From fire fighting towards sharing the responsibilities; 
Thoughts on financial crisis management

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1. Introduction

The world has experienced several serious financial crises in the last decade of the twentieth century. Fortunately, these crises were all relatively quickly overcome and the world did not experience a depression similar to what we saw in the thirties. Nevertheless, the immediate effects for the crisis countries have been substantial in terms of welfare loss. Globalisation and integration in the international financial markets create opportunities to raise living standards. Free international flows of capital enable more efficient allocation of capital across economies. For emerging markets, this means more resources to invest, thus enhancing their growth opportunities. In addition, free international capital flows reward good macro-economic policies. However, they also contain risks of crises. The main risk can be found in the so-called boom-bust cycles. Capital that is flowing into an economy in enormous quantities one day, may flow out as massively the next day, resulting in a financial crisis. The challenge is to manage these risks as much as possible, without squandering the benefits that international flows of capital bring.

The first challenge is to prevent crises. Two factors that are important in the prevention of financial crisis are sound economic policies by the authorities and good relations between the debtor authorities and its (foreign) creditors. The first element should prevent a loss of confidence in the ability of the country to meet its obligations. The second should preclude surprises, which may deter investors. However, accidents will happen and financial crises will never be eradicated. This necessitates to think about crises management as well. Sound crisis management provides the proper incentives to all parties involved to solve the financial problems effectively, at short notice and with as little damage as possible. It avoids sowing the seeds for the next crisis and it does not stop capital flows all together. This implies that when looking for proper crisis management tools and tactics, their effects on the (future) behaviour of private and public sector agents should be taken into account. In this respect, there is no intrinsic contrast between crisis prevention and crisis management. This paper focuses on what has been labelled private sector involvement. Private sector involvement is a somewhat misleading term, as the issue concerns the division of responsibilities in orderly crisis resolution between the three parties involved: the national authorities of the crisis country, the international official community and the financial market participants. The analysis centres on this division, and how it affects the incentives and disincentives that the private and public sector face in financial crisis and its resolution.
2. Debt crisis in the 1980s

The 1990s were not the first decade in which developing countries were confronted with financial crisis. An important predecessor was the debt crisis of the 1980s. In its resolution, the national authorities had to put their economies on a more sound footing. The IMF assisted in these efforts by giving advice and providing finance to ease the adjustment burden. Finally, the IMF looked for the official and private creditors to provide part of the external financing, through debt rescheduling. At first, debt reduction was not aimed for, because the crisis was assumed to be a liquidity crisis. This approach was time-consuming. Banks wanted an IMF-programme in place before a rescheduling, as an assurance that debtor countries would adequately reform their economies and that consequently their repayment capacity would improve. At the same time, the IMF held up its disbursements until a critical mass of banks had agreed on new financing, to catalyse new capital flows (Bakker & Kapteyn, 1998).

At the end of the 1980s, it became clear that many developing countries would not grow out of their debt problem, because financial flows to the developing countries dwindled. By this time, banks’ balance sheets had strengthened and their incentive to agree to a rescheduling diminished, sometimes resulting in a deadlock between the authorities, the IMF and the creditor banks. A new crisis resolution mechanism was proposed by the then US Treasury Secretary Brady. The Brady plan put pressure on creditor banks to accept debt reduction when countries were serious about economic adjustment. Creditor governments should examine accounting and regulatory requirements to ensure that these would not impede debt reduction by banks. The Bretton Woods institutions were allowed to lend to countries that had not yet finalised the other elements of the financing package, yet were engaged in good-faith negotiations. The Brady plan effectively shifted the balance of power in the negotiations from the creditor banks to the debtor authorities (Eichengreen & Portes, 1995).

The debt reduction could take various forms. As a rule, a representative committee of 15 creditor banks (the London Club) would review the proposals made by the debtor. As the proposals often contained various options, and in light of the uncertainties regarding the future prospects for both the debtor and the world economy, the reviews were time-consuming (Bank of England, 1991). If the committee was satisfied, it would recommend to all creditor banks to accept the exchange offer. However, in some cases, some banks refused to accept the offer. For example, by 1992, agreement was reached on rescheduling the debt of most Latin American countries. However, the Brady exchange for Ecuador was finalised as late as 1995, and Panama’s only in 1996.
3. Complex environment

It took several years to find a proper mechanism to resolve the debt crisis of the 1980s, whereas the setting of the financial relations at that time was relatively straightforward. Per country, there was only one debtor, the government, and a limited number of similar creditors: internationally active commercial banks. Since then, the financial landscape has changed and the environment has become more complex. This has created new challenges to maintain financial stability and manage financial crises when they occur. This paragraph describes four developments that have added to the complexity.

3.1 Nature and scope of capital flows

First and foremost, the scale and the nature of the capital flows to developing countries has changed. Figure 1 shows that private capital flows to developing countries have increased strongly since 1975. In light of the capital inflows, the investment opportunities and the resulting economic growth, the recipient developing countries are now referred to as emerging market economies. The nature of capital flows has changed as well with respect to maturity, composition, and sector. The average maturity of bank loans to emerging markets has diminished. More importantly, from 1991 onwards, capital flows no longer move in tandem with bank credit flows. Instead, portfolio flows and direct investment have grown to become the major sources of external finance for the emerging market countries. Liberalisation of capital market regulation, both internationally as well as domestically, contributed to the increase and diverse nature of capital flows. This change in the composition of flows can also be attributed to the rescheduling of the bank credits of the 1980s, when bonds were left out of the rescheduling negotiations. Bonds were subsequently seen as a safer class of assets.

