

The International Reform Agenda: Unfinished Business

Address by Dr SA Grenville, Deputy Governor, to the William M. Mercer's Global Investment Forum, Sydney, 6 December 1999.

The two years since the Asian crisis have seen quite a bit of rethinking. Over time, there has been a growing acceptance that – whatever the mistakes and deficiencies of domestic policy – the problem was wider in scope: something was wrong with the international financial framework. If the crisis could be distilled down to two principal elements, it was the fatal interaction of huge and volatile international capital flows, with fragile domestic financial sectors.

It would be nice to be able to report that the international community has now worked out what needs to be done, and is on the way to doing it. In practice, there is some consensus about what needs to be done, but some shortfall in actually implementing it.

What has been achieved?

- Democracy has spread, not just to Indonesia, but to international economic discussions as well. The recently formed Financial Stability Forum and the G20 are more representative than the G10-based groups where many of the discussions of this type have taken place in the past. If all countries are to be subject to the ‘Golden Straitjacket’ (the rules imposed by the international marketplace, as described by Thomas Friedman (1999)), then the

process of setting those rules should be more democratic.

- The early emphasis was on *transparency*. A higher degree of transparency has been achieved in the *official* sector. This is a distortion and partial application of the original concept, which was that markets would work better if there were greater transparency *all round* – i.e. including from major private-sector players. But, by-and-large, some progress has been made.
- Until the near-death experience of LTCM in August 1998, there had not been any widespread acknowledgment of the role of hedge funds in exacerbating the problems. As LTCM pulled back from the brink, the urgency to address the question of hedge funds faded somewhat, but it looks like there will be some progress, at least in lenders learning more about hedge funds.
- And when it comes to the reform of domestic policies, there is now a wide measure of agreement that very considerable resources need to be devoted to ensuring the health of the financial sector (and a greater readiness to accept foreign financial institutions). There is a recognition that aspects of exchange rate management in the crisis countries made them excessively vulnerable.

So on all of these issues, there has been a fair degree of progress on the financial reform agenda. But today, I want to talk about one

aspect where there has been some change in thinking, but not much actual action – this is in ‘private-sector burden-sharing’ (aka *bailing-in the private sector*).

The case for addressing this problem seems overwhelming. The steps in the argument are these:

- Capital reversals (i.e. sudden outflows) were at the heart of the crises.
- The foreign private sector (particularly the banks) were very important (probably dominant) in these reversals.
- While other measures which have been taken may make these countries less vulnerable to capital reversals, they will happen again.
- These reversals are analogous to a bank run which, if left to its own devices, results in an outcome disproportionate to any initial problem (in the jargon, there are ‘multiple equilibria’).
- We have known, for more than a century, how to respond to bank runs: there needs to be a lender-of-last-resort.
- The IMF can help by acting, to some extent, as a lender-of-last-resort. Its ability to do this, however, is limited by two factors. First, the size of its resources relative to the problem. Secondly, by the problem of ‘moral hazard’.
- So either we need to take a very Darwinian view of the market, and say that these crises should be left to sort themselves out, or we need to find a better way of funding the bailout and, at the same time, address moral hazard issues.
- Bailing-in the private sector addresses both of these issues directly.

Let me now flesh out this bare skeleton.

Were the capital reversals at the heart of the crisis, and was private foreign capital a central player? Like most cataclysmic events, there was multiple causation. It may be enough to say that, when capital inflows equal to 11 per cent of GDP in Thailand in the year to the July 1997 devaluation turned into outflows of 7½ per cent of GDP in the year following the July devaluation, it is a shock of huge magnitude, that would destabilise the

most secure economy. Why blame the foreigners – didn’t domestic players take part in the outflow? Of course they did. But to put this in perspective, with reference to just one component of private foreign capital inflow, the annual average inflows of bank-to-bank capital into the five badly affected Asian countries was around US\$50 billion. In the nine months following the crisis, the outflow of this bank-to-bank money was US\$70 billion.

