The Role of the Private Sector in Resolving Financial Crises in Emerging Markets[1]

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Introduction

Three years have passed since the outbreak of the East Asian financial crisis, and six since that of its Mexican precursor. Numerous official groupings and private analysts have sought to derive from these experiences appropriate lessons for international policy, including especially the manner in which private creditors can most fruitfully be involved in crisis resolution (G-10, 1996; G-22, 1998; IMF, 1999a; G-7, 1999; IIF, 1996, 1999a, 1999c; Council on Foreign Relations, 1999; Eichengreen, 1999; Meltzer Commission, 2000). Although there is considerable agreement on the central issues of crisis prevention, and although substantial improvement has occurred in this area (including in heightened data transparency and a shift from fixed to floating exchange rates by a number of key economies), more significant divergences persist regarding how to involve private creditors in the resolution of those crises that do occur.

The principal divisions on the latter issue are on the questions of whether official support on the relatively large scale of the key packages of the late 1990s is desirable (given evident success in the cases of Mexico, Korea, and Brazil) or undesirable (e.g. because of the risk of moral hazard); and whether the nature of private sector involvement should follow predetermined rules or should be determined on a case by case basis. On the latter question, some European officials have tended toward a rules basis while US officials have emphasized the need for case by case resolution of crises.

This paper will suggest that the approach most in keeping with an understanding of today's international capital markets is one that seeks to involve private creditors on as voluntary a basis as possible given the circumstances; and that within the classic principles of financial crisis management (Bagehot, 1873), temporary large official support can indeed be appropriate where the country is illiquid rather than insolvent and a prompt turnaround in private flows through adjustment and restoration of confidence is likely.

The first section reviews the differences between today's capital market and that of the 1980s, as a basis for inferring appropriate changes in crisis resolution strategy. Next the discussion considers what economic theory about sovereign lending would tend to counsel in the design of crisis resolution approaches. The paper then turns to actual

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experience in several of the recent country crisis cases. After evaluating one of the more prominent proposals for reform (inclusion of collective action clauses in bonds), and briefly considering the likely future composition of lending to emerging markets, the discussion concludes with a synthesis of policy implications.

The 1980s versus 1990s

It is sobering that each of the past two decades has witnessed a widespread crisis in external financing for emerging market economies. The Latin America debt crisis of the 1980s was the more severe, precipitating a "lost decade" of growth there and ending up in debt forgiveness of about 35 percent for bank claims on much of the region (Cline, 1995, p. 234). The spate of financial crises that began in 1995 with Mexico and was followed by East Asia in 1997-98, Russia in 1998 and Brazil in 1999, turns out to have been approximately comparable in scope even though not (generally) in severity. Thus, as shown in table 1, the fraction of external debt to private creditors involved reached about 60 percent of the emerging-markets total in both the 1980s and 1990s crises. The geographical pattern was sharply different, with concentration in Latin America in the 1980s but involvement of Asia and Russia in the 1990s.

The 1990s crises were more oriented toward collapses of currencies and domestic financial systems, and less centered on excessive burdens of external debt. A severe mismatch of large short-term external debt against reduced external reserves was a typical precipitating factor (especially in Mexico, Korea, and Thailand), rather than a high ratio of total external debt to exports and GDP as was more typical in Latin America in the 1980s. Underlying economic structures and policies tended to be better in the 1990s (with the advent of trade liberalization, privatization, and fiscal adjustment). Stronger underlying conditions and the shorter-term nature of the financial squeeze meant that it was possible for the key economies involved in the 1990s crisis to return to economic growth much faster than those in the 1980s crisis, and to do so on a basis of return to normalized capital market access without debt forgiveness (excluding the cases of Russia and Indonesia where political incoherence was far more severe).

One important difference between the 1980s and 1990s was the prevalence of capital controls in the former and capital mobility in the latter. This meant that when difficulties occurred in the 1980s, there was a tendency to go into arrears on official debt and to ration availability of foreign exchange for payment of external debt by private firms that otherwise were capable of servicing it. In contrast, under mobile capital regimes in the 1990s, the crises manifested themselves in plunging exchange rates rather than foreign exchange rationing, and in balance-sheet shocks to domestic banks and corporations exposed in foreign-currency denominated obligations. The presence of capital quantity rationing in the 1980s in contrast to price-clearing in the 1990s is one reason the latter crisis was shorter and much more front-loaded in its severity.[2]

[2] Thus, Korea's GDP fell 6.7 percent in 1998 but by 2000 is 13 percent above its 1997 level. In comparison, weighting by 1984-86 GDP, output fell only 1.6 percent in 1983 for Argentina, Brazil, and Mexico, but by 1986 was still only 10 percent above the 1982 base (IMF, 2000).

