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Abstract[*]

There is an increasing need for a system of international lending of last resort (ILLR) to provide a safety net in the event of financial crises in vulnerable countries as financial globalization deepens and spreads. Multilateral progress to address liquidity and solvency crises has been patchy and inconsistent, with no clear distinction between the two; in particular, there is still no framework to address sovereign debt restructuring. This paper proposes an integrated system of specialized ILLR facilities to address problems of liquidity, adjustment, and debt restructuring in a focused but robust way as crises evolve and morph, structured in tiers to cater to countries' capacity to prequalify for automatic support. It further proposes feasible legal reform to subject creditors to standstills and seniority dilution as in domestic bankruptcy in order to empower ILLR to facilitate orderly workouts in debt restructuring. Multilateral development banks would play important supporting roles.

JEL Codes: F34, F53, F55
Keywords: Safety nets, lender of last resort, liquidity crisis, solvency crisis, sovereign debt restructuring

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1. Introduction

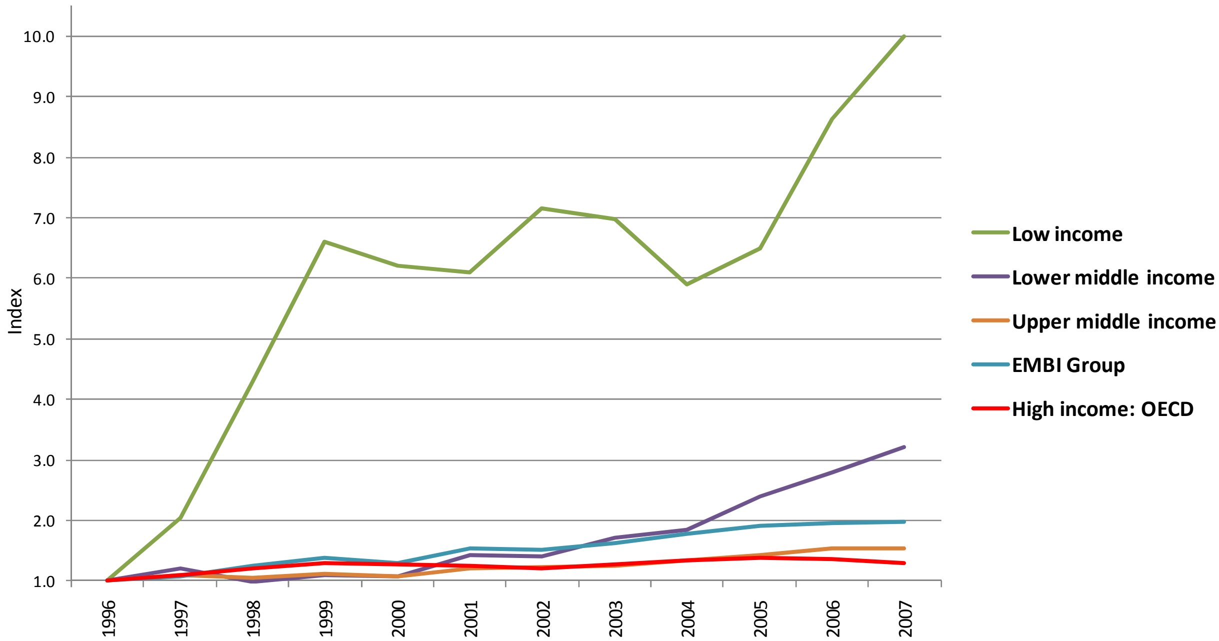
Financial crisis, i.e., the interruption of normal access to financing, is a serious and increasing threat to the economic development of developing countries that are financially integrated into the world. The crisis experience of the last decade or two and the unrelenting pace of financial globalization 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. However, progress in establishing an effective ILLR in that period has for the most part been slow and misguided. It is high time to tackle this failure and take advantage of the momentum created by the empowerment of the IMF to address the global crisis and the new multilateral impetus associated with it.

Crisis experiences over the past 15 years, after the Brady debt restructuring in several countries, clearly show that modern international finance is volatile and crisis prone. Starting with the Mexico crisis of 1995, aptly termed the first crisis of the twenty-first century, financial crises have erupted all over the world. A brief survey of the epicenters includes the Asian crises of 1997, the Russian crisis of 1998 and its aftershocks felt across the emerging world, Argentina's debacle in 2002 and Ecuador's serial debt restructurings over the last decade. The recent global crisis produced widespread financial stress and the threat of financial crisis, leading to poorer performance or outright collapse in countries with weak liquidity (Blanchard, Faruquee and Das, 2010). The generalized recession and public debt expansion have dangerously weakened solvency in a number of countries, advanced and emerging alike; Jamaica's recent debt restructuring may be the first instance in a new wave after the dust of the global crisis settles.[1]

The crisis experiences of emerging countries are becoming important lessons for an ever wider set of countries now with access to borrowing from commercial sources. More and more developing countries are at risk as financial globalization deepens, and the harm done when the flow of international financing becomes seriously impeded by reluctance to finance is correspondingly increased. Financial globalization is becoming more and more relevant to low and middle-income countries emerging into the world financial arena as targets of portfolio international investment; the poorer they are, the faster they are globalizing (Figure 1).

[1] Greece's collapse, after this note was prepared, provides another warning.

Figure 1. Share of Portfolio Inflows in Total Capital Inflows (1996=1)



Source: Authors' compilation based on IMF (2010) data.

The international financial architecture, however, has not been up to the task and remains wanting. The initial liquidity crises in emerging markets generated by financial panic and contagion in the new financial world of post-Brady debt restructurings caught the multilateral system of ILLR by surprise: the traditional remedies of economic adjustment as a condition for lending missed the point of the illiquidity disease and unnecessarily delayed recovery. By now this feature of the new financial order is better understood; in fact, the world saw a number of international liquidity provision mechanisms emerge in the context of the recent global crisis. However, it is difficult to tell whether a financial crisis is and will remain a liquidity crisis or may, on the contrary, mutate into a solvency crisis. In fact, as ILLR is more and more becoming synonymous with pure liquidity provision, the specter of country insolvency, requiring adjustment and perhaps debt restructuring, is still around and impatiently waiting to see if it can enter the scene in those countries where the global crisis may take them over the edge.[2] Sovereign debt defaults tend to happen in clusters and overwhelm the international financial architecture. It would be sad if once again ILLR is caught by surprise and happily lends to insolvent countries or freezes into inaction and lets them bleed. This paper proposes a

[2] Perhaps a scene of the Greek tragedy, which is unfolding at the time of writing.

comprehensive ILLR framework that integrates liquidity provision with potential adjustment and debt restructuring.

