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Panel Presentation
Involving the Private Sector in Crisis Resolution

Peter B. Kenen

My comments will focus mainly on crisis prevention and crisis management, but I will start with brief remarks on the causes and characteristics of the Asian crisis.

In chapter 4 of this volume, Steven Radelet and Jeffrey Sachs identify five types of financial crises—a rubric under which they implicitly subsume what we usually describe as currency crises. While financial and currency crises go together frequently, it is still useful to distinguish between them. The European Monetary System crisis of 1992–93 was a currency crisis. The savings and loan crisis in the United States was a financial crisis, although limited to a subsector of the financial system. It is still useful, moreover, to distinguish between crises due to weak fundamentals, including microeconomic fundamentals, and self-fulfilling crises that would not occur if market participants did not expect them.

I insist on the relevance of these distinctions, not for the purpose of arguing that the Asian crisis can be stuffed into one analytical box, but because that crisis can best be understood by drawing on several approaches.

The Thai crisis that touched off the general crisis can be blamed mainly on bad fundamentals. On the microeconomic side, inadequate prudential supervision allowed financial institutions to take on huge amounts of foreign currency debt and offset it by foreign currency lending to local borrowers having no foreign currency revenues. On the macroeconomic side, the current account deficit was large and growing, due to the Thai government's stubborn defense of an overvalued currency and to falling export

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growth, reflecting excessive East Asian investment in a rather narrow range of export industries. In short, Thailand was an accident waiting to happen, and that was widely recognized long before the crisis. The International Monetary Fund (IMF) warned the Thai authorities repeatedly that they were courting disaster.

But were the other Asian countries accidents waiting to happen? Many people say so now. The involvement of Malaysia, Indonesia, and Korea has shown, they say, that the so-called Asian model was doomed to failure or had at least been rendered obsolete by its initial success. Absent the Thai crisis, however, would the stock markets and currencies of Indonesia and Korea have collapsed as they did? Some firms and banks were in trouble, serious enough perhaps to trigger a full-fledged crisis. But I am far from sure. Indonesia and Korea might have found "Asian solutions" to the problems of those firms and banks—solutions that would not satisfy us now but might well have earned admiration from some of the same people who now ascribe those problems to the fatal weakness of the Asian model.

Be that as it may, we should be quite cautious about recommending remedies to the Asian countries—the further, rapid liberalization of financial markets and the dismantling of long-standing links among banks, businesses, and bureaucrats. Greater transparency is needed to deter corruption and promote a sounder credit culture. But we will deceive ourselves and the Asian countries if we claim that these objectives can be achieved quickly, even when governments have agreed in good faith to undertake major reforms. Old habits cannot be altered rapidly. They will merely find new ways to manifest themselves.

I am intrigued by another aspect of the Asian crisis—the speed with which a so-called liquidity crisis can turn into a solvency crisis when it leads to a steep depreciation of the domestic currency. Whenever banks and firms have large foreign currency debts, they will scramble for cover when they begin to believe that their national currency might depreciate. That is what happened in Asia as soon as the depreciation of the baht raised doubts about other Asian exchange rates, and the problem was exacerbated by the sharp fall in stock markets. There was indeed a pernicious interaction between stock markets and currency markets. Falling stock markets led to large foreign sales of equities (see table 4.2 in chap. 4). These sales were then reflected in sales of the domestic currency, depressing its value and provoking additional sales of equities. The numbers suggest, moreover, that local banks and firms contributed to the process, as they sought—or were forced—to repay their foreign currency debts.

This cumulative process, however, made it increasingly expensive for banks and firms to service or repay the rest of their foreign currency debts, and those that were solvent at the exchange rates prevailing before the crisis became insolvent because of the crisis. Some might be solvent again, however, if Asian currencies recover significantly, which leads me to ask whether there has been too much talk of the need for permanent debt workouts as distinct from short-term suspensions of debt service payments.

This comment leads me directly to my main point. There may be better ways to deal with financial crises.

