Recent approaches to involving the private sector in the resolution of international debt crises

As a consequence of the Mexican debt crisis of 1994-5, and intensified by subsequent similar crises in other countries, a broad, intensive debate has been taking place recently on how the international financial architecture can be improved. There is no significant support for regressive approaches that call the advancing integration of the financial markets into question. Rather, the thrust is towards paving the way for the financial markets to function better. That is the only convincing way to help developing countries, which are vitally dependent on a steady inflow of private capital from abroad. In particular, reform efforts must be aimed at getting private creditors to assume individual and complete responsibility for their exposures in the event of a crisis. Only if this responsibility is assumed can a lastingly satisfactory functioning of the financial markets be assured. In the past few years, this axiom has been violated, at times flagrantly. The present article therefore focuses on proposals which could help make it easier in future to involve the private sector in crisis resolution to a greater extent than in the past. In the debate on the international financial architecture, the Bundesbank has advocated such an approach from the beginning.

The growing importance of capital movements

Main features of the world monetary system

Today's international monetary system, which has evolved over a lengthy period of time from the Bretton Woods monetary system conceived in 1944, has two main features:

– Firstly, freedom of capital movements is, *de facto,* one of the system's integral elements. Initially, a very few countries (particularly the United States, Germany and Switzerland) played a leading role in the liberalisation process for a long time; now, all industrial countries have accelerated the process of deregulating their capital movements since the early eighties, and have in the meantime abolished all restrictions. Moreover, at the beginning of the nineties, the most advanced developing countries and countries in transition also embarked on this path.

– Secondly, as a result of the increasing liberalisation of capital movements, a system of diverse exchange rate arrangements replaced the former Bretton Woods par-value system. It has been left to each country to choose the exchange-rate regime best suited to its own needs. For exchange-rate relationships between the key countries in the world economy, there was no getting around a transition to flexible exchange rates. Given the relatively large domestic economies of those countries and their at times diverging economic priorities, that was the only way to ensure that monetary policy was geared towards their respective macroeconomic requirements. Today, in the remaining countries, by contrast, one encounters a wide spectrum of exchange-rate arrangements, ranging from freely floating exchange rates to rigid exchange-rate pegs (such as currency boards).

Increasingly free financial markets have enhanced the efficiency of the world economy

On the whole, the world economy has functioned quite well with the increasingly free world monetary system. The international exchange of goods and services, a source of prosperity, has increased at a great pace. One factor which has played a significant role is that the growing freedom of capital movements has facilitated the exchange of expertise by means of rising international direct investment. In addition, the financing of current account deficits has been hampered less and less by the availability of official funds (as was typical of the previous Bretton Woods system); instead, such financing has increasingly and predominantly been bolstered by business relations with foreign private investors and creditors. As a result of all that, the world economy as a whole has vastly increased its efficiency in the past few decades. It is those industrial and developing countries which have adapted the structure of their economies to the demands of globalisation the most radically that have derived the greatest benefit from advances in the integration of the world economy.

Private capital exports to developing countries initially mainly through bank loans

The developing countries, which are especially dependent on foreign private funds, have registered two major waves of capital inflows since the beginning of the seventies. The first major wave of private capital exports to developing countries was an upshot of the

sharp oil-price rises of 1973-4 and 1979-80, with countries already at an advanced stage of industrialisation and having sizeable per-capita incomes (emerging market economies) being the main recipients of funds. Other significant importers of capital included countries like Mexico, which, although they benefited from the rise in energy prices (being oil producers), also made use of foreign savings to additionally accelerate their economic growth. The main channel of these capital imports was public sector indebtedness to the internationally operating banks of industrial countries. According to information provided by the Bank for International Settlements (BIS), in the period between the end of 1977 and the end of 1981 alone (comparable data for earlier periods are not available) the indebtedness of all developing countries to banks rose by US $ 188 billion to US $ 362 billion (excluding offshore centres, but including formerly centrally planned economies). In addition, from 1985 a considerable volume of bank loans flowed specifically to the former Soviet Union upon the institution of political reforms by President Mikhail Gorbachev. According to BIS statistics, claims by western banks on the Soviet Union rose between the end of 1984 and the end of 1990 (i.e., not including the crisis-stricken end of the Soviet era) by US $ 36 billion to US $ 53 billion. A considerable share of the outstanding bank loans to the USSR, however, was based on government guarantees by the creditor countries and, to that extent, was to be equated with official lending.

The second major wave of private capital exports to developing countries set in at the beginning of the nineties. In 1996 it reached a temporary peak, with net private capital exports to that group of countries (which also includes transition countries) totalling no less than US $ 212 billion, according to IMF figures for that year. Between the end of 1990 and the end of 1996, such inflows added up to US $ 983 billion. A large portion of this sum, 43 %, was accounted for by direct investment. Moreover, investment in securities, particularly in government paper denominated in foreign currencies, played a major role, making up 44 % of overall inflows. New bank lending, by contrast, dropped sharply. The diminished overall significance of bank lending, however, owed much to some sharply diverging regional trends. During the aforementioned six-year period, the banks distinctly downscaled their claims arising from book

Sharp increase in capital exports to developing countries in the nineties through many channels

Net capital flows to developing countries *

US $ billion

Item	Annual average 1984 to 1990	Annual average 1991 to 1995	1996	1997	1998
Direct investment	14	60	115	140	131
Portfolio investment	6	70	81	67	37
Bank loans and remaining assets	– 2	24	16	– 58	– 104
Total	18	154	212	149	64

Source: IMF. — * Comprises all developing and transition countries, including Korea, Singapore, Taiwan and Israel (Hong Kong has been excluded owing to insufficient data).

