

CURRENT ISSUES

IN ECONOMICS AND FINANCE

November 2000

Volume 6 Number 13

Financial Crises in the Emerging Markets: The Roles of the Public and Private Sectors

Terrence J. Checki and Ernest Stern

In the wake of the emerging market turmoil of recent years, a broad consensus has developed on ways of strengthening the institutional framework to create more robust, and thus more crisis-resistant, economies. But there is no comparable consensus on how best to handle crises once they do erupt, or the respective roles of public institutions and the private sector in containing and resolving such crises. This article examines some of the key issues and outlines a flexible, managed-market approach to crisis resolution that allows for different forms of participation by the public and private sectors.

The Current Impasse

The current debate on crisis management is profoundly colored by how participants view the experiences of the 1980s and 1990s, by the fundamental changes that have taken place in recent years in the patterns and instrumentation of capital flows to the emerging markets, and by the understanding of how these changes affect financial market behavior.

The Experience of the 1980s

At the outset of the sovereign debt crisis of the 1980s, the official community had a clear, and initially very effective, mode of coordinating the roles of the public and private sectors.

The support packages extended by the International Monetary Fund (IMF) were conditioned on private creditors—exclusively banks in those days—agreeing to defer debt payments due them from the sovereign and, in some cases, providing new funds in an amount sufficient to meet estimated balance-of-payments needs as defined in the IMF program. The release of IMF funds typically was conditioned on agreement between the country and its bank advisory committee on the terms of a debt restructuring. Advisory committee banks were then expected to persuade other banks in their respective countries to participate. Even reluctant participants generally were brought on board by the combination of their own balance-sheet pressures and encouragement from their extensive network of interbank counterparties.

Much has been made of the authorities' ability to "orchestrate" and even "compel" private sector cooperation. In fact, creditor banks shared a common objective with regulators and governments, and the actions of the official community worked very much with the grain of the private sector's interests and motivations. Indeed, this was much of the genius behind the policy approaches pursued initially by U.S. Treasury Secretary James Baker and Federal Reserve Chairman Paul Volcker and subsequently by Treasury Secretary Nicholas Brady. The banks were heavily exposed to developing-country government borrowers. Therefore, recognizing the outstanding loans as nonperforming and provisioning against them would have raised critical solvency issues for such a substantial number of the banks as to create a serious risk to the global banking system. Time was needed to strengthen the banks' capital position, and it was provided by an approach combining concerted restructuring and forbearance.

Of course, that approach was not without its drawbacks. Banks, aware of the inability of governments to pay—and because they had neither the ability nor the appetite to take on more risk—provided little net new financing to the debtor countries. Over time, as banks' balance sheets strengthened, the institutions became progressively less willing to provide so-called new money loans. The absence of alternative sources of capital for the developing countries contributed to a marked decline in investment as well as to Latin America's "lost decade" of no growth.

This situation did not change until the introduction of the Brady Plan in 1989. Under the Brady Plan, the official community again adapted its approach to the current environment. The plan facilitated the conversion of bank loans into marketable securities and encouraged banks to reduce their claims through the offer of publicly financed enhancements. In addition, the public sector—realizing that time would be needed to negotiate the complex arrangements this strategy entailed—moved away from requiring debtor-creditor agreements at the outset of IMF-supported programs, instead holding back only a portion of official sector funding for release when needed to finance enhancements to complete a deal. By relieving the debt hanging over both the countries and the banks, the plan helped to restore countries' solvency and revive their capital market access.

The Current Environment and the Limited Applicability of the 1980s Model

The cooperation of the public and private sectors in dealing with the debt crisis of the 1980s is rightly seen as a major achievement. It successfully bought time to ward off a systemic threat to the U.S. and other national banking systems and, with a lag, helped to bring about a fundamental reorientation of economic policy in Latin America.

Understandably, this success has left some nostalgic for the degree of leverage and certainty that seemed to prevail in the past. However, it is a mistake to view the experience of the 1980s as providing a viable tactical blueprint for dealing with current or future crises, because the convergence of interests and the circumstances on which those approaches were based no longer exist. Today's structure is different in every way.

Today, the relevant considerations relate more to markets, and the problem of restoring market confidence, than to individual borrowers and creditors. To the extent that systemic concerns pertain to the current environment, they more often relate to the risks of market disruption, over-adjustment, and contagion than to potential domino effects caused by the failure or impairment of key institutions.