At the Halifax summit in 1995, the G-10 countries were asked to establish a working group to study new ways to resolve sovereign liquidity crises. Jeffrey Sachs can take partial credit. He proposed a radical solution—a bankruptcy regime for sovereign debtors—although, in the end, the working group rejected his approach. Its recommendations were more like those of Barry Eichengreen and Richard Portes (see Sachs 1995; Eichengreen and Portes 1995; Group of Ten 1996).

The working group's views can be summed up in two sentences: The response to the Mexican crisis of 1994–95, massive financial assistance to avoid a default on the Tesobonos, was appropriate under the circumstances. Hereafter, however, debtor governments and private creditors should not expect that response.

What might be done instead? When a government cannot service its external debt, it should suspend its debt service payments temporarily and initiate negotiations with its private creditors in order to reschedule or reduce its debt. It should not be refused ordinary access to IMF credit if it adopts appropriate policies and is making a good faith effort to reach agreement with its private creditors. In other words, the IMF should "lend into arrears" when doing so would signal confidence in the debtor's policies and its long-term prospects. Finally, new foreign currency bonds should include certain clauses aimed at facilitating negotiations between a debtor government and its private creditors when debt service payments have been interrupted. These proposals were endorsed by the G-10 governments.

Although the working group's report was concerned chiefly with Mexico's problem—the inability of a national government to honor its own obligations—the group knew that the next crisis might well involve private sector debt. In fact, some of its members were already worried about Thailand, and the report contained two paragraphs that are directly relevant to the Asian crisis:

> On the question of the spectrum of claims to be covered, a suspension of payments will in general be applied uniformly to all claims in a particular class but will differ in scope depending on the severity of the liquidity problem, the composition of the country's obligations, the prospective contribution of a particular creditor class to the restoration of balance-of-payments equilibrium and other considerations. . . . It may no longer be possible to exempt bonds and other claims because of their increased importance. Each case will have to be considered on its mer-

its, taking account of the fact that trade credits and interbank lines *are crucial for maintaining links with the world economy.* (Group of Ten 1996, par. 86; emphasis in original)

It must also be recognized that if the suspension of payments is extended to obligations of the private sector, this may require the use of formal or informal exchange controls. However, the resort to such controls, even temporarily, can have long-lasting adverse effects on a country's access to international capital markets and may not be practicable once a country has completely liberalized external payments and dismantled the machinery for imposing controls. Debtors may nonetheless be tempted to resort to such controls to slow a "rush for the exit" by holders of claims, including domestic holders, which have to believe that a suspension of payments can occur soon. In the case of marketable claims, however, sales may be discouraged by sharp falls in prices caused by the expectation that controls will be imposed; this effect can be reinforced by a depreciation of the domestic currency. When appropriate, a degree of exchange-rate flexibility could help to conserve the country's remaining foreign exchange reserves and may even obviate the need to obstruct the servicing of the private sector's obligations. (par. 88)

The predictions made about falling asset prices and depreciating currencies were not borne out in Asia; far from deterring the exit of foreign capital, they may have intensified the capital outflow. Nevertheless, some of the sentences in these two paragraphs help to explain why the working group's approach was not adopted in the Asian crisis—why it was not decided to impose a prompt, comprehensive ban on debt service payments by the private sector rather than provide increasingly big packages of official credit.

It might have been very hard to make the Thai government adopt the working group's approach and imprudent to count on strict enforcement. The Thais were in denial until they ran out of reserves. At that early stage in the crisis, moreover, the risk of exchange rate contagion was underestimated, and a suspension of debt service payments may have been viewed as being more dangerous to neighboring countries than a large devaluation of the Thai baht. But the objections listed in the G-10 report—the need to protect trade credits and interbank lines and the adverse effects on future creditworthiness—may have been the main objections to a suspension of debt service payments. The approach actually adopted, however, has had very grave effects of its own—not on the Asian countries themselves, but on future funding for the IMF.

