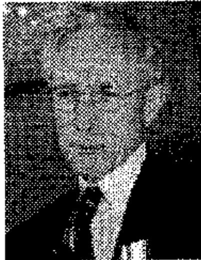
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Learning the Lessons of Financial Crises: The Roles of the Public and Private Sectors

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1. Introduction

Ladies and Gentlemen.

It is a great pleasure to be with you here today. Addressing the Emerging Market Traders' Association makes a change from speaking to gatherings of central bankers, finance ministry officials, or financial supervisors. On those occasions I explain how the IMF labors tirelessly to reduce economic and financial volatility. And the audience seems to appreciate our efforts.

But here I am not so sure. For most of you, volatility—to be sure, predictable volatility—is your daily bread and butter, not a source of distress. But the dramatic events of the last two-and-a-half years surely demonstrate that you can have too much of a good thing. The economic instability associated with the recent wave of financial crises, and the large publicly financed support packages they demanded, have left policymakers determined to reform the architecture of the international financial system.

One widely held conclusion is that the efficient operation of the international system requires more private sector involvement in the prevention and resolution of financial crises. I am well aware that this view has been causing concern to some in the private sector—and this was well reflected in the thoughtful article in the fourth quarter *EMTA Bulletin*, "Is Burden-Sharing Being Pushed Too Far?" But we surely have a common interest in many aspects of reform in this area, as well as other parts of the international financial architecture.

For one thing, we all have an interest in the development of fair, efficient and predictable trading arrangements for emerging market securities. This will help integrate emerging market countries more deeply and more durably into the global economy, to the benefit of all.

You have already played a valuable role in this process, by helping to create the Emerging Markets Clearing Corporation. Similarly, all of us want to avoid situations in which the relationship between creditors and borrowers breaks down completely in difficult times. As the Russian crisis last year demonstrated all too clearly, the consequences of such breakdowns may be systemic in nature, bad for almost everyone involved, and with far too many countries and people involved.

I will begin today by discussing the health of the emerging market economies in the wake of their recent traumas. The bottom line is that they are in encouragingly good shape, but that we are far from what used to be normal conditions. I will then turn to the lessons of recent events for the architecture of the international financial system, beginning with the importance of further measures to help prevent financial crises. Finally, I will turn to the controversial question of crisis resolution, to bailing-out and bailing-in.

2. The Road to Recovery

First, the global economy. It is hard to believe that it is just over a year since there were serious and well-justified fears of a looming world recession, one that seemed to be spreading—from Russia to Latin America to New York. Fortunately, the doomsday scenario did not come to pass. Policymakers responded decisively. The Federal Reserve cut interest rates and other central banks followed. Congress finally supported expansion of the Fund's capital base. Japan announced further fiscal stimulus and stepped up the pace of banking reform. And the IMF assembled a support package for Brazil, that helped stabilize markets at a time of unprecedented global financial fragility. When Brazil was forced to devalue in January this year, the effects in Brazil and the market fallout were far less adverse than they would have been a few months earlier.

In recent months activity in the emerging market nations has been stronger than we and others expected. Take Asia first. Korea is expected to record economic growth this year of 9 per cent. Thailand has been growing at an annualized rate of between 3 and 4 per cent. Growth has resumed in Indonesia, where macroeconomic stabilization took longest to achieve and where market sentiment has been undermined in recent months by the Bank Bali scandal and violence in East Timor.

The big economies in Latin America have also outperformed expectations. With the possible exception of troubled Ecuador, the entire region seems to be pulling out of recession. In February the Brazilian economy was expected to shrink by 4 per cent this year. Now it looks as though growth will be slightly positive. Mexico has put in a robust performance in the third quarter. Argentina's deep downturn seems to have bottomed out. And Chile—whose former Finance Minister Eduardo Aninat will next week join the IMF as a Deputy Managing

Director—is undergoing an impressive turnaround, helped by an aggressive easing of monetary policy and a weaker currency.

These improvements are welcome indeed. But some are not yet totally secure. The outturn depends on a host of factors. I will touch on three.

First, the health of the industrialized economies. Activity in the US remains robust and the Fed's recent tightening of monetary policy should help ensure that this remarkable upswing continues at a sustainable pace. Europe's biggest economies are also perking up, as the unexpectedly strong factory orders and labor market data from Germany illustrated earlier this week.

By contrast, the third quarter drop in Japanese GDP comes as a disappointment, although in part it reflects upward revisions to output in Q2. But the latest data underline the need for macroeconomic policies, especially monetary policy, to remain expansionary—indeed to become more so—until the recovery in Japan becomes firmly rooted.