There are five key aspects of this shift toward markets. *First, sovereigns are no longer the predominant obligors.* In today's world, the foreign debt of a sovereign typically represents only part, and in some cases (Asia and Brazil) a relatively small part, of the underlying problem at the outset of a crisis. Debt capital flows now are overwhelmingly private-to-private, not private-to-public. Private capital flows to private entities in middle-income countries are now four times the aggregate (public and private) flows to public entities, and the net growth of private claims on private borrowers is more than two and one-half times the growth of private claims on public borrowers.

Second, most medium-term debt (an area where emerging market sovereigns remain important borrowers) is now

raised and traded in the global capital markets and held by a broad range of diversified and generally well-capitalized investors with a range of investment objectives. Even where financing takes the form of syndicated bank loans, these loans are increasingly documented in a way that facilitates their sale, making them more like tradable securities that can be priced readily. Furthermore, with few exceptions, investors have well-diversified portfolios, with only a small fraction of exposure to any one country or in any total asset category. At the same time, these investors are focused on rate-of-return objectives publicly compared with those of their peers, and are concerned with their fiduciary responsibilities to their clients rather than with long-term relationships with a sovereign.

Third, complex linkages have developed between domestic and international markets and within and across countries. These linkages reflect the greater complexity of capital flows; the internationalization of debt, equity, currency, and banking markets; and the growth of international trade. As a result, the behavior of those sectors is often highly interdependent and potentially critical in the evolution of a given case and its implications for others.

Fourth, the role of banks has been transformed. Internationally active banks remain important players, but their role has changed. Banks still account for more than half of the private debt flows to middle-income countries, largely in the form of trade finance, interbank lines, or other short-term credit. As a result, they still generally account for the largest share of maturing debt in a given crisis period. But these flows and claims usually do not involve the public sector. Moreover, with their strengthened balance sheets, improved risk controls, and complex funding structures, banks are driven much more by market forces via their share prices and trading books than by other factors.

Finally, a key variable—time—has been altered dramatically. The net effect of the numerous accounting, regulatory, technological, and structural market changes that have occurred over the past dozen years or so has been to remove time—and its shock-absorbing and beneficial aspects—from the system.

This new environment has significant implications. Crises unfold more quickly, more virulently, and with more surprising dimensions than they did in the past, and policy also needs to react more quickly. At the same time, financial recoveries can also proceed more rapidly, because market participants generally have the ability—and many have little choice, because of the prevalence of mark-to-market accounting—to digest losses and move on.

Moreover, the scope for official intervention and influence has been dramatically undermined by mark-to-market accounting, stop-loss strategies, trading into and out of positions, and exchange offers. The clear, institutionally based systemic risks to the global banking system, which

provided the shared sense of purpose for the public and private sectors, have been replaced by a wide range of disparate interests and influences.

All of these changes require corresponding adjustments in the way the international public sector thinks about and deals with unfolding crises. Most notably, the ability to compel solutions does not exist. The reality is it never did. Today, as in the past, the pressing need is to understand and define common interests in the new market setting and to find ways to induce and encourage desired behavior on the part of investors and creditors.

The Legacy of the 1990s

The 1995 Mexico rescue package marked an important turn in the official sector's response to payment crises. For the first time, large-scale public disbursements were used, not to catalyze, but rather to substitute for, concerted private sector financing. Designed to reverse what was perceived as a temporary loss of confidence—in Mexico, and in the emerging markets more generally—the strategy of massive financial support and strong corrective policies proved successful, although extremely controversial, given its longer run implications.

Large-scale support packages were subsequently extended in a number of other cases, including Thailand, Indonesia, South Korea, and Brazil. Moreover, with the establishment of the Supplemental Reserve Facility, the IMF institutionalized its ability to respond in size to future confidence crises, that is, without the constraint of quota limits.

However, despite the IMF's "success," this move toward large-scale support packages has raised two concerns. The first, perhaps overstated, is that the practice distorts market incentives and creates moral hazard. That is, by potentially shielding some investors, such as holders of short-term debt, from loss, financial rescues encourage excessive inflows of volatile short-term capital, making future crises more likely or more difficult to manage. This result was particularly acute in the case of Mexico, where holders of short-term, dollar-linked domestic debt were fully protected.

The second concern is that the approach is, or could become, too expensive—financially or politically. In general, large-scale commitments of public money in themselves have been insufficient to turn the tide of market sentiment. Significant capital outflows have persisted in the short run even in the most successful of cases, prompting fears that the public sector might be taking on too much risk and that the growth in the scale and complexity of capital flows could easily outpace the scale of feasible future support packages. Even if the economic risks may be tolerable because of the preferred status of the public creditors, the appearance of financing large-scale private outflows with large-scale public inflows is politically untenable.

