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Crises Prevention and Crises Resolution: The Roles of the IMF, Governments and Markets

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This conference is about 60 years of dialogue between past and future. On balance, the last sixty-year period has been truly remarkable. Eric Hobsbawm referred to the first half of it in his autobiography *Interesting Times. A 20th century life*: "In the thirty years after the Second World War, the world and what it was like to live in it changed more rapidly and more fundamentally than in any other period of comparable length in human history." He was referring just to the first half of the last 60-year-period, but the second half was no less impressive. Hobsbawm's observation may seem a bit vague for those who take for granted everything we have observed so far. Some may even consider the observation as displaced in a conference which is looking ahead. Of course, we should be forward looking. But the fact is that without recognizing how fast, deeply and irreversibly the world has changed from the 1940s to today, one will not be able to have a feeling for the possible future. Because the world has changed beyond recognition since the two Bretton Woods institutions have been created.

Just two examples to illustrate this point: when the Committee on Quotas decided on their allocation to the 44 initial members at the final conference in Bretton Woods, there were only four member countries in Africa: South Africa, Egypt, Liberia, and Ethiopia. Only three in Asia: China, India (still British India at that time) and the Philippines. Only two in the Middle East: Iran and Iraq. It was true that there were 19 in Latin America, but 14 of them, together, had roughly the same number of quotas as those assigned to the Czech Republic at that time. Today, just Africa, Asia and the Middle East have more than one hundred and ten fully fledged member countries in the Bretton Woods institutions.The second example is related not to the growing number of sovereign states' membership, but to demographic dynamics: it took thousands of years for humanity to come to 2.5 billion people (in 1950, coming from 1.6 billion in 1900) and only 50 years more for the world's population to reach the extraordinary number of six billion people!

The magnitude of the challenges involved was extraordinary and not only due to the huge needs for investment in basic social infrastructure. Expectations about

fast improving living standards, higher income and consumption , on the part of hundreds of millions, rose exponentially as never ,ever before. At the same time, there has been economic growth; the level of technical knowledge is much higher, as is the understanding of the issues and the real or potential availability of resources. Therefore, one could well argue that, if complexity has increased, so has the ability to handle it. But the fact remains: expectations have also increased, and much faster.

This is one the reasons for the never-ending dialogue between past and future and for conferences like this one. Every generation revisits, rewrites and reinterprets the past in the light of two sets of factors: concerns about the burning issues of the present, and hopes, dreams, fears and expectations about the future.

Can history be of any guidance as we attempt to deal with the issues of crisis prevention and crisis resolution? The recurrent pattern of the many episodes of financial manias, panics and crashes observed over the last two centuries, indicates clearly that, unless human nature changes, there will be future crises. The question is how to make them less frequent, less deep and less disseminated. In other words, how to be more effective in terms of prevention and, once crises have erupted, how to have a quick and less costly resolution. This is the name of the game. The basis for which should be the view that the IMF and the markets must have complementary rather than antagonistic roles as the experience of successful cases of crisis prevention and crisis resolution has clearly suggested.

Experience seems to suggest that real life is far more daring than any effort of the imagination. History often surprises us with strange combinations and ever-shifting patterns The same sort of approach that Jeffrey Frankel followed in discussing exchange rate regimes: "there is no right exchange rate regime for all times and all countries or even for one single country at all times", could be applied more generally. Take, for instance, monetary regimes. A large and apparently growing number of countries adopt inflation targeting as a monetary regime. The regime is a very reasonable one, but it is doubtful whether inflation targeting could have been applied by all countries or even by a given country at all times.

The same reasoning applies to fiscal regimes. Countries differ in terms of the level and composition of their expenditures, the level and composition of their taxation, different phases of the cycle, some use structural measures or cyclically adjusted fiscal deficits, others not. So there is no right fiscal policy for all countries at all times. The same applies to growth strategies. There is no single way, no "one size fits all", not one unique path that all countries should follow. There is, admittedly, a huge diversity in this world .Countries do differ, in their history, economic structures, institutions, politics and cultural values. All of them subject to change.