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loans to Russia and other countries in transition. Much the same applies to the Latin American emerging economies, which thereby evolved into leading issuers in the markets for emerging market bonds. However, Asian emerging economies continued to incur a considerable volume of debt in the form of bank loans, with short-term borrowing being in the forefront.

Initiatives to improve the international financial architecture as a consequence of repeated debt crises

No significant support for backward-looking proposals

The debt crises of individual countries or whole regions that have occurred repeatedly in the wake of the sharp rise in the capital imports of the developing and transition countries sparked off a comprehensive debate on how the world economy could be made less vulnerable to crises. This process, under the aegis of the G-7 countries, began after the Mexican crisis back in 1994-5. The strategy adopted rested then, as it does now, on the prevailing opinion that trade and capital movements alike should continue to be as free as possible (as opposed to a regressive change in the system towards more restrictions). However, for exactly that reason, much remains to be done to ensure that the financial markets can perform their allocation function in the international use of macroeconomic savings in the best way. At the 1995 G-7 economic summit, attention was drawn in this connection to the need for some changes in the architecture of international financial institutions, implying the assignment of new duties, in view of the fact that, since the establishment of the Bretton Woods institutions, the world economy had been liberalised beyond all expectations. Today, it is customary to speak of the international "financial architecture" which needs to be improved.

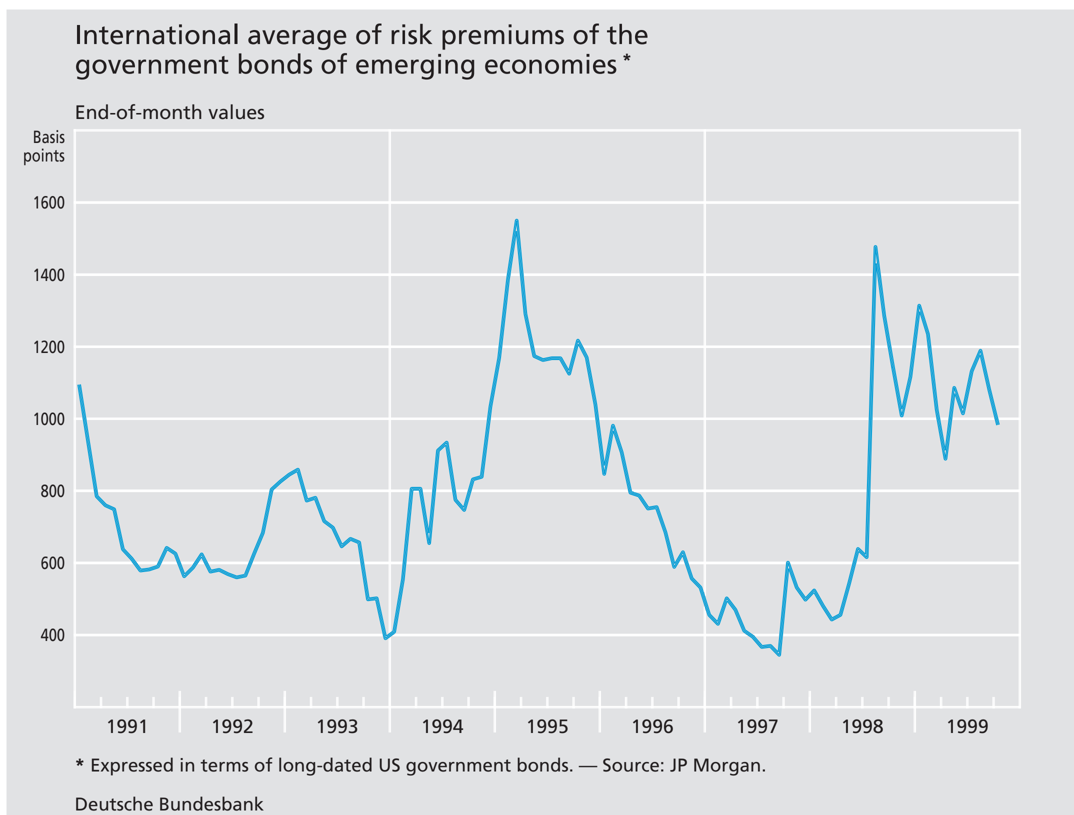
Numerous starting points for improving the financial architecture

