The Orderly Resolution of Financial Crises – A G20-Led Initiative

How could a Leaders' Level G20 make a difference?

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BRIEFING NOTE

Ariel Buira

Financial Crises and International Cooperation

International financial flows have expanded at a much faster rate than world GDP and international trade. For middle income emerging market countries, they represent the major source of external finance. Financial markets have expanded, globalized, and innovated at an unprecedented rate. These markets have provided a vast pool of resources to the global economy, which has extended well beyond the developed countries to finance dozens of "emerging market" countries. International investment flows, both portfolio and direct investment, have benefited from this expansion; privatizations were often financed through these markets. But this expanded financial market activity also has a well known down side, a vulnerability to financial market volatility leading to financial crises, posing a problem for global economy that existing institutions have been unable to solve.

In their search for higher growth rates, developing countries must sustain high levels of investment, but since they lack the deep financial markets of the industrial countries, their governments and private investors must resort to foreign borrowing in order to meet a substantial part of their financing requirements. This makes them vulnerable to exchange rate movements. In addition, their export earnings are often less diversified and as a result, they are more vulnerable to commodity and terms of trade shocks. Since their political institutions and regulatory agencies do not often have the reputation of those in developed countries, their policy credibility, is frequently less recognized by market participants than that of governments and institutions of industrial countries. This results in a heavy concentration of debt in shorter maturities thus adding maturity mismatch to currency exposure, giving rise to higher risk.

On the other hand, investor sentiment can change suddenly and unpredictably, provoking large reversals in capital flows.[1]

The Mexican crisis of December 1994 which led to the collapse of the peso exchange rate, resulted in sharp declines in the stock markets of other emerging markets. Crises in Indonesia, Korea and Thailand in 1997 started a round of speculative attacks that affected other countries in the region and a number of countries in other areas of the world. Russia, Argentina, Brazil, Turkey are among the major countries that have recently experienced financial crises.

Under the Bretton Woods system, exchange rates were maintained by government economic policies, including controls on trade and capital movements to sustain the exchange rate stability. The Bretton Woods system was replaced by arrangements allowing exchange rates to float in the foreign exchange markets. The new arrangements intended to accommodate market forces result in frequent movements among different exchange rates.

Why do Financial Crises Happen?

Financial crises may result from poor domestic policies or from exogenous factors; in many cases they are the outcome of a combination of both. They occur more frequently than in the past because new categories of investors, such as hedge funds, are always seeking to improve their performance in order to retain the funds entrusted to them and to gain ground at the expense of their competitors. Thus, they are always ready to move in and out of markets rapidly, giving rise to rushes for the exit, often based on rumors and partial information. This gives rise to contagion, herding behavior and self- fulfilling speculative attacks.

As markets are freed from restrictions, they gain efficiency but volatility also increases. Empirical studies show that emerging market countries face a much higher volatility and vulnerability to exogenous shocks than either developed or low income countries. Whatever the differences in their economic structure, emerging market economies in different parts of the world are significantly correlated because of the behavior of investors.

Due to the large size of their portfolios, when the investment funds move money from one country to another, they may have a significant destabilizing effect on the smaller financial markets. While poor economic policies can provoke capital flight, it is also widely recognized, that capital flows to emerging markets are often volatile for reasons

[1] Financial crises are not exclusive to emerging markets. Recall the worldwide stock market crash of October 1987, the collapse of US high yield debt two years later, the September 1992 run on the British pound, the attacks on a number of other European currencies in 1993 that forced the realignment of the ERM (to 15%) and delayed progress towards European monetary integration, the failures of Baring Bros. and S.G.Warburg in 1994 and 1995 that forced the sale of both investment banks.

that that have little relation to a country's policies. Among these are:

- Changes in financial conditions in industrial countries, particularly sharp unanticipated interest rate and exchange rate movements that increase the cost and diminish the availability of financing to developing countries.
- The pro-cyclical behavior of capital markets tends to undermine the creditworthiness of countries. Capital flows, including both commercial bank lending and bond placements by developing countries are markedly pro-cyclical, reflecting conditions in both developed capital exporting and capital importing countries. Capital flows out from the former when low levels of domestic demand or low interest depress returns. Capital flows go most readily to the latter when economic and business prospects are good, and less readily when the economy contracts or when uncertainties intensify. Imagine in the national context, what would happen if banks were suddenly to cut credit flows to the corporate sector during a recession and started closing off existing credit lines. The result would be a financial collapse that would bring down even well managed firms, including banks.
- Market behavior is often characterized by asymmetries in information and contagion effects. Country risk analysis is often characterized by herding behavior, by which a country may lose its creditworthiness almost overnight, when unexpected events, such as large macroeconomic or financial shocks in a neighboring country, trigger sudden shifts in market sentiment towards all countries in a region or to countries with similar characteristics, leaving the authorities little time to react. As liquidity dries up, the country may face excessive adjustment costs.

Dealing with Financial Crises

The surveillance of countries economic, fiscal, monetary, exchange rate and debt policies require the timely provision of data as well as the application of standards and codes, together with good regulation and supervision of the financial system. These necessary precautionary measures are not sufficient to prevent the emergence of confidence crises giving rise to major reversals of capital flows.

Since massive capital outflows can inflict great damage to an economy very quickly, the current IMF approach to financial crises must be considered unsatisfactory. The approach may be characterized as one of IMF lending to the countries after the outbreak of the crisis, after capital flight has caused a large depreciation of the currency, a deep recession resulting in a severe fall in output and employment and a sharp rise in interest rates, more often than not leading to a banking crisis. The IMF offers support for a program designed to restore macroeconomic balances, generally at a low levels of activity. This is a departure from the purposes of the Fund, which include, sustaining high levels of employment and providing countries with the opportunity to correct imbalances without resorting to measures destructive of national and international prosperity.