This does not mean that anything goes, or everything is permissible. On the contrary: To state that there is no single fiscal, monetary and exchange rate regime, or a single growth strategy, does not imply that we have not learned a lot –

in many cases in a painful and hard way over the last few decades. For instance, regardless of the differences in terms of implementation, countries must have fiscal responsibility in the sense that they ought to be concerned with the inter-temporal solvency of their public sectors and in controlling debt to GDP ratios. They have to be concerned about the efficiency of government expenditure. They have to be concerned about the efficiency of the tax system in terms of the stimuli to investment, especially private investment. They have to be concerned about inflation control and monetary responsibility; having an exchange rate regime and trying to minimise excessive overshooting in either direction of the exchange rate. And they have to have sound institutions. Ultimately, the quality of governments and the quality of their interactions with the private sector depend, to a large extent, on the quality, the nature and the effective functioning of their institutions.

The observations above are relevant to the subject of crisis prevention. Barry Eichengreen highlighted the four elements usually underlying financial crises. Three of these elements are probably uncontroversial at the level of generality they are presented. The three of them are: first, countries should not have unsustainable macro-economic policies. Second, countries should not have fragile financial systems. And third, countries should correct institutional weaknesses, broadly defined. No trivial matters, those three, for real-life policy makers.

But there is a fourth issue, related to the international monetary financial and trading system. This system is global by its very nature, and requires actions which cannot be taken by individual countries in isolation. Here, supranational institutions and organisations come into play, and the essential role of the IMF has been increasingly recognized. However, for many years, up to a recent past, a relatively large number of developing countries considered themselves as passive victims of external events beyond their control, and blamed the outside world, and the external environment, as working against their advantage. As a reaction to this rhetorical position, the pendulum may have swung too far in the other direction. In fact, for many years, industrial countries used the "mind-your-own-business" type of counter-speeches: be concerned about your policies, improve your domestic situation, put your house in order and be less obsessive about the interactions that characterize the world economy.

Over the last 60 years, especially during the recent period, the understanding of the nature of these interactions has improved. Trade, finance, foreign direct investment and a host of other less tangible interactions are absolutely essential for most developing countries and their development efforts. Even when, as it is widely recognized, the truly fundamental development battles are fought, won, or lost ,in the domestic front.

Therefore, the best crisis prevention act comprises a set of policies that any developing country should take, and are related to moving forward in the three areas: sustainable macro-policies, sound financial systems (including their

regulation and supervision) and strengthening institutions. But these are processes. Which take time, counted by generations, in the case of successful countries?

Nevertheless, it remains true that there are key issues which are international in nature, and must be internationally addressed. Trade, protectionism and subsidies to production and exports are as obvious as hard to handle. Not so obvious – and no less complex – are the issues related to international lending and international borrowing. It is important to discuss whether there was sufficient flexibility in the contracts under which capital was being internationally transferred in the late sixties/early seventies, given the contingencies that might have arisen.

Eaton and Gersovitz (1986) suggest that this topic subsumes important differences between lenders and direct investors. The fact is that the international indebtedness problem turned into a crisis largely as a consequence of an a priori asymmetrical allocation of risks between lenders and borrowers. And as we know, the late 1970s/early 1980s saw the very materialisation of these very high risks. The event suggested discussing whether contingency mechanisms of some sort, absent from earlier contracts, could emerge in the future to deal with this real or perceived asymmetry.

Richard Cooper, in a text published in 1979 (Dornbush and Frankel, 1979), showed a remarkable analytical acumen, writing before Volcker's dramatic interest rate increases and the second oil shock: "In many semi-industrialised countries and in a number of less developed countries there is a degree of financial precariousness that is much more widespread than at any time since at least 1950." What happened was that a number of countries took conscious and rational decisions to ride out the recession. They chose not to experience it in 1974 and 1975 but to borrow abroad instead and to maintain growth and domestic demand, and external debt rose accordingly. They took a more or less rational gamble, and that indeed was very healthy from the point of view of the world economy as a whole because they helped to limit the extent of the downturn. But it was a game they essentially lost. The recession was much sharper and longer than was anticipated at the time and now the countries made serious decisions as to how much to retrench and how to accomplish it."

