

Crisis Resolution : Next Steps

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Abstract

At the 2003 spring meetings of the International Monetary Fund (IMF) and World Bank, it was decided to push ahead with the contractual approach to smoothing the process of sovereign debt restructuring by encouraging the more widespread use of collective action clauses (CACs) in international bonds. This decision was shaped by Mexico's successful launch the preceding February of a \$1 billion global bond, subject to New York law but featuring CACs, and by subsequent issues with similar provisions from a number of other emerging market countries. This paper reassesses this strategy's efficacy for addressing problems of crisis resolution. The paper concentrates on two questions, drawing on both theory and new empirical evidence. First, are speculative credits likely to follow investment grade countries in adding CACs to their loan instruments? While this paper's analysis of sources of resistance to contractual innovation creates reasons for hoping that Mexico's path-breaking issue may have broken an important logjam, both theory and evidence highlight the moral hazard associated with restructuring-friendly provisions for countries with poor credit. They suggest that CACs may raise the cost of borrowing for countries with poor credit ratings, especially in periods when sentiment toward emerging markets is relatively unfavorable, leaving them slow to embrace these provisions. Second, are CACs sufficient to solve problems of cross-issue coordination among creditors, the so-called aggregation problem? The market appears to be most concerned about aggregation with respect to poor credits with very limited market access. However, because investors may not anticipate the relapse of good credits into repayment difficulties, cross-issue coordination may become a problem for other issuers as well. This paper therefore concludes that there is a need to encourage the development of supercollective action clauses, bondholders committees, and a code of creditor conduct.