■ bail-ins

A bail-in is an agreement by creditors to roll over their short-term claims or to engage in a formal debt restructuring with a troubled country. Bail-ins are usually done in conjunction with a broader program of International Monetary Fund (IMF) lending and policy changes to help restore a country's economic and financial health. In a bail-in, creditors with claims coming due are asked to defer repayment deadlines—and in some cases to agree to reduce their claims. In a bailout, by contrast, a country borrows hard currency reserves from the IMF, enabling it to pay off its maturing debt.

Academic models usually try to posit a clear choice between lender-of-last-resort financing and a standstill on all payments. In practice, though, policymakers rarely confront a binary choice between a complete standstill and lender-of-last-resort financing. Sources of existing or potential financial pressure on a crisis country are usually diverse: it is possible to bail in some creditors and bail out others. A strategy that combines a bailout (of some) and bail-in (of others) consequently can make sense. A successful bail-in of some creditors eliminates one potential source of financial strain. The benefits of securing additional financing from a set of private creditors, however, have to be balanced against the risk that attempting to bail-in some creditors will only prompt other creditors to run.

A bail-in is usually initiated when a country in financial trouble asks a set of its creditors to agree to roll over or reschedule their maturing claims. The debts coming due can be the obligations of the crisis country's government—for example, a maturing international sovereign bond—or they can be obligations of private borrowers (most often cross-border loans to the country's banks) in the crisis country. Convincing the country's creditors to defer payments, whether through a bond exchange or an agreement to roll over maturing bank loans, requires at least the implicit threat that the country will halt payments if the creditors do not agree on a restructuring. But the nature of the country's negotiations with its creditors can nonetheless vary. A country that tries to negotiate an agreement with its creditors to defer payments is acting quite differently from a country that just stops payments and demands that its creditors agree to reduce their claims.

Debt Restructuring and Burden Sharing Debt restructurings are a part of borrowing and lending; they would occur in the absence of any official-sector intervention. The trigger for a bail-in, however, is often a policy decision by the official sector not to provide a country with sufficient emergency financing to allow it to avoid a debt restructuring. The IMF, the Group of Seven (G7), and others can condition their lending on a requirement that a country keep its foreign exchange reserves above a designated level (effectively requiring the country to initiate a restructuring if it cannot find private sources of financing), refuse to lend in the absence of a restructuring, offer to provide financing to facilitate a consensual restructuring, or even help the country organize a rollover of its maturing loans. The Paris Club—a group of bilateral lenders—can also condition its willingness to restructure the debts a country owes to bilateral creditors on a country's willingness to seek a comparable restructuring of the debt the country's government owes to private creditors. (The official sector generally has leverage over the debtor, not the debtor's creditors. The official sector sometimes can, however, exert leverage directly on certain types of creditors—particularly banks. The official sector usually stops short of telling banks what to do. Nonetheless, major governments can make clear that it is in the banks' collective interest to cooperate to avoid default by agreeing to roll over their exposures.)

The line between a normal, voluntary market transaction—issuing a new bond, a voluntary debt exchange—and an involuntary concession to avert a crisis is not always clear. Some IMF programs rely on the expectation that the combination of financial support and policy adjustment will catalyze new private financial flows. Some debt exchanges done in the context of an IMF program occur at market rates and are altogether voluntary—the creditors who do not participate can expect to be treated as well as creditors who do participate. Because these exchanges must be done at market rates, they are often expensive. The most famous example is Argentina's megaswap in the summer of 2001: the swap extended the maturity of Argentina's bonds, but at an implied annual interest rate of close to 15 percent. This transaction allowed Argentina to avoid default only for six months, however. These voluntary exchanges are not a true bail-in: private creditors are extending credit at a market rate in the expectation of earning a commercial profit, not making a concession to help the country through a crisis.

Other debt exchanges are done at below-market rates to avoid an imminent default. These transactions are also voluntary in some loose sense. Creditors often are willing to defer payments at an interest rate lower than the prevailing market interest rate at the time of the exchange—as in Uruguay's 2003 exchange—or even accept a deep "haircut"—as in Argentina's 2005 exchange—rather than hold debt that the sovereign debtor is not willing (or able) to pay. A haircut typically involves a reduction in the face value, a reduction in the coupon (the amount to be paid at fixed intervals), or a reduction in both the face value and the coupon of the bond. The actual losses experienced by creditors who mark to market (that is, value the bond as an asset at its open-market price) depend on the price at which they bought the bond and the discount rate the market assigns to the payment stream on the restructured bonds. The decision to voluntarily agree to these kind of terms reflects the fact that the alternative to a restructuring is often default—and creditors lack the legal ability to force a sovereign debtor that is in default to resume payments.