1.1 The Objectives of ILLR in Addressing Financial Crises: Distinguishing between Liquidity and Solvency Crises

It is key to distinguish between liquidity and solvency crises, both for analytic and practical reasons. Crisis experience shows that both types of financial crises are relevant. As we will see, required ILLR differs substantially between the two types, and, a fortiori, it is important to device ILLR systems that are robust to misdiagnosing the type of crisis. In the domestic context lending of last resort functions for each type of crisis can be institutionally separated, so that an agency like the Central Bank takes care of lending in liquidity crises and a bankruptcy institution takes care of resolving solvency crises. However, the lack of similar institutions able to create liquidity and to suspend stakeholders' property rights in the international arena implies that ILLR needs to devise instruments and modalities to deal with both. In particular, while in the domestic context lending of last resort is usually associated with liquidity crises, because addressing solvency crises through the bankruptcy process may not even need lending of last resort, as we will see, in the international arena ILLR is also inextricably linked to addressing solvency crises.

In the case of liquidity crisis, meaning a financial crisis faced by solvent borrowers, there is a coordination problem: while the provision of normal lending would result in a perfectly satisfactory outcome for all, panicked lenders massively withdrawing financing would cause real adjustment costs and ultimately insolvency, thus self-validating the panic. Lenders rationally stop lending in anticipation of insolvency, but such a final outcome is only realized because lenders massively stop lending. This is a case of two equilibriums: along with this bad equilibrium, there is a feasible good equilibrium attained when a critical mass of lenders continues lending, thus ensuring that solvency is not lost and eliminating the reason for anybody not to lend. The existence of ILLR solves the coordination problem by restoring normalcy: the credible establishment of ILLR would diffuse liquidity crises and avoid the crisis equilibrium as potentially panicked lenders realize that solvency will not be at risk in any event because required financing is assured (in fact, it would not even need to be disbursed). In contrast, the absence of ILLR would allow a liquidity crisis to destroy solvency and turn into a solvency crisis.

The objective of the ILLR for liquidity crises is simply to allow the financial market to regain normalcy, the restoration of normal access and terms of financing without any change to the status quo, either the economic fundamentals of the borrower or the debt claims of lenders. To the extent that there are risk factors that are more conducive to prompt liquidity crises, such as weaker solvency, illiquid assets or debt management with a short-term bias calling for substantial debt rollover, it may also be appropriate to undertake reforms to reduce the propensity to suffer liquidity crises, but those objectives would be separate from the ILLR design discussed in this paper.

In the case of a solvency crisis, however, meaning a financial crisis suffered by an insolvent borrower, the mere disposition to lend or provision of liquidity by ILLR will not avoid crisis (will not restore normalcy). An insolvent borrower is uncreditworthy and therefore, unless ILLR loses money, it cannot escape financial crisis. In this case there is a single crisis equilibrium. ILLR can only help in mitigating the adjustment costs of insolvency and resolving it.

The objective of the ILLR for solvency crises is to help the borrower with the restructuring needed to regain solvency and, in this way, regain financial normalcy. ILLR should support with liquidity to help mitigate and resolve the crisis in order to minimize the destruction of value associated with lack of financing during the transition until the solvency crisis is adequately resolved. However, an adequate resolution of insolvency also entails a prompt orderly restructuring of the claims of all relevant stakeholders, possibly including debt restructuring, and the reform of unsound policies leading to insolvency. How much of a debt restructuring "haircut" is warranted by efficiency considerations, if any, results from a complex tradeoff between the costs of too little haircut and too much haircut. If the debt restructuring is not deep enough, it runs the risk of prolonging an inefficient debt overhang situation with high risk of crisis recurrence, while if it is too deep and not warranted by fundamentals, it may impair financial terms in the future as lenders will assess a high credit risk spread on account of a high propensity to default. The resolution of this tradeoff ought to be in the spirit of "excusable default" (Grossman and Van Huyck, 1988), in which, in equilibrium, lenders are flexible and implicitly willing to accept losses when the borrower is under distress conditions but not so if borrowers deviate and act opportunistically. In summary, in the case of a solvency crisis, ILLR ought to accomplish a number of complex objectives of an orderly workout requiring more than simply lending.

In practice it is not easy to distinguish beforehand between a liquidity crisis and a solvency crisis, and therefore there is a risk of misdiagnosis. If a liquidity crisis is wrongly assessed as a solvency crisis, there will be lost value as a viable entity (with ILLR liquidity support) is unnecessarily restructured through costly means. If a solvency crisis is wrongly assessed as a liquidity crisis, ILLR will result in lost value (as necessary restructuring is postponed) and a risk of losses to the lender. Since a liquidity crisis may become a solvency crisis if not addressed promptly and successfully (at some point a solvent borrower deprived from financing may become insolvent), a poorly treated liquidity crisis may over time mutate into a solvency crisis, rendering the initial diagnosis invalid. There is a range of financial crises which, depending on the effectiveness of ILLR and exogenous factors subject to uncertainty, may prove to be a crisis of either type. This gray area implies a substantial risk of misdiagnosis. Political economy reasons are in practice additional reasons why solvency crises may be treated as liquidity crises, as borrowers bet on a lucky strike instead of biting the bullet of adjustment. Therefore ILLR facilities need to be robust to address effectively a wide spectrum of problems and flexible to change modality as the situation evolves.

1.2 A History of Failed Attempts to Establish an Effective ILLR

The Mexico crisis of 1995 caught the multilateral system by surprise, slow to recognize that it was a liquidity crisis whose key remedy was in liquidity provision rather than adjustment or debt restructuring. The Asian crises of 1997, especially the Korean crisis, prompted much internal debate and confusion as to the diagnosis of these new breed of financial crisis and the right policy to follow without any clear progress concerning ILLR. The widespread financial turmoil in emerging markets in the aftermath of the 1998 Russian crisis as a result of lack of liquidity on the lenders' side demonstrated conclusively that the multilateral system was unresponsive when confronted with this "new financial disorder." Inspired by an intellectual movement for reform of the international financial architecture towards a system ready to help in liquidity crises that developed in that year (e.g., see Fernández-Arias, Gavin and Hausmann, 2000),[3] the IMF

[3] See for example IDB (2000), which compiles this and other works presented and discussed at the IDB Conference "Crisis and Contagion in Emerging Financial Markets: The New Policy Agenda" in October 1998 as a reaction to the Russian crisis a few months earlier.

established the Contingent Credit Line (CCL) facility in 1999. However, it refused to adopt country prequalification and was therefore subject to a slow and uncertain process of approval and ex-post conditionality. The CCL expired in 2003 and was never used.[4] Other facilities such as the Reserve Augmentation Line (RAL) and the Short-term Liquidity Facility (SLF) also came and went.

Recently, the IMF has established the Flexible Credit Line (FCL) in replacement of the SLF to respond to the current global crisis. The FCL can be used as a preventive arrangement (a pre-approved credit line), thus correcting some of the defects of the past, for any balance of payments shock, not necessarily a quick-reversing, self-correcting liquidity shock requiring no adjustment as in the SLF. The FCL has been so far joined by Mexico, Poland and Colombia, and has been described by IMF as "…the biggest change in how the IMF interacts with its members since the end of the Bretton Woods" (*Finance and Development*, 2009). The FCL is certainly an important step forward, so the first order of the day is to make sure that it does not erode for lack of client interest or funding as the global crisis that gave rise to it recedes (IDB, 2010). However, whether it is the start of the right path towards an effective ILLR or of another dead end will only be known after the current crisis is past.

