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

− Comments on the Article in the November 2000 Issue of Current Issues in Economics and Finance −

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Introduction

An article titled "Financial Crisis in the Emerging Markets : The Roles of the Public and Private Sectors" was published in the November 2000 issue of the Federal Reserve Bank of New York's *Current Issues in Economics and Finance*, by Terrence Checki, of the Federal Reserve Bank of New York, and Ernest Stern, of J. P. Morgan. Mr. Checki, an experienced central banker, has been deeply involved in emerging-market issues, as well as the challenges related to the global financial system. Mr. Stern was involved in emerging market economies as Vice President of the World Bank in the 1980s, and since the second half of the 1990s, with J. P. Morgan, he has been directly involved in the resolution of financial crises.

The article was unique in its discussion of the roles to be played by the public and private sectors in crisis resolution, and was based upon the co-authors' experiences over the past two decades. It is also a valuable contribution to the debate on the roles of the public and private sectors, since this debate holds the key to resolving financial crises. In the November issue of the Japanese magazine *Kokusai Kinyuu* (International Finance), I also referred to the importance of public and private sector dialogue; here, I would like to comment on this interesting article by Mr. Checki and Mr. Stern.

In the introduction, the co-authors point out that, although a broad consensus has developed on ways to strengthen the institutional framework to prevent crises, no comparable consensus has been reached on the respective roles of public institutions and the private sector in resolving them. The co-authors conclude that the only realistic approach is a "flexible case-by-case, managed-market approach," which allows different forms of participation by the public and private sectors, and they discuss several features that should be taken into consideration in this approach. This conclusion broadly reflects private sector institutions' views that have emerged from the experience of various economic crises.

The co-authors argue that it is important how one looks at the experience of the 1980s and 90s, based upon the fundamental changes that have taken place, such as in capital flows to emerging markets and their impact on financial market behavior.

The Latin American Debt Crisis of the 1980s

At the outset of the Latin American debt crisis of 1982-3, there was a rule that disbursement of public funds—such as IMF stand-by facilities—was conditional upon the private sector's agreement to rescheduling and sometimes providing a fixed amount of new money under the IMF program. That this method basically followed the official sector's guidance is shown by the regulatory authorities' decision not to classify new money provided by banks. The co-authors state that, at the start, "the official community had a clear, and initially very effective, mode of coordinating the roles of the public and private sectors," and that "creditor banks shared a common objective with regulators and governments." The common objective was to avoid "critical solvency issues for such a substantial number of the banks as to create serious risk to the global banking system." Cooperation between the public and private sectors "successfully bought time to ward off a systemic threat."

In the first three years after the eruption of the crisis in 1982, this rule appeared to work. In the meantime, however, the following events were also occurring.

- Many banks increasingly feared that, at some point, their sovereign loans would be classified as insolvent, and that the continuation of rescheduling and provision of new money would be judged inappropriate in light of sound banking practices.
- Many banks, including large US regional banks, dropped from the front line.

Banks began to resist providing new money, and those involved in the process suffered from "debt fatigue." The provision of new money became impractical when Citibank declared in 1987 that it would set aside a massive provision against Latin American sovereign loans. The Brady bonds scheme was introduced two years later, in 1989, and banks were asked to forgive part of their loans to governments.

In the 1980s, burden-sharing between the public and private sectors was coordinated by the strong leadership of the public sector, as led by the US government. At that time, the US Congress took a firm position, insisting that the public sector should not bail banks out. Consequently, to sustain the quality of sovereign loans and to avoid insolvency, banks had to take contradictory action, allowing debt rescheduling, while at the same time extending new money to the same debtors.

An unfortunate aspect of the Latin American debt crisis was that the method for solving the problem was inflexible, denying from the outset the option of injecting large-scale public funds into the debt-ridden countries. This was one of the reasons why the debt problem took such a long time to resolve, resulting in the "lost decade" of Latin America. It was said at the time that the general public was critical of the banking sector, but viewing bailouts as an evil practice was dominantly a US argument, and not as much so in Japan or Europe.