The relevant proposals for improvement and measures, which have in some cases already been introduced, can be divided into two groups, according to how far they have been achieved. There are no differences of opinion in the competent international institutions regarding the need to strengthen crisis prevention by means of sound economic policies on the part of the debtor countries. These include getting emerging economies to be more prudent with government guarantees in favour of domestic borrowers, so as not to encourage frivolous lending practices. Time and again, in fact, it has been found that exchange rate pegs, in the absence of an uncompromisingly exchange-rate-oriented economic policy, may increase a country's vulnerability (as a consequence of deteriorating competitiveness or by fostering volatile capital imports). In cases of doubt, the pace of liberalisation in capital transactions will have to be slowed down if the underlying economic conditions of the country in question are not yet sound enough to withstand strain. Above and beyond these economic considerations, it is generally believed to be important to ensure that international agencies, the governments of debtor countries and private borrowers each do their part to enhance the transparency of the markets. That is meant to make it easier for creditors to take sound lending decisions. In addition, it has turned

out that the existing Basle Capital Adequacy Standards have an undue tendency, at least in terms of their approach, to grant privileged status to short-term interbank loans to emerging economies in the context of prudential capital requirements. It is generally likewise agreed that deep-seated fragilities in the financial systems of the debtor countries should be eradicated as quickly as possible to reduce both the dependency of those countries on foreign capital and their vulnerability in the event of a crisis. This is a particular area for the attention of the Financial Stability Forum, established in spring 1999. Even if, in individual cases, it is by no means easy to make definite and speedy progress in all those fields, the direction to be taken is certainly obvious. The practical improvements being envisaged here will, above all, require patience and perseverance.

Undue expansion of official financing options

By contrast, controversy pervades the debate being held in the relevant organisations on the issue of whether, and to what extent, private creditors should be involved in the resolution of debt crises. The official – and in itself successful – operation performed in 1995 to rescue Mexico and its private creditors, consisting of a package of multilateral and bilateral financial aid measures running at a hitherto unprecedented level and, in particular, making it possible for Mexico to redeem, on time, high-yielding, exchange-rate-guaranteed, peso-denominated Treasury bills, opened the floodgates for further similar interventions by the official community. The example of Mexico was consequently followed by official rescue operations of comparable magnitude benefiting a number of east Asian countries and Brazil. In connection with this trend, the range of IMF financial aid instruments expanded strongly, and the Fund's borrowing facilities were extended by the New Arrangements to Borrow adopted in 1998. With the Emergency Financing Mechanism (1995), the Supplemental Reserve Facility (1997) and its Contingent Credit Lines (1999), the IMF has moved into new dimensions in the field of balance-of-payments financing. These facilities were complemented by the provision of major bilateral financial aid, with the BIS acting as the coordinating agency. In addition, the increasing participation of the World Bank in balance-of-payments assistance operations is problematic. The idea that international debt crises or looming contagion effects should automatically be countered by injecting massive official financial aid is, however, a questionable approach. In 1944, in an accurate appraisal of its possibilities and requirements, the IMF was only assigned a financial mandate to help bridge, by means of conditional aid, periods when current account deficits have expanded to a critical extent. Abandoning this principle in the sense that the international community also jumps in to finance massive confidence-related capital outflows would be tantamount to relieving private creditors of the risks they ought to bear themselves in the interests of a lastingly satisfactory functioning of the world financial markets and the global monetary system as a whole. It is quite possible to interpret the sharp decline in risk premiums on emerging market bonds, which was discernible shortly after the Mexican crisis of 1994-5 subsided, as a reaction to the problematic manner in which that crisis was



* Expressed in terms of long-dated US government bonds. — Source: JP Morgan.
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resolved (as an international average, the spreads prior to the onset of the east Asian crisis were actually below the level before the outbreak of the Mexican crisis). It appears just as questionable to provide major financial aid packages to those countries whose economic policies are by and large considered sound to shield them from the spillover effects of another country's crisis. This might potentially greatly promote moral hazard not just among investors and lenders but also among the debtor countries (i.e. by deferring necessary adjustment measures in economic policy). The increasingly insistent efforts of late to soften the conditions for access to the IMF's Contingent Credit Lines should therefore not be supported. Rather, what is necessary is to refocus the mandates of the Bretton Woods institutions on their traditional, proven tasks, as has likewise been called for recently by an independent US think tank.

Gradual progress in involving the private sector in crisis resolution

Instead of seeking to expand the IMF to constitute an omnipotent fire brigade for coping with financial crises, it must be ensured that, in line with the basic principles of a market economy, which underpin the world economy, the private sector contributes substantially to resolving capital-flow problems in the event of a crisis. This demand addressed to the private sector cannot be side-stepped by citing the inevitable, painful depreciation of financial assets in a crisis scenario. Internationally active financial institutions, in particular, emphasised such burdens repeatedly, actually reckoning with share-price losses. To the extent that depreciation of debt instruments is not offset anyway by market recov-

ery, it should be regarded over the longer term as offset by the risk premiums formed in the market. After the IMF and some of its most important members had hesitated for a long time, welcome headway has been made in the right direction of late. For instance, within the G-7 there is a far-reaching convergence of opinions, in principle, about the necessity of involving the private sector in crisis resolution. This was clearly reflected in the report of the G-7 finance ministers on strengthening the international financial architecture which was presented to the June 1999 economic summit. Accordingly, the IMF likewise began to change its strategy a short time ago.