Table 1 shows a crucial difference between the capital markets in the 1980s and the late 1990s. For the emerging markets in aggregate, in 1984 external debt to banks was nine times as large as that owed to nonbank private creditors. In contrast, in 1996 the debt owed to banks was approximately equal to that owed to nonbanks, the latter primarily in the form of bonds. These estimates confirm the by now widely recognized transformation of the emerging markets debt composition from overwhelming dominance by international banks to approximate parity between bank and bond obligations.

Another key difference between the two decades is that for the banks, exposure to emerging markets was much larger relative to their total assets and capital in the 1980s than it is today. Thus, for US banks, exposure to emerging market economies fell from 12 percent of total assets in 1982 to 2.5 percent in early 2000 (Dallara, 2000). The sharp reduction in banks' vulnerability to emerging markets debt, combined with the decline in their share of total debt, has meant that increasingly such 1980s-style solutions such as "concerted lending" by banks have become outdated.

Finally, by the late 1990s the capital markets were much more heavily dominated by equity flows, especially direct investment, than in the 1980s, when bank lending was predominant. Thus, of total net foreign private capital flows to 29 major emerging market economies, direct equity accounted for 31 percent in 1993-96 but rose to 68 percent in 1997-2000 (IIF, 2000a,b). As a result, the impact of private creditor participation in crisis resolution has become at least as important through its confidence effect on direct investment flows as through its direct capital impact through lending. The same point applies to portfolio equity flows, although these have held more steady (15 percent of net foreign capital flows in the first period and 13 percent in the second). In contrast, both direct and portfolio capital flows to emerging markets in the period 1980-84 accounted for only 11 percent of the total in that period, with net flows from banks accounting for 74 percent and nonbank private credits, 15 percent.[3]

Other contrasts between the 1980s and 1990s are also important. There has been a shift in lending away from sovereign borrowers toward private corporate and bank borrowers. Within bank lending, there has been a shift toward shorter-term (typically trade-related) credits, in part because banks considered long-term lending to Latin America to be vulnerable to restructuring after the 1980s experience. Finally, the shift away from bank toward bond and other nonbank lending has been especially pronounced when evaluated in terms of flows rather than outstanding stocks (cumulative new net flows from banks to 29 major emerging market economies in 1997-2000 will have been a negative $61 billion, compared to a positive $204 billion from nonbank lenders). As discussed below, there are reasons to expect the role of banks to remain reduced in the future, even though their net lending is likely to turn positive again.

The overall implication that emerges from consideration of today's composition of capital markets is that involvement of bank lending alone will usually be too small in potential to resolve crises directly. Instead, the principal impact will have to be through the general improvement in confidence that any such involvement will have for a much

[3] IIF database.

broader array of capital flows, especially in the form of direct investment. This inference is consistent with the premise that market-oriented, voluntary resolutions are desirable, because it is such outcomes that are most likely to preserve a capital market atmosphere that is congenial to business as usual for direct investment, portfolio equity flows, and new bond issues.

Table 1

Scope of Debt and Financial Crises in the 1980s and 1990s
(Debt owed to private external creditors, $ billion)

	1984			1996		
	Bank	Other	Total	Bank	Other	Total
Latin America						
Argentina	32.7	8.1	40.8	a	a	a
Bolivia	1.1	0.1	1.2	a	a	a
Brazil	79.8	4.7	84.5	51.2	126.4	177.6
Chile	16	0.7	16.7	a	a	a
Ecuador	4.9	0.5	5.4	2.3	6.2	8.5
Mexico	81.2	5.7	86.9	30.1	79.4	109.5
Peru	4.5	1.1	5.6	a	a	a
Uruguay	2.9	1	3.9	a	a	a
Venezuela	31.8	3.2	35	a	a	a
Africa-Middle East						
Cote d'Ivoire	4.9	0.9	5.8	a	a	a
Morocco	3.5	0.1	3.6	a	a	a
Europe						
Poland	7.2	1.5	8.7	a	a	a
Russia	a	a	a	37.7	25	62.7
Asia/ Pacific						
Indonesia	a	a	a	55.9	25.2	81.1
Korea	a	a	a	127.8	28.8	156.6
Pakistan	a	a	a	4.4	5.8	10.2
Malaysia	a	a	a	19.8	13.9	33.7
Philippines	14.4	3.7	18.1	12.2	15.4	27.6
Thailand	a	a	a	68.8	13.5	82.3
Total	284.9	31.3	316.2	410.2	339.6	749.8
Percent of total for 37 major emerging market economies	65.7	41.5	62.1	57.4	54.4	56.0

a. Not directly involved in the period's crisis
Source: IIF (2000a; 1994)

Conceptual Framework[4]

Default pain as quasi-collateral

It is crucial that policies toward crisis resolution be framed with an understanding of the underlying theory of sovereign lending. A seminal contribution to this theory is Eaton and Gersovitz (1981). They ask why anyone would lend to a foreign sovereign. There is no physical collateral. The tradition of sovereign immunity is a further deterrent. Their analysis appeals to consumption smoothing as the motive for sovereign borrowing. Countries borrow abroad when times are bad (e.g. because of an export price collapse) and repay when they are good. On the side of lending supply, the principal assurance lenders have that they will be repaid is the sovereign borrower's knowledge that if it defaults it will be locked out of capital markets in the future and will no longer have recourse to the opportunity to borrow for consumption smoothing.