In the meantime, the discussion on how to deal with commercial debt restructuring, abandoned after the Brady restructurings of the 1990s, was taken up to face the likelihood of debt restructuring needs of bond debt, which displaced the bank debt of the past. To its credit, the IMF introduced a multilateral institutional proposal for a Sovereign Debt Restructuring Mechanism (SDRM) designed to coordinate private bondholders. However, it did not prevail against an alternative hands-off approach of market-based debt renegotiations recommending the adoption of Collective Action Clauses (CACs) in sovereign bonds to facilitate achieving coordination, which by now has become the standard. The good news is that bondholder coordination is not a problem as severe as first feared; the bad news is that there are many other problems to solve to ensure successful debt restructuring. Sovereign debt restructurings in the past decade have found their way—sometimes amicably, sometimes acrimoniously, always unpredictably and enriching imaginative lawyers (see Panizza, Sturzenegger and Zettelmeyer, 2009 for an account). It is worrisome that there is at the moment no multilateral framework to deal with commercial debt restructuring.

[4] See Cordella and Levy-Yeyati (2005) for a retrospective assessment of the CCL facility along the same lines.

1.3 A Reform Proposal

This paper discusses the intrinsic limitations of an FCL-like facility to grow and become a generic solution to the problem of financial crises in emerging markets. It proposes instead an integrated system of specialized ILLR facilities with tiers to accommodate countries with different capacities, in which an FCL-like facility would be a top tier, in order to cover financial crises that the current framework would leave out. 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. This paper proposes a multilateral ILLR system that would enable 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 are necessary or sufficient to resolve them.

The next section describes the construction 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 following section it proposes a tiered system of specialized ILLR facilities as the best feasible solution to address financial crises in a robust and consistent way. In section IV it goes one step further and explores how feasible 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. In the final section it discusses the supporting role of Multilateral Development Banks in an ILLR system.

2. Modeling ILLR after the Traditional Doctrine of Lending of Last Resort (LLR)

The traditional doctrine of LLR in the domestic context deals with both the prevention and the mitigation of financial crises of domestic institutions, so it is natural to try to model ILLR on this basis.[5] In this section we characterize the traditional doctrine and then discuss the limitations of such model in the international context.

[5] The approach of modeling international financial architecture after the classical principles of lending of last resort to domestic banks (liquidity crises) and the domestic bankruptcy institutions (solvency crises) subject to sovereignty constraints is also taken in Fernández-Arias, Gavin and Hausmann (2000) and Fernández-Arias and Hausmann (2002), from which this section draws heavily.

2.1 Traditional Lending of Last Resort

In the case of liquidity crises, it is well known that to obtain the desired effects, speed, certainty and power are of the essence to bridge the financial gap and remove unnecessary lack of investor confidence. Bahegot (1873) and subsequent authors, in the context of banking crises, have proposed a number of principles for LLR for liquidity crises that 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 at market terms in normal times
- Establish the above principles ex-ante and apply them automatically

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

In the case of solvency crises, bankruptcy proceedings incorporate the principles of applicable LLR, which could be characterized 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 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

While there is usually one self-sufficient LLR (e.g., the Central Bank), it is clear that the presence of multiple LLR would only add to their power because there would be multiple sources of financing, which would empower this kind of facility at a time of liquidity scarcity. In the case of solvency crises, however, LLRs do more than lending, and therefore it is important that they are coordinated. In the context of bankruptcy, the process itself would ensure that LLR financing is not siphoned off by other stakeholders but rather serve the purpose of orderly restructuring. In this way, bankruptcy law mandates collaboration among LLRs.

As noted, a practical difficulty with these principles is that their application requires the determination of whether a crisis is of liquidity or solvency. Diagnosis of illiquidity rather than insolvency needs to be taken as a temporary diagnosis to be reversed if the provision of liquidity does not produce the expected normalization results. Besides the risk of LLR financial losses, the natural tendency of beneficiaries to avoid restructuring and bet on resurrection, if not the possibility of simply planning to loot the money and leave the keys, are additional reasons for erring on the side of caution.

Another less obvious cost of this practical difficulty of diagnosing the type of crisis is moral hazard. If liquidity and solvency crises could be told apart perfectly, the beneficiary institution would never profit from LLR because LLR would always be repaid (with good collateral in the case of a liquidity crisis and being a secured senior lender in the case of a solvency crisis under bankruptcy law). Without an external party that can be made to pay by choosing certain actions, the cost of risk is internalized (lenders would charge a premium on account of credit risk) and there is no moral hazard. While it is true that the beneficiary will make less effort to avoid potential liquidity crises, that is a socially optimal strategy in the low-risk environment produced by this perfect LLR. In the same way, an LLR able to minimize deadweight losses in restructurings may enable socially optimal riskier strategies by reducing the economic cost of risk. The issue of moral hazard becomes relevant only to the extent that the determination of the nature of the crisis is subject to substantial error and a solvency crisis is misdiagnosed as a liquidity crisis (Fernández-Arias, 1996): collateral pledged in a financial crisis presumed to be a liquidity crisis may be not good if it turns out to be a solvency crisis. The expectation that in some states of nature the LLR will lose money, in particular lending freely to institutions that are or will be insolvent, would encourage excessively risky strategies.[6]

In order to deal with moral hazard resulting from misdiagnosing crises, traditionally the authority relies on prudential regulation and the design of incentives to promote private sector monitoring in order to control the risk that moral hazard begets. Moral hazard would also justify erring on the side of restructuring, as opposed to financing.

[6] This line of reasoning would suggest that the so-called "constructive ambiguity" about the delivery of LLR support is not helpful, since (unbiased) ambiguity would amount to compounding the confusion between both types of crisis.

2.2 How Applicable is the Traditional Doctrine of LLR to the International Context?

In cross-border LLR to sovereigns or ILLR, the consolidated public sector (inclusive of the Central Bank) would replace the domestic institution as the beneficiary of lending of last resort.[7] The key difference between domestic LLR and ILLR is the question of sovereignty: ILLR is subject to sovereign risk. Sovereigns are not bound by laws enforceable in foreign courts. In this connection, the concept of solvency needs to be interpreted not as ability to pay in a financial sense, as regulated by law and enforced by courts, but as willingness to pay in an economic sense. Because multilateral creditors are "preferred," however, it can be presumed that for a multilateral ILLR this risk is smaller than for other creditors. Another difference connected to sovereignty is that ILLR ought to take into account the international linkages which may lead to important repercussions outside the beneficiary country, and which may in fact hold the key to solving financial distress in other countries. ILLR interventions in a specific country may be justified because of their international spillovers, while LLR interventions are only calibrated to the national interest.