The first lesson to be learned from the experiences of the 1980s is that burden-sharing based on predetermined rules should not be repeated. Second, the manner in which the crisis was dealt with was considered a policy failure, allowing the situation to deteriorate so badly as to end up in a massive sovereign debt reduction. Occurrence of a similar situation should be avoided at all costs. Banks recycled oil-money accumulated by oil-producing countries in the 1970s and 80s into emerging market economies, got caught in a spiral of rescheduling and providing new money, and were in the end forced to forgive debts.

Markets Changes and the Mexican Financial Crisis

The flow of public funds into emerging market economies hardly increased in the 1990s—compared to the 1980s—whereas the flow of private capital grew to several times that of public funds, becoming a dominant source of capital in emerging market economies. Out of total private flows, direct investment and funds through capital markets increased, and the relative weight of bank loans declined. Adding to these factors, as the co-authors explain, the changes in accounting and financial regulatory practices brought about important changes in the way financial crises occur and are resolved.

When the Mexican public debt crisis broke out in 1995, massive public funds were provided to solve the liquidity crisis, which was a totally different approach from that used in the 1980s. As a result, private investors could recover their investments in short-term government bonds. The US government's priority was to stabilize the markets, and to maintain the financial system at the expense of moral hazards. The US Congress was no doubt critical to the use of public funds, but using presidential prerogative the Clinton Administration successfully disbursed the necessary funds to Mexico. A crisis was avoided, and Mexico quickly returned to the market and repaid the official funds they had borrowed.

Asian and Brazilian Financial Crises

The Asian financial crisis started in Thailand and spread to Indonesia and South Korea during 1997-8, and then to Brazil at the beginning of 1999. This was recognized as crisis that could have a serious impact on the international financial system, and therefore massive public funds were injected, as was previously done in Mexico. In South Korea, banks agreed on a voluntary-basis extension of the maturities of inter-bank facilities to Korean banks, amounting to some US$20 billion. In Brazil, banks agreed to maintain trade and inter-bank lines on a voluntary basis.

The characteristics of 1990s crisis-resolution was that an IMF policy package, together with a large official funds injection, effectively helped crisis-hit countries to return to the capital markets within a short period of time, due to which their economies recovered swiftly. Private bank creditors worked together with the official sector, either by extending of debt maturity or by maintaining credit lines on a voluntary basis. The public and private sectors had a complementary relationship, by each taking a different role in helping stricken countries recover market access. Three years after the crisis, their economies regained market confidence as they adopted necessary policies under the IMF packages, and started repaying their debts. It is impressive that South Korea has repaid most of the borrowed $50 billion in public funds. South Korea and Brazil provide good examples of public and private sector cooperation.

Within public sector groups, however, the injection of massive public funds led to active debate on private sector involvement in crisis resolution, as part of the international financial architecture discussions. There were also extensive debates on private sector involvement at the G7 Finance Ministers' meeting in Cologne in 1999, as well as in Fukuoka in 2000. As stated earlier, we cannot go back to the practices of the 1980s, and the public and private sectors must engage in dialogue to understand the nature of this complex issue, and to eliminate misunderstandings and biases on various subjects.

Tendencies and Biases

On some interesting points, Mr. Checki and Mr. Stern introduced tendencies held by the public and private sectors, leanings which may create obstacles to dialogue between the public and private sectors. The co-authors arguments are persuasive, because their observations are based upon their own experiences. I would like to comment on some of those tendencies.