Change of course towards the underlying strategy of the eighties

The change of course which is under way in tackling international debt crises takes up where approaches to fighting government debt-service problems that occurred in Latin America, and subsequently in Russia, in the early eighties, left off. Thanks to the IMF's low resources at that time, it was essential to involve banks affected by balance-of-payments crises in crisis resolution. In this context, the London Club, which evolved in parallel to the Paris Club (a body of government creditors responsible for rescheduling public sector debt), has undoubtedly proved invaluable as a bank negotiating body for rescheduling official debt. The earlier practice of involving the private sector was superseded on the outbreak of the Mexican crisis by the fact that, in view of the new method of incurring debt by issuing bonds, as mentioned earlier, there were no proven methods of cooperation between issuers and creditors.

Agreed principles for involving the private sector in crisis resolution *

a) The approach to crisis resolution must not undermine the obligation of countries to meet their debts in full and on time. Otherwise, private investment and financial flows that are crucial for growth could be adversely affected and the risk of contagion increase.

b) Market discipline will work only if creditors bear the consequences of the risks that they take. Private credit decisions need to be based on an assessment of the potential risk and return associated with a particular investment, not on the expectation that creditors will be protected from adverse outcomes by the official sector.

c) In a crisis, reducing net debt payments to the private sector can potentially contribute to meeting a country's immediate financing needs and reducing the amount of finance to be provided by the public sector. It can also contribute to maintaining appropriate incentives for prudent credit and investment decisions going forward. These potential gains must be balanced against the impact that such measures may have on the country's own ability to attract new private capital flows, as well as the potential impact on other countries and the system in general through contagion.

d) No one category of private creditors should be regarded as inherently privileged relative to others in a similar position. When both are material, claims of bondholders should not be viewed as senior to claims of banks.

e) The aim of crisis management, wherever possible, should be to achieve cooperative solutions negotiated between the debtor country and its creditors, building on effective dialogues established in advance.

* Excerpt from the Report of the G-7 Finance Ministers on strengthening the international financial architecture, published in June 1999. The report was posted on the Internet, together with the Communiqué of the heads of state and government dated June 20, 1999 (http://www.bundesregierung.de).

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Recent experience using a case-by-case approach to involving private creditors in crisis resolution

Experiments using different approaches to individual crisis scenarios

The perception that the practice of putting together gargantuan public financial aid packages, such as have been put together during recent international debt crises, is no longer warranted either politically or economically has done much to ensure that progress has been made of late in involving private creditors in crisis resolution. The international community has tried out various approaches deriving from the individual cases.

Involving the banks in the Korean and Brazilian crises

In some instances where outstanding bank loans constituted a key component of the debt-service problems, it proved possible to win over the lending institutions for voluntary participation. In the case of the crisis that broke out in Korea in December 1997 (where indebtedness to banks played an outstanding role), the credit institutions, once the monetary authorities had prepared the ground for the creditor countries by appropriate moral suasion, agreed to a prolongation of their short-term loans. Moreover, they concluded longer-term debt rescheduling agreements relatively quickly. It must also be emphasised that it was primarily this involvement of the private sector in the resolution of the crisis (i.e. getting it to share responsibility) that enabled conditions to calm down durably. Following the Brazilian crisis, which worsened in January 1999 (this was reflected in the sharp devaluation of the real), the IMF modified the terms of the comprehensive financial aid package it had approved in autumn 1998 in such a way that the government undertook to make efforts to persuade foreign banks to keep their interbank and trade credits at least at the level of the end of February 1999 for a minimum of six months (while the IMF refrained from imposing any rescheduling conditions on the considerable debt of the Brazilian government arising from foreign-currency-denominated bonds and Brady bonds). During both crises, the IMF also took certain precautions against excessive financing of capital outflows by agreeing on floors for holdings of net foreign reserves or ceilings for the central bank's monthly foreign exchange sales.

Experience of securitised debt

Experience of the involvement of bondholders has been gained recently in Pakistan, Ukraine, Romania and Ecuador. The progress that has been made in some cases is especially important since, in the past, securitised debt *de facto* enjoyed a privileged status which was justified only as long as international emerging market bond issues did not play a major role.

Pakistan

Pakistan has been negotiating with the Paris Club on a debt rescheduling agreement (which in turn is a condition for receiving additional IMF financial aid) since summer 1998. However, since the Pakistani government still has to meet considerable payment commitments arising from foreign bonds, the Paris Club, in line with its principle of treating public and private creditors alike, continues to insist on including international bonds in the debt-crisis resolution. Pakistan resisted this for a long time, in order to make its later reentry to the financial markets as smooth as

possible. In this dispute, however, the official creditors are not so interested in the rescheduling of bonded debt as such as in a comparable contribution on the part of private creditors, which could also be effected in a different form. Ultimately, in mid-November 1999, Pakistan presented proposals for solutions to its bondholders (the exchange of old bonds for new ones with later maturity dates), which should enable the debt rescheduling issue to be settled comprehensively, and soon.