Although financial crises before World War II have also been associated with bonds, the present situation differs, as the creditor base is much more dispersed, hampering a co-operative solution. Apart from banks, mutual funds, both dedicated and cross-over funds, insurance companies, pension funds and individuals now invest in emerging markets. The growing number of investors in emerging markets makes it more difficult to approach them for consultation when problems arise. Many of them, bondholders and shareholders for instance, are even usually unknown to the debtor. Moreover, the creditors of a country will now be a more heterogeneous group with different interests, risk appetite and risk management practices. In addition, these investors are less susceptible to moral pressure by central banks, governments and regulators than creditor banks. On the debtor side, capital flows have increasingly been directed to the private sector rather than the public sector, making the debtor base more dispersed as well.
3.2 Complex financial products
Secondly, the financial products that are available have become more sophisticated and complex. Derivatives have been developed that enable the unbundling of financial products in different forms of risks that are subsequently resold. As a consequence, economic ownership is being separated from legal ownership, changing the incentives that a holder of a bond faces in a financial crisis. It is therefore more difficult to address the owner of a claim to ask for his consent to change this claim, as he will not necessarily be the person who carries the risk of default. Apart from derivatives, cross-default clauses and put options have been increasingly included in bond contracts. Debtors have chosen for these clauses to limit the costs of the bonds. However, this has weakened the debt profile of the debtor and it has made the bonds more vulnerable to default in times of turbulence.

3.3 Accounting systems
Thirdly, accounting systems have changed to better reflect the risks of a bank’s balance sheet. With the advent of mark-to-market systems, assets that are traded in a market are registered at the balance sheet at their real-time market value. This implies that a drop in the market rate of a product is immediately felt by the bank, thereby strengthening the incentive to sell this product at the first sign of financial distress. This system tends to aggravate market turbulence. At the same time, it increases the incentive to accept a reduction of the nominal value of the claim after a crisis has erupted, as the claim is already recorded on the banks balance sheet at a much lower level than its nominal value. The net effect of the new accounting system on the management of financial crises is unclear.

3.4 Increased integration
Because of information and communication technology, the international capital markets have become truly global. News spreads fast throughout the world. Contagion has become an increasingly forceful phenomenon that can take many forms. Economic contagion occurs when a country runs into trouble as a result of a crisis in its major trading partner, which leads to falling export earnings. Contagion can also affect economies that are perceived by the markets to have similar economic flaws as the original crisis country, a combination of economic and psychological contagion. Technical contagion is the result of an investor that liquidates its investments in one economy to cover losses or meet margin calls on other parts of its portfolio. For example, relatively healthy economies, for example Hong Kong and Singapore, suffered major capital outflows during the Asian crisis. Through contagion, movements in one market affect movements on other markets that may seem unconnected at first glance. The pace and breadth of contagion has increased the systemic risks of a financial problem in one country or market, raising the stakes for crisis management.
3.5 Added complexity leads to new crises

The developments described above have led to a new type of international financial crisis. This crisis originates or at least flows from, an emerging market countries’ capital account. It is a crisis often characterised by an abrupt haemorrhaging or drying up of short term capital flows, a crisis which involves an enormous complexity of instruments and variety of lenders, and sometimes of borrowers too. It is a crisis where the financial sector of the affected country plays a central role. The changes in the financial markets have brought forth a new kid on the block, emerging markets, and have added new dimensions to global financial turmoil. As the workings of the international financial markets have grown more complex and the magnitude of the flows has expanded considerably, the risks of imbalances leading to full-blown crises have increased as well. This in turn has posed new questions for financial crisis and their management.

4. Concerns in the context of crisis management

In the 1990s, we have witnessed several of these new types of crises, the first of which erupted in Mexico around Christmas of 1994. In the second half of 1997, a financial crisis erupted in south-east and east Asia. This crisis broadened and deepened, not only in the region, but it also affected Russia and Brazil, with repercussions for other transition economies and Latin American countries. In the efforts to manage and contain these crises, several concerns play a role. In this paragraph, five concerns are described, on the basis of which principles for sound crisis management will be formulated.

4.1 Moral hazard

A first concern of the international financial authorities in the design of crisis management is moral hazard. Moral hazard refers to the risk that financial market participants may take on more risks than they normally would, because they believe they will be shielded from negative consequences when things turn for the worse. Moral hazard is a well-known phenomenon in the insurance business, where people take on more risks precisely because they are insured against the consequences when these risks materialise. In the context of financial crisis management, the international official community can be viewed as the insurer, when it stands all too ready to provide financial support to authorities in financial distress. Moral hazard can occur with private sector creditors, when these expect to be bailed-out if a debtor country is unable to meet its external obligations. Authorities of countries can also be associated with moral hazard, if they do not take their debt obligations seriously, in the belief that they will receive financial assistance from the international official
community. This latter effect is reduced by the policy conditionality that applies to IMF-credits. This conditionality is often substantial and can carry high political costs for the authorities concerned.

Moral hazard is an inevitable side-effect of the possibility of official interference. Financial markets assume that the public sector will step in to correct disruptive market failures, and in the past they have mostly been proven right. This expectation naturally does alter their behaviour somewhat, yet it should not elicit reckless behaviour that leads to crisis. It is therefore important that actions by the official sector lead to the least possible degree of moral hazard. This is an argument against large-scale official assistance and an incentive to link it with conditionality that helps to prevent accidents in the future.

