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Prior to joining the IMF's European Department, Susan worked in the organization's policy development and review department, where she oversaw lending operations for Russia, other Commonwealth of Independent State countries, Turkey and South Africa. She was also responsible for creating a division that carried out the IMF's ex post evaluation of lending to low- and middle-income countries.

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EXECUTIVE SUMMARY

The timely resolution of severe debt crises has long been one of the most difficult challenges for global financial cooperation. Focussing on the case of Greece, this paper examines how the euro crisis precipitated large International Monetary Fund (IMF) loans that violated the framework developed on the basis of the preceding decade to prevent a costly delay in restructuring.

The paper reveals that safeguards meant to prevent the IMF from providing support for crisis countries without a reasonably clear path to debt sustainability failed. In fact, changes made in the context of the euro crisis to the IMF's framework for lending in severe sovereign debt crises will weaken the IMF's effectiveness in future crises. The paper concludes with four suggestions for how to re-establish an adequate framework for IMF intervention in severe debt crises in the future.

INTRODUCTION

The timely resolution of severe debt crises has long been one of the most difficult challenges for global financial cooperation. The heart of the challenge is deciding when financing a program of adjustment policies can get a country back on track, and when a restructuring of debt is unavoidable. The euro crisis, and most flagrantly Greece, has shown that there is still a deep bias in favour of financing, even past the point where restructuring is widely seen as inevitable. Although private debt was restructured some two years into the Greek crisis, it came too late and was therefore too little to re-establish sustainability. Now, more than three years after the start of the crisis, Greece has not regained market access, while output and employment continue to fall.

Focussing on the case of Greece, this paper examines how the euro crisis precipitated large IMF loans that violated the framework developed in the preceding decade to prevent a costly delay in restructuring. The paper draws on IMF documents prepared throughout the Greek crisis and on interviews with some 30 policy makers and market analysts involved from a variety of perspectives with events in Greece. Similar, though far from identical, developments in Ireland and Portugal are not examined, though the relevance of the analysis for those crises is strong.

The paper concludes that the safeguards meant to prevent the IMF from providing support for crisis countries without a reasonably clear path to debt sustainability failed. This was partly because of the unusual circumstances of a crisis within a currency union. But it also reflected the IMF's insufficient resistance to regional political pressures to delay measures to resolve the crisis. The paper proposes several steps that should be taken to avoid allowing the euro crisis to serve as a precedent for future crises: effectively, the IMF's defences against lending into unsustainable debt need to be strengthened, while some flexibility for short-term involvement in emergencies is likely to be essential in some circumstances.

The structure of the paper is as follows. The next section discusses the framework governing the IMF's exceptionally large lending to crisis countries, including its recent history and rationale. The following section presents the salient facts and timeline of the Greek crisis. Then the next section examines four key questions concerning why and how the framework for exceptional access — developed over the previous decade — was changed in order to permit the extension of exceptional access to Greece. The paper concludes with several ideas for resurrecting a viable framework to constrain the IMF's discretion in handling severe debt crises.

EXCEPTIONAL ACCESS TO IMF RESOURCES: A SHORT HISTORY

After the 1994-1995 Mexico crisis, exceptionally large IMF bailouts of private creditors became a hot-button issue.[1] That crisis, which was, in the words of the IMF's then Managing Director Michel Camdessus, "the first financial crisis of the twenty-first century," placed in sharp relief the staggering financing needs that a new breed of crisis — capital account crises or sudden stops or reversals of capital flows — could precipitate. It focussed attention on the magnitude of vulnerabilities from the rapid growth of cross-border securitized lending, from the heavy dependence of many emerging market countries on foreign capital, and from the speed and interconnectedness of changes in capital market sentiments. The Mexico crisis was followed in quick succession by crises of similar precedent-breaking force in Asia and Russia.

The response to these early capital account crises was largely taken from the playbook of traditional balance-of-payments crises. The IMF agreed on programs of policies with the debtor country involving fiscal and monetary restraint, large devaluations and structural reforms. Where these programs differed from previous practices was in the access to IMF support: whereas the commitment of IMF resources had, in the past, been calibrated to cover a share of an unfinanced current account deficit and serve as a catalyst for private or other official lending, in capital account crises, the current account deficit plus a sudden and large outflow of private capital had to be financed. Obviously, the larger the stock of debt and more intense the outflow, the larger this new form of balance-of-payments need.

By the end of the 1990s, the spate of exceptionally large IMF loans had pushed several related questions onto the global stage: Should official and private creditors *share* the burden of financing crises? Could all financial crises be resolved effectively through a combination of adjustment (on the part of the debtor) and financing? If not, were global institutions adequate to ensure timely and efficient debt restructuring?

The first stab at answering these questions came in the Prague Framework in 2000.[2] The framework was far from an explicit road map. Rather, it endorsed the principle of placing some of the financial burden of crisis prevention and management on private sector creditors — an

1 In the parlance of the IMF, "exceptional access" to IMF funding (or resources) is access in excess of the "normal" access limits, which are calibrated as a percent of a member country's quota share. Annex 1 explains the terminology of IMF lending and provides a brief history of access limits.

2 The Prague Framework was laid out in the communiqué at the end of the 2000 annual meetings held in Prague.

approach referred to as private sector involvement (PSI). It also recognized that not all crises could be resolved through adjustment and financing. But the guarded language of the document reflected deep divisions on how far along the spectrum of "coercive" techniques (from voluntary rollover of existing exposures to unilateral debt restructuring or default) PSI should go.

The Prague Framework recognized three types of severe debt situations: ones where catalytic financing at exceptionally high access levels to support policy adjustment would have good prospects for success; ones where such an approach would need to be accompanied by encouragement of voluntary approaches to overcome creditor coordination problems; and ones where "early restoration of market access at terms consistent with external sustainability would be unrealistic" and "a broader spectrum of actions by private creditors, including comprehensive debt restructuring, temporary payments suspension or standstill may be warranted."[3]

This "framework" left open many practical questions. Two framed the debate on implementation over the next few years. First, the framework gave, at best, vague guidance on the circumstances in which private creditors should be bailed out: it therefore left timely bail-in/bailout decisions to the discretion of IMF management and, ultimately, the executive board — neither immune to political influence, which almost always favoured financing over restructuring. Second, it gave no direction on procedures for "voluntary approaches to overcome creditor coordination problems" or, in the most severe circumstances, "a broader spectrum of actions by private creditors."