Second, policies in the emerging market countries. The resumption of growth in Asia reflects expansionary macroeconomic policies and an encouraging start to ambitious structural reforms, as well as the recovery of the Japanese economy and electronics exports. But these achievements should not be used as an excuse to slacken the pace of financial sector reform and corporate restructuring. If growth is to be sustained, and long-term growth rates in the Asian miracle economies are to return to close to their previous levels, policymakers in these countries will need to maintain the momentum of reform efforts, even as the direct role of the international financial institutions in their countries is scaled down.

Third, access to finance in the emerging market countries. International fund raising by the emerging markets dropped sharply in the third quarter. At $33bn, inflows during the quarter were barely up on the immediate aftermath of the Russian default. Capital flows to Asia were stable, but Latin America saw big declines in both bond issues and loan commitments. The data show that financing picked up in October, though that is to some extent a statistical illusion, reflecting the voluntary Brady debt exchanges. The pace in November was down from October, and Y2K concerns suggest an imminent upsurge is unlikely.

In the secondary market, emerging market bond spreads have recovered considerably since their peak of around 1700 basis points after the Russian crisis. The declining spreads have made these markets more attractive to many. But at over 900 basis points today, spreads remain uncomfortably high. No-one wants a return to indiscriminate and ultimately destabilizing capital inflows. But some improvement in financing conditions would certainly help strengthen these still fragile upturns. That is another reason why the issue of private sector

involvement in crisis financing is so critical.

These factors will all be important to the outlook for emerging market economies in the short term. In the longer term, it is also vital that the international community restore the momentum of trade liberalization, which has been the engine of global growth during the post-war period. The recent events in Seattle were profoundly worrying. We must hope and work for progress here before too long.

3. Crisis Prevention

Let me turn now, very briefly, to the lessons recent events have taught us. We will undoubtedly talk a great deal about crisis resolution and what this means for the role of the private sector. But the first priority for the Fund and the emerging market nations should be *crisis prevention*. Among other things, this means:

- promoting sound economic and regulatory policies;
- avoiding exchange regimes that are vulnerable to attack;
- ensuring effective prudential regulation of financial systems;
- opening capital accounts in an orderly fashion;
- making debt structures more robust to external shocks;
- ensuring that implicit or explicit guarantees do not shield the private sector from the consequences of unduly risky behavior; and
- improving transparency and the provision of information to the public and to investors.

This list is familiar. What may be less familiar is the intensified work the international community is pursuing along these lines. The IMF has stepped up its surveillance of economic policies and prospects in our member countries. For some time we have been paying greater attention to capital account and financial sector questions, the sustainability of exchange rate systems, plus debt and reserve management practices. We are also looking more at vulnerability analyses, the spillover effects from national policies, inter-country comparisons, and regional developments. We have also taken steps that will encourage countries to act more decisively on the policy advice they get.

The remarkable improvements in IMF transparency and in the information we provide are visible on our website. We are also encouraging countries to make more information available to the private sector, not only so that investors are in a position to take more soundly-

based decisions, but also through greater transparency to encourage good policies by governments. For example, our Special Data Dissemination Standard (SDDS) now demands better coverage of international reserves. Countries are also being encouraged to provide more information on the level, structure and composition of their external debt.

International standards have also been agreed for transparency in a number of other policy areas. These include monetary and financial policies, fiscal policy and banking supervision. The IMF is also working together with the World Bank to identify and help remedy weaknesses in financial sectors. These failings were central to most of the recent crisis episodes. Pilot schemes have been under way for some time to pull together information on the observance of these standards into transparency reports, or as they are known in their most recent incarnation, ROSCs—Reports on the Observation of Standards and Codes.

As a result of these changes, much more information—more timely and of better quality—is now becoming available on national economic and structural policies. But the incentives for good economic policy provided by greater surveillance are not just the responsibility of the official sector. If this information is to help prevent crises, investors must make good use of it. We know you will do that as you become more familiar with the information.

4. Crisis Resolution and the Role of the Private Sector

Improved crisis prevention can help make the global financial system a safer place. But countries will still get into trouble from time to time, as a result of poor policies, bad luck in the form of internal or external shocks, or a combination of these factors. The international community is ready to help when this happens, provided countries take measures to deal with their problems. As our Articles of Agreement explain, IMF lending is there to provide our members "with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity". The lending is to take place "under adequate safeguards", which is interpreted as meaning subject to conditionality on the policies the country will pursue.

A strong policy response by the country, together with official lending, should provide the basis for stabilization and a return to growth. But typically that is not enough, and normal growth can only be restored when private capital begins to return.