4.2 Political resistance

A second concern for the public sector with respect to large official financial rescue packages is constituted by the increasing political resistance against what are perceived as large-scale bail-outs of the private sector with public money. The size of rescue packages since the Tequila crisis has been substantial and actually unprecedented (figure 2). For comparison, the average size of an IMF-credit between 1989 and 1999, including these emergency loans, has been SDR 700 million (±USD 940 million). This has induced questions in parliaments of the creditor countries on their participation -be it indirect- in these arrangements. It should be noted, however, that these financial packages consisted of loans, not gifts. So far, all recipients have met their repayment obligations including interest and, in some cases, a premium, on schedule.

To counter the public criticism, the Institute for International Finance presented figures to show that the private sector incurred losses in the financial crises since 1997 (IIF, 1999). It estimates potential losses in East Asia and Russia to be about USD 223 billion for foreign equity investors, USD 60 billion for international banks and USD 50 billion for other private creditors. Two qualifications are in order with respect to these figures. Firstly, the potential losses on equity markets were calculated by comparing June 1997, just before the Thai collapse, with June 1998. Before and after this period, equity investors have enjoyed impressive profits in emerging markets. For comparison, figures for June 1999 have been added to those of the IIF for June 1997 and June 1998 (table 1). These computations show that the losses for investors would have been reduced by more than 50% if they stayed until June 1999 and investors in the equity market in Singapore and South Korea would have made a profit.

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1 See for example Hills, C.A.; P.G. Peterson & M. Goldstein, 1999.
Secondly, it is clear that losses have differed amongst investors. Share holders and other holders of unhedged paper in local currencies, including long-term investors, have taken the hardest hits. Other classes of creditors, however, have had different experiences. In the Asian countries, holders of foreign currency bonds have been repaid in full. In other cases, creditor banks have been asked to extend their credits, sometimes at market rates, but they have not been asked to accept a reduction of their claims. In sum, it is difficult to conclude in general who gained from the financial crisis and who lost and to what extent. It depends on the characteristics of the debtor and the investment vehicle chosen.

4.3 Systemic risk

A concern of the international public community as well as the private sector when faced with a serious financial crisis is the threat of systemic risk. When a country suspends its external payments, this may have repercussions throughout the international financial system. Through contagion, other countries may be confronted with a loss of confidence too. The crises in 1997-1999 provide a good example of this. No observer had predicted the speed nor the scope of the impact of the devaluation of the Thai baht throughout emerging markets or the impact of the Russian default on Asian spreads in August 1998 (figure 3). A suspension of debt payments may also affect the liquidity of a large internationally active bank or market that may obstruct the workings of the international payment and settlement system. This may have severe economic effects world-wide.

Systemic risk is especially perceived as a threat when the economy in crisis is large in terms of integration in the international capital markets. In the present context of highly integrated financial systems, systemic risk seems to have increased. This induces the international official community to step in quickly, often with large financial packages. For example, out of concern for systemic risk, the official community provided large-scale financial assistance to the Asian crisis countries, Russia and Brazil. However, this strategy gives rise to moral hazard, as certain economies may be considered by the markets to be too big to fail. This creates a dilemma between systemic risk and moral hazard for the international official community.

4.4 Drying-up of capital flows

The concerns expressed above, regarding too large emergency credits, are also countervailed by a concern for the damage done to emerging economies when the international financial authorities offer too little assistance. The market access of these economies may be damaged for a prolonged period of time when investors perceive that they have had a solution forced upon them that was
unequitable. This would negatively affect the capacity of these economies to invest and thereby diminish economic growth and poverty reduction. The experience of the 1980s illustrates the negative impact of faltering financial crisis management on capital flows (see figure 1). The negative consequences for growth in Latin America have turned this decade for these countries into a lost decade. The wish to prevent a second lost decade also motivated the international community to use exceptionally large amounts of official assistance (figure 2). The international credits were believed to have a confidence-enhancing and thus catalytic effect.

4.5 Herd behaviour
A dilemma that private participants face in a crisis is a prisoners’ dilemma. Investors always risk losing money. This risk that each individual creditor faces, depends in part on true creditworthiness of the borrower. Importantly, however, it also depends on the behaviour of other creditors. If one set of creditors run, and the debtor is liquidity-constrained, this imposes externalities on all other creditors in the event of them requiring repayment (Haldane, 1999). Herd behaviour has led to market sentiments in times of turbulence that are reminiscent of bank run psychology. Because creditors have become dispersed, it has become difficult to diffuse such a run for the exit.

The changes in the financial landscape as described above have only aggravated these difficulties. As creditors are no longer a more or less homogeneous group, as the internationally active creditor banks once were, their interests, risk appetites and risk management systems also tend to diverge. For example, creditor banks are usually more focussed on longer term customer relations than bond holders are. Making one group pay systematically more than another, or asking one group of creditors to maintain their exposures, while another group is allowed to retrieve its investment and leave a crisis country relatively unscathed, is not a desirable path either. It may alter investment flows into the type that normally receives a senior treatment. The shift from bank credit to securitised investments in the 1990s, described in paragraph 3 above, is an example of such a shift.