What was the nature of the problem? The reversals of capital flow had all the hallmarks of a bank run – the sudden change of opinion and the perfectly rational desire of each of the individual players to get out ahead of the crowd (or at least not to be left behind). It is hard for the market to respond effectively. To offer higher interest rates in an attempt to persuade investors to stay is likely to be futile – like offering discount admission tickets to a theatre which is clearly ablaze. History provides many examples, and we know the textbook response: activate the lender-of-last-resort. As Bagehot advised a century ago: the authorities should ‘lend freely’. Mexico in 1994/95 was a successful example of how to deal with the equivalent of a bank run. This was, in almost every sense, a success: confidence was restored and Mexican GDP had a ‘V’-shaped dip-and-quick-recovery. But it is not realistic (nor, many would argue, desirable) to go on repeating this formula for subsequent crises. First, there is not enough money. The US\$50 billion package which was put together for Mexico was, substantively, far greater than anything made available for the Asian crisis countries – Mexico was seen as a unique once-off event, directly affecting America’s vital interests. So if the funds are not available to fully meet the bank run, then somehow the runs have to be funded in another way.

There was a second problem: Mexico gave the wrong signal to foreign investors everywhere – that they would be bailed-out by official assistance. In the Mexican bailout, creditors ‘remained whole’ – they were paid back quickly in full by the rescue package. This left a legacy of moral hazard. Whatever

problems of moral hazard had existed before Mexico, these were exacerbated by what was otherwise a very successful rescue. Unless private-sector creditors pay some price when things go wrong (either in terms of delayed repayment or some kind of 'haircut' or debt-reduction), then risk assessments will be distorted: as a result, capital will not be allocated in the right way and, most serious of all, we will get repeats of these enormous and disruptive influxes of capital, with the resulting problems. Those who doubt the strength of the moral-hazard argument should examine the 1998 Russian default – money had flooded in to get big returns on Russian Government debt. This inflow was not based on the rational expectation of a sound Russian economy, but on the confident expectation of an IMF bailout. The markets knew – or thought they knew – what they were doing: this investment was, in fact, widely known on Wall Street as the 'moral-hazard play'. Investors were dumbfounded when Russia defaulted without the official sector bailing them out.

So this leaves a choice. You could get rid of moral hazard by eliminating IMF bailouts (which, of course, also solves the financing problem – there isn't any). This solution has been put forward by such eminent people as George Schultz (1998). It cannot be faulted in logic – only in the undesirability of the outcome: a scramble by creditors to get hold of any assets and the collateral damage to the debtor economy at large.¹

Domestic business arrangements do not rely on such a Darwinian process. There is a better alternative. All countries recognise, through bankruptcy and receivership legislation, that businesses can get to a stage when a third party should take over, to ensure that the best use is made of the assets, and if the business is not viable, the net value of the enterprise is distributed in an orderly (and hopefully equitable) way. A fresh start can be made. Moral hazard exists with every type of

insurance, but the usual response is not to abolish insurance, but to limit the extent of moral hazard. Why does this logic not carry over into international businesses, at least to provide a starting point that such an arrangement, in certain circumstances, is appropriate? Eichengreen (1999, p. 15) again: '... the difficulties of restructuring are greater in international markets than in domestic markets and ... this needs to be corrected'.

To bail-in the private sector seems fair. The private-sector inflows have, invariably, come at interest rates which embody a significant risk premium – as former US Treasury Secretary Robert Rubin (1999) said: 'The high yields on many emerging market debts indicate private creditors' expectations that some of these debts will not be paid in full or on time'. It seems eminently fair that, where a risk premium has been received, the lenders should be faced with the consequences of their actions when things do go wrong. To quote Rubin again: 'market discipline will work only if creditors bear the consequences of the risks they take'. There is nothing particularly fair about the disruptive scramble to be first out the door: it is one of those cases where the race should not be to the swift – or the swiftest in fleeing. In a bail-in, it is fair, too, that the authorities impose some modifications to private contracts. Bailouts are, after all, bailouts of the creditors at least as much as they are bailouts for debtors, and the authorities are putting taxpayers' money on the line to achieve a socially-more-optimal outcome which, at the same time, will benefit creditors. 'The official sector cannot – commentators insist – be expected to pour funds into countries in difficulties merely to rescue the apparently inexhaustible supply of foolish or irresponsible creditors' (Wolf 1999). This gives them the right to have a say in the arrangements.