This theory means that any international arrangements that convey the impression that default is painless will tend to depress capital flows to emerging market economies. Essentially, a default-friendly international regime deprives international lenders of their quasi-collateral: heightened economic difficulty for the defaulter. The defaulting country may enjoy a one-time windfall gain of not having to repay its outstanding debt, but will face a dearth of willing lenders in the future. Perhaps more importantly, there will be a negative externality of the defaulting country's actions for other emerging market borrowers. If blessed by an international regime seen as facilitating the default, the country's actions will increase the perceived risk of lending to all emerging market borrowers.

In such a conceptual framework, it is easy to see how good intentions by international policymakers could turn counterproductive. There are grounds for judging that this has in fact happened during the course of 1999-2000. The seeming shift toward official international facilitation of default, most notably in the case of Ecuador, seems likely to bear some responsibility for the sluggishness of the return of capital flows to emerging markets three years after the onset of the East Asia crisis, and the persistence of high lending spreads to many emerging market economies. Thus, for 2000 the net flow of bank and non-bank (mainly bond) lending to 29 major emerging market economies is projected by the IIF at only $26 billion (IIF, 2000b). Although this is up from the trough of -$17 billion in 1999, it remains minimal compared to the average of $157 billion annually in 1995-97.

Similarly, whereas spreads (above US treasury obligations) on long-term Eurobonds for Argentina and Brazil averaged 360 basis points at the end of 1996, by early September 2000 they were still as high as an average of 680 basis points, albeit below their peak average of 1,240 basis points at end-August 1998 after the Russian

[4] Also see Cline (2000).

default. A spread of 700 basis points on 30-year paper implies a probability of default of two-thirds, if the recovery rate is 50 percent (Cline and Barnes, 1997, p. 40). This seems an exaggerated pessimism and is consistent with a capital market that remains poorly recovered from the crises of the late 1990s.

Moral hazard

On the other side, the principal conceptual argument that has been invoked in favor of "bailing in" private creditors and leaning toward ensuring they take default losses has been that otherwise the public sector would be creating a moral hazard that would induce excessive lending and risk-taking by creditors anticipating high returns in the good-case outcome and public bailout in the bad.

The large headline figures for the official support packages of the late 1990s ($50 billion for Mexico, $17 billion for Thailand, $34 billion for Indonesia, $57 billion for Korea, $16 billion for Russia, and $42 billion for Brazil; IIF, 1999a, p. 48) not surprisingly spurred critiques that such public support had created moral hazard (e.g. Meltzer Commission, 2000). It is certainly likely that even the meager lending flows that have returned would have been smaller, and the still high spreads would have been higher yet, in the absence of these packages and the strong turnarounds they permitted in most of these crises (with Russia and Indonesia the exceptions, primarily for political reasons).

The more fundamental point, however, is that public sector intervention that permits a large positive-sum-game outcome will often have some inevitable moral hazard side effect, just as the existence of automobile insurance and home theft insurance may at the margin make drivers a bit less cautious and homeowners a bit more willing to go on long trips. The central question is not whether there is moral hazard, but whether it is large and whether its costs exceed the social benefits provided by the intervention in question. There is no doubt that the impressive economic recoveries in Mexico, Korea, Brazil, and to a lesser extent Thailand would not have happened without the confidence supplied by the official support programs, so their social benefits appear to have been large.

As for moral hazard costs, in the large financial crises of the late 1990s private creditors and investors took large losses (for estimates, see IIF, 1999a, pp. 57-61), so they are hardly likely to have learned the lesson that emerging markets investments are risk-free because of official bailouts. Specific econometric tests reject the hypothesis that the first of the packages, for Mexico in 1995, induced excessive lending at low spreads.[5] After the broader set of support programs in the late 1990s, the evidence shows that lending flows remain small and spreads high, strongly suggesting that any moral hazard was too small to induce excessive new lending at unduly low interest rates. In short, the critique that public support in resolving the major financial crises of the late 1990s