The second of these issues — procedures for restructuring — was the first to catch global attention. Responding to intense frustration about the barriers to sovereign debt restructuring in the 2001 Argentine crisis, the IMF's then First Deputy Managing Director Anne Krueger proposed the establishment of a sovereign debt restructuring mechanism (SDRM). She pointed to the gaping holes in the Prague Framework: "we lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only mechanism requires the international community to bail out private creditors."[4] The proposal, however, failed to secure the support of major creditor countries, financial market participants or emerging market countries. By early 2003, the proposal was relegated to further study. In its place, greater use of collective action clauses (CACs) to overcome any creditor coordination problems was pursued.

Following this debate, the IMF took up the first issue: establishing criteria to limit the IMF's discretion in determining when to bail out private creditors. The SDRM and criteria debates were highly complementary. Where the SDRM/CAC debate focussed on providing an alternative to IMF bailouts, the criteria debate focussed on whether that alternative would ever be used. To put this issue in the context of the Argentina crisis, the aim of the criteria was to establish a framework that would have required the IMF to cease financing in the absence of PSI when prospects for the success of that strategy became low — in other words, well before November 2001, when a significant portion of debt had been assumed by official creditors, interest costs had skyrocketed and market participants jockeyed to position themselves for an increasingly probable default or restructuring. All of these developments made the ultimate restructuring more difficult and costly than it could have been.

Fund staff kicked off the debate on limiting the IMF's discretion by raising four systemic vulnerabilities stemming from the absence of constraints up to that point: the moral hazard arising from the potential availability of exceptionally large access; a lack of clarity contributing to systemic uncertainty (notably, about when Fund financing would be accompanied by restructuring of private claims); the vulnerability of the IMF to political pressure to provide exceptional access even when the debt burden of a country was likely to be unsustainable; and credit concentration from exceptional access cases jeopardizing the IMF's financial position.[5]

In 2002, the IMF executive board approved four criteria to be met by debtor countries to gain exceptional access to IMF resources. The criteria purposely departed from the rigidities of traditional quantitative access limits. Instead, they aimed to allow maximum discretion on how to handle a crisis within the constraint that decisions on exceptional access have a clear and transparent basis, emphasizing "a positive assessment of prospects for debt sustainability,"[6] safeguarding the Fund's resources and ensuring uniformity of treatment.[7] The criteria required:

1. The member is experiencing exceptional pressures on the capital pressures that cannot be met within the Fund's normal access limits;

3 IMF (2009), *Communiqué from the 2000 Meeting of the Interim Committee*.

4 Anne Krueger (2011), "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring," address to the National Economists' Club, American Enterprise Institute, November.

5 IMF (2002), *Access Policy in Capital Account Crises*, July 29.

6 Ibid.

7 Uniformity of treatment is a fundamental obligation of the IMF, entailing the application of guidance and principles across the membership, regardless of the size or other defining characteristics of the member.

2. A rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable;[8]

3. The member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund's financing would provide a bridge;

4. The policy program of the member country provides a reasonably strong prospect of success.

During 2002–2009, tests of the new criteria were, at most, modestly challenging. Four countries received exceptional access during 2002–2005, followed by a complete hiatus during 2006–2007, when a strong global economy and rising international capital flows created an easy market financing environment. 2008–2009 saw a first wave of lending requests from countries hurt by the global financial turmoil — 21 countries received exceptional access during this period.[9] In most of these, the four criteria were judged to have been met.

Nevertheless, teething issues related to the four criteria arose during this period. These mainly concerned narrowness in the criteria that made them inapplicable in certain situations. Modifications to the criteria in 2009 addressed most of these problems. The first criterion was broadened to acknowledge that exceptional balance-of-payments pressures could arise from actual or potential current as well as capital account imbalances. The second was modified to allow for a forward-looking focus that would take into account the effects of policy adjustment and restructuring in assessing debt sustainability. The modification also narrowed the definition of debt sustainability to apply only to public debt — not overall external debt. The third was changed to recognize that some countries needing exceptional access might never have had market access, so that gaining (not regaining) market access would be the relevant marker.[10]

The Greek crisis in 2010 posed the first fundamental challenge to the criteria. Not only did access as a percent of quota far surpass existing records, but also, the IMF could not reconcile a role for itself in the crisis with adherence to the four criteria.

GREECE: THE FACTS BEHIND THE CHALLENGE

The path to IMF involvement in the Greek program was bumpy. In the face of vulnerabilities stemming from a decade of rising fiscal deficits and falling competitiveness, a series of events — the global financial crisis, credit rating downgrades and disclosure of inaccurate fiscal data — triggered a market sell-off of debt in late 2009. While this was an obvious entry point for the IMF, Greece and its EU partners rejected Fund involvement, except through technical assistance. Jean-Claude Trichet, then European Central Bank (ECB) president, was particularly outspoken against Fund involvement. In the Fund's absence, the European Commission (hereafter the "Commission") negotiated a fiscal program involving cuts in the budget deficit relative to GDP by four percentage points in 2010, and a further three percentage points in each of the next two years. With widespread skepticism about the feasibility of the plan, market conditions deteriorated further. By early April 2010, it was clear that the Fund's expertise and its contribution to funding would be politically convenient and reassuring to increasingly pessimistic markets. Unusually in IMF procedures, a formal partnership of the Commission, the ECB and the IMF (the troika) was formed to conduct negotiations and oversee the program.[11]

At this point, time for preventing a default was short. A large debt amortization due in mid-May set the deadline for approving the program and disbursing the first funding tranche. Conditions for proceeding at this pace were complicated by two facts: first, the fiscal program negotiated between the Commission and the government — viewed by IMF staff as unrealistically harsh — had to be renegotiated; and, second, without an exchange rate instrument, the Fund pressed for a complex strategy of structural reform going to the heart of social and institutional conditions to rebuild competitiveness, reduce the current account deficit and regenerate growth. Preparing this program and getting board approval in five weeks was a tall order.

The program approved on May 9, 2010 was widely seen, and even acknowledged by Fund staff, as optimistic. Skepticism centred on three parts of the program, though myriad related details were also questioned. First, though the targeted fiscal adjustment had been pulled back from

8 The IMF defines public debt as sustainable "when the primary [fiscal] balance needed to at least stabilize debt under both [a] baseline and realistic shock scenario is economically and politically feasible, such that the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level." See IMF (2013), "Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries."