What are the elements of a bail-in? A preliminary point should be emphasised – these should occur exceptionally and

1. As Eichengreen (1999, pp. 15 and 62) says: 'Capitalism without bankruptcy is like Catholicism without sin, it is said, but the sovereign bankruptcy often is simply too costly to contemplate under present institutional arrangements'. 'The option is shunned because governments, and the international policy community as well, regard the collateral damage as too severe.'

infrequently. Eichengreen (1999, p. 62) notes: 'A moratorium on repayment *should* be unattractive; otherwise, the sanctity of loan contracts would be jeopardised ... Without penalties for default, the credit market will not function'. Just as with domestic bankruptcy, there are two critical elements: someone in authority needs to 'blow the whistle' (i.e. declare the bankruptcy a legitimate one). This cannot, of course, simply be the debtor acting alone – you cannot expect the protection of some form of bankruptcy simply by saying that you do not intend to repay your debts, and similarly a country claiming to be unable to pay its debts will need something more than its own word to convince the international community that it is not defaulting unnecessarily. The second element is that you need some method of 'closing the door' – ensuring that, once the bankruptcy has been declared, no creditors get any preferential treatment, but instead 'sit around the table' to work out a fair division of the assets which remain.

The Asian crisis provided an example of the sort of thing that might be done – the Korean bank rescheduling of December 1997/January 1998. This had the two necessary elements – 'blowing the whistle' and 'closing the doors'. The blowing of the whistle took place when foreign exchange reserves were, essentially, exhausted. The closing of the doors took place in a very low-key way: there was no formal declaration of any capital controls or default, but the Korean banks could obtain foreign exchange only by going to the central bank, so the central bank could strengthen the Korean banks' bargaining position vis-à-vis the creditors by simply not making foreign exchange available to them. The outcome looks to have been a good one, from the point of view of debtor, creditor, and the country as a whole. As soon as the rescheduling was made public, the climate in financial markets markedly improved. Within a few months, Korea was again borrowing in

international capital markets. Who, among the creditors, could now complain, as they received the certainty of getting their money back plus a higher interest rate? Looking back on it, the only element that might, with hindsight, have been done differently – and this is the forward-looking lesson that might be learnt from this experience – is that there might have been a case for a 'haircut'.²

What are the arguments against such an arrangement? First, the obvious one is that it is a lot harder to put together an agreed and binding code of behaviour in the extra-territorial international world. Of course this is a powerful argument, but it is more about the limitations that might be imposed on the process by the difficulty of international decision-making, rather than its unfeasibility. After all, there are many international arrangements, rules and forums which decide other issues. They are 'softer' and more difficult to enforce, but useful none-the-less.

Secondly, some argue that this would lessen the flows of capital. Bill Rhodes, Citigroup Vice-Chairman and doyen of the debt rescheduling experts, argues that such measures would 'reduce private capital flows to both public and private-sector borrowers in the emerging markets' (quoted by Wolf (1999)). To this, the proper answer is that, to the extent to which risk has been socialised, bringing it back to the parties directly involved is exactly what needs to be done to improve resource allocation. If, as a result of getting risk where it belongs, less capital comes, so be it. Wolf again: 'The costs would not be raised "unduly" if the terms properly reflected underlying risk. Maximisation of the flow is a silly goal'. A good argument can be made that Asia (with its huge domestic saving) would have been better off with much less capital inflow.