[5] Zhang, 1999. The tests show instead that the large flows at low spreads by early 1997 were driven by global capital market conditions as proxied by spreads in the US high-yield corporate market. Removing this influence and that of country-specific economic debt and economic indicators, emerging markets spreads in the fourth-quarter of 1995 through the second of 1997 were not statistically significantly lower than before the Mexican support program.

involved moral hazard is true but trivial and misses the more relevant point that moral hazard costs were minor relative to recovery benefits.[6]

Burden sharing

A general notion that the private sector should bear its share of the "burden" of resolving financial crises has also driven policy discussions. Here the key is to recognize the intertemporal pattern likely in well-managed crises. At the height of the crisis there may be temporary public sector support even as private lending is low or even negative. Once forceful adjustment measures are taken and it becomes clear the country will not enter into protracted default, a strong renewed inflow of private flows can occur. Thus, in Korea, net private capital inflows (including equity) fell from $48 billion in 1996 to -$14 billion in 1997 and -$24 billion in 1998 but rebounded to $8 billion in 1999 and $24 billion in 2000. Net official flows were -$0.4 billion in 1996, jumped to $18 billion in 1997 and $12 billion in 1998, but dropped to -$9 billion in 1999 as Korea repaid IMF funding. So although a snapshot of capital flows at the height of the crisis in 1998 would give the impression that the public sector was bearing the burden and the private sector was escaping, this interpretation would miss the more fundamental point of the balance-wheel role of official intervention and the dynamic picture of a return to private flows once adjustment measures have been taken and confidence restored. A similar U-shaped pattern for private flows, complemented by an inverted-U for public flows, depicts the resolution of the Mexican crisis in 1995 and the Brazilian crisis in 1998-99 (Cline, 2000b).

It is also the case that for emerging markets as a whole, private capital flows have by far dominated the totals, casting further doubt on any broader impression that the "burden" of development finance is being borne by the public sector (even though the private flows are certainly not undertaken to shoulder any burden, but for profit). Even in 1997-98 at the height of the crises, net public capital flows to 29 major emerging market economies were less than one-fourth private flows (a two-year total of $97 billion versus $409 billion, respectively). By 1999-2000, the relationship was back to its far more lopsided dominance by private flows, with a total of only $8 billion in net official flows versus $330 billion in net private flows (IIF, 2000b).

The most narrow application of burden sharing is in the notion of "comparability" for private sector treatment in Paris Club rescheduling of bilateral claims. Although unexceptionable in principle, this concept has sometimes been applied in questionable ways. Apparent public sector support for default on Ecuador's Brady bonds – which had already forgiven private claims whereas bilateral claims had not been forgiven – is one example (although the Paris Club itself may not have formally requested Ecuador to default prior to the government's action). Paris Club relief for political purposes, as in the case of Poland in the early 1990s, is questionably appropriate for extension to the private sector, which does not enjoy the same political benefits as the industrial country

[6] It should be noted that the one country where moral hazard likely played a significant role in buoyant lending was that of Russia, where geopolitical importance was frequently assumed to ensure support if needed.

governments. Nor has the Paris Club typically accepted comparability when it could work in the opposite direction. A notable recent case is that of Russia, where private creditors gave substantial forgiveness in early 2000 but the Paris Club has resisted Russian government requests to grant comparable forgiveness.

The underlying point is that a rigid approach to burden sharing will be misguided when its effect is to damage the prospects of return to voluntary capital markets and thereby more likely harm than help the country in question over the medium-term.

Market-based collective action

An important concept for understanding the potential for private sector involvement in crisis resolution is that of private sector collective action on a voluntary or quasi-voluntary basis. Where a moderate number of relatively large financial institutions have short-term claims coming due, they may be able to carry out a joint action that is to their collective benefit by undertaking to maintain rather than run off their credit lines. This was the case in the Korean crisis (more formally through conversion of short-term to 1-3 year claims) and the Brazilian crisis (less formally through a pledge to maintain credit lines). The basic dynamic may be seen as a positive sum repeat game. Each institutional "player" knows the others, or most of them, and knows that its own adherence to the joint endeavor will affect the other players' future confidence in its reliability.

Voluntary club-based collective action is sharply different in effect from mandatory action imposed by the public sector, even though advocates of the latter also frequently cite the private creditors' own collective interest. It is noteworthy that neither in the Korean nor Brazilian cases was there legal prohibition by the government of payment rather than rollover (or conversion) of short-term claims, and in fact a number of smaller institutions did elect to withdraw. A critical mass of support from larger firms nonetheless was successful. If instead there had been a comprehensive official freeze on payments, the results would have been radically different, with the return to capital markets greatly delayed.