4.6. Principles for crisis management
On a macro-level, all parties involved in a financial crisis, the national authorities of the afflicted country, the international official community and the private sector have an interest in a balanced and orderly approach to crisis resolution. National authorities have an interest in limiting the immediate damage of a crisis as well as in the maintenance or quick resumption of capital inflows. The international official community is concerned with moral hazard, political resistance against too much interference and systemic risk. This latter effect is also of concern to a large part of private
investors, who, with the exception of some well-informed private market participants, in general do not profit from herd behaviour in a run on a currency. The balance between these concerns is central to the issue of the resolution of currency crises and the question of how to involve all the parties concerned, known as the debate on private sector involvement. The feeling that remains with many spectators is that in the resolution of the Asian, Russian and Brazilian crises, there was too much bias towards official rescue packages. To define a more balanced approach, principles have been developed.

A first principle is that the goal of crisis management should be to achieve co-operative solutions wherever possible between the debtor country and its creditors. This means among other things that any approach to crisis resolution must not undermine the obligation of countries to meet their debts in full and on time. Creditors should make a proper assessment of the potential risk associated with a particular investment and bear the consequences of these risks, e.g. roll-over their claims or accept a loss in cases of payment difficulties.

A second principle is equal treatment of creditors and equal treatment of debtors. It is important that no class of creditors is regarded as inherently privileged, and that all creditors within one class are treated equally. Similarly, no debtor country should be deemed ex ante too big to fail, that is, no country is so big as to be rescued by official credits alone. However, potential implications for systemic risks may induce the international official community to apply different crisis management strategies to different countries.

Because of the judgement involved in the implementation of the first two principles, transparency is the last but not least principle in this set. During a crisis, transparency regarding remedial steps by the national authorities as well as the international community is important to restore confidence. Making clear in advance the basic considerations that will guide the actions of the official sector in case of crisis, could help to create a degree of predictability for investors. However, this could also lead to moral hazard. Defining the criteria for cases where assistance is deemed appropriate, could lead to over-investment in countries that are believed to fit those criteria. Moreover, by precisely laying down future actions, crisis may be triggered at an earlier stage. For example, if the IMF would state that any country that approached it for an adjustment programme, would be forced to restructure its external debt, countries would approach the Fund only when the crisis was already raging. In addition, the appropriate role of the private sector and the policy approaches will vary

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2 See for example the report by the G7 Ministers of Finance to the summit in Cologne, July 1999.
depending on the circumstances of a particular case. Therefore, a certain degree of flexibility must be maintained, similar to the constructive ambiguity on the functioning of a lender of last resort in many countries.

5 Crisis management in practice
In the end, balanced crisis management, with an appropriate strategy of private sector involvement, is in the interest of financial stability and thus the economy as a whole. The concerns and principles in this respect have been outlined. The experience gained in the crises cases of the last few years with finding the right balance between these concerns and principles, will be discussed in this paragraph. From the analysis of these cases, lessons should emerge with respect to an appropriate division of responsibilities between the private and the public sector. The causes for and unfolding of the crises will not be described in this paper³. This paragraph focuses on seven cases, roughly in chronological order. First, two cases in the Asian currency crises will be discussed, Korea and Indonesia. Then, two examples of large economies with sizeable external debts will be reviewed, Russia and Brazil. In these cases, private sector involvement mainly implied the involvement of banks. Finally, three smaller cases are analysed, where private sector involvement took place in the context of bonds. Although the same principles for crisis management apply, this complicates the setting, with consequences for the practical approaches.

5.1 Private sector involvement Asian style
The large-scale official assistance to the Asian economies in crisis did not immediately succeed in stopping the capital outflows or the fall of the currencies. One reason for this was that the implementation of the announced policy reforms was lagging, due to political unrest. A second reason was the timing of the assistance. In some cases, the bank-run psychology had already taken hold and a vicious circle was set in motion. These crises were only defused when the private sector was approached to stop the massive exodus.

The example of Korea is often cited in this respect. In spite of the large credit package and a substantial first tranche of the IMF credit (USD 5.5 billion), the won kept falling and usable reserves were nearly exhausted on Christmas eve. At that point, creditor banks were approached with the request to roll-over short-term claims on Korean banks, as the international capital flows were largely channelled through the banks. The subsequent agreement between the Korean government and the international creditor banks to maintain their exposures was monitored by the authorities of

³ For more details on the background of the Asian crises, see for example Lane et al. 1999.
the creditor countries and the IMF. This “organised moratorium” (Berg, 1999, p. 21) prevented large-scale free-riding and ensured equal treatment across banks. At the end of January, preliminary agreement was reached to restructure USD 22 billion in short-term claims on banks. The won stabilised throughout January and February, Korea’s credit rating was improved and Korea returned to the international markets in April 1998.

In Indonesia, a similarly organised approach was not feasible. First of all, because of Indonesia’s political turmoil and its uneven track record in implementing policy reforms. Secondly, the major part of Indonesia’s external debt (± USD 70 billion) was owed by hundreds of non-financial corporations. Indonesia could not provide a blanket guarantee for the credits to corporations, because of uncertainties regarding the total amount due, the unclear but probably substantial impact on the government budget and the moral hazard implications. Instead, the Indonesian authorities created a framework to encourage voluntary restructuring of short-term external debts, with limited support in the form of exchange rate guarantees (Berg, 1999). As this framework met little enthusiasm with private creditors, some work-outs have started on a bilateral basis, but this process has been slowed by weak bankruptcy laws and courts.