9 While this was a large number, it reflected the unusually difficult global economic conditions, as well as the fact that quotas had not been adjusted since 1999 and access limits had been unchanged since 1994. In other words, with the extraordinary growth of global trade and capital flows, the scope for imbalances had far overtaken the normal limits on IMF lending. Both quotas and access limits were doubled in early 2011. Many of the exceptional access cases during 2008–2009 would not have been exceptional if calibrated against the new metrics.

10 The criteria as of the beginning of 2010 — at the outset of the Greek crisis — are reproduced in Annex 2.

11 For a comprehensive critique of the troika arrangement see J. Pisani-Ferry, A. Sapir and G. Wolff (2013), *EU-IMF Assistance to Euro-Zone Countries: An Early Assessment*, Bruegel Institute, Volume XIX, May.

the original amount negotiated with the Commission, it nevertheless envisaged a sustained primary surplus of six percent of GDP after 2014 and large receipts from privatization of state assets. The scale of this adjustment was very large by standards of other crisis countries. Second, even without a depreciation, structural reforms were projected to turn growth around sharply: a deep drop in GDP was envisaged to end by late 2011, and thereafter steady growth of 2.7 percent was projected through 2020. Third, public debt was projected to peak in 2013 at 150 percent of GDP, and Greece was expected to regain access to medium- and long-term credit markets several months before even this high-level stabilization. The staff report supporting the program included a litany of risks, and the notional fan chart of 10-year ahead indebtedness was sharply skewed to the upside of baseline. Moreover, the report hinted at the prospects for debt restructuring: "there may be scope for bolstering this [market access] by seeking coordinated voluntary rollover understandings among creditor groups."[12]

The IMF funded €30 billion, 27 percent of the total from the troika, in a three-year Stand-By Arrangement. At 3,200 percent of quota for the three-year arrangement, this amount far surpassed the normal annual access limit (200 percent of quota), cumulative access limit (600 percent of quota) and the previous record breaker — Korea (1,900 percent of quota in 1997).

In a highly unusual procedure for altering IMF policy, a critical change in the four criteria was part of the approval of the arrangement with Greece. Staff in the central reviewing department of the IMF, who doubted the feasibility of the programmed policies, were unwilling to sign off on the proposition of a high probability that public debt was sustainable in the medium term. The report therefore proposed a modification of the second criterion for exceptional access: in cases where there is a "high risk of international systemic spillover effects," exceptional access could be granted even when the debt sustainability criterion was not met ("the systemic risk waiver"). The other three criteria were judged to have been met. The strategy then was to have executive board approval of the modification *implicit* in the approval of the arrangement with Greece. In other words, in a stark departure from normal procedures for changing Fund policy, there was no separate discussion of the modification of the criteria (which staff explained clearly to the board was not an exception to the standing policy but rather a permanent change). The report had a paragraph briefly listing possible spillovers from the crisis.

In the event, the assumptions and projections underlying the program proved far off the mark (Table 1). The recession was more deeply entrenched than projections had envisaged: as of mid-2013, GDP continues to fall. The difficulty of implementing reforms meant that the strategy of structural reform-led improvements in competitiveness and the current account balance had to be replaced with a deflation-led "internal devaluation." Fiscal and debt developments were disappointing as the government struggled with institutional reforms and public resistance to austerity.

Discussion of restructuring privately held debt gradually seeped into the public debate. In the first year of the program, official discussion of debt restructuring was muzzled, although the Greek government and some euro-zone members floated the idea behind the scenes. Open talk of PSI within Europe started at a meeting in Deauville, France between German Chancellor Angela Merkel and then French President Nicolas Sarkozy. That discussion was about procedures only for the prospective European Stability Mechanism (not in the existing program with Greece), but it was widely perceived as a change of heart on the part of Europeans toward PSI. Then, in April 2011, German Finance Minister Wolfgang Schaeuble rocked markets when he stated "If [the forthcoming review of the

12 IMF (2010), *Greece: Staff Report on Request for Stand-By Arrangement*, IMF Country Report 10/110, May.

Table 1: Greece — Changes in Key Projections

	2010	2011	2012	2013	2014	2015	2020
May 2010 projection							
GDP (percent change)	–4.0	–2.6	1.1	2.1	2.1	2.7	2.7
Primary fiscal balance/GDP	–2.4	–0.9	1.0	3.1	5.9	6.0	6.0
Public debt/GDP	115	133	145	149	149	144	139
June 2013 actual/projection							
GDP (percent change)	–4.9	–7.1	–6.4	–4.2	0.6	2.9	2.7
Primary fiscal balance/GDP	–4.9	–2.4	–1.3	0	1.5	2.0	3.0
Public debt/GDP	148	170	157	176	174	168	124

Source: IMF, various publications.

Greek program] concludes that there are doubts about the debt sustainability…something must be done about it."[13]

In July, the troika and creditors agreed on a restructuring plan for Greece involving lengthening maturities and lowering interest rates with no cut in the face value of debt. As news on the Greek economy worsened in the months that followed, the package was revised to include a 50 percent cut in the face value of most privately held debt.[14] Initially, the aim was to craft the restructuring so that it could be called "voluntary" and could avoid triggering credit default swaps. Ultimately, the mechanics of the deal made this impossible. The restructuring of domestic law debt was completed in March 2012 and of foreign law debt two months later. In November, a second restructuring through a debt buyback was completed.

The systemic risk waiver on exceptional access continues to define the IMF's involvement in the European crisis. Lending arrangements with Ireland approved in December 2010 (2,322 percent of quota) and with Portugal approved in February 2011 (2,306 percent of quota) used the systemic risk waiver on debt sustainability. For Ireland, Fund staff pursued a restructuring option that would have reduced doubts about debt sustainability — a writedown of bank debt held by senior creditors — but failed to prevail within the troika. The systemic risk waiver has been invoked in most of the periodic reviews (prior to tranche releases) for Greece, Ireland and Portugal. In other words, a clear path to debt sustainability remains unclear.

IS LENDING INTO UNSUSTAINABLE DEBT GOOD POLICY FOR THE IMF?

The Greek crisis put extremely difficult choices before the IMF. There were good reasons for the IMF not to be actively involved: Greece was in a currency union that could afford to finance any bailout desired, and the strategic approach to the crisis was bound to be wrapped up in political manoeuvring not just of the debtor, but also of the union. There were also good reasons for the IMF to play a role: the IMF has unparallelled experience with handling severe crises, it was clear that the crisis would have global repercussions that could be minimized with proper handling, and, in a politically fraught environment, the IMF could bring a degree of objectivity to decisions and reassurance to markets.