It is also important to recognize that the positive impact on confidence from a voluntary collective action such as maintenance of credit lines can be far greater than might be expected by the share of total debt directly comprised by the initiative in question. Thus, in the case of Korea, $22 billion in short-term bank claims were converted, compared with Korea's total external debt of $159 billion at the end of 1997. Similarly, short-term trade and interbank claims of banks in Brazil were only about $25 billion by March, 1999 when the banks entered into a voluntary arrangement to maintain credit lines (IIF, 1999b), compared with total external debt of $259 billion at end-1998. Yet in both cases the agreements to stem short-term outflows were crucial catalysts to the rapid rebuilding of confidence. In part this is because much of the rest of debt was at longer-term and could not immediately exit. The longer term nature of bonds, in particular, means that they are rarely the proximate cause of a sudden liquidity crisis. More fundamentally, however, the initiatives, done on a quasi-voluntary rather than

mandatory basis, sent a strong signal that key private sector players had confidence in the country's longer-term prospects. This signal helped restore confidence more broadly.

Lender of last resort and size of official support

Another key issue is whether the large official support programs of the late 1990s were appropriate. Here the most useful conceptual premise is Bagehot"s (1873) rule for a central bank: in a panic, lend in unlimited amounts to a solvent but illiquid bank; do not lend at all to an insolvent one. Cline (2000) proposes a "Bagehot curve" as guidance for public policy in crisis resolution. On the vertical axis is the amount that can be provided in official support; on the horizontal axis is the probability that the country's situation is one of insolvency (ranging from zero to unity). Near the y-axis (near-zero probability of insolvency) official support can be extremely large (for example, many times the usual IMF quota) under the Bagehot lender-of-last-resort principle. As the probability of insolvency rises, the appropriate amount of official support drops rapidly.

By this gauge, the large official support programs in a quasi-lender of last resort function were highly appropriate for Mexico, Korea, Thailand, and Brazil. They were arguably more doubtful for Russia and even Indonesia, although it warrants emphasis that neither IMF nor bilateral forgiveness has occurred even in these cases despite defaults on private claims (though in Indonesia defaults were only by private debtors). It should also be stressed that the country's underlying likelihood of assuring solvency, primarily by forceful policy action, should be the appropriate guide to whether relatively large official support is made available – not the criterion of systemic importance . The latter (for example, as proposed by Council of Foreign Relations, 1999, which argues that in nonsystemic cases the IMF should "just say no" to large packages) would discriminate against small countries. In short, there is no room for financial acrophobia in international financial policy for crisis resolution, even though policymakers need thick skins to withstand the public backlash that typically accompanies big-ticket headline numbers.

A related question regarding the size of official support is whether it should be limited to traditional magnitudes relative to IMF quotas. The answer would seem surely not, considering that these quotas were set at a time when trade imbalances were the primary determinant of financing needs rather than today's highly mobile capital flows. It became particularly evident in the case of Korea that the traditional IMF financing magnitudes of 1 to 3 times quota had become outdated, and the new Supplementary Reserve Facility created in late 1997 made it possible for the IMF to lend $21 billion to Korea, or more than 19 times Korea's quota. The SRF, with its much larger and front-loaded lending capacity with high and rising interest rates to encourage early repayment, is one of the most important concrete institutional changes to come out of the late 1990s financial crises. The likelihood of prompt repayment to the SRF (as occurred in the cases of Korea and Brazil), moreover, means that the international financial community is likely to have available the resources to make relatively large temporary financing available in a crisis (except perhaps in a scenario of massive contagion once again enveloping a number of the largest emerging market economies). Whether it will have

the corresponding political will is unclear, although this would seem more problematical for the mounting of bilateral components of any future crisis management efforts than for the use in the IMF of the SRF and, perhaps, Contingent Credit Line (CCL), which were designed specifically for this purpose.

Voluntary approaches to private sector involvement

In view of the conceptual framework outlined here, the fundamental principle of private sector involvement in crisis resolution is that it should be on as voluntary and market-oriented a basis as possible in view of the circumstances. This will maximize the chances of a prompt return to private market access and limitation of public support to a temporary balance-wheel role for restoring confidence. Publicly mandated approaches, such as involuntary standstills enforced by exchange controls, should be avoided whenever possible, because they undermine the underlying dynamic of sovereign lending by facilitating default, and not only delay return to market access but risk adverse spillover to private lending to other countries through heightened perceived risk.

Along the spectrum from voluntary to involuntary approaches, the cases of Mexico in 1995, Korea in 1997-98, and Brazil in 1998-99 are toward (or, for Mexico, at) the voluntary end; those for such countries as Ukraine and Pakistan toward the involuntary end; and the unilateral defaults of Russia and Ecuador at the involuntary end. The discussion that follows reviews in summary fashion the course of private sector involvement in crisis resolution in these and other cases. The experience to date tends to confirm that more voluntary approaches generate more favorable outcomes for the country itself, and arguably for the system as well.