An approach to crises that would be efficient, and consistent with the purposes of the Fund, would require the IMF to intervene in a timely manner, with enough financial support to restore market confidence, before the meltdown takes place. This requires an ongoing dialogue between the Fund and the authorities to enable the country to approach the Fund at short notice, and to enable the Fund to respond promptly. Countries whose policies were considered appropriate by the Article IV consultation and had continued to pursue sound policies would be eligible for immediate Fund support should the need arise.

This was the purpose of the Contingent Credit Line established in 1999, to give emerging market countries with sound fundamentals, the assurance of IMF support to discourage and protect members from speculative attacks. But it was designed in such a restrictive manner that, despite the high costs of self-insurance and the many difficulties they encountered, no country resorted to it in its five years in existence. Although a majority of the Fund Board, particularly Directors representing potential users, supported the continuation of a reformed CCL, they did not achieve the 85 percent majority of the vote required to prevent its termination on November 2003[2]

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Among the problems that led to the failure of the CCL are the signaling effects of the entry and exit into the mechanism. Contrary to what was desired, access to the CCL could be seen as an announcement of vulnerability that would harm confidence. There was also a lack of clarity as to the amount of support that would be available and the timing. Often, unnecessary demands on the part of the Fund and resulting uncertainties led countries to seek to strengthen fundamentals, increase reserves, and adopt other self-insurance policies. The lack of an exit strategy from the CCL posed another problem. How could the IMF disengage without giving rise to negative expectations? In fact, the Fund could be faced with a conflict of interest between not lending and its unwillingness to precipitate a crisis. These are issues that any new precautionary scheme should address.

The proposed approach would take the place of a formal precautionary facility, and it would have the advantage of avoiding the signaling problems of the CCL. The essence of the suggested approach would be the willingness of the international community to provide sufficient and timely financial support to a country with good fundamentals in order to preserve or restore weakening market confidence. In fact, this could be done without a special facility, under a fast track stand-by that provided exceptional access in a more or less automatic way to countries with good fundamentals that qualified for it.

The dog that did not bark led Sherlock Holmes to the solution of a mystery, and in the case of Greece, we have a good example of a financial crisis that did not happen because the country was thought to have ample access to liquidity. Greece had debt in excess of 100% of its GDP, very large fiscal deficits, and a low level of exports to debt. However, long before Greece adopted the Euro as its currency, the country was presumed by financial markets to be able to count on the support of other EU member countries. Thus, despite having fundamentals that were considerably worse than those of a number of emerging market countries that suffered devastating financial crises, Greece did not

[2] It is likely that the outcome of a G20 Heads of State discussion of the CCL would have been different.

experience a financial crisis.

Last year, net capital flows to developing countries rose to $241billion, an increase of some 37 percent over 2002 and are expected to remain at that level in 2004.[3]

Private sector debt and equity flows, which increased by a third, lay behind the rise. The recovery in capital flows has been heavily influenced by low interest rates in the industrial countries, as well as structural improvements and better economic management in the developing countries. Strong commodity prices also contributed to a favorable environment and to increasing the credit quality of developing country borrowers. Looking ahead, Latin America, with substantial external financing requirements and high levels of external debt, is particularly vulnerable to the risk of rising US interest rates that could trigger a reversal of current favorable external financing conditions. The possibility that a new financial crises may emerge in the next 18 months cannot be discounted.

If we see the risk of a crisis ahead of time, we should be able to act in a timely manner to try to prevent it. Among the early warning signs are rising spreads on external borrowing, the concentration of external liabilities in the very short term, a rapid decline in international reserves, commodity price, interest rate and political shocks. Surveillance coupled with a policy that ensures countries with good fundamentals have rapid and sufficient access to Fund and other resources when threatened by crises could replace the CCL[4]

. Other measures to reduce the foreign exchange risk of external borrowing should be developed. For example, portfolio diversification should allow markets and major lenders, including multilateral development banks, to lend to countries in their own currency.[5]

A code of conduct, as agreed by lenders and borrowers setting out mutual obligations, may also contribute to enhanced confidence and market stability. Among the unresolved problems to be dealt with by a G20 is the development of a cooperative approach for burden sharing by external creditors in the restructuring of unsustainable external bond debt.

Conclusion and recommendation

The policy stance of the IMF to financial crises needs to be revised and its resources enlarged. The Heads of State of the G20, considering international financial stability is a global public good, could bring about the necessary changes and as required, commit to provide additional financial support to members with sustainable policies,[6]

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[3] IMF, WEO estimates, September 2004

[4] Fund support would not avoid the need for adjustment but would provide time to effect it in an orderly manner and over a reasonable time.

[5] See paper by Randall Dodd "Up from Sin, A Portfolio Approach to Salvation" in the G24 web page: www.24.org/rpapers.htm

[6] In the technical judgment of the IMF

, should they face a liquidity crisis due to a speculative attack. To supplement Fund resources, the G20 could establish a network of readily available swaps or reciprocal credit lines. Similar support could be provided by the G20 to other emerging market countries whose policies are sustainable. In cases where the policies of a country that comes under a speculative attack were not sustainable, the country could receive prompt financial support in exchange for a credible commitment[7] to enter into an appropriate adjustment program with the IMF. A credible commitment of financial support from the G20 will prevent a loss of confidence leading to speculative attacks and financial crises; and more often than not, the resources provided under the credit lines would not have to be used.

[7] Usually requires a strong constituency for reform and political institutions for its implementation.