This explains why a very large number of developing countries (and not only oil importers) faced serious debt problems in the early 1980s, beginning with Mexico in August 1982. It should be mentioned – and this has to do again with the patterns of cooperation between key governments, the Bretton Woods institutions and the markets – that it took more than seven years (from 1982, when the crisis erupted, to 1989) for the official sectors to recognize that there was no way out of the quandary other than having a scheme for debt reduction under an official umbrella.

This was the Brady Plan, which allowed countries individually to negotiate with their creditors, with a clear blessing of the official sector, a reduction either in the stock of debt or in debt service. The negotiations, such as the one with Brazil from 1991 to 1993, were long, difficult and painful, but the banks, as well as national

officials, knew that there was a basic, internationally agreed official structure underlying their negotiation.

The case of Brazil is a good example of the issues involved. In the negotiations (1991–93), there were three important issues which still bear some relevance to the current discussion. First of all, the banks were very much insistent, from the very beginning, on a condition that there would be no deal unless a formal IMF agreement were in place before the time of the signing of the agreement. Brazilian national officials argued that the discussions were primarily between Brazil and the private creditors, and there was no point in bringing, to that forum, a Fund formal programme at that particular stage of the game. It was, for Brazil, a question of forum, form and timing, not of substance. But for the private sector, a formal IMF programme with Brazil, agreed early on, was a sine qua non condition.

The position of the creditors seemed to be rather strong. Larry Summers, who was Under-Secretary of the Treasury at the time, told the Brazilian negotiators , more than once, that under no circumstances the U.S. Treasury would make the "traditional" special issue of zero-coupon bonds, which was the basis for the collateral, unless there was a prior formal agreement with the Fund before the time of the signing.

When, during long and difficult negotiations, it became clear that a reasonable number of creditors banks were signaling an interest in reaching an agreement, Brazil proposed the introduction of a clause, similar to the collective action clause of more recent fame. In essence, the condition precedent for the deal remained a formal IMF agreement, unless a qualified majority of the creditors decided to waive the condition and to go ahead in the absence of such agreement. An important practical lesson about the relevance of voluntary, collective action clauses were learned when a qualified majority of the banks did vote for waiving the condition.

Secondly, since the Brazilians knew that a special issue of zero-coupon bonds was not going to be made by the U.S. Treasury, Brazil started earlier on, quietly and discretely to buy 30-year U.S. treasury bonds in the marketplace. Therefore, collateral was ready when it came to the signing. This was the second lesson from the Brazilian deal: one should not become totally paralysed because of a given government position.

Thirdly, an important rogue creditor decided not to go ahead with the deal, and requested an acceleration of payments under the old contracts. Brazil decided to go to court convinced that it had a very strong legal position and wide international official support .It is worth noting that at our request, the U.S. Treasury entered as "amicus curiae" with an affidavit in Brazil's favour, which proved important in our winning the legal fight in a New York Court against the rogue creditor.

All this shows that the interactions and the patterns of cooperation between the debtor country, the official sector(governments and multilaterals) and the private creditors is absolutely essential for successful strategies of crises prevention and

crises resolution. This would always require consideration of specific circumstances.

The original proposal for an overall sovereign debt restructuring mechanism (SDRM),as put forward by the IMF would have been too far fetched ,because it would have required amending the Articles of Agreement and involving the IMF, which is already a lender and a policy advisor ,also as rating agency and as a judge, in setting up the terms and deciding if and when a given debt restructuring was required.

Therefore, many concerns have been raised about how these proposed procedures would affect the relationships between creditors and debtors, especially those debtors with a long-standing reasonably good relationship with the international financial community, intending to keep this relationship well into the future, and not willing to be seen or interpreted in other fashion. For this class of countries, collective action clauses are clearly a superior solution.

As is known, politics is less about facts and more about competing interpretations or versions about the facts. Consider for example what could have happened in Brazil, if the original SDRM had been in place and officially recommended for the country. The public sector external debt had a longer maturity and duration than the private sector's. It was relatively high, but well administered and sustainable, under reasonable assumptions. It had already been rescheduled in 1994. And, as rarely noticed, the public sector net external debt of Brazil (at SDRM discussion time) was already lower, in absolute dollar terms, than it was in the mid 1980's.