Resolving Liquidity Crises: Mexico, Thailand, Korea, Brazil

This section reviews the role of the private sector in achieving crisis resolution in four major country episodes that together represent a class of cases that involved potential systemic stakes and achieved relatively successful outcomes on the basis of voluntary or quasi-voluntary private sector involvement. The discussion focuses primarily on how the private sector participated in each case. The treatment is chronological, because there was a learning-by-doing process at the international policy level, as well as a changing political environment for policy options.

Mexico

A large current account deficit (7 percent of GDP), two key political assassinations in an election year, adherence to a nearly-fixed exchange rate regime, heavy reliance on short-term obligations in the government debt structure, and considerable sterilization of capital outflows all played important roles in Mexico's end-1994 crisis. It is questionable whether more skilled management by the new economic team in December could have averted the collapse.

The US Treasury led an international program of official support amounting to $50 billion. The decision to do so undoubtedly reflected recognition that otherwise the encouraging revival of emerging capital markets after the prolonged debt crisis of the 1980s and its tentative resolution by the Brady Plan would be in serious jeopardy of collapse. The magnitude of the package reflected the dimensions of the key variables capital markets were focusing on at the time: some $30 billion due in short-term dollar-indexed government obligations (*tesobonos*) against reserves that had eroded to only about $6 billion.

Direct private sector involvement in initial resolution of the crisis is easy to describe in the Mexican case: there was none. US Treasury Secretary Robert Rubin often stated in response to later critiques of bailing out the private sector that if he could have found some way to make private creditors pay some price without hurting Mexico, he would have done so. However, the obligations in question were dispersed capital market holdings, so the 1980s tactic of calling a London Club meeting of banks to reschedule claims was irrelevant. Importantly, Mexican policymakers were loath to repeat the August 1982 measure of a unilateral suspension of principal payments. Mexico had simply paid too dearly in reestablishing its credit reputation in the intervening decade to make that an attractive option at end-1994.

Some private sector investors believed they had been penalized, because they had held Mexican equities and peso-denominated government paper (*Cetes*) only on government assurances that there would be no devaluation. Instead, the peso lost 35 percent of its value in December alone. Such private sector complaints did not take account of the rich interest rates that had been earned on peso obligations (14-15 percent annually in 1993-94 while the peso had remained virtually unchanged against the dollar).

The private sector did eventually participate in Mexico's crisis resolution, by renewing inflows of capital after the devaluation and once tight monetary policies began to take hold. Private flows swung from -$4.8 billion in 1995 to $13.6 billion in 1996, primarily in direct investment and to some extent bond flows. Mexico was thus the first 1990s case of successful balance-wheel official intervention that, along with forceful policy adjustment, revived confidence and a return of private capital.

Thailand

Thailand was the first case of the East Asian financial crises of 1997-98. The region's crisis was marked by greater incidence of short-term bank claims than in Mexico, where nonbank holdings of short-term government obligations were the proximate problem. The relatively greater involvement of banks in Asia reflected the fact that after the Latin American debt crisis, banks had shied away from that region but had increasingly considered lending to Asia relatively safe and promising in view of the region's image of sustained high growth. Thailand was the first country where the growing strains of rampant expansion became evident, including an increasingly overextended domestic financial system. Rapid domestic credit expansion and an

increasingly overvalued exchange rate (accompanied by a current account deficit of almost 8 percent of GDP) set the stage for a crisis.

By the second quarter of 1997 there was an increasing awareness that Thailand had undertaken forward currency commitments that made its effective reserves far lower than the reported totals. Facing increasing pressure on the baht, at the beginning of July the government allowed the currency to float, ending its 13-year peg to the dollar. Within the month the currency fell 22 percent, and it was destined to fall considerably further.

The crisis exposed the fragility of the domestic financial system. The greatest weakness was among some 90 finance companies, whose lending was concentrated in property, auto, and securities margin lending vulnerable to the sharp turnaround from rapid growth in the economy to recession. The central bank suspended operations of 16 finance companies in June 1997 and of another 40 in August.

Direct private sector involvement in crisis resolution in the case of Thailand centered in the restructuring of claims on these finance institutions. These claims amounted to some $4 billion, only about 6 percent of total foreign claims (IIF, 1999a, p. 65). The Thai government distinguished between financing companies, whose obligations were restructured, and commercial banks, for which the government guaranteed obligations. For claims on the 16 finance companies closed in June, amounting to about half of affected foreign claims, creditors were entitled only to proceeds from auctions of assets. For claims on the 40 finance companies subsequently closed, creditors were given 5-year obligations on the main state bank at 2 percent interest.