These concerns have prompted a search for ways to ensure increased private sector involvement in the resolution of financial crises. The search has led to a host of studies as well as to experimentation in responding to specific crises over the past several years—for example, "voluntary" rollovers of interbank lines in Brazil, the concerted restructuring of interbank claims in South Korea and Indonesia, and the restructuring of government bills and/or bonds by Pakistan, Ukraine, and Ecuador. It has also prompted strong interest by some in the official community in more structured, formal approaches to underscore the message that there are limits to the public sector's willingness to help finance the repayment of private sector claims.

Obstacles to Progress

The lack of consensus on how to proceed cannot be said to reflect a lack of effort on the part of the public or private sectors. Rather, the search for a better way to move forward has been hampered by a number of tendencies for the dialogue to go off track, including:

- *A tendency to reduce the choices to polar extremes.* There is an assumption that full-fledged bailouts or comprehensive defaults are the only relevant options. In fact, experience has shown that middle courses, involving various degrees of voluntarism, are feasible.
- *A tendency by the private sector to make "case-by-case" the concluding point, rather than the starting point, for discussions of how the markets and the public can best build on their common interests in managing financial crises.* The assertion that the approach to crisis management should be flexible because circumstances will vary is, of course, eminently reasonable. But in current practice, case-by-case too often has become a slogan to ward off any and all suggestions for defining general approaches in advance of a crisis. Not surprisingly, this leaves many on the official side profoundly suspicious that case-by-case is merely a stalling tactic.
- *A tendency to overlook the fact that the divergence or convergence of interests between the public and private sectors varies substantially across cases.* In systemically important cases, for example, large private creditors may have a greater self-interest in cooperating with collective efforts. In more peripheral cases, the desire to move on is often decisive, reinforced by technology, by financial engineering, and by accounting and regulatory considerations. Similarly, the public sector feels constrained about acknowledging the distinction between systemically important countries and other countries in principle—although it observes this distinction in practice.
- *A tendency to overestimate the practical difficulties of engineering restructuring (such as fears of litigation, problems identifying creditors, concerns about free*

riders) and to underplay the strategic concerns (such as possible disruptions to the crisis country's economy and markets and to those of other countries). In practice, experience has shown that the "rush to the courthouse" has not been a major problem, many creditors can be identified through distribution channels, and not all creditors need to be brought on board for a financing operation to be successful.

- *A tendency to search for "magic bullets," which leads to an emphasis on the artillery, rather than the art, of crisis management.* As a result, attention is given to possible techniques for making the workout process more orderly in a formal sense (such as collective-action clauses and legal stays) without adequately exploring whether such measures would really make the markets—and the overall financial environment—more orderly. For instance, the possibility of shifting to U.K.-type contracts for sovereign bonds has received an enormous amount of attention. Such a shift undoubtedly would have merit and would facilitate restructuring. But it would be of no practical value for the next decade or more, until the current stock of bonds matures. Moreover, the servicing of sovereign bonds has not often been the critical issue in recent financial crises.
- *A tendency to presume, rather than to articulate, a clear and defensible hierarchy of public sector objectives that would justify and define public sector involvement.* As a result, the importance of subsidiary objectives, such as the containment of moral hazard or the attainment of "fair burden sharing," is at times overemphasized relative to higher order concerns (such as global growth and prosperity, market stability, and well-ordered and well-functioning financial systems).
- *A tendency to presume coordination problems.* It is often assumed that private creditors and their debtors, left to their own devices, cannot efficiently and effectively resolve an emerging liquidity problem. In fact, in some recent cases, countries and their creditors have shown a noteworthy ability to conclude agreements with a minimum of public sector intervention.
- *A tendency to reach for certainty and control, when circumstances dictate using flexibility and calculated risk taking to obtain the best possible outcome.* This bias encourages a tendency to aggregate problems at the macro level, rather than to try to keep them small and separate.
- *A tendency to ignore the fact that risk is borne quite differently by different types of credits and creditors.* While everyone generally subscribes to the basic proposition that all creditors should fully understand their risks and

be responsible for any losses, everyone does so knowing full well that there are many exceptions.

Official creditors, particularly the IMF and the multilateral development banks, are "preferred creditors." By common consent, debt service to them is maintained. The risk of losses on emergency assistance from the international financial institutions (IFIs) is reduced to virtually zero by this preferred creditor status as well as by the use of gradual and conditional disbursements, assured means of repayment, and the inability of countries to access either the global capital markets or the private bank loan market while in arrears to the IFIs.