Let us examine the principles above of traditional LLR to see which ones can be replicated and which ones cannot in an ILLR subject to the sovereignty constraint. In the case of a liquidity crisis, meaning an interruption to normal access to financing from abroad not prompted by country insolvency, the above principles could be applied, by and large, *mutatis mutandis*.[8] The main difference concerns the need for collateral. Collateral could actually be used when the sovereign holds international financial assets, such as sovereign wealth funds which own valuable but illiquid financial assets, but this is not common practice.[9] However, the absence of collateral in multilateral ILLR is only apparent: the preferred creditor status of

[7] There are intermediate cases not addressed in this note. 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; in this note we sidestep this issue and purposely consolidate the entire public sector facing a financial crisis requiring support from abroad. Furthermore, 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. In fact, the internationalization of firms may also lead to cross-border LLR to private institutions.

[8] Like in the domestic context, an ILLR may attempt to alter market conditions rather than rescuing its victims, supporting private financial markets in general through global financial policies not directed to any particular country. For example, it could utilize its resources to buy an EMBI basket of sovereign bonds according to some rule designed to smooth its volatility, and in particular prevent a collapse from triggering panic (Calvo, 2002). This paper focuses on country operations and leaves market operations aside.

[9] In fact, this would allow countries to convert part of their international reserves into more illiquid assets.

multilateral ILLR amounts to implicit collateral.[10] While in common practice collateral is not posted, we would argue that such difference is immaterial provided that ILLR is applied in the presence of adequate financial safeguards ("sufficient implicit collateral"), because the provision of collateral only serves the purpose of making sure that the LLR will not suffer financial losses at the expense of the beneficiary. If sufficient financial safeguards cannot be produced then the financial crisis would be of solvency rather than liquidity.

What are adequate financial safeguards for ILLR? Sometimes the preferred creditor status of multilateral lending is equated with seniority status in legal parlance, but that is not an adequate model. Senior debt would be paid in full before any junior debt is paid, meaning that credit risk for senior lenders is only a function of the stock of senior debt (S), independent of the stock of junior debt (J). It is doubtful, however, that financial safeguards for multilateral ILLR may disregard the burden of non-multilateral debt on the country's solvency. Most likely, if a substantial haircut on non-multilateral debt is not enough to recompose solvency, multilateral debt is bound to eventually face a credit event of some kind. Let h be the debt restructuring haircut on non-multilateral debt that can be expected before multilateral debt becomes unprotected, where h, less than 100 percent as argued, is an implicit measure of how preferred multilateral creditors are. By way of example, looking at recent debt restructurings reported in Panizza, Sturzenegger and Zettelmeyer (2009), average h may be about 40 percent.[11] With this metric, financial risk to ILLR would be measured by "core" debt equal to $C= S+(1-h)J$, in between multilateral debt S suggested by a seniority model and total debt $D=S+J$ corresponding to a model with no preference for multilaterals. In other words, the relevant debt indicator to assess multilateral credit risk is a weighted average between own debt and total debt: $C=hS+(1-h)D$.[12]

At the same time, an assessment of financial risk to ILLR also requires an evaluation of the economic outlook of the country. This analysis is similar to the one required to diagnose the nature of the crisis to determine whether the only problem is liquidity or there are solvency considerations involved. It is clear that the financial safeguards of the ILLR may be adequate (i.e., core debt C is low) and, yet, the country may be facing a solvency crisis calling for

[10] The parallel includes the fact that such implicit "pledging of collateral" detracts from the "collateral" available to other stakeholders (i.e., willingness to pay to others is diminished).

[11] We disregarded "reprofiling" operations in the Dominican Republic and Uruguay not designed to maximize h.

[12] We note that in this model the credit risk faced by each multilateral lender is the same and depends on overall multilateral debt S, irrespective of its share in it.

adjustment and even debt restructuring (i.e., total debt D is too high). It can be argued that in the sovereign case the analysis is more complex and uncertain than in the corporate case because it involves public policy considerations, which suggest that in case of doubt, solvency-enhancement adjustment should be considered.

In the case of a solvency crisis, however, the inapplicability of the traditional principles to ILLR is more fundamental. First, senior lending cannot be enforced. A multilateral ILLR can lend with preference, but an assessment of financial risk along the lines above (or actual collateral) would still be needed as a financial safeguard. Second, the concept of bankruptcy reorganization itself needs to be redefined more specifically as economic adjustment and policy reform to regain solvency, which may or may not include the debt restructuring typical of the corporate case. These two differences can be regarded as marginal or a matter of degree. The fundamental difference is that the traditional principles cannot be translated to ILLR because in the sovereign context there is no equivalent to a bankruptcy code and court to ensure enforcement of ILLR determinations limiting the property rights of the 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 finds it difficult to catalyze new lending in the absence of seniority protection, all of which compromises the financial soundness of the rescue effort.[13] And of course, the ILLR cannot take a crisis management role for obvious sovereignty reasons. In particular, the same "equity holders and management" need to be retained. Similarly, prudential regulation to limit moral hazard is also infeasible in the sovereign context. ILLR can only add to what stakeholders agree to do unilaterally (e.g., adjustment and reform) or under bilateral agreement (e.g., market debt restructuring); its only power is to condition financial support on certain actions of the stakeholders, such as policy conditionality (e.g., 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.

[13] In fact, some assurance to private sector lenders would also be desirable in the case of liquidity crises.

2.3 *Adapting the Traditional Doctrine of LLR to the International Context: Private Sector Involvement and Country Conditionality*

The inability to grant senior status protection to fresh lending is a fundamental impediment to the ILLR's ability to restore private sector confidence and thus allow for the normalization of financial activity. How to approach this objective within the limited legal powers of a feasible ILLR depends on circumstances. For example, in the case of generalized lack of confidence in a given country, the role of the ILLR in helping improve fundamentals and the policy framework beyond the mere act of lending is relevant in this regard. While it is less important in the case of a liquidity crisis, in which lending by itself may be enough to restore confidence, in the case of a solvency crisis requiring adjustment it would be critical. However, in the case of a global financial crisis, or for example in the midst of global deleveraging, the private sector would be more concerned with its own liquidity needs and less with the countries' fundamentals, in which case involvement of the private sector would require more direct interventions (see, for example, IMF, 2009a, on moral suasion or guarantees). In what follows we mention some feasible ideas for the ILLR to catalyze private sector lending in a financial crisis within the existing legal framework.

