

Public and private roles in the management of global financial crises (By Ngaire Woods)

(Final version appearing in *OECD Observer* 2000)

Financial crises in Mexico, East Asia, Russia and Brazil over the last decade have focussed the minds of policy-makers on a new kind of global economic problem. Private capital flows have not only become more volatile, but reflect a much larger range of investors and are held by an increasingly diverse set of borrowers. This makes a large group of countries vulnerable to crises catalysed by events which may well take place outside their own borders. As a result, policy-makers have been cast into a debate not only about the desirable speed and nature of adjustment and response to financial crises, but equally about who should bear the burdens of intervention and adjustment.

One of the most controversial issues which has arisen from public intervention into the financial crises of the 1990s is the idea that the private sector is being 'bailed out' with public money. Taxpayers in industrialized countries are concerned that they are being asked to foot the bill for poor investment decisions taken in the private sector. Furthermore, many economists argue that bailouts are magnifying the prospect of future crises by setting up incentives for investors to make poor decisions. A broader issue raised by 'bail-outs' is who bears the most cost of a crisis: critics of existing policies argue that the social costs of crises are being borne disproportionately by poorer sections of populations within debtor countries - a further reason for ensuring that the private sector bear more of the burden of adjustment in the working out of financial crises.

The present sharing of roles between public and private sector has been moderated by the international financial institutions. Yet the consequences of their intervention have been asymmetric. Until the 1990s, interventions by the IMF ensured that debtor countries undertook radical adjustment programmes and honoured their external debt commitments. The IMF refused, for instance, to lend to members in arrears to private creditors - saying essentially that a government would only have access to Fund resources if it kept repaying all its other debts. Of course, it was (and still is) much easier for the IMF to lean on a debtor government seeking assistance, than to attempt to coordinate the actions of a divergent group of private sector creditors and their governments. In 1998 and 1999, however, the IMF began to stake out a new role, extending its policy on lending into arrears and thus opening up more latitude for governments to negotiate with their private creditors. Additional means have also been used to involve the private sector more fully in sharing the burdens of crisis management.

One solution has been to 'bail-in' the private sector, pressuring creditors to lengthen their credit lines to countries. For example, in Korea the G-7 Central Bankers and the IMF applied heavy pressure to persuade European, Japanese and US banks to roll over their loans for a short period so as to allow the government to negotiate a more comprehensive restructuring package. However, Korea was, in the words of a senior Fund official, 'easy' given that 'the only thing that was involved basically was inter-bank lines, and you could get those banks together around the table and get central banks to exert a little moral suasion on them to roll over and then to restructure'. More profoundly, the Korean example underscores the difference between 'bailing-in' and 'not bailing-out'. By ensuring that private creditors provided bridging funds at very high cost to the crisis-ridden borrower, the international institutions lightened the load on themselves, but did not substantially redistribute the burden of adjustment away from the borrower and towards the creditors. A stronger commitment 'not to bail-out' creditors, by contrast, would redistribute burdens - as has occurred in other cases.

A very different solution was found for crises in Pakistan and Ecuador which involve a large variety of different instruments and creditors. In these cases, governments effectively defaulted on their bond obligations, with the approval of international institutions, forcing creditors to renegotiate. The precedent created here is for financial crises to be resolved through some kind of stay on payments or informal 'standstill' - at least in smaller countries whose crises do not pose a risk to international financial stability. Yet this way of resolving crises has been trenchantly opposed by the private sector, especially in the United States. Interestingly, however, the present climate in Washington DC may well bring this method

of resolving crises more to the fore - albeit through the backdoor. Let me elaborate.