In effect, then, a relatively limited restructuring of only a small portion of foreign claims – those on the suspended finance companies – was the only direct involvement of the private sector in resolution of the Thai crisis. In the case of Thailand, moreover, there continued to be a running down of foreign bank claims during 1998 through 2000, primarily from conscious deleveraging on the demand side rather than further contraction on that of lending supply. These repayments were facilitated by a massive swing of the current account from a deficit of about 8 percent of GDP in 1996 to a surplus of almost 13 percent in 1998. [7]

Because the Thai case involved only surgical rescheduling, it stands toward the voluntary end of the spectrum of private sector involvement in crisis resolution. Although there is some support for a resulting reflow of voluntary capital in the fact that inflows of (mainly) direct and portfolio equity more than doubled from 1996 to a range of about $7 billion annually in 1997-99, the persistence of net debt repayments after the crisis leaves the case for renewed market access ambiguous so far.

[7] Net bank flows to Thailand fell from $13.4 billion in 1996 to -$6.9 billion in 1997, -$9.7 billion in 1998, and -$12.1 billion in 1999 (IIF database).

For its part, the international official support for Thailand was complicated by the political backlash to the earlier US official support for Mexico. The US Congress had passed legislation prohibiting use of the Treasury's Exchange Stabilization Fund for this purpose for a specified time period after the Mexican package, and this time limit had not yet expired by July, 1997. In any event there appears to have been some official sentiment that whereas Mexico was primarily the United States' problem, Thailand was primarily that of Japan. By August, an international support program had been assembled involving a total of $17 billion, with $3.9 billion from the IMF, $1 billion each from the World Bank and Asian Development Bank, $4 billion from Japan, and $6 billion from other governments. The support and economic adjustment program contributed to economic recovery by 1999, but only after a severe recession (10 percent decline in GDP) in 1998.

Korea

By the time of the September, 1997 IMF-World Bank meetings in Hong Kong, there was a nervous relief in international financial circles that Thailand's crisis was being managed with little damage to the international economy. There had been significant declines in regional exchange rates (by 20-25 percent from end-June to end-September for Indonesia, Malaysia, and the Philippines, though only 3 percent for Korea), but there was not yet a sense of severe regional crisis. Soon, however, the force of contagion was to prove far more virulent than anticipated, as the largest and most industrialized economy in the region was swept into the crisis.

Korea had already experienced signs of difficulty in the spring of 1997 as problems from excess capacity and high corporate debt began to surface. Some large corporate bankruptcies had begun to reveal the exposure of the banking system. Korea's earlier entry into the OECD, along with some financial sector liberalization, had contributed to a sharp run-up in borrowing from foreign banks. Short-term debt, in particular, had soared (from $39 billion at end-1993 to $97 billion at end-1996; IIF, 1999a, p. 89).

The incipient regional crisis brought an intensified focus of attention on Korea and other major borrowers in the region. Through most of 1997 foreign lenders took comfort from the broad notion that the government was capable of rendering support if needed, especially to the Korean banking system. By the fourth quarter the uncertainty associated with the presidential election contributed to more pressure on the capital account. The most severe blow, however, came in early December, when it was revealed that the central bank had already committed the bulk of its reserves to foreign branches of Korean banks. With usable official reserves below $10 billion and short-term external debt in the range of $100 billion, there was an acute market realization that even if the Korean government wanted to support external obligations of domestic banks or corporations, it might not have the resources to do so. In the final days of December there was thus an incipient financial melt-down even though the president-elect had committed to undertaking a far-reaching IMF adjustment program (involving structural changes such as deleveraging by the highly-indebted *chaebol* conglomerates).

Even under a stringent definition, Korea qualifies as potentially system-threatening. Given the experience with international official support for Mexico, as well as that for Thailand, it is not surprising that international official support was thus soon mobilized for Korea (and by this time the restrictions on the US Exchange Stabilization Fund had expired). The magnitude had to be large to be convincing, especially because financial markets were highly focused on the large gap between short-term external debt and usable reserves. A package of $57 billion in official support was thus assembled, with $21 billion from the IMF, $14 billion from other multilateral sources, and $22 billion in "second-line of defense" funds available from US and other bilateral sources. Notably, the IMF opened a new lending window (the Supplementary Reserve Fund) to permit such large lending relative to Korea's small IMF quota, and incorporated sizable and rising interest rates to provide a strong incentive for prompt repayment.

Announcement of the program by mid-December did not suffice to stem capital market pressures, however, perhaps in part because only $14 billion was to be available immediately. Reported reserves fell from $31 billion at end-October to $21 billion by end-December, and usable reserves were much lower at some $6 billion. The government was no longer able to hold its daily limit to the decline in the currency, and the won lost 31 percent of its value from end-November to end-December after having already lost a cumulative 22 percent during October and November.