The ILLR could facilitate private sector fresh lending through issuing partial guarantees to such lending powerful enough to make countries creditworthy. A very powerful instrument, and therefore to be used with extreme care, would be to co-finance in parallel, in a so-called A/B structure, effectively sharing the multilateral preferred creditor status. This device would require little ILLR capital resources but would entail an implicit expansion of exposure from a risk management viewpoint. A more structured approach to bail in the private sector together with ILLR lending is to arrange private contingent credit lines to be triggered when ILLR acts, or under pre-specified contingencies, to the effect that ILLR would co-finance with the private sector (Fernández-Arias, Gavin and Hausmann, 2000). In the extreme, countries could buy actual private insurance against certain contingencies (possibly verified by the ILLR), by which countries would pay premiums up front and receive a transfer at times of crisis. In theory, in contrast to credit lines or rescheduled payments which only solve the liquidity aspect of financial crises, if insurance is well calibrated it could completely offset the shock and eliminate the need for ILLR for such contingency.[14] If contingent credit lines or insurance that appear contractible and not subject to asymmetric information (e.g., they refer to verifiable exogenous events) are seen as "too expensive" for reasons of political economy distortions, as it is not politically beneficial to pay premiums with no visible return, then this kind of prudential policy would be legitimate material for conditionality (Fernández-Arias, 2007).

Nevertheless, a substantial catalytic effect on new lending may be ineffective if it is offset by increased private capital outflows. Furthermore, even if capital outflows do not react to new inflows, 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). Controls on capital outflows to be triggered by certain agreed-upon events in financial markets, such as a generalized sudden stop certified by the ILLR, could conceivably be stipulated contractually and be one of the instruments used to "bail in" private creditors in financial crises. Note that contrary to controls on capital outflows imposed ex-post as emergency measures, the exercise of these ex-ante contingent controls would not be a breach of contract and should not therefore carry a reputational cost.[15]

Another limitation of ILLR is its inability to enact and enforce prudential regulations as well as "management" decisions in bankruptcy proceedings. The natural adaptation to this limitation is policy conditionality in exchange for financing, the power of which is limited because it is not legally enforceable. However, it could be argued that this is not an important limitation of ILLR because conditionality has no legitimate use by ILLR. In fact, it is not clear that there is a legitimate interest of the ILLR in imposing conditionality, because, contrary to corporate equity holders, decisions made by the country's people (represented by their government) would ensure that all the domestic welfare consequences of economic behavior would be internalized. This domestic welfare self-interest would in principle imply that governments would produce by themselves both optimal prudential policies ex-ante and optimal

[14] Some authors doubt the merits of private contingent credit lines (actually experimented by Argentina and Mexico in small scale) because they claim they would only add to the country's relevant debt exposure, thus actually anticipating the onset of a debt crisis (for example Cordella and Levy-Yeyati, 2005). This argument however does not seem to work in the case of financial crises that are not commanded by the country's high debt. Similarly, the argument would not apply to insurance of this kind.
[15] They would of course imply a higher cost of financing, which will dampen down capital inflows.

adjustment ex-post, rendering conditionality useless. Therefore, the case for conditionality needs to be made.

In what follows we review a number of circumstances in which policy conditionality is appropriate, and a fortiori, its limitations are important for the effectiveness of ILLR. There are two clear-cut cases. First, there is the case of financial risk to the ILLR. It stands to reason to impose policy conditionality for fiduciary reasons, and more generally to control the moral hazard that financial risk breeds. Since the traditional measures to deal with moral hazard based on prudential regulation (and supervision) and the imposition of incentive schemes to promote private sector monitoring are off-limits due to sovereign considerations, conditionality is a natural substitute (Cordella and Levy-Yeyati, 2005).[16] Second, there is the case of relevant international ramifications of ILLR interventions, which would be a legitimate interest of the ILLR but would not be internalized by the government. This strict interpretation would lead to justifying ILLR conditionality on account of adjustment consistent with "international prosperity" as mandated in the Fund's Articles of Agreement, but not with respect to "national prosperity," which would be well taken care of by the sovereign. Under this interpretation, ILLR conditionality should be confined to international spillovers.

There are also more debatable cases of justified policy conditionality. A comforting justification for conditionality for national prosperity is that the government is constrained by political economy considerations that lead it to deviate from the right policies and would gladly embrace conditions on them in exchange for ILLR. This interpretation of conditionality as an enhancer of policy commitment is the justification stressed in official documents (for example, IMF, 2009c). (However this partnership interpretation is evidently not valid in cases in which governments are clearly in disagreement with conditions and go to great lengths to avoid them). Another benign, paternalistic justification is that ILLR's interest is to maximize the country's welfare with optimal ex-ante and ex-post policies that governments resist precisely because of political economy factors or other distortions, or just in error. In these cases, ILLR conditionality for domestic concerns would be justified, but only to the extent that the multilateral view is better than the government's.

In contrast to legal provisions, conditionality cannot be enforced and therefore the system needs to define what to do if it is not fulfilled up to an acceptable standard, or if it will likely not

[16] Although official monitoring and public disclosure may help with the latter.

be fulfilled in the case of ex-post conditionality. To the extent that the fulfillment of conditionality is critical for successfully addressing financial crisis, the ILLR needs to define standards for eligibility. At the same time, conditionality in exchange for valuable ILLR may steer country's policies in a direction that may be desirable beyond its enabling effect on ILLR; this incentive effect would also be a relevant factor in determining conditionality standards.[17]

In all cases, lending of last resort needs to be expeditious. This is explicitly stated in the case of liquidity crisis to be prevented from developing into a solvency crisis, but it also holds true in the case of adequate adjustment and restructuring so that the economy does not stop for lack of an adequate arrangement among stakeholders. In the case of ILLR, this implies that conditionality is better applied ex-ante in lieu of missing regulation and bankruptcy code; ex-post conditions take time to negotiate, and uncertainty on its content fuel financial crises, so they are inferior to pre-arranged conditions. Therefore ILLR would ideally define standards for eligibility preconditions and utilize ex-ante conditionality to the maximum extent possible.

3. A Reform Proposal: An Integrated System of ILLRs

Recapping the previous discussion, there are four clearly desirable principles of a feasible ILLR that are similar to those inspiring the traditional doctrine:[18]

- *Power*: Sizeable support, i.e., sufficient to meet short-term financial obligations and avoid a collapse (either of demand or supply) in the case of a liquidity crisis or inefficient adjustment in the case of 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 (i.e., non-discretionary) financial assistance according to pre-arranged mechanisms and conditions with an adequate repayment period to match extraordinary financial need; uncertainty undermines confidence that ILLR will do its job and breeds crises.

[17] In theory this may lead to less conditionality (in the case of a country which would otherwise not bother to reach the standard) or more conditionality, in an attempt to maximize the conditionality value of ILLR.
[18] 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 Fernández-Arias, Gavin and Hausmann (2000).

- *Focus*: Low or no commitment fee to incentivize the preventive use of the facility but substantial charges on delivery without prepayment impediments to disincentivize the use of facility outside a financial crisis.

There are however four important distinctive characteristics of a feasible ILLR to bear 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 bankruptcy framework to grant seniority to fresh money, a powerful ILLR function may need (pre-arranged) 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, ILLR needs to resort to satisfactory prior compliance with prudential conditionality
- *Adjustment (and debt restructuring) conditionality*: In the absence of enforceable bankruptcy system to reorganize stakeholders claims in an efficient manner, ILLR needs assurances from countries and lenders that solvency-related conditionality will be fulfilled.