The IMF navigated these pros and cons for engagement, but was left with a critical hurdle: in the absence of good prospects for debt sustainability, some way around the four criteria would be needed. The decision to introduce the systemic risk waiver was only one of several firsts that the Greek program presented.[15] But it is an important one, both because it had implications for the course of the crisis and because it set a critical precedent for future crises. Discussions with some 30 key players in the handling of the European crisis explored four key questions surrounding the circumstances that lead to this situation and the decision on how to proceed:

- Does the IMF need a framework constraining its discretion on exceptional access decisions?
- Though the four criteria did not prevent the decision to fund a country without good prospects for debt sustainability, did they at least succeed as a framework ensuring that all strategic options were on the table?
- Was the case for departing from the four criteria credible?
- Are the modified criteria an adequate framework for constraining the IMF's discretion in future crises?

This section distills and critiques the main views expressed in the interviews on these questions. As many interviewees spoke confidentially, no attribution is provided.

DOES THE IMF NEED A FRAMEWORK CONSTRAINING ITS DISCRETION ON EXCEPTIONAL ACCESS DECISIONS?

Contradictions abound in answers to this question. Officials dealing with financial crises like discretion. Indeed, the first take of most interviewees was that to the extent the four criteria meaningfully narrowed the Fund's options, they were too rigid. However, presented with the alternative of leaving the Fund with no constraint, most advocated a framework of some sort. Indeed, most concurred with the proposition that holding the IMF to a set of principles was likely to produce decisions on crisis resolution with lower costs to global stability than in the absence of such constraints. At a minimum, a framework would ensure that options for crisis countries were thoroughly considered in light of the costs and benefits for the debtor country and for global stability. Most also thought that without the intention to apply the framework uniformly, it would not be useful. If nothing else, haphazard application would raise problems in terms of time inconsistency and the Fund's mandate for uniformity

13 *The Telegraph* (2011), "Fears Grow over Greek Debt Default Despite Bail-out," April 15. The statement was a sign that the IMF's doubts about debt sustainability from the beginning of the program were not clearly understood.

14 At the end of 2009, the face value of privately held Greek government bonds (i.e., excluding €9 billion in Treasury bills) was €253 billion against a face value of €205 billion that was restructured. See Miranda Xafa (2013), "Life after Debt: The Greek PSI and its Aftermath," *World Economics* 13, no 1.

15 See IMF (2013), *Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement*, for a thorough review from the perspective of the IMF staff.

of treatment. Crafting a viable framework — one with both credibility and a high degree of flexibility — would be a tall order.

What debt sustainability is and why it is important is evidently not uniformly clear, even to some policy makers. It is not controversial that the main reason to constrain IMF discretion is to ensure that political pressures do not produce undue delays in decisions about how to resolve a crisis. It is widely accepted that the "value added" from the IMF in debt crises is to support a program of policies (including, when absolutely necessary in severe circumstances, restructuring privately held debt) that will, within a three-to-five-year period, return a country to potential output, market access and the ability to service its debt. Yet, it is clear that the complex technicalities of the IMF's debt sustainability analyses have created a gap between, on the one hand, this "common wisdom" and, on the other hand, a practical understanding of why "flexibility" to allow Fund involvement without good prospects for debt sustainability makes little sense. Isn't debt sustainability in the eye of the beholder? What is wrong with a period of uncertainty about whether debt will be sustainable? It is not consistently appreciated that endowing the Fund with the option of lending in the absence of confidence about debt sustainability means that one of three possible outcomes is close to inevitable: Fund lending goes on indefinitely; an as-yet-reluctant official creditor is persuaded to step in; or debt is restructured. Until the choice is made, costly uncertainty and adverse spillover effects prevail.

For the most part, avoiding moral hazard was not seen as an important reason to have a framework constraining the IMF's discretion. Consistent with much theoretical and empirical research, most policy makers and market participants did not believe that moral hazard was an important cause of debt crises.[16] A strong disincentive to debtor moral hazard exists in the hardship involved in debt crises, while creditor moral hazard is mainly discouraged by volatility and adverse asset price movements in crises.

One current within the answers to the question "does the IMF need a constraining framework" was cynicism. In this view, the Fund was a creditors' institution and the political influence of creditor countries could not be overruled by any framework. A few officials pointed to the procedure for introducing the systemic risk waiver as a clear indication that any framework for constraining the IMF's discretion was likely to have credibility problems. Modifying the criteria as an automatic by-product of approving the May 2010 arrangement with Greece meant that no separate discussion of the coherence or effects of the modification took place. Unless directors voted to oppose the loan to Greece, they could not vote against the modification. The situation was described as executive directors having "been cornered." But even those voicing this sort of skepticism about the effectiveness of a framework still favoured having a framework that could at least exert some constraining influence on the IMF.

Few, if any, interviewees thought that having an SDRM in place would have made constraining the Fund's discretion easier. Most pointed to the successful and fairly rapid negotiation of the restructuring agreement in 2011–2012, when creditor coordination was not seen as a problem. The critical determinant of the decision in mid-2011 to proceed with the first restructuring was the change of heart of major European countries as the costs of the crisis, in part anticipated by the Fund staff, became hard to ignore. The second restructuring — the debt buyback in late 2012 — resulted mainly from IMF staff and management questioning the viability of the program.

DID THE FOUR CRITERIA SUCCEED — AT LEAST AS A FRAMEWORK FOR ACHIEVING TRANSPARENCY, CLARITY AND GOOD COMMUNICATION ABOUT UNCERTAINTIES AND OPTIONS?

One key strength the IMF staff can bring to multi-party negotiations on the resolution of a crisis is an objective perspective. The essence of this role is getting all strategic options clearly on the table. By at least placing a speed bump for the IMF in extending exceptional access, the four criteria should bolster the IMF's ability to insist on open consideration of all strategic options. Yet, in the tense and fast-moving negotiations during the five-week period leading up to board approval of the May 2010 program, personalities and politics made this tricky.