Those who believe that the IMF should be abolished because it interferes with the workings of free markets would have been even more vociferous if the IMF had endorsed or required a suspension of debt service payments. Those who believe that the IMF should give more attention to the environment, labor standards, and human rights would not have been appeased if the Fund had followed the advice of the G-10 working group.

But the IMF has also been criticized for helping to hold open the exit by providing large-scale financing and thus helping foreign banks and others having foreign currency claims to leave without taking large losses. Some suffered very large losses on their loans to nonbank borrowers, especially in Indonesia, but others exited early enough to avoid large losses, and the banks that agreed to roll over their loans to Korean banks will not take large losses either. They could not obtain the big interest rate spreads on which they insisted initially, but their claims were guaranteed by the Korean government.

Bearing in mind the concerns expressed in the G-10 report itself—the need to keep trade credit flowing and maintain interbank lines and the concern about creditworthiness—let me propose amendments to the strategy described in the G-10 report. The fundamental premise is, I believe, unassailable. If a country with large foreign currency debts, whether those of the government or the private sector, faces an acute liquidity crisis, a comprehensive suspension of debt service payments may be superior to the mobilization of massive financial assistance. The latter tends to reward those who were doubly dumb—who lent too much initially and were not nimble enough to rush for the exit quickly.

Trade credit flows must not be cut off, and that aim can be achieved by the method now being devised for the Asian countries—concerted action by the export credit agencies of the country's chief trade partners to underwrite or supplement private sector credit flows, with IMF credit used perhaps to back up that effort. Interbank lines must be maintained but should be limited in advance. An emerging market country that is not ready to exercise rigorous prudential supervision of its own banks should be expected to impose strict ceilings on the gross foreign currency debts of its banks—gross, not net, to rule out the ridiculous practice of offsetting debt to foreign banks by making foreign currency loans to domestic entities. (Banks might be allowed to offset foreign currency debt with claims on foreign counterparties, such as forward contracts, but not with foreign currency claims on their own offshore affiliates.) How could such limits be enforced? By amending the Basle capital adequacy standard. Loans to banks in countries that fail to meet well-defined international standards for bank supervision and do not impose strict limits on their banks' foreign currency debts should be given high risk weightings.

Many problems would have to be solved to implement this scheme. It would require the creation of a new international agency or a new division in the IMF to assess the quality of bank supervision in emerging market countries. But that would be easier than trying to create a single supranational regulator for those countries' banks. The scheme would have the effect of limiting the size of interbank lines and thus limiting the moral hazard effect of exempting those interbank lines from a suspension of debt service payments.

One more observation to avoid misunderstanding. I am not proposing that the suspension of debt service payments be followed by a comprehensive negotiation between private sector debtors and their foreign creditors. When it comes time to end the suspension of debt service payments, some private sector debtors will be able to meet their obligations, including arrears accumulated during the suspension, without great difficulty. Much will depend, of course, on the level of their country's exchange rate when the suspension is ended. Other private sector debtors will have much more trouble and will have then to negotiate with their creditors or enter into bankruptcy. Which leads me to my last suggestion. Credit-rating agencies should be strongly encouraged to examine the bankruptcy laws and practices of emerging market countries when they rate corporate borrowers. It is not enough to assess the risk of default. It is also necessary to assess the consequences.

I have not tried to supply an agenda for full-fledged reform of the international financial system. Much more must be done. There is need to amend the IMF's Special Data Dissemination Standard to require that countries supply timely data on the foreign currency debts and claims of commercial banks and the rest of the private sector. There is need to take a fresh look at ways in which the IMF might punish member governments for failing to heed confidential advice on their exchange rate policies. And there is an obvious need to work long and hard on strengthening bank supervision in emerging market countries. My chief aim in these brief comments has been to revive and revise the main proposal in the G-10 report—to find an acceptable way of replacing massive financial support with short-term suspensions of debt service payments.

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