/solvency, systemic/country-specific). For example, a facility designed to cover systemic liquidity crises would deliver substantial upfront lending to almost all countries in need, subject to monitoring to detect individual cases requiring transition to facilities addressing solvency crises. By contrast, idiosyncratic financial crises traceable to weak fundamentals would be addressed by an adjustment facility, which except for its most select tier would tie part of the financial support to some ex-post conditionality.

The paper further proposes legal reform to subject creditors to standstills and seniority dilution as in domestic bankruptcy, thus empowering ILLR to facilitate orderly workouts when debt restructuring is necessary to restore solvency. This reform would make efficient financial reorganization possible including the attraction of (senior) new private lending, thus minimizing ILLR financial involvement. In that way, old debt would be diluted in the case of overindebtedness and ex-ante incentives of countries and creditors will become aligned. The Debt Restructuring Facility would be called by countries in need of "bankruptcy" protection or by the ILLR if other facilities are insufficient to deal with financial crisis in particular countries. ILLR would set standards on "excusable defaults" and apply its financial muscle to help countries adjust and regain solvency, thus lowering costs of justified restructuring while exposing frivolous defaults.

While the IMF is at the center of the ILLR system, MDBs have a number of supporting roles to play in the system. This requires that they act in concert and mutually reinforce country eligibility for emergency facilities.

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<<A>>Notes

1. Greece's collapse, which occurred after this chapter was written, provides another warning.
2. For an analysis of the failed attempts at establishing safety nets for financial crises in the past and the shortcomings that persist, see Fernández-Arias (2010).
3. See, for example, Fernández-Arias, Gavin, and Hausmann (2000) and other works presented in IDB 1998 Washington Conference on World Financial Stability) in the wake of the Russian crisis (reflected in IDB 2000).
4. Fernández-Arias, Gavin, and Hausmann (2000) and Fernández-Arias and Hausmann (2002) also model international financial architecture after the classical principles of LLR to domestic banks (liquidity crises) and domestic bankruptcy institutions (solvency crises), subject to sovereignty constraints. This section draws heavily on both papers.
5. There are intermediate cases not addressed here. There is the issue of the proper role of the central bank in using its reserves to bankroll the fiscal accounts in a financial crisis; I sidestep this issue and purposely consolidate the entire public sector facing a financial crisis requiring support from abroad. In a globalized economy, the power of the traditional domestic LLR becomes more limited because of currency mismatch between lending power and financial needs as well as the global repercussions of domestic lending. The internationalization of firms may also lead to crossborder LLR to private institutions.
6. Some assurance to private sector lenders would also be desirable in the case of liquidity crises.
7. Insurance-like mechanisms need to be arranged ex ante and may very well be part of multilateral conditionality. This chapter focuses on ex post mechanisms with which to respond following the onset of financial crises.
8. For an early proposal along these same lines after the liquidity crises in emerging countries of the 1990s made it clear that ILLR needed to break with the past, see Fernandez-Arias, Gavin, and Hausmann (2000).
9. A policy framework could also include adequate insurance-like arrangements.

10. Excessive conditionality may also result from an ILLR designed to use the countries' need in times of crisis to extract (ex ante or ex post) extraneous conditionalities not actually needed to ensure the effectiveness of a particular ILLR operation. Such an action may lead to unnecessary crises in countries not willing to further "optimize" their policy frameworks. Experience shows that official views on optimal policies are not infallible, which calls for caution and parsimoniousness in designing pertinent, let alone extraneous, conditionality.

11. Just as a presumed liquidity crisis may develop into or turn out to be a solvency crisis requiring other facilities, the expectation that debt restructuring is not needed may require revision and a change of facility.

12. I prepared a first draft of this proposal in 2009 (IDB 2010). After the note was written, it was brought to my attention that an IMF Staff Position Paper (IMF 2009) also envisioned a variety of scenarios and country eligibility requirements for ILLR that are broadly compatible with my own (albeit not integrated with a debt-restructuring function).

13. This point is moot in countries in which the driver of reserves accumulation is export promotion rather than risk management.

14. Arrears (which would disqualify countries for the other facilities) would also be an indication that this facility is needed, with the same caveat applied to customary policies of lending into arrears of good faith negotiation with private creditors.

15. The precedent of the UN Security Council protecting Iraq's oil assets against foreign creditors, valid in the jurisdictions of all country members, offers a model of how existing institutions may help shape this legal reform.

16. The proposal did envisage a substitute of a standstill on payments (the "hotchpot" rule). Even this moderate proposal was shelved, however, in favor of a contractual approach to the problem to include collective action clauses in new bond issues, which are now the standard.

17. If default costs were reduced indiscriminately, incentives to default would increase (Dooley 2000).

18. In the absence of risk-sharing features such as GDP–linked coupons, the negotiated debt reduction is likely to be too limited to enable lenders to potentially extract higher payments later on ex ante.

19. This pattern suggests that the growing financial integration of most countries will lead to an increasing need for countercyclical support.