For private creditors, the situation is quite different. The impact of payment delays goes beyond missed payments to the underlying market or book value of their assets. For banks, loan defaults generally require provisions of capital, and institutional investors find the secondary market value of their claims to be sharply reduced. Even when defaults are avoided, most private creditors experience significant losses because of the sudden decline in their assets' market value. Given the disparities in risk, and in the impact on the value of assets, it is little wonder that different groups of creditors react differently to crises and their resolution.

- *A tendency to view the need for "burden sharing" as self-evident, without recognizing that the appropriate contributions of the public and private sectors hinge on the specifics of the given case.* When the public sector makes available emergency support loans, it is motivated by public policy considerations such as maintaining a stable global monetary system or helping to minimize the disruption of an economy. The loans finance an important public good, yielding benefits that are not limited to the crisis country.

However, it is not self-evident why such lending should be the basis for demanding *equivalent* participation by private investors, whose inclinations and fiduciary responsibilities may dictate something quite different. In times of crisis, these investors generally have already lost money, and providing additional funds entails substantial additional risk—risk that is not shared in the same way by the providers of public sector emergency loans.

This is not to suggest that private investors deserve a free pass. Rather, the point is that because the public and private sectors face sharply different risks and motivations, there is no natural comparability between the contributions that each should make. Formulaic approaches run the risk of producing outcomes that appear "morally" sound and politically attractive but are practically misguided in terms of whether they best address the public sector's underlying interests.

Is There a Way Forward?

If the burden-sharing discussion is about “who takes the hit,” that scenario dictates one way to proceed. If, however, it is about “who will provide the support necessary to stabilize a situation once it has gone off track,” the way forward may be quite different. Assuming that the latter scenario is the case, experience and a reading of the historical record suggest that the seductive allure of grand solutions must be resisted. Cases differ greatly with respect to what is possible and desirable in terms of their associated implications for the interests of the public and private sectors. Moreover, if history is any guide, environmental changes will quickly render obsolete those measures that might seem well attuned to today’s circumstances.

Then what is the solution? The solution is neither a single piece of financial engineering nor a compact between the official lenders and the innumerable private creditors. Rather, it is a process incorporating a number of elements.

First, working to break problems down into manageable pieces, rather than aggregating them and attempting to resolve them at a macro level. It is important to resist the bias to reach for certainty and control when circumstances dictate flexibility and calculated risk taking and to overcome the tendency to reduce choices to polar extremes (that is, full-fledged bailouts or comprehensive defaults). The G-7 finance ministers, through their Cologne and Fukuoka communiqués, have provided a starting point for exploring how a case-by-case approach can and should operate. That exploration needs to be pursued more aggressively than it has been.

Second, a clearer and more transparent articulation of the public sector’s objectives. The current situation has been confused by unclear and potentially competing objectives, such as avoiding defaults, limiting systemic fallout, reestablishing market access, and minimizing moral hazard. The question of whether burden sharing has become too much of an objective in its own right needs to be addressed, as well as the question of how equivalence can be approximated between risk bearers as different as the IFIs, the G-10 governments, official export credit agencies lending according to a variety of credit criteria, and the private sector.

Greater emphasis and clarity are needed as to the purposes and limits of public intervention, and the extent to which those interests warrant different degrees, modes, and timing of public and private sector involvement, depending on the particular country and circumstances. Discussions of this topic neither can nor should await the onset of the next crisis, and they need to be undertaken between those governments likely to provide financial support in major financial crises.

A better understanding of these issues would facilitate greater openness and transparency and ultimately would generate greater consensus on the strategies to be followed in individual cases. More focus and clarity would also help

to keep the importance of subsidiary objectives—such as moral hazard, which is but one of many market imperfections—in perspective relative to higher order concerns. Many public interventions (such as deposit insurance and fire insurance) introduce elements of moral hazard, but they still serve useful purposes.

Third, a greater emphasis on working with the grain of the situation. As noted, the various strategies for private sector involvement in the 1980s were successful because they helped speed outcomes that served the mutual interests of all the relevant players. In the current context, this means:

- *Recognizing the realities and limitations inherent in the current market structure and its functioning, and tailoring approaches accordingly.* This step involves acknowledging that attempts to impose solutions are unrealistic and potentially counterproductive, and identifying ways to induce and encourage the desired behavior.
- *Avoiding departures from normal market functioning whenever possible.* Experience has shown that minimalist approaches to payment disruptions generally offer the best prospects for minimizing spillover effects and for rapidly restoring market access. In this respect, the public sector’s motto should be “first, do no harm.” While the public sector may not always find it appropriate to step in to *decrease* the likelihood of default, public sector involvement should never be seen as *increasing* the scope for payment interruptions. The credibility of the international community’s commitment to voluntary, market-oriented approaches and its support for honoring contractual commitments is crucial if private investors are to be persuaded not to run at the first sign of trouble. Otherwise, many avoidable problems may become inevitable.
- *Realizing that a crisis is not over when capital outflows have been halted and financial stability restored.* Emerging market economies depend on regular access to international capital market and bank credit. Economic recovery and restoration of growth depend on confidence being reestablished, so that the necessary financing, beyond emergency lending, can be obtained. This the private sector can provide. And with effective recovery programs in place, private finance can ensure timely, if not early, repayment of public financing provided at the peak of the crisis.
- *Relying as much as possible on the efforts of debtors and private creditors to work things out on their own.* The public sector’s perception that private creditors are not interested in resolving payment problems expeditiously is mistaken. If nothing else, investors are interested in restoring liquidity to debt instruments in order to move on to new opportunities.

Fourth, an exploration of creative ways to stretch public sector support. The use of *partial public guarantees* might allow the creation of instruments that entail neither pure private sector nor pure public sector risk. This could help to leverage-in modest amounts of private capital in circumstances in which the funds might not otherwise be available, thereby helping to contain the cost of purely market-based financing while also helping to reduce the potentially excessive political costs of emergency lending. Such guarantees have been used in a limited way in the past, either to extend maturities or, as with Brady bonds, to reduce the risk of failure to meet interest payments. To be sure, they remain untested in an active crisis situation. Moreover, important issues of which risks would be guaranteed, at what price, and by whom would have to be worked out, as would ways to avoid increasing moral hazard.

In some instances, *placements with private creditors of receivables-backed loans or bonds may be appropriate*. Granted, this sort of financing also raises concerns, but in a world where official support is politically costly, it may make sense when the primary goal is to stabilize a situation and buy time for confidence-restoring measures to kick in.

Experience also suggests that the *signal value of well-executed market placements should not be underestimated*. Just as a sudden loss of reserves can trigger a run by the remaining creditors, so can indications of market confidence prompt these creditors to stay. Conversely, a lack of issuance that stems from narrow pricing concerns can potentially prove far more costly in terms of lost confidence.

Efforts should also be made to encourage *market-based mechanisms that help build time back into the system*. For example, the use of embedded options in debt instruments, which would allow borrowers to extend their debt maturities automatically even by modest amounts, might help convert some crises to close calls.

Fifth, an allowance for different forms of participation, recognizing that relevant parties' interests may diverge to a greater or lesser degree in different cases and that perceptions of burden will vary across creditors. In cases where a sovereign is unable to meet all of its

obligations according to originally scheduled terms, it seems natural to expect that all material creditors would provide relief. But fair treatment does not necessarily mean identical treatment. Private perceptions of “burden” look to changes in market value, whereas public perceptions look to contractual cash-flow relief over specified, short-term intervals. These differences often lead to profound gaps in the public/private dialogue—when either side insists on identical treatment—or they can be a source of leverage. The experience with the Brady Plan suggests a general model for how “comparability” between liquidity relief and debt reduction might be obtained—that is, by consciously allowing more near-term cash to flow to those who write off legal claims. These and other issues—such as official sector propensities toward secrecy, serial rescheduling, and politically motivated terms—need to be resolved.

Finally, the restoration and revitalization of the IMF's role as guardian of policy and crisis mitigator (not crisis manager). By trying to manage too much, the IMF has diluted the very useful signal value of its involvement and financing. Policy action remains central to the restoration of confidence, and IMF support should provide an unambiguous signal of the international community's confidence in the capacity of crisis-affected countries to take the measures necessary to restore economic health.

Conclusion

If the history of financial crises has taught us anything, it is that money can buy time, but only sound policy can bring stability. The challenge remains, as always, to encourage and work with countries that are ready and able to implement strong corrective actions and to cooperate toward finding the financial solutions best suited to the needs of the individual case and the broader functioning of the global financial system when difficulties arise. A flexible case-by-case, managed-market approach, incorporating the elements outlined above, represents the best bet—and the only realistic option—for achieving those goals going forward.

This article is based in part on remarks that the authors delivered independently at various conferences during the past year.

About the Authors

Terrence J. Checki is an executive vice president of the Federal Reserve Bank of New York and head of the Bank's Emerging Markets and International Affairs Group; Ernest Stern is a managing director of J.P. Morgan & Co.

The views expressed in this article are those of the authors and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

Current Issues in Economics and Finance is published by the Research and Market Analysis Group of the Federal Reserve Bank of New York. Dorothy Meadow Sobol is the editor.