The Fund staff's debt sustainability analysis (DSA) is central to defining strategic options.[17] From the start, the DSA for Greece was subject to two fundamental political pressures: Europe's refusal either to accept restructuring or to provide more funding on easier terms; and the IMF's eagerness to be involved, even if the program did not chart a path to debt sustainability and renewed market access. These pressures produced two awkward questions for Fund staff and management. First, should the DSA simply be jerry-rigged to show sustainability, or should it present a realistically sober picture of the outlook? A middle ground was chosen. Though the DSA (using quite optimistic assumptions) showed public debt relative

16 See, for example, IMF (2007), *Fund Financial Support and Moral Hazard: Analytics and Empirics*, March.

17 The DSA is a set of projections for public debt over 10 years, embedded in a model projecting key macroeconomic variables. Analysis of the sensitivity of the debt projections to various shocks to the macro variables defines a range within which the actual outcome is expected to lie. The DSA is the basis for the Fund's determination of whether the combination of feasible policies and exogenous developments are likely to produce sustainable debt.

to GDP stabilizing in the baseline scenario at about 150 percent of GDP after three years, the implicit fan chart of the public debt ratio (based on analyses of sensitivity to a number of plausible shocks) was sharply skewed to the upside. Second, should the Fund place a high probability on this outcome? Here, doubts of some key staff about the feasibility of the size and duration of the fiscal adjustment (including privatization) prevailed. The DSA clearly served the purpose of forcing a systematic assessment within Fund management and staff of the perils of the program.

Interviews suggest that IMF staff doubts about sustainability were not evenly understood outside the IMF. Some key players chose to ignore the Fund staff's conclusions: they essentially argued that debt sustainability was in the eyes of the beholder. Other key players, for example, Greek officials, perceived the staff's doubts, but their attention was focussed almost solely on whether the near-term amortization schedule would be met, not on whether the debt trajectory would be compatible with renewed market access a few years out. In fact, Greek officials saw the DSA as reasonably hopeful, a view reinforced by the troika's eagerness to proceed with the arrangement. Other key players said debt sustainability was not seriously discussed until April 2011, after Finance Minister Schaeuble publicly admitted the possibility of debt restructuring. The ECB appears not to have been *formally* informed of the skepticism within the Fund staff about debt sustainability. Fund staff, however, state that they held focussed discussions on the DSA and its implications during the negotiation period in unrecorded bilateral and small group meetings with key country officials. An informal meeting of the IMF executive board took place the week before approval of the arrangement; informal board meetings have no minutes, so verification of what was revealed is impossible.

Discussion of the costs and benefits of policy options was also fraught. Interviewees were starkly divided on whether substantive discussion of the options took place. One former policy maker involved in the discussions said if then Managing Director Dominique Strauss-Kahn thought that restructuring or more EU money was needed, he dropped the idea early on. Jean-Claude Trichet, a staunch opponent of restructuring, is reported not to have countenanced discussion in any fora of the restructuring option. He was, however, a forceful, behind-the-scenes advocate of larger European funding. Others said that the inevitability of one or both of those options was understood prior to the May 2010 board meeting. Generally, interviewees confirmed that the decision to proceed was based on a qualitative European commitment to provide additional funding if necessary and to honour IMF creditor seniority.

In sum, if one aim of the four criteria was to provide transparency and clarity on the Fund's decisions in severe crises, it was not met. Awareness of the four criteria and an understanding of their significance — particularly the meaning and importance of debt sustainability — is low outside the IMF. None of the market participants and not even all of the government or central bank officials interviewed were either aware of the four criteria or that they were changed to approve the Greek loan. An official of one euro-area country who did know about the four criteria said that his government calculated that the IMF's eagerness to be involved in the Greek program would ensure that some way around the four criteria would be found.

WAS THE CASE FOR CHANGING THE FOUR CRITERIA CREDIBLE?

The underlying logic of the four criteria is unassailable. Recognizing that normal access can be inadequate in unusual circumstances, the four criteria avoid the arbitrariness of quantitative limits and aim only to constrain the Fund from financing crises when other options (especially restructuring) are likely to be needed. Because debt sustainability analyses have an element of judgment, placing the bar for prospects of debt sustainability at "a high probability" allows for flexibility when legitimate differences in view arise. Finally, the four criteria form a tight and integrated framework: the market access test (criterion 3) reinforces the debt sustainability test (criterion 2), and neither is likely to be met in conditions of significant balance-of-payments pressures (criterion 1) unless the policy program is credible and likely to be effective (criterion 4).

Did Greece really present circumstances that warranted changing the criteria? This question is best considered in the context of three time frames and their attendant pressures: first, the very short term, when there was an immediate threat of default and financial chaos in May 2010; second, the next few months, when important changes in euro-area institutions were possible; and third, the full three-year program period, along with inevitable extensions of that period.[18] These will be considered in turn in the following paragraphs.

The immediate threats in the Greek crisis in April–May 2010 were widely seen as a viable challenge to the constraint the four criteria placed on IMF involvement. The IMF joined the crisis management only after circumstances had become dire. The intra-European negotiations had produced an unrealistically harsh program with inadequate funding commitments. Markets were not persuaded of its feasibility. Most policy makers interviewed felt that the IMF had played an invaluable role in guiding the talks back to a firm but measured policy

18 In March 2012, immediately after the first restructuring agreement, the three-year Stand-By Arrangement was terminated a year early and a four-year Extended Arrangement, taking the program to 2016, was put in place.

program. Greece did not have the funds to meet a large debt amortization payment coming due in mid-May. The consequences of default at that time were seen as dire: weakness in other peripheral euro-area countries left them ripe for contagion; the ECB did not, at that point, accept downgraded government bonds as collateral for bank funding; neither the euro area nor the European Union had adequate funding arrangements for crisis resolution. All these factors were credible threats to the survival of the currency union. In other words, the counterfactuals to Fund involvement — cutting Greece loose immediately, or proceeding with an excessively harsh and underfinanced program — were likely to entail larger systemic costs than those in the course chosen.

Justifying IMF involvement in the six to nine months after the immediate threat of default had been addressed is more difficult. In this period, the outlook for financial market chaos and even systemic spillovers arguably changed. Within days of the approval of the Greek loan, institutional changes began. The ECB suspended the link between sovereign credit ratings and eligibility of collateral for bank refinancing operations, began to intervene directly in the government bond market, and started accepting uncovered bank bonds guaranteed by governments as collateral for refinancing operations. The European Financial Stability Facility was created, and plans to establish a permanent European crisis resolution fund were announced. By end-year, Irish creditors had received an official bailout, rumours swirled that Portugal was close behind, and Spain and Italy had begun to feel market pressures. These changes raise the following question: once the threat of a disorderly default in May passed, did the calculus of the risks of systemic spillover effects continue to favour lending without a high probability of debt sustainability?

