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Private Sector Involvement in Crisis Resolution and Prevention

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Introduction

The financial crisis that erupted in Thailand in July 1997 spread like a wildfire to other East Asian countries, as well as to Russia and Brazil. The manner in which the crisis spread was clear evidence of the weakness in the international financial system. Ever since, finance officials such as IMF and G7 have conducted extensive studies on crisis resolution and prevention, referred to as discussions on the international financial "architecture." One significant element in these discussions is the issue of private sector involvement (PSI), which was taken up by the June 1999 G7 Summit in Cologne and at the Okinawa Summit this July.

While IMF and World Bank reforms are advancing, discussions on PSI appeared to have made little progress. This is because finance officials and private sector representatives have hardly had the opportunity to engage in active discussions on PSI for crisis prevention and resolution. There are also a number of issues in which there are differences of opinion or conflicts of interest between public and private sectors with regard to PSI. An IMF staff report says that one key principle for the framework of PSI in crisis resolution is that "in a crisis, reducing net debt payments to the private sector can potentially contribute to meeting a country's immediate financing needs and reducing the amount of finance to be provided by the official sector." This statement indicates a potential conflict of interest between the two sectors.

Characteristics of Measures Taken During the Asian Financial Crisis

Looking back at the Latin American debt problem, which began with Mexico in 1982, its primary cause was the accumulation of a huge amount of public-sector debt, mainly from foreign banks. The parties involved were debtor governments and creditor banks. At that time, creditors' responsibilities were pursued. When a financial gap emerged in the economic restructuring plan based on an IMF package, foreign creditor banks were asked to share the burden by providing for a portion of this financial gap. Only after a fixed commitment was given by foreign creditor banks did the IMF agree to provide stand-by credit to a debtor country. This method only worked at the beginning of the crisis, and in a few years time, new money could no longer be raised from the market in this way. The debt problem was finally dealt with through the radical "Brady Plan," which entailed a massive debt reduction.

While public debt had been the core of the Latin American debt problem, private debt from diverse creditors and investors was at the heart of the Asian crisis. The Thai government resolved to seek IMF involvement after devaluation of the Baht on July 2, 1997. On August 11, 1997, the Japanese government, along with the IMF, called a meeting in Tokyo, and successfully put together a package worth US$17.2 billion for the Thai government. The initiative taken by Japan on behalf of the Thai government set an example for Indonesia and South Korea when the crisis spread to those countries.

This, in effect, was the method adopted by the United States government during the Mexican crisis of 1994-5. The US Treasury, together with IMF and other countries, provided liquidity crisis-stricken Mexico with a total amount of US$52 billion (the US provided US$20 billion). The US Congress criticized this method at the time, because a huge amount of public money was provided to bail out foreign investors, creating a serious "moral hazard" issue. In subsequent finance officials' meetings, such as the G10, it was widely argued that official funds should not be used to bail out private sector investors.

The decision by the Japanese government to provide necessary liquidity to resolve the Thai crisis should be appreciated in light of such a background. The reason why the official sector injected funds first was that banks were no longer in a position to provide a debt-ridden country with new money under sound banking practices, and only the official sector could cope with the crisis. The official sector expected that its funding, together with the IMF program, would play a catalytic role so that the private sector (which became a main player in international capital flows in the 90s) would return to the market once the confidence in the market was recovered. Indeed, in the 90s international capital flows changed dramatically, and private capital flows became more important. Let me now focus on the changes in the markets.

Changes in the Flow of Capital

The beginning of the 1990s saw a dramatic increase in international capital flows through capital accounts. In the 80s the amount of funds flowing into emerging-market economies amounted to only an average of US$35 billion per year on a net basis, whereas in the 90s it climbed to US$170 billion per year. The average net flow of public funds in the 90s amounted to less than US$30 billion per year, a small increase from the 80s. In 1999, official funds amounted only to only US$5 billion.

As these figures show, foreign funds flowing into emerging-market economies were dominated by private funds, while the role of public funds decreased considerably. The breakdown of such private funds changed as well. On a flow basis, foreign direct investment and portfolio investment (such as in securities and bonds) increased dramatically, while bank loans decreased. The large increase of foreign direct investment was especially notable. Taking 1999 as an example, foreign direct investment amounted to US$150 billion out of a total net flow of US$200 billion in private funds.

In the 90s, it became even more important for emerging-market economies to have constant access to capital markets, and financial crises occurred when these countries suddenly lost access to them. It is my opinion that the prescription for the crisis-hit countries should be to help them regain access to the markets as soon as possible.

Public and Private Sector Dialogue indispensable for Crisis Resolution

Since the goal of a country facing a crisis is to regain access to the markets as quickly as possible, private sector creditors have stressed that any measures taken by debtor governments (such as unilateral action like standstills or moratoria) should be avoided at all costs. Adoption of such measures could result in a country losing market access for a considerable amount of time. The private sector has also stressed that debt resolution should always be considered on a market-based, case-by-case approach.