Ukraine

Since autumn 1998, Ukraine has been attempting to reschedule securitised short-term debt, the interest payments on which have been temporarily suspended, after its government had undertaken to do so as part of a stand-by agreement it had previously reached with the IMF. On the basis of a balance-of-payments forecast, the Fund recently recommended a private refinancing volume amounting to 80 % of the debt owed. The rescheduling that was actually achieved fell short of that level, however, and could only be reached at the cost of high interest premiums. This goes to show that creditors' bargaining position vis-à-vis a debtor country is especially strong if the claims in question are relatively low, enabling temporary payment arrears to be coped with easily.

Romania

In spring 1999, Romania encountered considerable problems in servicing debt on international bonds. During negotiations on stand-by loans, the IMF first recommended requesting bond creditors to reschedule the debts voluntarily. Later, though, the Fund endorsed the government's intention of trying to attract a comparable amount of new private loans into the country, instead of rescheduling bonded debt, in the light of the improved economic outlook. In August 1999, however, the IMF approved its stand-by loan even though the new private funds that had flowed to Romania up to then were well below the amount actually required.

Ecuador

Ecuador approached the IMF in summer 1999 with a request for financial assistance, after having shown signs of serious difficulties in servicing Brady bonds (which make up some 45 % of the country's official foreign liabilities). The IMF demanded that the private sector be involved, as a condition for granting an IMF loan. After the government had failed to reach an agreement with the creditors of Brady bonds on payment relief, at the end of September 1999 Ecuador fell into arrears in its interest payments on some of this paper, thus forcing the private sector to become involved. Shortly thereafter, the arrears also spread to Ecuador's international issues after such bonds had become due owing to cross-default clauses.

The special case of Russia's unilateral moratorium

A special case of private sector involvement supervened owing to the Russian balance-of-payments crisis in the summer of 1998. In parallel to the floating of the rouble, the Russian government, without giving the slightest hint of any willingness to cooperate, imposed a unilateral moratorium on payments of some categories of debts. The markets saw this behaviour as an alarm which signalled that the contractual fidelity of debtors might generally be on the wane. Many other emerging economies felt this development in the

form of an abrupt deterioration in financing terms.

Past experience suggests setting some guidelines

Recent experience of involving the private sector in the resolution of debt crises, as described above, has shown that the approach adopted by the official community has to be well-thought-out so as to be successful, on the one hand, and, on the other, to safeguard the legitimate interests of debtors and creditors, in order to ensure the optimum functioning of the markets. This suggests setting a number of guidelines for private sector involvement. Such a framework would at the same time give a more credible signal to market players that the official community will in future insist on equitable burden-sharing and, not least, support equal treatment of all major groups of private creditors.

Possible guidelines for involving the private sector

Five key features

On the basis of the aforementioned principles of the G-7, and in the light of recent experience, the debate is centred around the following five key features of a framework for private sector involvement:

– Firstly, in a crisis, debtor countries should do all they can to reach a cooperative solution. This might be all the more successful, the better heavily indebted countries and market intermediaries can work together towards forming lasting relationships based on trust. Openness and reliability on the part of the debtor countries must be the prime criteria. In spring 1999, the Institute of International Finance published detailed proposals, geared mainly to crisis prevention, but which could also be conducive to crisis management. Lasting, proven contacts would, in particular, reduce the surprise element involved in an unexpected deterioration of the debtor countries' economic situation, thereby lessening the risk that the first signs of weakness in a country, considered a harbinger of imminent private sector involvement in crisis management, will lead to massive disposals of assets, which is the very thing that should be avoided. On the contrary, relationships based on mutual trust can help debtor countries and banks to enhance their resistance to crises, *inter alia* by concluding liquidity assistance agreements. The IMF should attempt to encourage the establishment of such investor relations. Moreover, it may be useful to set up a forum for addressing global financial market issues which would host a regular exchange of views between emerging economies, private lenders, creditor countries and international financial institutions and would likewise contribute to enhancing crisis prevention, while also safeguarding comprehensive cooperation in the event of a crisis.

– Secondly, in the event of a country being confronted with an actual or impending debt crisis, recourse to the IMF should normally be restricted to the regular ceilings (which depend on that country's quota). For aid packages in excess of those limits, safeguards would definitely have to be

envisaged to ensure that the funds provided are only used to finance lasting current account deficits but are not used to fund massive capital outflows. For example, in the event of a noticeable undershooting of a floor for reserve assets, special consultations could be envisaged in which the question of a tightening of economic policy conditions would be raised. It must especially be pointed out that the often-cited danger of a system-endangering crisis, with a chain reaction of banks failing one after another, is diminishing with the growing significance of the bond markets. At all events, lending by EU-based banks to developing and transition countries accounts for only 2 ¼ % of their balance-sheet total, and this figure is even lower in the United States and Japan. In addition, according to studies by the ESCB's Committee on Banking Supervision, one-fifth of EU banks' exposure to those countries is protected by public and private guarantees. In addition, one must not overlook the fact that national safety nets would come out in the event of a banking crisis. Therefore, strict conditions should be attached to any diagnosis of risk, however one chooses to define it (it is sometimes also associated more with the risk of an adjustment-induced dampening of global business activity), that would warrant a Fund exposure in excess of the normal financing limits of the IMF. In that connection, the debate on reform has also seen the demand that a systemic risk should only be diagnosable by a supermajority in the IMF's decision-making bodies.