From the Korean example it is clear that IMF-lending cannot by itself ensure co-ordination among creditors. Indeed, the first disbursements of the IMF credit to Korea were used to cross-subsidise private sector creditors as they ran for the door (Radelet & Sachs, 1998). The first lesson is thus that the catalytic role of official credits is uncertain and limited. Moreover, no direct relation between the size of an assistance package and its effectiveness in combating contagion has been established. In some cases, the international official community will have to actively involve the private sector, especially when a run on the currency occurs. Secondly, Indonesia’s experience underlines the importance of decisive reform efforts by the national authorities themselves. The lack of progress in this field and the ensuing uncertain economic prospects provided little incentive for the private sector creditors to take actions to reschedule the debts. The corporate debtors had little incentives to start negotiations either, as the institutional structure was inadequate to deal with corporate bankruptcies. The presence of many corporate debtors hampered a central solution.

5.2 Russia and Brazil
In the middle of August 1998, Russia took a drastic step with the announcement of a de facto devaluation of the ruble, a suspension in payments on its domestic obligations (GKOs), of which 30% were held by foreigners, to be followed by a compulsory restructuring. Moreover, a 90-day
moratorium was announced on repayment of external debt and commitments on forward contracts by banks and corporations (IIF, 1999). When the moratorium ended in mid-November, it became clear that banks would not be able to settle their obligations. A range of bilateral negotiations were initiated, which are mostly continuing. The restructuring of the GKOs has not run smoothly either. Different packages have been offered for residents and non-residents (OECD, forthcoming). Russian authorities have also discontinued their debt service payments on Soviet era liabilities to the Paris Club (creditor governments) and the London Club (creditor banks). Progress in these fora has been slow as well. At the same time, Russia has remained current on its Eurobond obligations, hoping that this would keep one route to the international financial markets open.

By contrast, the Brazilian authorities made every effort to maintain market confidence and to avoid at all times any reference to a possible restructuring. They were afraid that any hints in this direction would increase investor perception of risk and aggravate capital outflow. Parallel to negotiating an agreement with the IMF, Brazil staged road shows to explain its policy intentions to the creditor banks and asked for their voluntary support. However, the implementation of the reform programme faltered. The resulting market pressure on the real forced the authorities to let the currency float. After that, the Brazilian authorities again approached banks and asked them to publicly pledge to maintain their exposure on interbank and trade-related credits for six months. The revised IMF programme contained explicit assumptions on the roll-over ratio for short-term credit lines. The IMF was asked to co-ordinate a monitoring exercise similar to the Korean exercise. The roll-over agreement was successful to the extent that lines were maintained overall, although banks did not increase their exposures during those six months. Brazil was able to place several international bond issues since July 1999.

Several lessons can be drawn when comparing the Russian and Brazilian approach to private sector involvement. Firstly, it is clear that in Russia, the private sector over-invested in a kind of geopolitical moral hazard play, believing Russia to be too important to fail (IIF, 1999). Up until August of 1998, they were strengthened in this belief by a sequence of large IMF credits. Given the dire economic situation of Russia, especially in the fiscal field, compared to its sizeable external obligations, some losses for private investors appeared inevitable. When the international community did not step in to secure that Russia remain current on its external obligations, this limited moral hazard in this case and perhaps also in other cases. In the case of Russia, a voluntary roll-over would probably not have been sufficient to restore its external viability. However, Russia’s approach has had a severe negative impact on market conditions for all emerging markets (see figure
3). The country itself has had no access to new capital inflows. However, it is unclear to what extent this can be ascribed to Russia’s structural economic, fiscal and political problems and to what extent it is due to a complete loss of faith, following the imposition of the moratorium. In any case, the tactic to maintain market access by ascribing a privileged status to its Eurobonds has not had the desired results. In a similar vein, it is undecided whether the slow progress in restructuring is due to rogue creditors, unwilling debtors or a lack of supporting institutions. In any case, the unequal treatment of resident and non-resident GKO-holders has not helped.

Brazil’s approach appears at first sight to be superior. It is important to note that the Brazilian economic situation was more favourable, especially with respect to the fiscal revenues. This implied that a restructuring of external debt was not deemed necessary and only banks were asked to merely maintain their exposures for six months. However, there are some concerns surrounding this tactic as well. The private sector was approached at a relatively late stage: banks were asked to maintain their lines when substantial outflow had already taken place. Banks that had so far maintained their exposures felt they were being tied in, while those that had already left, got out safe and sound. Moreover, other sources of capital flight were left outside the scope of the arrangement. The Brazilian approach thus created incentives for investors to choose other instruments than bank credits and to withdraw at an early stage from a country experiencing turbulence.

5.3 Involving bond holders

More recently, three cases of financial crisis have occurred in relatively small economies where debt to creditors other than banks was an issue. As was described in paragraph 3, it appears more difficult to reach a co-ordinated approach with bondholders, as they are more dispersed and heterogeneous than banks. At the same time, their share in total capital flows to emerging markets increases, increasing the likelihood that bond holders will have to be involved in crisis.

The first example of a country that faced the need to restructure its external bonds, is Pakistan. This country approached the Paris Club\(^4\) at the end of 1998 to ask for a restructuring of its debts. It was subsequently confronted with the demand for equal treatment of all its external debts, including its Eurobonds. This move took the markets by surprise. Before this, the Paris Club demand for comparable treatment implied a rescheduling of bank credits on similar terms. In the case of Pakistan, the Eurobonds constituted for the first time a significant part of the debt service for the

\(^4\) A club of official creditors of variable composition that discuss the settlement of official credits to countries with payment problems.
period for which Pakistan had asked relief. To prevent this relief from being used to pay private
investors, the Paris Club decided to extend its demand for comparable treatment to Eurobonds,
although Eurobonds had so far been treated as a senior claim by all debtor governments.