As analyzed in the previous section, each one of these four characteristics calls for adaptations of ILLR. In particular, the need for prudential and adjustment conditionality possibly involves both ex-ante conditions of eligibility and ex-post conditions of approval that deserve closer examination:

- *Ex-ante country eligibility* on the basis of pre-set 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. According to the previous discussion, pre-arranged conditions included in ex-ante eligibility

- Frameworks for financial system stability according to international standards
- Prudent macroeconomic liquidity policies such as low short-term debt and minimum reserves to cover it under normal circumstances
- 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

- *Ex-post conditionality* on economic adjustment, policy reform and debt restructuring along the same lines as needed to resolve a solvency crisis. It is clear that ex-post conditionality implies negotiating conditions of approval that collide with the principles of speed and certainty, so it is to be used only when otherwise the required adjustment/debt restructuring is expected to be ignored or delayed and the solvency crisis is expected to drag on.

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 they are so strong that the country can be presumed to be able and willing to react appropriately to adverse shocks autonomously, so that the ILLR could dispense with undesirable ex-post conditionality. This is arguably the case of the recently established FCL, which is entirely based on ex-ante conditions of eligibility. The FCL is a substantial improvement over its predecessors and is in many ways an approximation to the above principles of a feasible ILLR. However, if eligibility conditions are so strong, then a large number of countries would choose to be outside the system rather than reform to meet the standard. Arguably, this is not consistent with an optimal ILLR system.

For all the benefits provided by providing incentives to countries to improve their fundamentals and policy frameworks to a high standard in exchange for ILLR, there is the cost of denying ILLR to countries achieving lower standards. We would argue that this cost may be substantial depending on the type of shock. On one extreme, in 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 a liquidity crisis. In this case the costs of exclusion are substantial. On the other extreme, in 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 facility such as the FCL, or for that matter a feasible ILLR as described above designed to address *any* type of shock generating a financial need, needs to be based on generic eligibility preconditions and minimal structure. For a global liquidity shock such as the generalized "sudden stop" to emerging markets after the Russian crisis, FCL standards or the above eligibility conditions would be too stringent. The recent global financial crisis was close to that situation; in fact, the economic downturn throughout emerging markets was strongly associated with the liquidity profile of the countries' liabilities (Blanchard, Faruquee and Das, 2010), and for most countries reasonably lax standards, weaker than FCL's, would have been enough for a successful ILLR. On the other hand, the global recession that followed impacted some specific countries in such a way that they are now in need of engaging in substantial adjustment and perhaps debt restructuring, which may require ex-post conditionality unavailable in FCL.

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 and excessive conditionality. A non-contingent ILLR is bound to lead to rigid, excessive conditionality in the case of widespread liquidity shocks of the kind we have seen repeatedly in the new global financial economy. An FCL-like ILLR is bound to require excessively strong eligibility, leaving out countries that a weaker ILLR with more ex-post conditionality may help with some effectiveness.[19] The specialized facilities ought to allow for a transition path from one to another as circumstances change so that they support each other and a given country receives appropriate treatment at all times.

It is useful to organize the contingencies calling for ILLR according to the modalities of multilateral intervention in countries under financial stress analyzed in Fernández-Arias, Powell and Rebucci (2009): i) only liquidity problems, with little or no expected adjustment need; ii) adjustment and reform are needed to regain solvency and expected to suffice, so that debt restructuring is not expected; iii) on top of adjustment, debt restructuring is expected to be needed to regain solvency. In what follows we describe the specialized facilities we envision for these contingencies. In the same way that a presumed liquidity crisis may develop or turn out to be a solvency crisis requiring accessing other facilities, an expectation of no debt restructuring need may require revision and a change of facility.

We propose an integrated system of specialized ILLRs, 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 corresponding ILLR facilities in the tier for which it is eligible.[20]

Liquidity Facility. One important contingency that merits special treatment is widespread liquidity turmoil or generalized "sudden stop," which could be certified by the ILLR on the basis of indexes such as overall EMBI. This liquidity facility would liberally provide liquidity on an emergency basis to address a liquidity crisis. There could be a Basic Tier with minimum eligibility requirements to cover all countries in good standing (e.g., no arrears and involved in IMF Article IV consultations) and allowing them to automatically access certain quotas (at steep rates to discourage unnecessary use of scarce funds other than for the emergency

[19] 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 conditionality not actually needed for the effectiveness of a particular ILLR operation, but which may lead to a steep cost of unnecessary crises in countries not willing to further "optimize" their policy frameworks. Furthermore, the experience shows that official views on optimal policies are not infallible, which calls for caution and parsimoniousness in designing pertinent conditionality, let alone extraneous.

[20] A first draft of this proposal was prepared for IDB (2010). After preparing that note a recent IMF Staff Position Paper, "The Debate on the International Monetary System," was brought to our attention, which also envisions a variety of scenarios and country eligibility requirements for ILLR which are broadly compatible with our own (albeit not integrated with a debt restructuring function).

at hand). A Top Tier would involve additional eligibility requirements related to solid fundamentals and policy framework (and low multilateral credit risk as measured by “core” debt indicators) to better screen out countries at risk of developing solvency problems (Fernández-Arias and Hausmann, 2002), in exchange for which countries would have access to larger amounts up-front. This is an example of how a tiered approach is able to cover the risk of misdiagnosing the nature of the crisis by modulating access to facility resources. Countries able to pledge marketable international collateral (e.g., sovereign wealth fund assets) could receive additional liquidity on this account. The establishment of this liquidity facility would reduce the incentives to accumulate excessive international reserves in each individual country as self-insurance, which is financially costly and systemically destabilizing.[21]

It is difficult to ascertain whether a financial crisis can be solved solely with liquidity provision, so while it may be worthwhile trying this non-invasive recourse, the Liquidity Facility ought to consider the possibility that it may fail to solve the crisis and solvency strengthening may be required. In that case, adjustment will be needed and the country case ought to be transitioned to the Adjustment Facility.

Adjustment Facility. We start with the case in which it can be presumed that adjustment and reform will be sufficient to regain solvency, so that no debt restructuring is expected. This requires a minimum standard of fundamentals and policy framework compatible with the level of indebtedness. On one extreme, it 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. There could also be a Low Tier for countries not qualifying for the Top Tier, and it could be available to all countries exceeding some satisfactory standard of fundamentals and policy framework as an eligibility requirement. This Low 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). Of course, there may be more than one Lower Tier 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

[21] However, in countries where the main driver of reserves accumulation is export promotion rather than risk management, this point is moot.

countries not qualifying for the Top Tier to receive automatic support and then seamlessly arrange a traditional stabilization IMF program with ex-post conditionality.

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 (e.g., a collapse in terms of trade). This facility may 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. This facility would recognize that under this contingency ex-post conditionality is probably less necessary for the country to adequately adjust to the shock. Of course facilities specialized in specific contingencies like this could also be organized in tiers.