- ***The Case-by-case Approach*** : The co-authors argue that "case-by-case has become a slogan to ward off any and all suggestions for defining general approaches in advance of a crisis," thereby deviating from its original meaning. They further comment that the public sector regards the case-by-case approach as a stalling tactic by the private sector. This tendency can be derived partly from the unfortunate experiences of the rule-based approach of the 1980s. The private sector should not hesitate to continue its dialogue with the public sector to work on a general framework, so long as it does not undermine the case-by-case approach.
- ***Collective Action Clauses*** : The co-authors dismiss collective action clauses as merely being a "magic bullet," and is one of the few points where I cannot agree with them. In the 1990s, the range of investors in emerging markets became more diverse. In the future, fund raising in the form of market-based instruments (such as bonds) will increase, while institutional investors and fund managers will play a greater role. The roles of banks, which provide short-term funds, will diminish. This means that it will be necessary to include bonds as part of the restructuring exercise to acquire sufficient funds for crisis-hit countries. By doing so, bond-holders and banks will be treated equally.
- ***Overestimating the Importance of Subsidiary Objectives*** : Moral hazard and attainment of fair burden-sharing tend to be discussed as if they were core issues, so it is necessary to redefine what the primary objectives are. This is easier said than done.
- ***Preferred Credits*** : Under the terms of the Brady Bond, bank loans were the target of debt reduction. Public creditors were not included in the scheme. Credits held by international financial institutions are in effect "preferred," and are not subject to restructuring. This has the de facto result of making international financial institutions risk-free. Preferred credit status should be taken into full consideration, in relation to the role of the public and private sectors.
- ***Burden Sharing*** : When a financial crisis erupts, private creditors and investors suffer huge losses resulting from corporate failures and crashes of financial and capital markets. This does not mean that the private sector has shared the burden. It is no longer consid-

ered constructive to evaluate who suffered the greatest loss; comparison of the burden to be shared between the two sectors is no longer a valid argument.

Comments on the Proposals for a Solution

Mr. Checki and Mr. Stern examine several issues that may be discussed between the public and private sectors. I share their view that the solution is "a process incorporating a number of elements."

- ***The Case-by-case Approach*** : In the report issued at the G7 Finance Ministers' July 2000 meeting in Fukuoka, crisis-hit countries were classified into three categories, and it was suggested that the respective roles of the public and private sectors should be considered for each category. The co-authors write that this provides a starting point for exploring the case-by-case approach, and that this exploration needs to be pursued more aggressively. I fully agree with this, and it should be the central theme of public-private sector dialogue.
- ***The Public Sector's Objective*** : I agree that the public sector's objective should be articulated more clearly, differentiating primary and secondary objectives. Usually, the IMF and a leading country will be in a position to determine such objectives. In the past, for example, when the Latin American crisis began, the United States took the leadership. When Asian countries were in crisis, Japan took the initiative in resolving it. A geographical division of responsibility may exist in this respect.
- ***Partial Public Guarantees*** : This is a proposal to encourage an additional inflow of private capital, using partial public guarantees as a catalyst. A partial guarantee may work in certain cases, such as for emerging market economies that have a high possibility of returning to the market in the foreseeable future. This option should be aggressively explored.
- ***Range of Menu*** : When taking a "menu" approach, it is important that all the products included in it are priced on a market basis.

Conclusion

The debate concerning the crisis-resolution roles of the public and private sectors has been conducted mainly by the public sector, including the IMF and G7. It is time now for the public and private sectors to interact and seriously engage in dialogue between one another. The “flexible case-by-case, managed market approach” proposed by the co-authors should be taken, and should be developed further through the public-private sector dialogue. The tendencies and proposals listed by the co-authors provide a useful base for such dialogue.

It is crucial to understand that the public and private sectors have played different but complementary roles in the resolution of the Mexican and East Asian crises. Dialogue should not be for the purpose of establishing rules for burden-sharing between the public and private sectors. The two sectors have different roles to play, so dialogue should emphasize how to complement their respective roles most effectively, so that crisis-hit emerging market economies can recover swiftly.

Trade talks are like riding a bicycle: if you stop pedaling, you will fall. Similarly, crisis talks are like preparations for natural calamities: if you do not prepare well in advance, you will suffer the consequences.

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