Although there were protests in the markets, the involvement of Eurobond-holders turned out to be
successful. In the end, 92% of the eurobond holders agreed to accept new bonds that only implied a
lengthening of the maturity, no debt reduction. Two factors may have contributed to this high
percentage. Pakistan reportedly bought over half of its own bonds and the bonds were UK-style,
meaning that they contained clauses that facilitated co-ordination with bond holders (see §6.2).
Predictions that Pakistan’s rescheduling of its Eurobonds would negatively affect the issuance of
Eurobonds by other emerging markets have remained unsubstantiated so far. On the contrary, the
difference in spreads between all emerging market investment instruments, as measured by the
EMBI index on stripped bonds, and uncollateralised Eurobonds has only widened in favour of the
Eurobonds (see figure 4).

Involvement of bond holders in the case of Romania and Ukraine was less successful. Both countries
met with substantial difficulties, but these were not primarily due to the fact that bonds were the
source of private finance. Romania and Ukraine turned to the IMF with balance-of-payments
problems in 1999. Their external debt obligations largely consisted of bonds. In an effort to prevent
a bail-out of these bondholders with official funds, the IMF explicitly required these countries to
involve the private sector. Romania decided not to restructure existing bonds (they were fully
repaid), but to search for new financing from the markets. This choice was made to avoid
jeopardising Romania’s access to the markets. Ukraine sought to raise new foreign capital through
the restructuring of its bonds. In both cases, the underwriting banks assumed a co-ordinating role,
obviating part of the dispersion problem. However, both countries suffered from adverse market
sentiment, that made it difficult to raise the required amount at an affordable price. This was partly
due to a general increased risk awareness following Russia’s default in August 1998. However, it
can also be ascribed to a dismal track record of the authorities. Moreover, gross international
reserves turned out higher than expected. This precluded a credible threat of default, making the
creditors reluctant to accept a debt rescheduling. As a consequence, the negotiations were protracted,
in spite of active involvement of the IMF in both negotiation processes. In the end, the goals were
only partly achieved. Some new money was attracted, although less than originally envisaged by the
IMF and at much higher costs, creating concerns about the medium-term sustainability of the
external position of the countries.
In sum, the case of Pakistan has shown that it is feasible to involve bond holders. Romania’s tactic, to fully repay and subsequently to attract new finance, was a gamble that did not pay off. Two reasons can be discerned for this. Firstly, spontaneous private sector involvement requires confidence of market participants that is hard to obtain with a bad track record, even when an IMF-programme is in place. Secondly, restructuring constitutes a more assured way of involvement. The question that remains is whether the IMF’s direct interference was appropriate. The private creditors felt they were being treated unfairly and the debtor countries had to pay a high price. This can be seen as a consequence of unwise lending and borrowing decisions. A co-operative approach will not always be feasible.

5.4 Principles in practice

In all the cases described above, some form of private sector involvement took place. This appears to be justified in the cases discussed, as private debt constituted a significant part of the external payment problems of these crisis countries. Yet, it is important to note that private sector involvement is a means to an end, not an end in itself. When a country has no market access, like, for example, many poor developing countries, private sector involvement is not an issue. In all other cases, it can be considered a tool in the orderly resolution of financial crises. Lending by the international official community to an economy in financial distress is not necessarily sufficient to defuse a crisis. Especially for the IMF, the emphasis in financial crisis should move from lending to crisis management. An important means to this end is a more structured approach towards involving the private sector, although the mechanisms will always have to vary according to the particular circumstances of the crisis at hand.

In practice, a co-operative solution is preferable but not always attainable. When the economy in crisis has positive economic prospects and the authorities are serious in their reform efforts and when the external obligations largely take the form of interbank credits, private sector involvement is easy and relatively straightforward. Creditor banks are approached to maintain their credit lines and the international community can assist by monitoring their compliance. The maturities of claims are extended, but no losses are incurred. From the cases, it is clear that under these circumstances, the timing of a roll-over operation is important to ensure equal treatment of creditor banks.

Implementing private sector involvement in practice becomes more complex and will take more effort when different forms of external debt are involved and debtors or creditors are dispersed.
However, it is important that other forms of debt besides bank credits are also involved. If one class of investment instruments would be invariably spared in reschedulings, private creditors would have an incentive to shift into this class of instruments, to minimise the risk of default. The shift from bank loans to bonded debt, mentioned in paragraph 3, can be seen as an example. Systematically treating one class of instruments as senior to other claims would create moral hazard and eventually, the senior form of investment would become dominant. The international official community would then either have to give up its aspiration of involving the private sector, or to involve this class of instruments all the same. The cases indicated that it is possible to involve other classes of creditors and specifically, that Eurobonds should not have a privileged status.

When the economic circumstances are more problematic, the track record is disappointing and debt reduction is called for, a co-operative solution is not always attainable and parties may be forced to accept more costs than they would accept voluntarily. Especially in these cases, equal treatment of different creditors and of different debtor countries in the same situation is very important.

6. Suggested tools
It is hard to imagine one standard for all cases to achieve private sector involvement, given the different circumstances of countries in financial distress. However, transparency about mechanisms that may be deployed will make the resolution more orderly. Defining ex ante a tool kit that may be used to achieve private sector involvement in the management of crisis appears to meet the two conflicting aims of increasing transparency and maintaining flexibility. Several tools have been worked out in detail and a few have even been tested in the markets.