– Thirdly, in the event of unavoidable debt rescheduling resulting from the limited availability of official standby credits, from debt-service deadlines and from an IMF longer-term balance-of-payments forecast, an equitable sharing of burdens between the Paris Club and private creditors should be ensured, provided both categories of claims are of material significance. In principle, the contribution of both groups of creditors to the financing should more or less match their respective shares of the debt-service obligations due in the relevant adjustment period.

– Fourthly, the IMF, in conjunction with the Paris Club if appropriate, should set only the total amount which the official sector expects to be contributed by private sources. It would remain up to the debtor country to negotiate with its creditors the manner in which the requisite overall amount is to be raised. Normally, the only way for the debtor country to have any success here is if all substantially significant groups of creditors are generally given equal treatment. This was clearly emphasised by the G-7 Finance Ministers in the principles they formulated in June 1999, taking the bond markets into consideration.

– Fifthly, account must be taken of the fact that under exceptional circumstances, i.e. if a debtor country's negotiations with its creditors have stalled, or if a crisis has struck suddenly and with great force, that country may be forced to suspend the service of its international official debt and

even to impose restrictions on capital movements. In such cases, it might be helpful for the IMF to demonstrate solidarity with the debtor country, subject to certain conditions. One such condition might be if the debtor country were seriously willing to take the necessary adjustment measures and to reach an equitable settlement with its private creditors. In such difficult situations (in which, however, the principle of contractual fidelity must not be called into question), the IMF should certainly be able to continue approving adjustment programmes and the appropriate financial assistance, by way of an exception, even before the necessary debt rescheduling agreements have been reached ("lending into arrears"). Such informal approval of a moratorium serves as a signal to creditors that the debtor country is willing to do everything in its power to maintain, as far as possible, the value of the claims that are in distress. This could facilitate the necessary agreement between the debtor country and private creditors.

Extension of the IMF powers in the event of moratoriums not on the table for the time being

Above and beyond the five-point plan outlined here, there is further debate in international bodies on whether the IMF, in the light of crises which would necessitate the rescheduling of private claims, should be empowered to impose a stay on litigation on individual creditors for a limited period, under the same conditions as would justify "lending into arrears". Such an instrument, by forcing a temporary standstill on creditors, would provide breathing room and thus improve the chances of reaching a negotiated solution in the best interests of all parties involved (this resembles the basic thrust of the new German Insolvency Code which entered into force at the beginning of 1999). Quite apart from the difficulty that amending the IMF Articles of Agreement would cause, there are, however, considerable legal obstacles in the way of this proposal, which would call into question the effectiveness of any such empowerment of the IMF vis-à-vis litigious creditors. Some have even proposed passing international insolvency legislation to deal with official debt problems, though this idea has no realistic prospect of being implemented. Besides, it must be pointed out that in the event of government debt-service problems with banks, proven procedures for safeguarding the interests of all parties involved already exist in the context of the London Club. In addition, the emerging economies must come up with practicable and effective national insolvency codes as soon as possible. With regard to private debt, methods can be found in this connection which can also make it easier to reach commonly agreed solutions.

Facilitating crisis resolution by generally including collective action clauses in bond contracts

Special problems posed by bonds

As part of private sector involvement in crisis resolution, the involvement of bondholders represents a special problem. In light of the increasing importance of international bond markets, there has been growing consensus that the redemption of bonds can no longer remain sacrosanct in a crisis if the relevant debt-service commitments make up a size-

able part of the balance-of-payments difficulties. In such cases, the only question can be how, if necessary, this objective can best be met.

G-10 proposals for debt rescheduling precautions

In reappraising the recent Mexican crisis, which was based on a high level of government debt in the form of quasi-foreign-currency-denominated bonds, in 1996 the G-10 proposed that the necessary rescheduling of bonded debt should be facilitated by generally furnishing emerging market bonds with certain clauses which make it less difficult for creditors to take decisions jointly.[1] The same recommendation is made in a further study written in 1998 by an *ad hoc* working group composed of representatives of industrial countries and emerging economies.[2] In particular, the G-7 finance ministers emphatically endorsed this request in the report they published in June 1999 mentioned earlier. The main focus is on the general introduction of rules providing for the appointment of negotiators and specifying which majorities of bondholders are needed for taking specific decisions (which would then be binding on all creditors).