In most cases capital inflows resume spontaneously through the catalytic effect of policy adjustments and structural reforms supported by the Fund and the rest of the official sector. This remains the case today—in

most IMF programs, it is business as usual. That could be seen for instance in the economic program with Colombia that was announced in the same week as the Ecuadoran default took place.

But there have been, and there will be, occasions on which the catalytic effect of the policy program is not enough to finance the necessary economic adjustment. If a country does not have a reasonable chance of regaining spontaneous market access without excessively large public lending, then it may be necessary to take extra steps to secure private sector involvement. There are two reasons for this:

First, there is the question of moral hazard. You are all familiar with the argument: by sheltering private creditors from the consequences of previous lending decisions, officially financed bail-outs can encourage imprudent lending in the future. This makes financial crises more likely to happen and more severe when they do. So we should not offer any promise that countries will always be able to service all their external debts.

I would like to amplify a bit on the topic of moral hazard. It is possible that official lending, unless accompanied by the right incentives, including private sector involvement, can create the possibility of moral hazard. But I do not want to push the argument too far. For example, some critics claim that the Mexican rescue package in 1995 caused the Asian crisis two-and-a-half years later, by encouraging investors to buy risky Asian assets, confident that the international community would shield them from losses if things went wrong.

But the evidence does not support this theory. Investments in Asia did not flow predominantly into the sorts of assets that were most likely to benefit from an IMF program. Holders of government debt were the main beneficiaries of the Mexican package, yet holdings of Asian government debt increased relatively modestly in the months that followed. One might also have expected greater lending to Asian banks, which might have been thought likely to enjoy protection in the event of a crisis. But again this was not the case.

It seems highly implausible that Asia was a moral hazard play. It is more likely that lenders could not imagine that the miracle economies of the region could get into such serious trouble after decades of outstanding economic performance. But moral hazard exists, and for a clear example of the dangers that it poses, look no further than Russia. Many investors thought Russia was too big to fail. They were wrong, and the consequences for them and for other countries were severe.

Let me return now to the second reason private sector involvement is needed: the IMF does not have enough money to ensure that countries can always service their debts. As a practical matter, our quota resources are limited, as they should be. And it is crystal clear from the reaction to

the crises of this decade that the public sector as a whole is not willing to provide the resources that would be necessary to enable any country that gets into trouble to continue servicing its debt in full.

We are of course familiar with the counter-arguments on private sector involvement in the resolution of external financing crises. As EMTA argued in September, with respect to sovereign debt: "While burden-sharing by the private sector is acceptable in principle, forced rescheduling of bonds will drive investors away from the emerging markets and effectively deprive countries of much-needed access to the bond markets".

In working towards a solution to the difficult and sensitive question of how best to secure private sector involvement when this is necessary, we are learning from experience. At the moment private sector involvement is at the center of programs with four of our member countries: Ukraine, Pakistan, Romania and Ecuador.

Let me touch briefly on the circumstances of the four countries currently in the spotlight—and I should emphasize that the circumstances of these countries differ greatly:

- With a relatively modest level of overall debt, **Romania** faced a liquidity problem meeting repayments on two bonds due in May and June this year. After consulting with their financial advisers, the authorities said they were confident of obtaining $600m in new money, covering 80 per cent of the maturing amounts. In the event, the Romanians managed to raise only a small proportion of the amount required, but our Board agreed to support—with less financing than originally envisaged—a program under which they promised to raise $470m for the first review. Even that money has proved hard to raise at a reasonable price in current markets. With other aspects of the program proceeding well, in particular with foreign exchange reserves much higher than expected in the program, the Executive Board has again indicated that it could go ahead with much less private sector financing.

- **Ukraine** also faced a liquidity problem, arising from a highly bunched debt service profile. The government negotiated with three major groups of creditors to secure conversion of short-term instruments into longer-term ones. Based on the results of past restructuring and the country's immediate balance of payments needs, it seemed prudent to seek refinancing of 80 per cent of the maturing amounts. With Ukraine's reserve position suggesting little immediate threat of default, the agreement proved difficult to reach. It has also left even steeper repayment peaks in 2000 and 2001. The authorities have indicated that they now favor a more comprehensive approach.

- In October **Ecuador** became the first country to default on Brady bonds since their inception in 1990. Investors unwilling to accept the government's swap offer assembled the necessary 25 per cent of bondholders to vote for acceleration. This case illustrates the problems that arise from a severe liquidity crisis, delays in reaching agreement with the IMF on adjustment measures, and delays in their implementation in a very difficult political situation, and a highly complex debt structure. A consultative group has now been set up, which is realistic in encompassing a wide range of bondholders.