6.1 Contingent credit lines
A first mechanism that has gained attention are private contingent credit lines. Some emerging markets have already made use of such facilities, notably Argentina and Mexico. The attraction of private contingent credit facilities lies in the fact that they are a market-based insurance scheme that insulates the debtor country -to a certain extent- against adverse conditions. Ideally, the commitment fee would vary with the soundness of the economic fundamentals of the country, thereby rewarding good policies. However, they have several drawbacks that make their value in practice questionable, in particular their additionality and the determination of the commitment fee. The first drawback is that there may be a substitution, or dynamic hedging effect. Sound risk management by the participating banks would lead them to include their participation in the contingency arrangement in their exposures on that country. As a result, the contingent financing may not be additional to
“regular” credits and other lines may be closed if the contingency arrangement were to be activated. Secondly, contingent financing may not be used by countries out of fear of the signalling effect that this may have on financial markets. The fact that Argentina has not used its arrangement, despite the turbulence caused by the fall of the Brazilian real, could be due to this signalling effect.

There are practical questions as well, which surfaced when Mexico drew down its contingent arrangement with 33 international banks and other private financial institutions at end-September 1998. Many of the creditors were unhappy about this, as the interest rate, 1 percent above LIBOR, was substantially lower than the market rate at that period. Moreover, in their view, the circumstances were not so adverse as to justify the activation of this second line of defence. This raised questions on the appropriate level of interest rate that a debtor country would have to pay when drawing down and the circumstances under which it would be used. Mexico’s actions apparently dissuaded its creditors and the arrangement was not renewed.

Other mechanisms for state contingent debt contracts have been proposed as well. For exporters of commodities, their debt service may be linked to the world price of these commodities. However, linking options on commodity prices to debt may result in overly complex and thus expensive products, limiting their suitability for wide-spread use.

Another variant of contingent financing that has been suggested, by inter alia the InterAmerican Development Bank (IIF, 1999), provides for public sector risk mitigation with private sector contingent credit lines. Co-financing arrangements between multilateral development banks and private sector firms have been applied outside the context of financial crisis or following a crisis. This proposal would also employ this mechanism ex ante, as a second-line of defence.

The use of private contingent credit lines stands in contrast with the common practice among debtors and creditors to include clauses in emerging country debt contracts which offer the option to the creditor to get out soon or which aim to prevent a less favourable treatment compared to other classes of debt. In paragraph 2, put options and cross-default clauses have already been mentioned. Foreign currency debt and short-term debt may also be regarded as a hedge by the creditor against adverse developments. Limiting these forms of protection would appear to be more important for a sound debt profile of the debtor country than creating contingent credit lines, whose value in practice remains doubtful.
6.2 Collective action clauses

While an increasing part of financial flows to emerging market economies takes the form of bonded debt, no mechanism existed to facilitate a co-operative approach of bond holders in case of payment problems. In 1996, the Group of Ten suggested instruments to facilitate co-ordination for bondholders in times of crises: inserting collective action clauses in bond contracts (G10, 1996). The clauses typically take three forms: collective representation clauses, majority action clauses and sharing clauses. A representation clause addresses the difficulty of establishing informal contacts with widely dispersed bond holders. It authorises a trustee to approach a debtor on behalf of bond holders at an early stage and possibly discuss terms of a rescheduling proposal. The purpose of a majority action clause is to prevent a small number of creditors from blocking an attempt to negotiate the terms of the bonds in the future. To this end, it determines the required quorum present and the majority needed to alter the payment terms of the bond. The third clause, the sharing clause, is copied from the syndicated loan market, where participating lenders agree that payments they receive from the debtor will be shared with their fellow syndicate members. This clause intends to prevent a rogue creditor from starting litigation. International bonds issued under UK law typically already include some form of collective action clauses (Buchheit, 1998).

The advantage of these clauses lies in the fact that ex ante mechanisms are put in place to facilitate co-ordination during debt restructuring, while still leaving the ultimate choice on a course of action to creditors. This would make a debt restructuring more efficient. This is simultaneously seen as their main drawback: they facilitate debtors to reschedule and may thereby encourage countries to pursue default sooner. This latter effect could raise the interest rates on these bonds. At present, hardly any yield difference can be discovered between US and UK style bonds, but this can also partly be attributed to unawareness about these clauses on the part of investors. Even so, the clauses appear to have advantages for both creditors and debtors. If collective action clauses raise the expected recovery value on defaulted debt, they could increase the value of the contract, even if the probability of default increases as well (Haldane, 1999). Collective action clauses would lead to efficient debt contracts that balance the bonding role of debt when the contract is first agreed against the efficiency advantages of restructuring unsustainable obligations when the possibility of default looms. In other words, they should be seen as the international analogy of national bankruptcy procedures. To counter the adverse signalling effect, their inclusion in international bonds should become standard practise. The official community together with the private sector, is now studying the possibilities to achieve such a standardisation.
6.3 Debtor-creditor relations

A third proposal that has been received positively are mechanisms to improve debtor-creditor relationships. Greater consultations between national authorities and their private creditors could help ensure that authorities become aware of any growing private sector concerns. Authorities would have a forum to explain their economic policies, which they could use as a sounding board. Ultimately, the aim is that through intensified dialogue, surprises are prevented and confidence is built and deepened. A model of regular meetings is the quarterly briefings initiated by Mexico in 1996 at a senior level. Other countries incidentally brief investors through teleconferences. The International Institute of Finance has proposed country clubs for all emerging markets that have market access. Another form of improved debtor-creditor relations is standing creditor committees that would facilitate negotiations in times of crisis (Eichengreen, 1999).

