

Commentary: Managing Financial Crises in Emerging Markets

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As I expected, the paper by Barry Eichengreen and Richard Portes is very much in line with their previous contribution to the issue of crisis handling. It is a thoughtful and carefully considered analysis of the policy challenges involved, and I fully endorse their basic position, which stands somewhere between the view that “suffice-it-for-markets-to-take-care-of-themselves” and the view that a major legal and institutional overhaul is called for.

I shall concentrate most of my remarks on issues of crisis management. For evident reasons, I strongly rely on the G-10 report as the baseline for the views I express, not that I regard this report as the gospel on such matters, but because it provides me with my limited expertise in this field. Indeed, the time may be appropriate, some fifteen months after its publication, to revisit some of its findings and recommendations.

Let me stress right away that I do not see a need to deviate in any substantive way from the messages of this report, even though the latest events in Thailand do not exactly fit in all respects with the type of crisis which led the G-10 authorities to request the study. It is too early to assess the implications of the Thai case for crisis handling, but I would submit that many relevant features are highlighted in the report.

As a starting point, it is useful to recall the desirable features of any process of crisis handling. The long list of such features, which is to be found in the report, can be roughly encapsulated in four principles: (1) prevention is better than cure, (2) moral hazard is a central concern, (3) work with the grain of the market, and (4) use a flexible, case-by-case approach.

Barry and Richard observe in their paper that the G-10 may have been too confident in a process of market-led reform. I shall come back to this.

Moral hazard is a two-way concern. For the creditors, the answer provided in the report is clear: private creditors should not expect that a public bailout will be forthcoming just because a sovereign borrower is involved, or because of the form of their claims.

For the debtors, it is suggested that moral hazard can be contained, provided relief is accompanied by strong conditionality. True, certainly. But, as a personal remark, I would observe that conditionality is thus assigned the ambiguous role of getting the country out of the mess in which it has fallen and of inflicting on it a penalty for past mistakes. More on this at the end of my remarks.

Coming to the assessment of the working of existing arrangements to handle a crisis, it seems to me that Barry and Richard do not challenge the view expressed in the G-10 report that these arrangements broadly satisfy the identified desirable features. It is part of their merit that they grew out of a cumulative mix of experience, practice, urgency, imagination, and determination, rather than by some comprehensive institutional advance planning. Clearly, they call for an iterative process of adaptation, and the G-10 report made such a call in connection with the increased share of capital flows taking the form of securities.

One measure of success is the speed at which the official institutions involved in dealing with situations of critical indebtedness have adjusted their procedures and working practices, over time, to respond to evolving challenges. Some of the merit goes to the G-7,

which has undertaken to be the driving force behind many such adaptations, while preserving the analytical and decisional integrity of the relevant bodies.

I would personally concede that the present institutional setup suffers from two limitations, on which the G-10 report remained silent, because they may be controversial and there is no obvious remedy anyway.

One is the potential emergence of conflicts of interest in the role of official authorities and multilateral institutions, as they are called to act as catalysts in workout arrangements between the debtor and private creditors, while having a stake themselves by reason of their own claims on the debtor country.

The other drawback is the sheer weight of the main creditor nations as shareholders of the International Monetary Fund (IMF), and the extent to which this entails the risk that some imbalance is seen to arise in the treatment of otherwise similar situations. The only counterweight to this lies in the spontaneous restraint of those who hold power. The checks and balances are indeed in the shared interest of all in the smooth functioning of a truly multilateral framework. I see no alternative arrangements, certainly not of the type which would seek to ignore the political nature of sovereign liquidity crises by resorting to more jurisdictional procedures.

On Barry and Richard's assessment of the present situation, I would offer only two comments.

They argue that the aftermath of the Mexican crisis has enhanced the IMF leadership in the handling of crises, somewhat at odds with the market-led reform recommended by the G-10. But I see no inconsistency. While the G-10 has indeed "trumpeted" the need for a market-led reform in the field of securitized debt, it has in no way sought to diminish the role of the IMF as the conductor of the orchestra when the music is rough, much to the contrary.