Whether debt restructuring is needed or justified to regain solvency is difficult to ascertain, but is usually becomes more clear as information on adjustment performance is in and the market reacts to the country's developments. The experience is that required debt restructuring usually takes too long to implement. There is the need for a multilateral facility addressing debt restructuring to which unsuccessful adjustment programs can be transitioned.

Debt Restructuring. Finally, there is the important contingency of countries likely in need of debt restructuring and "bankruptcy protection." For example, arrears (which would disqualify countries for the other facilities) would be an indication that access to this facility is needed. This contingency may also 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). A negative review of the prospects of sensible adjustment and reform to be able to avoid debt restructuring under the previous facilities would also prompt a switch to this facility.

Eligibility to this facility ought to be as wide as possible, only leaving out countries unable to work under multilateral ILLR rules (e.g., countries severed from Article IV consultations). Under this facility, 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," which would reduce the reputational cost of non-payment or justified controls on capital outflows, or even eliminate these costs if these actions are part of

ILLR conditionality. (In the next section we discuss how granting legal powers to the ILLR would substantially empower ILLR for this function.)

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 more political clout. In this regard, elements of automaticity and objectivity, meaning rules rather than room for discretion, are helpful (Obstfeld, 2009). A particularly difficult problem of this nature is how to disqualify a country which ceases to comply with eligibility criteria (e.g., an FCL country after a negative semiannual review). While the signaling value of such determination is unavoidable, it may help the transition if privileges are removed gradually, for example through lower caps and/or steeper charges. The tiered approach proposed could also help solving the problem of exit or disqualification by providing a smoother transition to a lower tier.

Another problem that has plagued this kind of facility is the so-called stigma of joining a program designed to provide emergency financing, under the view that such a move in anticipation of need would reveal weakness. In fact, this effect led to the total failure of all the predecessors of the FCL, such as CCL, RAL and SLF, to attract clients, which could otherwise have prevented crises. While the FCL is by design accessible to a select group, which helps with the stigma problem, and has been able to attract three countries, countries with the strongest policy frameworks have not joined and it is not clear at all 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 leakage 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 utilized 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 choose not to 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. In this alternative, the ILLR system would proactively produce the list of eligible countries in each tier based on set criteria. This alternative would ameliorate or eliminate the stigma problem, but it would also publicize the rejection of the excluded, so while superior, it would not be unanimously acclaimed.

Finally, a key reason why countries have historically not relied on these facilities is simply mistrust. There has been 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 the stress to eligible countries, and to all countries if prequalification for eligibility is 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, has solved this problem for the handful of countries eligible for it. However, even countries eligible for FCL may mistrust the criteria that would be used in the future for recertification every six months and concerned about the potential loss of being disqualified. As to non-eligible countries, despite added flexibility in the setting and verification of conditionality, they still face most of the same uncertainties of the past. Trust can be helped by more transparency and the incorporation of trusted institutions into the process (a possible role for MDBs and other multilaterals).

4. Radical ILLR Reform: International Bankruptcy Court and Sovereign Debt Restructuring

The absence of stipulated and enforceable law akin to bankruptcy proceedings implies substantial limitations on the ILLR when solvency and debt overhang considerations are dominant. As in the case of a domestic institution going through bankruptcy, efficiency calls for some “optimal adjustment” and “optimal debt restructuring,” but the ILLR does not possess the traditional legal instruments for undertaking those activities. Country conditionality may steer crisis resolution in the optimal direction but does not guarantee the kind of resolution that would be feasible with bankruptcy-like legal power: strong conditionality may fail to be fulfilled, and weak conditionality is bound to have only limited effects. 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 contain liquidity crises and manage solvency crises.

It would be naïve to propose the creation and empowerment of an international bankruptcy court similar to its domestic counterpart because of sovereignty. Even if sovereigns attempted to cede ex ante some sovereignty prerogatives by accord in order to make ILLR country conditionality closer to a legal framework, commitment to such a concession would be unenforceable and a limitation would remain. However, international legal reform to empower ILLR vis-à-vis international lenders along the lines of a bankruptcy framework appears feasible, either by treaty or contractually, and may bring substantial improvements. In this section we focus on this feasible legal reform.

The absence of an international bankruptcy system entails two critical limitations with respect to financing adjustment in an insolvency situation. First, the ILLR cannot supersede the rights of creditors to free ride and cash in, nor make them wait until a viable debt restructuring arrangement is designed and agreed upon under efficient rules (a standstill on debt payments). More generally, the absence of a bankruptcy process in the international context does not yield forced collaboration among lenders and other stakeholders with conflicting interests. In this context, the Sovereign Debt Restructuring Mechanism (SDRM) proposal announced by IMF in 2001 was a moderate move toward instituting rules to facilitate creditors' collective action for debt restructuring but did not impinge on creditor rights such as a standstill on debt payments or a stay on litigation and therefore fell short on this count.[22] 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, which makes it almost impossible to succeed in private sector involvement through fresh financing to accompany ILLR (a point emphasized by Bolton and Skeel, 2005). The action of ILLR without any mechanism for catalyzing private sector participation may thwart the whole effort. In the absence of legal power, ILLR is limited to indirect means of influence on 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 in arrears or condoning controls on capital outflows.

As it stands now, countries can only control financial flows in an insolvency situation through blunt and conflictive instruments such as arrears and hastily arranged debt restructuring. 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, but even in the best of circumstances, debt

[22] Even this timid proposal was shelved, in favor of a contractual approach to the problem to include the so-called collective action clauses (CACs) in new bond issues, which is now the standard.

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 debt restructuring, the imposition of controls on capital outflows on the part of countries may be a way out in certain circumstances but may also carry enormous costs for the future if they poison the well of financial integration. ILLR can help diffuse the reputational cost of arrears by lending into arrears if the country is making a good faith effort at restructuring and could also help with this issue by activating its lending and at the same time 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, as it were). However, all of these methods rely on individual countries' unilaterally defaulting on 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 outflows controls is to endow the ILLR with legal powers to grant a standstill on international payments when a country's ability to service is insufficient according to rules similar to a standstill ordered by a domestic bankruptcy court (as suggested by Jeffrey Sachs some time ago). In that way, the ILLR would then 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, thus increasing the reputation cost of frivolous default. The discrimination of defaults and debt restructuring terms in justified and unjustified, 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).[23]

The ability to legally impose a standstill on payments and capital outflows provides needed flexibility 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). It would also substantially empower ILLR. First, it would enable the ILLR to disburse automatically without concern that its lending will translate into increased capital outflows and little real effects. Second, it would help coordinate lenders

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

and investors, and buy time for an appropriate debt restructuring under equitable conditions for all involved. And third, by conditioning the lifting of the standstill on an appropriate debt restructuring agreement, it would give the ILLR an effective instrument to ensure that adjustment and restructuring will be successful. This last point is worth elaboration because it is one of the main benefits of this radical legal reform.