Questions that remain to be answered regarding any institutionalised form of debtor-creditor councils comprise the representation, confidentiality as well as the role of the international official community, notably the IMF. Representation refers to the question who will be asked to join the dialogue and this becomes a pertinent issue when the information presented is deemed to be confidential. In some scenarios, the IMF is supposed to participate to brief on economic developments or to evaluate the policies of the country and its progress under a programme. In light of the confidential character of the discussion between national authorities and the IMF and the insider-outsider problems of a debtor-creditor committee, it is questionable whether, in such a setting, the Fund could give any information that was not already made available to the general public. Improving debtor-creditor relationships is thus first and foremost a task for the debtors and creditors themselves.

6.4 Sanctioning standstills

A fourth possibility that has been brought up is sanctioning unilateral standstills. Standstills are a standard feature of company bankruptcy procedures on a national level. They defuse a run for the exit and create a breathing space in which debtors and creditors can work out a solution. However, Russia’s experience has shown that standstills can have an impact on market access for the country itself as well as other emerging markets (figure 3). Unfortunately, there is no international equivalent of a bankruptcy court to sanction a standstill of a country. Such an international body could mitigate some of these costs. It would serve to show that the standstill would be in the collective international interest of financial stability instead of motivated purely by national self-interest. Moreover, it would
indicate that the standstill is temporary and is not used as an alternative to policy adjustment, but that reforms are underway.

The only international body at present that could provide such a sanction of a standstill is the IMF. Although it is potentially a powerful tool to pull the emergency break in times of large-scale liquidity crises, the international community has been hesitant to adopt it. The major objection is that this would provide the IMF with substantial power over the financial markets. As the IMF is often an official creditor itself, and is governed by creditor governments, private sector participants have doubted the capacity of the Fund to take the role of an objective arbiter. The indication by the G7 and the IMF’s political body, i.e. the Interim Committee, that in exceptional circumstances capital controls by national authorities can be seen as a crisis management tool, can be viewed as a form of sanctioning. Capital controls can function on a national level as a form of standstill of external payments. Acceptance by the IMF of the use of this instrument in certain circumstances, would amount to a sanctioning by an international body. Moreover, the extended policy of lending-into-arrears (see §2) even enables the IMF to support a country in such a situation with credit.

7. Conclusion
In summary, to underpin sound crisis management, three principles have been developed by the official community. Crisis resolution should -to the extent possible- proceed in a co-operative and market friendly manner, parties should be treated equally and participants should make the process transparent. However, these are principles that still need to be translated into practical instruments. From recent cases, it has become clear that one uniform operational solution does not exist. Tailor made approaches should be construed for each case. Nevertheless, some guidelines for the tasks of the various parties can be formulated.

In any case, national authorities should pursue sound economic policies to prevent, contain and resolve financial crises. These policies comprise a proper policy mix, robust institutional and financial infrastructure and sound external debt management. Transparency can contribute to the prevention of crises as can surveillance of these policies by the international community. In addition, authorities and the private sector creditors should take the initiative to establish regular debtor-creditor relations. The private sector should also properly assess and price risks pertaining to the

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5 Communiqué of the Interim Committee of the Board of Governors of the IMF, 1998: The Committee asked the Board to review the experience with the use of controls on capital movements and the circumstances under which such measures may be appropriate.
investment in emerging markets, taking into account that no one instrument should be inherently
privileged when a debtor has to reschedule its external obligations. The objective of these guidelines
is to arrive at a robust international financial system, where countries can profit from free
international capital flows, whose risks are mitigated.

Still, crises will happen, so that a sound crisis management strategies should be devised. It is vital
that these strategies do not sow the seeds for the next crisis. Their aim should be to create incentives
that help prevent future crises, that is to limit moral hazard. Therefore, involving the private sector is
important for the stability of the financial system. On the one hand, this involvement has a
permanent character. Private contingent credit lines, collective action clauses and debtor-creditor
relations are instruments that should be implemented in peaceful times to create transparency,
contribute to adequate risk management and promote the orderly resolution of crisis where
necessary. Although they offer no panacea, they can thus contribute to crisis prevention as well as

On the other hand, private sector involvement can also be sought in the management of acute times
of crisis. Regarding the international official community, specifically the IMF, the first guideline is
that lending is not enough to defuse a financial crisis, active involvement of the private sector should
be sought. In this respect, private sector involvement is about more than who foots the bill. How and
at what moment private investors are involved is just as important as to what extent they are asked to
contribute. Moreover, it is essential that private sector involvement should not become an end in
itself. In some cases, the costs may be too high: Systemic risks may be too large. In other cases, the
circumstances may make it very difficult to reach a voluntary solution between all parties involved
and pressure will be put on debtors and creditors to reschedule external obligations.

Under what circumstances such pressure is justifiable needs to be determined. What constitutes a fair
division of responsibilities between public and private agents and between different classes of
private creditors themselves, and how this can be realised remains an open question. The appropriate
timing of a request to private creditors requires further study, too. Some of these questions will by
their nature only be answered for each case individually. In this respect, private sector involvement
is like central banking: more an art than a science.
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