Strong views are held on either side of this question. Several policy makers (both within and outside Europe) and market analysts believed that the process of restructuring privately held debt could, and perhaps should, have started immediately. It would, of course, have involved larger losses than ultimately realized for private creditors, because exposures were larger in mid-2010 than they were in February 2012, when the first restructuring occurred. But it was far from clear that these were unmanageable threats to general financial stability. Contagion — including to Spain and Italy — would have been brought forward, but few argued that it would have been worse than it turned out to be. Others felt that risks to the currency union from restructuring were significant, so that waiting to see if a favourable scenario, even if improbable, could play out was worthwhile. Most saw the authority of Jean-Claude Trichet as a decisive factor in the decision not to start a serious consideration of restructuring. Trichet was widely perceived as having a deep understanding of the costs and benefits of restructuring (he had been the chairman of the Paris Club) and (as head of the ECB) of the risks to the currency union. No one was able or willing to challenge his position in the early months of the program.

Justifying longer-term IMF involvement without good prospects for sustainability is even more difficult. IMF documents — for the nine reviews (prior to each release of a funding tranche) and for the initiation of the four-year arrangement in March 2012 — continued to invoke the "systemic risk waiver."[19] In other words, even in the period since the 2012 restructurings of private debt, Fund staff have not found a high probability of debt sustainability. Yet the high level of funding continues. Is there any justification beyond political expediency?

The case *for* long-term IMF involvement despite continuing uncertainty about debt sustainability rests on two pillars. First, Europe strongly wanted the IMF to be involved. The European Union provided a quasi-explicit commitment eventually to foot the bill to render Greece's debt sustainable.[20] How would this play out? The by-product of the 2010 bailout was a sharp increase in the share of Greek government debt held by the official sector — the IMF, the ECB, and countries and institutions of the European Union. By end-2012, over 60 percent of total debt was in official hands. To the extent that debt (even after the restructuring) indeed proves to be unsustainable, the official sector will take the bulk of the losses. These losses were anticipated. Even before the lending arrangement was approved, IMF staff reportedly made it clear that the strategy chosen would involve significant losses and that European official creditors must bear their entirety. In essence, the international community accepted a large and prolonged role for the IMF without a high probability of debt sustainability because the Europeans, by confirming the IMF's senior creditor status and accepting ultimate financial responsibility, implicitly took on the cost of the strategy chosen.[21]

The case *against* continuing IMF involvement has two conceptual pillars around its costs — which have two conceptual pillars. First, the IMF's Articles of Agreement (Article V, Section 4) allow that prescribed limitations

19 The exception was one review document, dated December 2011, after the agreement, in principle, for a 50 percent reduction in the value of most privately held debt, when the waiver was not invoked, implicitly suggesting that debt was considered sustainable.

20 The three-year arrangement started in May 2010 was terminated in March 2012 when a new four-year extended arrangement was approved. IMF support will thus cover 2010 to 2016.

21 Several interviewees suggested that apart from domestic political considerations, one reason the Europeans did not want to commit openly to absorbing the costs of the crisis and establishing an endgame was that they felt it necessary to perpetuate uncertainty as a method of holding the feet of the Greek government to the fire. This is puzzling insofar as disbursements of all official lenders were contingent on Greece meeting performance reviews.

on IMF lending can be waived if the member pledges "as collateral security acceptable assets having a value sufficient in the opinion of the Fund to protect its interests." But the quasi-explicit intention of the European Union to back Greece's debt does not meet that standard.

Second, and more important, the case against prolonged IMF involvement centres on the costs — in IMF parlance, spillover effects — of an unresolved debt crisis for the global economy.[22] Ironically, in introducing the systemic risk waiver, the IMF effectively ducked an assessment of this cost. It is unimaginable that any crisis serious enough to require exceptional access to IMF resources could have no or limited spillovers regardless of the way in which it is resolved. The question is not whether a severe crisis has systemic spillovers (they all do); rather, it is whether those spillovers are likely to be lower in a scenario that delays restructuring when it is likely, or in one that includes restructuring alongside adjustment and financing. Had the IMF squarely addressed this question, the case for continued involvement without good prospects for debt sustainability would likely have been negative.

This question then goes to the heart of how systemic spillover effects are assessed — a question that few, if any, interviewees had considered. Were systemic spillovers larger in the course chosen (exceptional access in support of a program that did not have a high probability of sustainability), or in an alternative course (such as an earlier move to debt restructuring or a larger upfront commitment of European resources)? Such an analysis should be broad in scope, encompassing spillovers not only through financial contagion, but also for growth, investment and employment. Though an *ex ante* comparative analysis could not have been precise, it should have been a prerequisite for determining whether the systemic risk waiver continued to justify IMF funding. Instead, in the few analyses of spillover effects that show up in Fund papers, the focus was on enumerating possible direct and indirect effects of the Greek crisis as it played out — not to consider how alternative strategies for addressing the crisis would affect the severity and nature of the spillovers.[23] The only hint of a comparison of alternative strategies came in the mid-2011 report on the annual consultation for the euro area, which stated, "Staff…also saw serious risks of contagion even under a strategy which tries to avoid default or credit events."

This gap in the Fund's analysis undermines the credibility of the systemic risk waiver. Faced with the immediate threat of a disorderly default in May 2010, assessing a counterfactual was arguably impossible. But once this immediate hurdle was cleared, a cold, hard analysis should have been done. Without a full analysis of spillovers under alternative strategies for addressing the crisis, the introduction of the systemic risk waiver appears to have been a hastily agreed way to sidestep legitimate constraints on the IMF's discretion.

ARE THE MODIFIED CRITERIA AN ADEQUATE FRAMEWORK FOR CONSTRAINING THE IMF'S DISCRETION IN FUTURE CRISES?

The four criteria were modified in the heat of the moment, when Fund involvement was seen as essential to avoid a disorderly default. Soon after becoming involved in the crisis, Fund staff decided that holding out for a strategy (i.e., more EU money at better terms or an early restructuring of Greek debt) that would produce sustainability was unrealistic. If the Fund was to be involved in May 2010, Fund staff and management saw two options, which were vigorously debated: take advantage of the subjective nature of the DSA and call the debt outlook sustainable, or state the doubts about sustainability and modify the criteria. It is easy to trivialize this debate as a bureaucratic storm in a teacup. But the latter group — who prevailed — felt that fudging would undermine the credibility of the IMF and its commitment to uniformity of treatment. While they recognized that the perception of favouritism for European members could not be eliminated, they made it clear that the modification of the criteria would apply for future crises.