- Like Ecuador, **Pakistan** faced insolvency rather than illiquidity. The Paris Club agreed in February to reschedule debt service payments due over the next three years, on condition that private creditors—including bondholders—accepted comparable terms. An offer to exchange three bonds maturing between now and 2002 closed on Monday and more than 90 per cent of holders accepted. This case raises several issues, including the definition of comparable treatment, how to coordinate a diffuse range of creditors and what role the official sector should play in the negotiations.

We are in the process of drawing lessons from this experience. We are aware that watching our approach evolve through these cases may be frustrating. Your position paper recognized the need for a case-by-case approach, but wanted it "guided by clearer and more consistent principles". We too hope that we will be able to develop a consistent set of general principles.

At this point two general principles are clear. First, when a country that has not managed its policies and its external borrowing well, and requires large scale public financing to continue servicing its debt, gets into trouble, the private sector will have to contribute to the resolution of its financial difficulties. In some cases, those corresponding in a sense to insolvency, this would involve debt restructuring.

And second, to the maximum extent possible, the official sector must encourage countries to honor contracts, and to service their debts. The international financial system cannot operate efficiently if default ever becomes anything other than a very painful option, a last and much-regretted resort. Nothing that has happened so far provides any incentive to countries to default; we have seen no country that wants to default, no country that has not gone to extraordinary lengths to avoid default, and no country that having defaulted does not wish it could have done otherwise. That is as it should be.

Beyond those general principles, lie mainly questions. First, at the organizational level: How should the debtor and the creditors interact—

via creditor councils, or some other way? What should be the role of the official sector in the discussions between the debtor and its creditors? And at the analytic level: Does the crisis appear to be one of long-term insolvency or short-term illiquidity? What is the type and structure of the debt? How should the debt be restructured if that is necessary? How do you judge when treatment is comparable between different creditors? And, from the viewpoint of the official sector, what consequences might a bail-in imply for other countries?

As we in the public and private sectors draw the lessons of these and other recent cases—and this evening's discussion is part of the attempt to do that—we should at the same time press ahead with pre-emptive measures that would make restructuring more orderly, bearing in mind the principle that contracts should be honored.

First, we should encourage better communication between countries and their creditors when times are good. Private investors who exchange views regularly with national authorities are better informed investors, more likely to be there for the long haul. These consultation mechanisms have shown their worth in Latin America during times of market stress.

Second, and I come now to a topic on which both EMTA and the IIF have expressed strong views, we need to find ways to encourage the adoption of contract clauses that will make restructuring easier when that becomes essential. For instance, emerging market nations could adopt British-style bond contracts, with sharing, majority-voting, minimum-legal threshold, nonacceleration and collective-representation clauses. This idea was first proposed in an important report of the G-10 Deputies in 1996, in the wake of the Mexican crisis. It was only subsequently that many discovered that such bonds already exist, in the form of British-style Trust-deed bonds.

Critics claim that features like collective-action clauses will push up the cost of capital for emerging market economies. There have been times, for instance in the spring of 1997, when spreads on many bonds have been too low. But that is not presently the situation.

However, let me raise the possibility that including such clauses in bond contracts could *reduce* spreads. The argument, which I first heard from a market participant, is that there is now great uncertainty about how any debt servicing difficulties would be resolved—and everyone knows that debt servicing difficulties can arise. The inclusion of renegotiation clauses would remove part of that uncertainty, and could thereby reduce spreads.

There has been some empirical work on this question. A preliminary study of spreads on existing US and British-style bonds by Eichengreen and Mody suggests that including negotiation-friendly clauses reduces spreads for the more credit-worthy borrowers and increases them for the

less credit-worthy. This is a more subtle outcome than the one I expected, and it is of course preliminary; however it could be interpreted as suggesting that the inclusion of such clauses makes markets more efficient than they would be without them.

In any case, these results suggest that this is a topic that deserves far more serious consideration on both the demand and supply sides of the emerging markets than it has received so far.

5. Conclusion

We have emerged from the dramatic events of the last two-and-a-half years with plenty of lessons, both for crisis prevention and crisis resolution. We must now ensure that the conclusions we have already drawn are translated into action, and that we work as fast and hard as we can to draw lessons in other areas, especially private sector involvement.

But crises will never be abolished entirely. When countries do get into difficulties, the IMF is available to provide short-term assistance, under appropriate safeguards. In the great majority of cases, an IMF program of normal size should be sufficient to restore access to private capital spontaneously or reasonably soon.

Under certain circumstances, however, it will also be necessary to bail in the private sector, sometimes by restructuring external debts. This will never be, and never should be, done except in extreme circumstances. But to recognize that possibility, and to take it into account both in pricing securities and in the design of contracts, will make for more efficient markets, and thereby for a more prosperous world.

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