The alternative to 'standstills' is for the IMF or the private sector to provide emergency funds to countries in crisis, giving creditors an incentive not to exit too hastily. The private sector provision of such credit, although politically popular, has proven extremely problematic. Commercial contingency lines of credit were arranged in the late 1990s for Argentina, Indonesia, and Mexico. However, it is clear that banks will not be willing to provide this kind of finance to all countries - especially poorer or less well-placed countries. Furthermore, the relationship of these lines with other forms of credit has not been clarified. It bears noting that Argentina, Indonesia and Mexico have all continued heavily to rely upon IMF credits (Argentina receiving approval for a US\$7.2 billion drawing on 10 March 2000, Mexico for a US\$1,216 billion drawing approved on 17 March, and Indonesia for a US\$5 billion drawing approved on 4 February). Finally, from the banking and financial risk side of the question, it has been argued that banks may well adopt dynamic hedging strategies in respect of these credits which end up leaving their overall exposure to a country the same - reinforcing and not alleviating the risks crises pose to financial stability, and hence the need for official intervention.

Continuing to use the IMF to provide credits (such as through the recently created 'Contingency Credit Line') is also problematic. It is criticized politically, as already noted above, for 'bailing-out' the private sector. Furthermore, if the Fund were to extend such credits to all qualifying cases (and also those which simply have to be dealt with due to systemic risks), the United States and other major shareholders would have to provide much more money. This is almost inconceivable given the present level of opposition and hostility in the US Congress towards the IMF.

And so what is the way forward? A patchwork of smaller measures have been proposed and seriously debated in order to effect some kind of stay on payments in a crisis. The most widely-debated proposal within this patchwork is for 'collective-action clauses' to be included in bond covenants. This would make it possible for a government to renegotiate bonds without kicking off a slew of paralysing legal actions (at present the unanimous consent of bondholders is often required for any restructuring and hence any renegotiation can activate cross-default and acceleration clauses).

The problem with collective action clauses is that many governments fear that it will increase their cost of credit unless all governments undertake to include such clauses in all bonds. For this reason some emerging market governments have joined the private sector in rejecting such proposals. Proponents argue that there is little evidence of additional costs - pointing out that UK-style government bonds are already framed with some measure of this protection relative to US-style government bonds and yet face no special premium as a result. At the policy level, proponents argue that the way to avoid any such additional premium is for all governments - led by the G-7 - to include such clauses in their own bonds as a normal and everyday occurrence. However, as yet, the technical objections to such measures have overwhelmed the arguments in favour of them.

A more ambitious proposal is to amend the IMF's Articles of Agreement (specifically Article VIII 2b) so as to put the IMF in a legal position to endorse a stay on payments of a country. This would be the 'muscular' standstill option - introducing the beginnings of a form of international bankruptcy procedure. Yet the proposal has not attracted the necessary political support. Although several members of the IMF approve of it, the United States is rather implacably opposed, and US agreement is both politically vital and formally required for any such amendments to the Fund's Articles.

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Yet in spite of the Fund's limited formal powers, the institution is already participating in debt workouts

such as those in Ecuador and Pakistan which involve informal stays of payment. So too, lending into arrears and behind-the-scenes pressures have become part of the Fund's armoury in managing crises. In looking to the future, it is hard to imagine that financial constraints will not further push the Fund in these directions. In particular, the IMF already does not have adequate resources to offer bridging finance to all potential debtors-in-crisis. Its resources will only permit it (in most cases) to offer support in the context of some kind of standstill or renegotiation.

The consequences for these longer terms trends are manifold for the private sector. There will be acute pressure on investors more carefully to monitor the position of borrowing governments so as to attempt to exit before some form of stay on payments begins. This, in turn, could easily result in more crises being catalysed by such exits. Furthermore, in the absence of a formal, institutionalized standstill procedure, creditors will have to be much more determined in resolving their own collective action problems. In other words, private sector actors will have to cooperate to suppress individual incentives to exit in ways which provoke and magnify crises. They will need to organize themselves to maximize the collective incentive to participate in more orderly workouts. The experience to date, however, suggests that for investors so to do, they will need ongoing and substantial official pressure.

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29 May 2000