Yet the fault lines in the modified criteria are clear. The pre-modification criteria are integrally linked. The challenge for a country facing a crisis severe enough to require exceptional access is to implement a credible policy program to render its debt sustainable and restore

22 The literature on the costs of delaying the resolution of unsustainable debt is thin. One analysis focusses on when the decision to delay or proceed maximizes the utility of the debtor country — see Struzenegger and Zettlemeyer (2006), *Debt Developments and Lessons from a Decade of Crises*, Cambridge: MIT Press. The framework of the analysis could be generalized to account for global utility. Essentially, the analysis makes the point that trying to delay default is utility-maximizing, depending on: how much there is to gain from some probability that favourable events or good policies allow the country to avoid default; the effectiveness of feasible policy adjustments in reducing the probability of default; and the costs (for example in terms of added uncertainty) of waiting to see if default proves unavoidable.

23 There were two exceptions. In mid-2011 — about the time that European partners began discussing the first restructuring agreement with banks — IMF staff reports for the euro-area surveillance considered the spillovers from a "poorly implemented debt operation or disorderly default" and more generically from a shock confined to the European program countries and from a shock that spreads beyond those countries. In a December 2012 report, a box assesses the cost of a Greek default and exit from the euro area. See IMF (2011), *Euro Area Policies: Spillover Report for the 2011 Article IV Consultation and Selected Issues*, and IMF Country Report No. 11/185 July, and IMF (2012), *Greece: First and Second Reviews Under the Extended Arrangement Under the Extended Fund Facility*, December.

market access. It is difficult to imagine a country resolving a serious crisis in the absence of restructuring without meeting all four criteria. Indeed, the skepticism of Fund staff about the prospects for debt sustainability was rooted in doubts about the feasibility of the Greek government to meet the demanding policy program agreed. And if debt sustainability was in doubt, market access within the period when Fund resources would be outstanding should equally have been in doubt. For the modified criteria to hold together, the systemic waiver would need to apply to the third and fourth criteria as well as the second. Without this structure, can the full force of doubts about the chances that a program will succeed be clear?

Yet an even more fundamental question is whether prolonged exceptional access is ever likely sensible when prospects for debt sustainability and market access are not strong. In other words, do risks of systemic spillovers argue for exceptional access to IMF resources regardless of prospects for debt sustainability or for avoiding any delay in spelling out the endgame of a crisis? Discussions with market participants were revealing on this question. All acknowledged that the decision to proceed without a credible medium-term path for Greek debt left substantial uncertainty in markets. Financial institutions dealt with it by forming their own views on how the crisis would be resolved. Some, particularly in Greece, had believed that the Europeans would ultimately bail out holders of Greek government debt. Others, mainly outside Greece, place far higher probabilities on an eventual restructuring.[24] Many banks cut their exposure to Greek debt, despite official encouragement to maintain their positions. The uncertainty, jockeying for position and impact on other markets were seen as spillovers from the continuing uncertainty left by a program without an explicit strategy for crisis resolution.

A critical question for the future is how the modification will affect IMF involvement in other crises. Fund staff made clear at the May 2010 executive board meeting for Greece that the modification would apply for future crises: the systemic risk waiver was not a one-off exception to the framework of the four criteria. Looking ahead, would it be possible in equally severe crises in other parts of the world not to invoke the systemic waiver when the probability of debt sustainability is not high? Would the largest regional neighbours with trade and financial interests in the crisis country not argue for invoking the systemic risk waiver, in the hope that with additional time, favourable shocks might eliminate the need for a large devaluation or debt rescheduling? Some argued that euro-area members would always be seen as unique cases, because the risks of systemic spillovers directly threatened the stability of the currency union. But most conceded that severe debt crises all carry risks of systemic spillovers and the European precedent would make it difficult to rule against invoking the waiver in the future. Searching for a balanced framework constraining the IMF's discretion was generally seen as important.

CONCLUSIONS

The framework constraining the discretion of the IMF in severe debt crises broke down in its first serious test. Whether the introduction of the systemic risk waiver is seen as a justified step or an emasculation of the framework, it was a clear statement that the framework did not stand the challenge that the euro-area crisis presented. This, in itself, is reason to undertake a thorough review of guidance on how the IMF should be involved in severe sovereign debt crises. It is difficult to imagine a better approach than establishing a parsimonious set of qualitative conditions that aim to ensure respect for the most basic elements of crisis resolution — timely decisions on how to re-establish debt sustainability. Any review, therefore, should start from the presumption that a framework following the logic of the original four criteria is optimal. The analysis in this paper points to four initiatives such a review should consider.

First, revoke the systemic risk waiver. This would be a largely symbolic move, but insofar as the economic rationale for the waiver is questionable at best, there is no reason to leave it on the books. Moreover, removing it would be an entrée into a thorough discussion of what is needed in a well-functioning framework for guiding the IMF's role in crisis management.

Second, ensure that emergency financing for very short (maximum six months) periods is available when a bridge to longer-term IMF programs that meet the four criteria is needed. There are valid reasons to argue that the constraint of the four criteria was too rigid for the immediate response needed to the Greek crisis. Specifically, many argue that had Greece failed to meet the large amortization payment in May 2010, a disorderly default would have been unavoidable. Yet, by relieving this inflexibility through the systemic risk waiver, the framework for constraining longer-term intervention was unduly weakened. A middle ground is needed. Some institution — whether it is the IMF with an explicit commitment of collateral security, the Bank for International Settlements or some other configuration of central banks — should be given the leeway to lend large amounts over a short period when two conditions hold: a member faces a severe emergency and more time is needed to put together a program (including, if needed, a debt restructuring agreement) that will render debt sustainable. The aim would be to provide fast-disbursing financial assistance, but to prevent the IMF from becoming

24 Several large international banks are reported to have approached the Greek government within a few months of the approval of the program to discuss restructuring options.

mired in a prolonged crisis without good prospects for sustainability.

Third, require that the IMF provide transparent and rigorous analyses of spillover effects. The IMF's appeal to the systemic risk waiver had no basis in an analysis of the spillovers that would result from different crisis management strategies. It is far from clear that the actual strategy still in effect is one that minimizes spillover effects. Thus, in the future, any appeal to risks of systemic spillover effects in utilizing a Fund facility for any purpose should be accompanied by a comparative assessment of the severity and incidence of those effects in alternative strategies. Such a requirement would obviously be particularly important if the systemic risk waiver were not revoked.