The recent cases of South Korea and Brazil are success stories, brought about by cooperation between official and private sectors. The question that remains, however, is how address countries that find it extremely difficult to regain access to the markets. There are no pre-set solutions applicable to such cases. There is a school of thought that supports a rule-based approach for such difficult cases, rather than a case-by-case approach. It is my understanding that some IMF executive directors consider it desirable to establish a presumption concerning the circumstances that would require concerted private sector involvement. I am afraid that a rule-based system to combat those cases is counterproductive because situations differ from one country to another, and such an inflexible approach would discourage potential private sector participation. It is important to establish an environment, in advance, in which all the parties concerned (debtors, official creditors, the IMF, and private creditors) can conduct open dialogue to cope with problems as they arise.

Major Issues Concerning Private Sector Involvement

G7 Finance ministers and central bank governors issued a report entitled "Strengthening the International Financial Architecture" in Fukuoka on July 8. Let me touch on three areas concerning PSI which are included in the report.

i. Establishment of Continuous Dialogue Between Emerging Market and Their Private Creditors

I fully support this. It is important in crisis prevention to establish open dialogue and highly transparent exchanges of information between emerging market economies and their private investors and creditors. Mexico's Finance Ministry established a section specialized in dealing with investors, which provides timely and transparent information on the Mexican economy to a wide range of investors. It is encouraging to see that other governments have followed suit, encouraged by the Institute of International Finance.

ii. Enhancing Use of Collective-action Clauses

This is a proposal to include collective-action clauses (CAC) in bond issues, allowing rescheduling when necessary, with the consent of-for example-three fourths of the investors, to enable bond holders and creditors to be treated equally. The IMF and World Bank are encouraged to use CAC for their operations. The report also suggested including CAC in foreign bond issues by emerging market economies in the capital markets of the G7 countries.

I support the inclusion of CAC, since it will provide equity between creditors and bondholders, although the inclusion of such measures will change the structure of bond markets and have various ripple effects. It is important that enough time be spent gaining the full understanding and cooperation of the parties concerned before implementation. It should not be made conditional upon the extension of a stand-by facility by the IMF or the extension of a guarantee by the World Bank for emerging market economies. With regard to bond flotation in G7 markets, I believe the inclusion of CAC should be decided upon voluntary negotiation between an issuer and its underwriters.

iii. Guidelines for Implementation of the IMF Program

The G7's report of July 2000 divides countries in crisis into three categories: (A) where a country can regain full market access by using official financing as a catalyst; (B) where voluntary approaches should be encouraged, and creditor cooperation should be gained; or (C) where early restoration of full market access is unrealistic, and a broader spectrum of action by the private sector (such as restructuring) is necessary. In cases (A) and (B) debtor countries have continued access to markets, or can regain access by using official financing as a catalyst. These are not difficult cases. Case (C) is the real problem.

The report sets forth operational guidelines upon which IMF programs should be based for case (C), where debt restructuring or reduction becomes necessary. It is significant that the IMF is going to play an even more important role in crisis resolution. The IMF program will evaluate the financial conditions of a country, whether it belongs to category (A), (B), or (C), and determine the extent of PSI. This means that dialogue between the IMF and the private sector will become crucial. As mentioned earlier, the IMF board has been conducting discussions on the rule-based approach in relation to PSI. Furthermore, they are also conducting extensive discussions on “standstills.” I am very concerned with these developments, because we do not know where such discussions are going to lead without inclusion of the private sector.

Expectations for the IMF

The IMF and World Bank meeting held in Prague at the end of last September was the first for Mr. Horst Köhler, the new managing director of the IMF. In his speech, Mr. Köhler touched on the role of the private sector in dealing with economic crisis, and commented as follows:

"There is broad agreement that the operational framework for private sector involvement should rely as much as possible on market-oriented solutions and on voluntary approaches. It is also undisputed that there may be exceptionally difficult cases that call for more concerted approaches to involve the private sector, including the possibility of standstills as a truly last resort. Judgement will always be a crucial element. Thus a rules-based approach needs flexibility and the use of discretion in a case-by-case approach certainly needs to be constrained. We need to explore the middle ground between these approaches further, to make the framework operational."

I do not know what "middle ground" implies, but feel that the public sector's attitude may become somewhat hardened towards PSI. Mr. Köhler made it clear that the IMF will be the link to the private sector. On September 12, Mr. Köhler gathered a "Capital Markets Consultative Group," consisting of private sector representatives from the international financial community, and, in effect, began the dialogue between the official and private sectors. Such a meeting is to be held twice a year. To prevent or mitigate the impact of future financial crises which are bound to occur, I strongly hope that dialogue between the two sectors will be actively pursued through this CMCG meeting.

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