Some argue that the existence of a set of 'bail-in' arrangements will make foreign capital more flighty and problems of

2. It might be worth noting that, while everyone sees the Korean rescheduling as a success (see, for example, Institute of International Finance (1999b, p. 10)), there are different interpretations of the essential elements. The IIF emphasises the 'voluntary' aspect. The element I remember is the late-night phone calls between central bankers trying to achieve this outcome. However the story is told, it needs to be acknowledged that, without the IMF-sanctioned halt to payments and official intervention, the outcome would have been different.

international contagion more serious. This is as hard to refute as it is to prove. Under the existing non-system, investors keep a wary eye on developments and know that there is a huge advantage in getting out ahead of the crowd, so will flee on rumour. This creates the likelihood of international contagion. I find it difficult to believe that the incentives for fleeing are much different in a system which has some rules for orderly resolution. But it *does* make the case that the bail-in process has to be activated promptly, as soon as the problem arises.³

Some downplay moral hazard by pointing to large losses made by private-sector investors on *some* of their investments (see Dallara (1999)). But while-ever there are private debts which are repaid in full, thanks to the provision of new official funds, the problem exists.

Some argue that reschedulings were possible when the debt was confined to a few creditors (mainly banks), but now that debt is securitised and more widely held, reschedulings are not possible. As we noted, much of the Asian debt was, in fact, bank-to-bank debt, but even when this is not so, reschedulings are possible, provided the rules do not require the prior agreement of each and every creditor. So this is a case for clear rules, accepted by all parties before the event, just like domestic bankruptcy rules. It is not a case for inaction. A further argument is that any rules will be complex, and their outcome imperfect. Again, the response is that this is correct, but it is not a reason for inaction. We do not abandon domestic bankruptcy procedures simply because the outcome is often imperfect, and some debtors manage to evade their obligations to their creditors. The issue is not whether perfection is attainable, but whether improvement is feasible.

Some argue that any 'haircuts' infringe the initial contracts between debtor and creditor: 'The steps we take must not undermine the obligations of countries to meet their debts in full and on time' (Rubin 1999). But domestic

bankruptcy procedures do precisely this, so this is not an inviolable rule – no matter how desirable in normal circumstances.

The debate on 'private-sector burden-sharing' pre-dates the Asian crisis. This idea was put forward by a G10 Committee – in the Rey Report in 1996 (i.e. after Mexico but before the Asian crisis) – but fell on deaf ears. Over the course of the Asian crisis, there has been quite a bit of progress in shifting the debate. When the IMF convened the Tokyo meeting in August 1997 following the Thai crisis, the chairman made it clear that bailing-in the private sector was not only off the agenda, but could not be put on the agenda. The IMF has now moved a long way on this, exploring the issues in great detail, and searching (through experience in a number of individual countries since then) for practical ways to achieve this. Now the Chairman of G10 – Canadian Finance Minister Paul Martin – is pursuing this issue vigorously. The G22 endorsed the idea and developed it in working group discussions (The Report of the Working Group on International Financial Crises 1998). The G7 has endorsed the idea (Report of G7 Finance Ministers to the Köln Economic Summit 1999) and the IMF Interim Committee lent support also. The Bank for International Settlements (1998, p. 170) says: '[There is a] need for the private sector to take some responsibility for the ongoing provision of credit to customers to whom they had previously lent all too freely. This is not just to avoid moral hazard problems, but also to acknowledge a simple reality. Capital flows have now grown so large that public sector funds simply cannot fill all the potential gaps that might open up as capital inflows reverse'. UK Chancellor Gordon Brown called for the 'international community to draw up explicit rules of the game for involving public and private sectors in crisis resolution' (*The Wall Street Journal*). A number of influential Americans are adding it to their agendas. The recent Report of an Independent Task Force

3. This problem clearly has the potential to arise, also, with domestic bankruptcy procedures. The response has not been to abandon the procedures, but to put in place rules which attempt to bail-in those creditors who left when bankruptcy was imminent.

of the Council on Foreign Relations (1999, pp. 13 and 14), made up of a Who's Who of mainstream economic figures, recommended that, in extreme cases, rescheduling of private debt should be a condition of IMF assistance and the Fund should be prepared to support a temporary halt in debt repayments. Alan Blinder (1999, p. 60) advocates 'procedures for orderly debt settlement'. The official US position, however, still falls well short of this, insisting on any arrangement being voluntary,⁴ which sounds a desirable quality (and seemed to work well enough in Brazil in 1998) but runs the risk of introducing enough delay to permit too many creditors to get out ahead of any collective arrangement.