On a purely factual point, I believe Barry and Richard overstate the case when arguing that securitized instruments have replaced bank loans. This does not fully square with the composition of capital flows to Southeast Asia, for instance.

Finally, on the gaps to be filled in the present system, I would like to make five points, two of which address Barry and Richard's views while three are my own.

First, Barry and Richard make a new plea for the creation of a standing committee of representatives of bondholders.

Much the better if that occurs and proves efficient. The main reason why this suggestion was not upheld in the G-10 report was the reluctance of market participants themselves, as came out of the survey. One may also wonder if such a pre-established body would prove sufficiently flexible to be accepted in most if not all circumstances. The variable geometry of such informal groups as the Paris Club or the London Club may be more attractive, and we might think of a Jackson Hole Club for securitized debt. Whatever the formal or informal arrangements put in place, it would still be required that individual bond issues incorporate some delegation of authority to negotiate a workout.

Second, Barry and Richard make the valid point that not much has happened in the market place since the G-10 dropped its hint that market operators should think of inserting clauses for collective representation, for majority voting, or for sharing payouts in the contracts for future sovereign borrowing in the form of securities. Should the G-10 authorities therefore contemplate, individually or collectively, to use more heavy-handed instruments to produce the desired result, including, perhaps, legislation? I find it difficult to go along with this suggestion, which, in my view, would seriously depart from the desire of the G-10 to work with the grain of the market. It was once discussed in the G-10 group whether the G-10 countries should lead the way by having these clauses added in their own bond issues, and one may regret that this course of action found no support. The real incentive to act may have to come from a

possible test case involving a sovereign default on bonded debt, with no prospect of a bailout.

Third, one fairly publicized suggestion in the G-10 report was for the executive board of the IMF to review the possibility of extending its policy on lending into arrears, albeit in a cautious way given the strong signaling effect involved. The matter is still on the board's agenda, as far as I know, and I believe it remains a useful course of action to explore.

Fourth, the issue of a sanctioned standstill has recently been revisited in a recent paper by Miller and Zhang,¹ on the basis of the alleged argument that sovereign debtors are less immune to grab race than the G-10 report has assumed. I am not aware of much evidence in this respect, but one may wish to raise the question again. Should the IMF be empowered to shield a debtor country from any court action to recover claims against it, using an amended form of Article VIII, 2, b in the Articles of Agreement? Truly, the main counterargument in the G-10 report, namely the need to amend the Articles of Agreement for that purpose, has been weakened now that an amendment is contemplated anyway for the purpose of capital liberalization. Yet, in my own view, such a step would carry the power of the Fund a bridge too far, and would not be seen as consistent with the paramount principle (recalled by the G-10) that the terms and conditions of contracts are to be met in full and on time.

My last comment refers to conditionality as a way to exercise pressure on the debtor. The IMF has unrivaled capacity to use this instrument, which cannot be separated from the provision of financial relief. As mentioned in the G-10 report, "The treatment of a debtor country by creditors should be influenced by the debtor's economic record and past history of cooperation and consultation, by its willingness to provide information and engage in dialogue at the time of a crisis, and by its readiness to accept an appropriate degree of conditionality *ex post*."

Unfortunately, IMF conditionality may be suffering from an undeserved image of penalty imposed by greedy creditors. Rehabili-

tating conditionality could be a useful task to undertake, not by any means as a result of softening it, but by the restoration of public awareness of its purpose and effects, measured on the basis of appropriate benchmarks. The IMF has consistently tried to explain the justification, the working, and the experience of conditionality. It could perhaps get useful support from other interested parties, such as the G-10 or wider groups. It will be particularly interesting to review the experience gained in a few years from the initiative for highly indebted poorer countries, where conditionality is the cornerstone of crisis handling without a crisis—at least without a financial crisis!

Endnote

¹ Marcus Miller and Lei Zhang, cited in Barry Eichengreen and Richard Portes' paper in this volume.