Throughout the 1990s, the G7 and the IMF had trouble reaching agreement on the right term to use to describe efforts to secure the coordinated provision of emergency financing from a country's existing private creditors. Calls for more "burden sharing" were considered too heavy handed: no private creditor happily takes on a burden. Talk of "constructive engagement" with private creditors was considered a bit too diplomatic: private creditors generally preferred other forms of engagement. The relatively informal term *bail-in* drew attention to the bailouts that sometimes were provided to avoid bail-ins. The most widely used term—*private-sector involvement in crisis resolution*—suited the international bureaucracy well: it was easy to reduce to an acronym (PSI).

Acronyms can still generate impassioned debate. "Market fundamentalists" opposed all forms of official intervention. They wanted to scale back IMF lending. But they also opposed the official sector's efforts to facilitate the coordinated provision of emergency financing by private creditors. This group wanted both fewer bailouts and fewer officially organized bail-ins. A more pragmatic group—including many in the G7 and the IMF—hoped to combine official financing with attempts to involve private creditors. This group argued that commitments by prominent creditors not to take their money out would help to limit the distortions introduced by official crisis support. Many Europeans viewed efforts to involve private creditors as a direct substitute for large-scale official financing—they wanted more bail-ins to reduce the need for financial bailouts. They emphasized the need to change the institutions for debt restructuring in order to make restructurings less disruptive—whether through the introduction of collective action clauses in international sovereign bonds or the development of an international bankruptcy regime. Many emerging economies—sometimes with support from those in the U.S. Treasury who believed recent emerging market crises were overwhelmingly the product of an international analogue to bank runs—wanted to banish all talk of combining bailouts with bail-ins, arguing that any effort to bail in some groups of creditors would scare market participants and keep IMF financial support from generating the desired improvement in creditor confidence.

Bail-ins were rarely part of the official sector's initial response to market turmoil. Most countries approached their private creditors to seek emergency financing only after an initial (and sometimes limited) round of official financing failed to end their financial trouble. There have, nonetheless, been important successes. Korea convinced the international banks that had lent to Korean banks first not to demand payment on their maturing loans and then to reschedule these loans. The rollover agreement eliminated the immediate threat of default and—along with continued financing from the IMF—helped to pave the way for Korea's financial recovery. Uruguay successfully combined a very large credit line from the IMF with a bond restructuring. The credit line stopped Uruguay's bank run and provided Uruguay the time needed to execute the bond exchange; the exchange assured that the IMF's funds were not used to finance a reduction in the country's bond exposure. Pakistan and the Dominican Republic also restructured their international bonds without stopping payments.

Other bond restructurings came only after the country had fallen into general default. Such restructurings sought to clean up an existing financial mess rather than avert a deeper financial crisis. Russia's 2000 restructuring of its "London Club" debt was technically a restructuring of syndicated bank loans, but since most of these loans had been securitized and sold into the market, it resembled a bond exchange. Both the Ukraine and Ecuador restructured their international sovereign bonds in 2000. Argentina's restructuring, though, dwarfs the others in size and complexity: in 2005 Argentina sought to restructure 152 separate bond issues with a face value of more than $80 billion.

The legal challenges associated with a bond restructuring, though significant, have to date proved to be smaller than many initially feared. The difficulty in keeping a bond restructuring from leading to broader financial collapse—and specifically a domestic bank run—proved larger than expected, however. In practice, many "international" sovereign bonds (bonds governed by a foreign law) are held not by international investors, but by the domestic banking system.

Crisis Management: Finding the Right Balance No single measure can gauge the success of efforts to obtain crisis financing from the country's private creditors. Success requires convincing private creditors to contribute, whether by deferring payments or by agreeing to reduce their claims on the crisis country. But success also requires that the private creditors' contribution not come at the expense of other goals—including preventing a sharp fall in output or triggering a broader run that leaves the country in a deep financial hole. Finding strategies that strike the right balance between these sometimes conflicting goals has been a constant challenge.

See also bailouts; banking crisis; currency crisis; financial crisis; international financial architecture; International Monetary Fund (IMF); International Monetary Fund conditionality; International Monetary Fund surveillance; Latin American debt crisis; lender of last resort

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