It would have to be said that the private sector, generally speaking, is still some distance away from accepting the need for pre-determined guidelines or procedures. I have described their general attitude as being one of 'bewildered resentment' at the idea of compulsory bailing-in in the course of an orderly debt arrangement (one observer put it more forcefully, describing the bail-in proposals as sending the financial world into 'paroxysms of anger' and 'near hysterics' (*Institutional Investor* 1999)). Private-sector creditors talk in terms of 'consenting adults', who have freely made a contract which no-one else should rend asunder. The curious thing, when we hear them talking about the sanctity of contracts, is that the idea of domestic bankruptcy is routinely accepted as an *in extremis* response when things go wrong – and this is, after all, exactly the circumstances in which a bail-in would be envisaged.

The Institute of International Finance (1999a) (a bank-sponsored 'think tank') represents their view: 'market-based collective behavior is preferable to more dirigiste public sector intervention'; 'there is a strong premium on identifying voluntary joint action mechanisms rather than resorting to forced,

general reschedulings or other mandatory vehicles likely to leave investors with "scar tissue"'; 'experience suggests that voluntary approaches that build on the strength, diversity, and resilience of the marketplace provide the most effective means of involving the private sector in crisis resolution. In contrast, approaches that would "bind in" existing creditors involuntarily are likely to delay the restoration of market access and can thus be counterproductive'. At the same time, the bankers have no objections to a helping hand in the form of official subsidies for their lending (called 'credit enhancements'): 'Multilateral bank partial guarantees could help encourage private-sector lending in near-crisis or early postcrisis situations'. They are reluctant to see the IMF 'lend into arrears' (i.e. provide new official money while existing private money is in arrears) because this would 'strengthen the negotiating position of debtor governments' – or, looking at the other side of the coin, they would no longer be able to use the prospect of new official money as a lever to get debtors to repay previous private-sector debts.⁵ The Bank for International Settlements (1998, p. 170) puts the counter-argument this way: '... the threat of a unilateral stay on payments would help bring banks to the negotiating table earlier. Such a threat would be more credible if the international financial institutions were to announce in advance their willingness to provide further needed financing by "lending into arrears" to countries whose domestic policies were deemed acceptable'.

This highlights the nub of the problem – how to develop a set of rules and institutions which gets the proper balance between debtor and creditor rights and obligations, and have this sufficiently well-accepted so that agreement can be reached quickly, thus allowing a return to business as normal (with the resumption of capital inflows and the

4. '...', private sector coordination can play a valuable role in the restoration of confidence. When investors start to withdraw large quantities of capital from a country whose underlying prospects are strong, the system as a whole has a stake in supporting policies that successfully turn those investors around. We have seen, notably in Korea in December of 1997, and Brazil in February of 1999, that voluntary private sector involvement in recognition of its mutual interest in avoiding withdrawals can form part of a successful solution' (Summers 1999).

5. As Eichengreen (1999, p. 71) says: 'If countries refused to settle on favourable terms, the banks could veto new IMF money in addition to denying their own, a fact the banks learned to use to their advantage'.

physical assets in the hands of those who can get on with the job of producing goods and services, rather than remaining in an unresolved legal limbo).