Different responses among market participants

As the repeated initiatives have shown, market participants have not hitherto adopted the proposal in the desired fashion. The emerging economies themselves, which are the key players here, are afraid that imposing such terms on their issues would arouse investors' suspicion, forcing the countries to offer higher yields, or even causing them to lose market access. By contrast, views among market intermediaries are very mixed, the specific areas of intermediaries' own business interests being the key determinants. However, German "universal" banks generally take a positive view of the matter. The Federal Association of German Banks, for its part, pointed out recently that the previous practice of exempting bonded debt from rescheduling runs counter to the principle of all parties involved making their due contribution to the rehabilitation of a debtor in financial difficulties. Therefore, in the opinion of the Association, it is fundamentally right to make efforts to enable bondholders to be involved effectively in rescheduling operations by generally introducing collective action clauses.[3]

Such rules are already in effect in some countries for bonds issued by residents

Such rules are already in effect in some countries regarding the issuance of bonds issued by residents. In Germany, the corresponding statutory provisions are in force for private domestic bond issues (above a particular volume); the powers granted to the meeting of creditors and to the representative of the creditors cannot be contractually revoked or restricted. The German Act Governing the Joint Rights of Bondholders (Debenture Act) dated December 4, 1899, in particular, provides that creditors can take certain decisions on the waiver or restriction of creditors' rights (with effect for all creditors) by a majority of

1 See: Group of Ten, The Resolution of Sovereign Liquidity Crises – A report to the Ministers and Governors prepared under the auspices of the Deputies, May 1996. This report may be obtained from the Deutsche Bundesbank free of charge.
2 See: Report of the Working Group on International Financial Crises, October 1998. This report may be obtained from the international organisations that took part in the study (BIS, IMF, OECD and World Bank) free of charge.
3 See: *Bundesverband deutscher Banken, Daten – Fakten – Argumente: Die Stabilisierung der internationalen Finanzbeziehungen,* September 1999 (available only in German).

German statutory provisions governing the joint rights of bondholders

Excerpts from the Act of 1899, as last amended in October 1994

Section 1 [Binding nature of decisions taken by a meeting of creditors]

(1) If bonds bearing pre-determined face values have been issued in the Federal Republic of Germany by someone residing or having a business establishment in this country, ... the decisions taken by a meeting of creditors of those bonds to safeguard their joint interests shall, under the terms of this Act, be binding upon all such creditors.

Section 3 [Advice of the meeting by the debtor]

(1) The meeting shall be convened by the debtor.
(2) The meeting shall be convened if creditors whose bonds, in the aggregate, amount to one-twentieth of the total amount of bonds in circulation, or a representative of the creditors appointed by the meeting of creditors, demand, in writing, that a meeting be convened, specifying the purpose and the reasons.

Section 10 [Voting rights – counting of votes]

(1) Decisions may only be taken by a majority of the votes cast, except as otherwise provided in this Act. The majority shall be calculated according to the values of the bonds. If a vote results in a tie, the number of creditors shall decide.

Section 11 [Decisions on a waiver or restriction of creditors' rights]

(1) The waiver or restriction of creditors' rights, in particular the reduction of the interest rate or the granting of a deferral, may be decided by the meeting of creditors for a period of not more than three years and only to avert a suspension of payments or the institution of insolvency proceedings on the assets of the debtor. If insolvency proceedings are instituted within three years of such a decision, the waiver or restriction of the rights of all creditors shall be null and void.
(2) The decision by which rights of the creditors may be waived or restricted requires a majority of at least three-quarters of the votes cast. The majority must amount to at least one-half of the face value of the bonds in circulation ...

Section 12 [Equal terms – -Ban on favouring of creditors]

(1) A decision of the type specified in Section 11 must set equal terms for all creditors. The setting of unequal terms is only permitted with the express consent of the disadvantaged creditors.
(3) The interest corresponding to the face value of the bonds cannot be eschewed by a decision taken by the meeting of creditors.

Section 14 [Appointment of a representative of the creditors]

(1) If the meeting decides to appoint a representative of the creditors, then the extent of that person's powers must be determined at the same time.
(2) If the representative is empowered to assert the rights of creditors, the authority of individual creditors to assert their rights independently may be revoked by a decision of the meeting of creditors.
(6) Without prejudice to his right to a contractual remuneration, a representative may be dismissed at any time by the meeting of creditors. Such a decision requires a majority of three-quarters of the votes cast; if the representative, in accordance with subsection 2, has exclusively been empowered to assert the rights of creditors, the majority shall amount to at least one-half of the face value of the bonds in circulation; ... If the representative has been appointed by the court ..., the authority to dismiss the representative shall be vested in the court.

Section 18 [Meeting of creditors]

(1) If insolvency proceedings have been instituted on the assets of the debtor, with regard to the meeting of creditors mentioned in section 1, the following special provisions shall apply:
(2) The meeting shall be convened and chaired by the insolvency court.
(3) Immediately following the opening of the insolvency proceedings, a meeting of creditors shall be convened in order to take a decision on the appointment of a joint representative in the insolvency proceedings; ...

Section 20 [No exclusion or restriction of the powers of creditors]

The powers granted by this Act to the meeting of creditors and to the representatives of creditors cannot be excluded or restricted by specification in the bonds.