Fourth, consider ways to enhance the independence of decision making in the IMF. This is a broad objective that goes far beyond the framework for exceptional access and the scope of this paper, yet it has a place in any serious review of ways to improve the IMF's crisis management. One common idea was voiced in several of the interviews conducted for this project: a better framework for preventing counterproductive political influence in IMF decisions in severe debt crises could only be secured in a decision-making framework that promotes greater IMF independence. Insofar as the IMF is an international — not a supranational — organization, political influence in its decision making will be an ongoing challenge, regardless of the IMF's formal governance. Nevertheless, ideas that must be debated include a number of changes in the structure of the IMF. Among these are narrowing the role of the executive board to more supervisory responsibilities, placing decision-making power with a small board of appointees with formal independence (akin to a monetary policy council in a central bank), and requiring the recusal of members of this council who are nationals of a crisis country or currency area. Though clearly not quick fixes, such ideas may well be fundamental to significant progress in preventing the IMF from financing debt crises with no endgame.

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ANNEX 1: A VERY BRIEF HISTORY OF ACCESS LIMITS[25]

Limits on access to IMF lending, expressed as a percentage of a country's quota subscription to the IMF, were established in the Fund's Articles of Agreement.[26] Originally set at 25 percent of quota on an annual basis and 100 percent on a cumulative basis, access limits were designed to ensure that the Fund had adequate resources to cover the needs of potential borrowers and to ensure that members did not borrow more than they could reasonably be expected to repay. The Articles specified that access limits were waivable, particularly when the borrowing country had a history of avoiding use of Fund resources and when needs of the member were exceptional.

Access limits have evolved through a complex set of increases, pullbacks and efforts to impart flexibility to respond to members' needs without compromising the Fund's financial position, commitment to uniformity of treatment and contribution to global stability. There have been three periods of change.

The first, 1945–1981, saw a checkered adherence to access limits and, especially at the end of the period, substantial increases in the limits. Waivers were used often (though access was seldom more than twice the cumulative limit), new lending facilities "outside the credit tranches" (not subject to access limits) were introduced, annual limits were briefly scrapped all together and, late in the period, limits were raised. In 1979, when a temporary lending facility financed by loans from the wealthy members was established, an "exceptional circumstances clause" was introduced. The clause states that the executive board needs to determine that a country borrowing in excess of formal access limits faces "special circumstances." No definition of "special circumstances" was given.

In the second period, 1982–2007, several quota increases eased the constraint on IMF financing available and access limits were reduced.[27] By 1998, normal access limits in the credit tranches were 100 percent annually and 300 percent cumulatively. During parts of this period, the early 1990s and early 2000s, very large balance-of-payments crises were infrequent and most instances of exceptional access were in capital account crises. In 2002–2003, exceptional access criteria formalized.

The third period, since 2008, has been marked by a significant increase in exceptional access lending arrangements. After a complete hiatus during 2006–2007, a rash of exceptional access cases came up with the global crisis. In response, in early 2009, quotas were raised and annual and cumulative access limits were doubled to 200 percent and 600 percent of quota respectively.

ANNEX 2: THE FOUR CRITERIA FOR EXCEPTIONAL ACCESS, AS OF JANUARY 2010

Criterion 1. The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current or capital account, resulting in a need for Fund financing that cannot be met within the normal limits.

Criterion 2. A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term.

Criterion 3. The member has prospects for gaining or regaining access to private capital markets within the time frame when Fund resources are outstanding.

Criterion 4. The policy program of the member provides reasonably strong prospects of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

25 This analysis draws on J. Boughton (2004), *Silent Revolution*, chapter 17, IMF; J. Boughton (2009), *Tearing Down Walls*, chapter 15, IMF; and IMF (2001), "Review of Access Policy in the Credit Tranches and under the Extended Fund Facility — Background Paper," August.

26 See IMF (1944), "Articles of Agreement of the International Monetary Fund," July, Article V, Section 3(iii).

27 After special facilities for low-income countries were established in the early 1980s, access limits for those countries were treated separately from those for market access countries, the focus in this annex.

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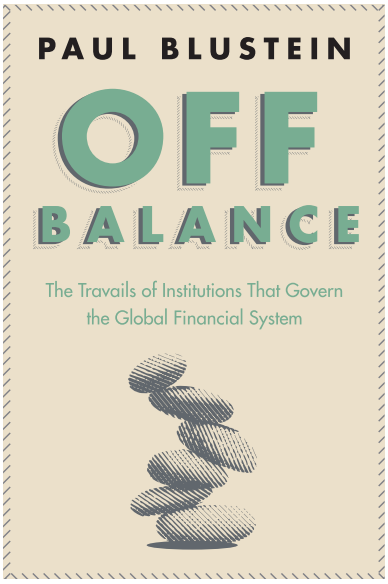

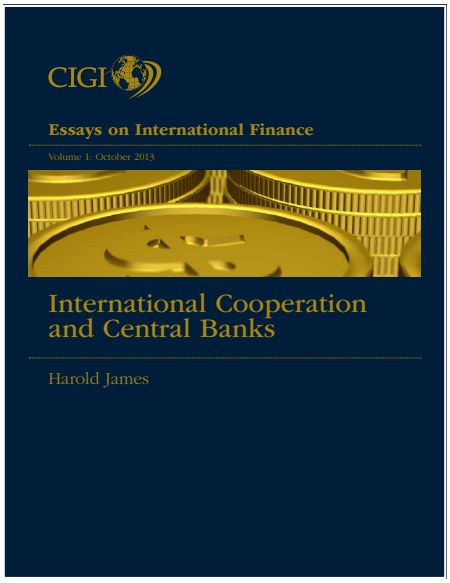

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Paul Blustein

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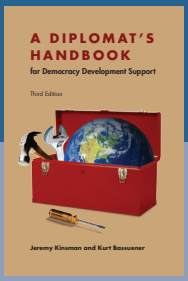

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The Sovereign Debt Forum: Expanding Our Tool Kit for Handling Sovereign Crises

CIGI Policy Brief No. 28

Richard Gitlin and Brett House

This policy brief proposes the creation of a sovereign debt forum (SDF) to address the lack of a simple and effective mechanism for dealing with sovereign debt crises by laying out the following: a small set of principles that ought to inform any efforts to enhance the international financial architecture's capacity to handle sovereign crises; the contours of a possible SDF; some processes by which an SDF could operate; a broad sketch of incentives for stakeholders to participate in the SDF's operations; and recommendations on possible next steps.

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