The level of private sector external debt was similar to the public sector. Private sector external debt in Brazil is the debt of relatively large domestic and international companies operating in Brazil, many of them exporters with a natural hedge against their foreign-denominated obligations. Of course, others do not, and one could always express concern about the transfer problem or conversion risks. However, it would be odd if the official sector would suggest that the Brazilian government should be involved in restructuring the external debt of large international and national corporations in Brazil. The public sector net external debt was not an insurmountable problem. And it should have been clear all along that the sovereign debt restructuring discussion should not have involved domestic public debt denominated and settled in national currency.

Another example which may illustrate my basic point about crisis prevention or resolution (and again with the Brazilian experience in mind), is the aftermath of our decision to float in early 1999. At first, this caused significant turmoil .But Brazil was fortunate in having strengthened up its financial sector, after it had defeated hyper-inflation in 1994. The government intervened in three of the seven largest banks in 1995, 1996 and in 1997. More than twenty (of the original thirty) state commercial banks were liquidated ,privatized or forbidden to operate with liabilities redeemable at par, a significant amount of private banks' mergers and

acquisitions reduced the problem, and foreign ownership was allowed under certain conditions.

Hence, some of the problems of mismatches and balance sheet effects in banks and in corporations, that are common in countries with managed exchange rate regimes, were sharply reduced before the move to a floating exchange rate system.

But the fact was that in early 1999, Brazil was facing an enormous decline in the supply of short-term bank credit lines. The government opted for a cooperative undertaking, trying to convince the private financial sector of its commitment to sound economic policies. In early March 1999, meetings were held in New York, Toronto, London, Paris, Frankfurt, Madrid, Tokyo, Rome and Amsterdam. Prior to this, Brazil had formed a group of persons (informal bank coordinators) to help the government with the organization of the meetings. Brazil's objective was to get a firm commitment from the banks to a voluntary, but coordinated standstill in their lines of credit. The fact that the setting of the negotiations was one of the premises of the various national Central Banks, with the presence of their senior staff (and of Fund's staff) proved to be instrumental to gain the commitment of the banks to the standstill. In the end, there was no need to renew these agreements because lines were naturally expanded after the original six month agreement..

Once again, we demonstrated, in practice, that the Fund, the official sector and the markets should not displace each other. Quite on the contrary: The more confidence can be build, the more intensive the interactions, the better for the debtor, for the multilateral organisations and for the private sector. While the actual situations may not be ideal, they certainly would be worse if one of the parts refused to negotiate or to engage in good faith dialogue.

The Brazilian more recent experience could again serve as an example. In the run up to the October 2002 presidential elections, the real or perceived risks and uncertainties surrounding the possible future course of policies of a yet to be elected future administration, led to a dramatically deteriorating situation ,expressed in sovereign risk premia and exchange rate overshooting. The outgoing Administration negotiated a major IMF programme (roughly USD 30 billion, at least 80% of which to be available only in 2003); explained publicly and privately to all major candidates why it had done so, and tried to convince the private sector, domestic and international, that Brazil had become a more normal country.

In other words, that any future administration would be fiscally responsible, keep inflation under control, and respect contracts and international agreements. The smooth and civilized transition in late 2002 and the responsible macroeconomic policies which have been followed by the new administration in its first two years, have vindicated this view and backed the calculated risks taken by governments, by the IMF and, ultimately, by the markets.

In conclusion, there is no right scheme either for exchange rate regimes, monetary regimes, fiscal regimes, or growth strategies that could be used and applied all the times in all countries. Each case is different. The important thing is

to understand past experience, develop an ability to assess current risks and uncertainties, have a feeling for the elements of continuity and change always present in any situation, and cultivate the art to become constructively engaged in addressing specific crises. The only thing that is sure, the only certainty we have as we move forward ,is that despite all strenuous efforts at crisis prevention, despite all lessons from the past, there will be crises in the future. And that they will have to be addressed. And that in doing so, neither governments, nor multilaterals, nor the markets can afford to ignore each other.

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