One way of moving forward on this issue is to confine and define the issue more specifically. Taking the Asian crisis as benchmark, the most important element is to bail-in the *bank-to-bank* debt. Why is this the proper focus of attention? The short answer is that most other types of debt were resolved in ways that may not be satisfactory, but at least did not exacerbate the crisis to the same extent as the withdrawal of short-term bank-to-bank credit lines. Looking at other types of debt, sovereign-to-sovereign debt tends to be longer term and in any case has an existing forum of resolution – the Paris Club. Debt of non-bank borrowers – to a considerable degree – experienced a *de facto* standstill and did not exacerbate the outflows (although it had big effects in harming confidence and needs to be resolved if normal business relations are to be restored). Unlike the holders of bank-to-bank debt, they certainly did not escape scot-free, and this category of debt will have to rely on national bankruptcy procedures for its eventual work-out, and while that is happening, it is not contributing to the capital reversal. So this leaves the bank-to-bank outflows as the principal problem – the US\$70 billion of outflows mentioned earlier. Why did (and could) it flee so readily? Domestic banks had the local-currency liquidity to make the repayment because they were guaranteed by the government (another way of looking at this is to say that this was quasi-sovereign debt). While-ever the foreign exchange markets were open, therefore, they were in a position to repay. The issue cannot be resolved simply by removing bank guarantees: no government, anywhere, will stand idly by while a systemic problem destroys its banking system, so absence of guarantees (no matter how vigorously asserted) is simply not credible.

Korea is the acknowledged successful model of bank-to-bank rescheduling, but two vital elements in that success are often ignored. It

would not have been possible to strike this ‘voluntary’ deal with banks unless:

- it had widespread international support and IMF sanction; and
- the bargaining position of the Korean banks had not been strengthened by the effective unavailable foreign exchange.

These issues are far from settled and there is certainly no acceptance on the part of the private sector, in general, that they should be bailed-in. But, having shifted its position quite a bit over the past couple of years, the IMF is working quietly and steadily to establish precedents – and case studies – for how this might occur. The present focus is on a number of cases where the private sector holds sovereign debt, with Ecuador providing perhaps the most interesting example. There is a belief that the Fund, if not actually encouraging Ecuador to force another rescheduling, has accepted this as the way to go. This is still quite a big step away from the sort of rescheduling of bank-to-bank private debt that would have been relevant in the Asian case. But at least this is moving in the right direction. We all should support these efforts. Bail-ins will only work if there is official international support in ‘blowing the whistle’ (i.e. sanctioning the cessation of payments). If it is not the Fund playing a key role, in whatever form, then it is hard to see who can do this with the degree of timeliness and universal authority which will often be needed.

Is there a better alternative, which would obviate the need for bail-ins, with all their imperfections and drawbacks? For those who see salvation in privately provided contingent credit lines, here is one private-sector view: ‘Banks will happily provide contingent credit lines to governments for a nice fee and then pull credit away from the consolidated national balance sheet when the lines are drawn in a liquidity crisis. Good luck in tracking this down’ (Folkerts-Landau and Garber 1999). The private sector seems no more attracted to the idea of uniform collective action clauses: ‘Entered into freely, such clauses could be useful and are already found in emerging market bonds issued under British law. Mandatory approaches could send

the wrong signal to borrowers and lenders and could label emerging market economies as second-class citizens when some are approaching high standards of creditworthiness' (Dallara 1999).

Will this, together with the other changes which have been made to the international architecture, be sufficient to do the job? If 'doing the job' means that future crises will be averted, clearly not. But the real issue is not whether crises can be averted, but whether we have done as much as possible. On this, it would be easy to share the views of Dr Sakakibara who says that it will take a couple more crises before we put in place an adequate system of international financial architecture. I have an open mind on this, partly because a lot can be done within the

existing architecture to make it much more stable. The biggest contribution would be for the capital-receiving countries to put great effort into strengthening their own financial systems, and their legal and accounting frameworks as well. This will take quite a bit longer than might have been suggested by the reform timetables laid down for a number of these countries – it is a matter of decades or even generations, rather than a year or two. But quite a bit can be done, within a relatively short time horizon, to make these economies much less vulnerable than they were. As well, there is now a better understanding of the balance between the benefits of foreign capital flows and their dangers. This will not do away with crises – nothing can. But it should make them less common.

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