Section 24 [Restriction of applicability]

(1) The provisions of this Act shall not apply to bonds issued by the *Reich,* a *Land,* or a local authority or local authority association.
(2) *Land* legislation may stipulate that the above-described provisions may also apply to bonds issued by local authorities or local authority associations.

Source: *Das Deutsche Bundesrecht, III H34, 826,* June 1999.

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not less than 75 % of the votes cast (which must normally represent, at the same time, at least one-half of the face value of the bonds in circulation). The underlying idea of envisaging contractual provisions for unavoidable debt rescheduling, such as is now being aimed at for foreign-currency government bonds of emerging market countries, is therefore by no means something new in Germany.

International bonds governed by English law also include collective action clauses

Comparable provisions also commonly govern the issue of international bonds under English law. That likewise applies to foreign sovereign bonds. After all, of the total volume of international emerging market bonds outstanding right now, 20 % are accounted for by bonds governed by English law. If, however, it is agreed that emerging market bonds are governed by US, German or Japanese law (their corresponding shares at present account for 49 %, 14 % and 10 %, respectively), it is standard market practice in cases of dispute not to include such clauses.

General introduction of collective action clauses would not, in itself, have much effect on prices

If one compares the yields on sovereign bonds issued with and without collective action clauses, there is no evidence that the general application of such contractual provisions entails a rise in risk premiums. If such fears were warranted, efficient national insolvency codes would also give rise to similar interest-rate disadvantages. However, if the general introduction of collective action clauses in emerging market bonds led to a widening of the spreads (which might occur at the less favourable end of the risk scale, in particular), this would merely constitute a realistic assessment of the actual situation and would in fact be desirable as a method of counteracting international misallocation of capital. Incidentally, contractual arrangements to cope with crises affecting distinctly high-risk paper might actually help dampen a rise in risk premiums.

Existing doubts about the legality of collective action clauses for bonds issued under German law not beneficial to the "Finanzplatz"

As regards foreign government bonds issued under German law, market intermediaries sometimes have their doubts as to whether the inclusion of collective action clauses is actually permissible. In response to the aforementioned G-10 report, representatives of the banking industry lobbied the Federal Government back in 1996 to bring the legal situation in Germany into line with the developments being called for by the official community, so far in vain. The Federal Ministry of Finance and the Bundesbank (i. e. the institutions which represent Germany's interests in international monetary and fiscal policymaking bodies) jointly believe that, in line with the principle of freedom to enter into contracts, there is no reason for foreign issuers, when concluding agreements under German law, not to be able to choose those terms of issue which they deem to be appropriate. However, by the same token they are bound by the principles of loyalty and good faith embodied in the Standard Contracts Act. Those principles would, for example, hardly permit the setting of rules enabling major issuing terms to be amended by relatively slim majorities. Provisions based on the German Debenture Act would, however, probably take due account of the provisions of the Standard Contracts Act. Here, it must be pointed out that the German statutory provisions do allow the deferral of debt

service and a reduction of interest-rate obligations by majority vote. However, any waiver of capital repayments would remain subject to insolvency proceedings (in which bond claims are not materially superior to bank loans). Against this background, it should be possible, in principle, to authorise, on a contract-by-contract basis, a waiver of capital repayments for foreign government bonds issued under German law extending beyond the German statutory provisions (since this authorisation would, in a sense, be applied under circumstances similar to those of national insolvency proceedings). Even so, the fact remains that foreign government or even corporate bonds issued under German law do not include collective action clauses. In cases where such clauses have been requested in the past, market intermediaries have sidestepped the issue, owing to the existing legal uncertainty, and have settled for foreign law, which has not been advantageous to Germany's position as a *Finanzplatz,* or financial centre.

G-10 will review options for promoting collective action clauses

In the debate on the proposed general introduction of collective action clauses taking place in a number of international bodies, a consensus has been reached that emerging economies should be encouraged in future to introduce such terms for new issues generally and voluntarily (which, in a crisis, should *de facto* make it easier to do the same for old bonds). The proposal that the industrial countries, as a group, should set an example by adopting such rules for their own government bonds, did not meet with the necessary unanimity in the Group of Ten owing to fundamental objections on the part of some countries, which pointed to the existing imperative of solvency (Germany was in favour of jointly "leading by example"). As announced by the G-10 in its communiqué of September 1999, it will, however, study other ways of promoting the general dissemination of such clauses. In particular, it anticipated that the International Primary Market Association would adopt a positive stance.[4] If noticeable progress cannot soon be achieved in this regard, the argument that the involvement of all private creditors in crisis resolution could make it necessary for the IMF to suspend the legal assertion of claims of individual creditors temporarily would carry more weight.

4 In this regard, the Communiqué states that: "Ministers and Governors also noted the constructive role that the voluntary use of collective representation and majority action clauses in sovereign bond issues could play in the resolution of financial crises. They welcome and encourage efforts by the private sector to promote the wider use of collective action clauses and similar arrangements in sovereign bond issues. They undertook to examine the modalities relating to the inclusion of the most appropriate collective action clauses in foreign-currency sovereign bond issues. Ministers and Governors reaffirmed their overall objective of fostering improvements in market practices relating to foreign-currency bond issuance."