As in domestic bankruptcy, an overall proposal for adjustment and debt restructuring needs to be agreed upon by stakeholders. The interest of ILLR is to promote a "reorganization" that combines country adjustment (including policy reform) and debt restructuring with the best interest of the country. There are many ways in which such combination may be faulty. It is clear that coordination problems among creditors may lead to chaos. Apart from creditor side issues, short-sighted governments may favor excessive debt reduction, hurting the country's prospects for future financing. At the same time, it can be conjectured that under normal circumstances debt restructuring will be negotiated too late because governments do not want to face the associated political costs and prefer to "gamble for resurrection" before engaging in such a prospect, which results in inefficient adjustment (see 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, however, debt reduction bilaterally agreed between lenders and borrowers may be too shallow and fail to remove adverse debt overhang effects.[24] This is a distinct possibility if ILLR financing is perceived to be dependent on the post-restructuring financial needs of the country, the typical case of a deep-pocket third party gamed 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 that 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 ILLR's ability to grant seniority to interim fresh lending. The available alternatives to attract voluntary new financing to a country in financial crisis reviewed in previous sections rely on substitutes of legal priority that are costly or

[24] We conjecture that in the absence of risk-sharing features such as GDP-linked coupons, negotiated debt reduction can be expected to be too small to enable lenders to extract higher payments on the upside.

difficult to obtain. If they 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 even be unable to provide fresh money because of legal interference of existing lenders in arrears. Legal seniority would resolve this issue by implicitly creating a built-in insurance mechanism. This (mandatory) insurance would be implicitly paid by the country via the expected dilution costs of regular debt in the event of financial crisis, thus aligning the allocation of cost and benefit of the risk covered.

Importantly, by creating the conditions for voluntary fresh market financing, this legal power would amount to a strong catalyst thus reducing the financial resources needed by ILLR. In the extreme, ILLR may 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 enormous funds.

5. The Role of Multilateral Development Banks (MDBs) in Supporting ILLR

In the international context there are multiple official ILLRs, meaning lenders ready to lend when "no other lender is capable or willing to lend in sufficient volume to deal effectively with financial crises," both multilateral (e.g., the IMF and MDBs) and bilateral. Contrary to the private sector, which needs to be granted substantial enhancements or be somehow coaxed to lend in a financial crisis because of its profit motivation, MDBs are natural components of a ILLR system because they are guided by a development purpose that makes them more willing to lend in riskier environments if social returns are high. At times of difficulty, or outright crisis, the risk of losses is high and so is the corresponding social return of containing them. In parallel, given their preferred creditor status, MDBs have a superior enforcement capacity to recover their capital at risk, which makes them more able to withstand risk. Both differences between MDBs and private lenders become dominant in high-risk situations such as in severe downturns or outright financial crisis, and these differences in turn translate into private creditors' being pro-cyclical and MDBs' being counter-cyclical. The historical record and econometric analysis are clear in establishing that countercyclical MDB lending replaces retrenching private creditors.[25] Controlling for a number of factors, the evidence suggests that in the typical developing country the share of MDB disbursements (relative to private disbursements) significantly increases during growth downturns and decreases in upturns.[26] More to the point, in the typical developing country the level of MDB disbursements moves opposite to the rate of economic growth.

While the natural institution at the center of ILLR functions is the IMF, it is clear that the coordination with other ILLRs would be important for success. The question is whether the active countercyclical role of MDBs during downturns and financial crises would remain with an ILLR system as proposed above. The answer is probably "yes" on several counts:

a) ILLR only applies in extreme financial situations, leaving out less severe financial market volatility and natural fluctuations resulting from the normal economic cycle of countries. MDBs modulate specific development projects and policy reform to the economic circumstances of countries, including helping in devising effective countercyclical fiscal policies where there is fiscal space that can accelerate economic recovery, or limit the size of contractions, while ensuring development value.

b) There are also a number of scenarios in which MDBs may actually be called to be partner ILLRs. MDBs are willing to lend in a financial crisis and do so long-term, so under normal operation they are implicitly partners ILLRs; furthermore, IMF may fail to deliver in its ILLR role because of the insufficiency of resources it may be allowed to disburse to a particular country and may benefit from MDBs as explicit partners. It is also conceivable that in the case of small countries IMF may find it more practical to delegate ILLR functions to MDBs, subject to its overall supervision (Fernández-Arias, Powell and Rebucci, 2009). Less optimistically, ILLR will miss a good number of opportunities because of country ineligibility, stigma or mistrust, and may need a concerted approach with MDBs to arrive at a constructive result. In particular, MDB participation may help in building trust in ILLR

[25] See Fernández-Arias and Powell (2006, available upon request) and Levy-Yeyati (2009).
[26] This suggests that the increasing financial integration of most countries will lead to an increasing need for countercyclical support.

adjustment and debt restructuring views in particular countries' solvency crises.

c) While ILLR is critical for providing countries with a larger financial envelope to shape crisis policies, MDBs are called upon in times of difficulty to participate in the actual reassignment of public sector activities within the available envelope. MDBs 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, all of these responsibilities are crucial for economic development but could not be addressed by an ILLR only concerned with macroeconomic balances. MDB participation would economize on ILLR adjustment conditionality.

d) Times of crisis may also open up opportunities to pursue growth-enhancing reforms, the comparative advantage of MDBs, which would otherwise not be undertaken. This includes development-oriented structural reforms through policy-based loans. For example, while the IMF is the agency in charge of monitoring the budget envelope in the short run, MDBs focus on reforms that would generate better frameworks for fiscal policy. MDBs may work in designing fiscal institutions that would not only serve well the purpose of fiscal adjustment under ILLR but would also ensure fiscal sustainability going forward. MDB participation would improve ILLR conditionality.

In all cases of extraordinary financing of this sort, the IMF and MDBs 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 MDBs 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 that is equivalent to saying that the ILLR system would be undermined if the IMF is harsher than what MDBs deem appropriate. In the last analysis, an ILLR system needs to be agreed upon by all multilaterals and then utilize coordination mechanisms. For example, once an ILLR system is agreed upon, countries asking MDBs for extraordinary financing (say lending involving positive net flows or net transfers to the country) may be required to request eligibility for ILLR facilities (if they are not already qualified), so that the ILLR assessment can be taken into account in 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 of the essence.

In a tiered ILLR system like the one proposed, the ILLR assessment is highly informative for an MDB willing to retain appropriate flexibility. For example, there should be a strong expectation that a country eligible for the Top Tier (e.g., with an on-going FCL arrangement with the IMF), could freely access extraordinary financing. In contrast, a country which would not qualify even for the Lowest Tier (e.g. ,has not being able to complete the Article IV consultation with the IMF for more than one normal cycle) would be expected to be denied such financing. Without prejudging the overall conclusion on the part of the MDB, 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 the formation of MDB judgment. It is important to note that the MDBs have an interest in long-run sustainability and the development effectiveness of policies that IMF may lack due to its shorter-run focus and that the market may lack due to its sole concern with commercial credit risk. The MDBs' assessment may take into account factors ignored by these two sources of information and therefore differ from them.

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