It was in this crisis environment that US policymakers and their G7 counterparts adopted a significant shift in the crisis management strategy of the late 1990s. They approached the major international banks and conveyed the message that it was essential to halt the rapid runoff in short-term bank claims, or otherwise the whole program would be in jeopardy.[8] By early January the banks had agreed to hold short-term credit lines for a period of three months, and discussions began on the conversion of these claims into longer-term obligations. The announcement of the short-term rollover initiative, combined with a surge in the monthly trade balance from near zero in October-November to a surplus of $2 billion in December, broke the momentum of the crisis, and as some measure of calm returned the exchange rate partially reversed its sharp descent to appreciate by 12 percent from end-December to end-January 1998.

By March the exchange of short-term claims was in place. Some $22 billion in short-term international bank claims on Korean banks was exchanged into one- to three-year bonds guaranteed by the government and bearing interest rate spreads of 225 to 275 basis points, considerably higher than the original terms but below market rates at the time of the crisis. In effect, this coordinated conversion of short-term claims came the closest of any crisis management episode in the late 1990s to the London Club reschedulings of bank claims on Latin America in the 1980s. This outcome was in part possible because much of Korea's external debt was to banks. At end-1996, 78 percent of external debt was owed to banks, and only 17 percent to bondholders and other

[8] It is not clear, however, that officials told banks there would be no more official support without a bank package, and indeed the official package had already been constructed. Such conditioning was much more explicit in the Latin American reschedulings with IMF support in the 1980s.

nonbank private creditors (IIF, 2000a), making Korea somewhat of a throwback to earlier debt profiles in comparison with many other emerging market economies by the late 1990s.

The conversion deal was de jure voluntary, as there was no legal restriction against running down rather than converting credit lines, and no control limiting foreign exchange availability to repay short-term loans. Some smaller banks did indeed run down lines rather than convert them. The Korean negotiating position was viewed by the banks as tough, although the government guarantee was an enhancement and by 1999 the interest spreads on the conversion bonds again looked attractive. Overall, the outcome was relatively balanced and, if not fully voluntary, at least quasi-voluntary.

Brazil

In 1994 Brazil ended decades of increasingly high inflation by adopting a successful stabilization program built around the anchor of a fixed exchange rate, the real. Underpinned by privatization, high real interest rates, and some fiscal adjustment, the Real Plan succeeded in halting inflation but left Brazil by 1998 with an arguably overvalued exchange rate and a relatively large current account deficit (4.3 percent of GDP in a large economy with a relatively modest export base). The strategy counted heavily on increased productivity to validate the exchange rate. Whether this would have worked in normal times is unclear, but in a context of global contagion from East Asia and then from the Russian crisis in August 1998, the strategy proved infeasible. From end-June to end-September reserves had fallen from $71 billion to $46 billion, and by January the exchange rate had collapsed despite the mounting of a large official support program.

Like Korea, Brazil was clearly one of the emerging market economies large enough to have a systemic impact. As market pressures mounted on Brazil following the Russia shock, and once the presidential election was safely won, the Cardoso government finally turned to the IMF for support in October. Once again the international official community assembled a "show of force" package of $42 billion, comprising $18 billion from the IMF, $9 billion from other multilateral sources, and $15 billion from the bilateral sources. The G-7 intervention to support Brazil was widely viewed as drawing a "line in the sand" to halt global contagion at the borders of a country too important to lose.

The IMF-supported adjustment package was centered on fiscal adjustment, and notably did not break the existing exchange rate anchor. Although the subsequent collapse of the real no doubt contributed to evolution in G-7 policy against large interventions to support fixed exchange rates, it is easy to understand the rationale for the program at the time. Brazil's past experience had shown a large inflationary response to depreciation of the exchange rate, and there were reasonable grounds for fearing that floating the real would be an invitation to inflationary destabilization. It is just conceivable that the program might have worked, but the proximate cause of its demise

was a domestic political unraveling in December when a renegade state governor threatened to default on state debt.

After a brief attempt to devalue modestly and convert to a crawling peg in early January, the government was forced to float the currency, and by end-January it stood 40 percent below its end-December level. It is a remarkable indicator of the subsequent success of the Brazilian adjustment program that 20 months later the real is almost 15 percent stronger than at its trough at end-February 1999. Currency overshooting was curbed by tight monetary policy and fiscal adjustment, rather than being allowed to explode into a spiral of domestic inflation and further depreciation as many had forecast at the time. Moreover, in part because Brazil's domestic banking system was relatively strong (Brazilians insist with justification that they experienced a *currency* crisis, not a *financial* crisis), Brazil's economy did not plunge into deep recession like those in the East Asian crises, though it experienced a second year in a row of near-zero growth before rebounding to growth of about 4 percent in 2000 as real interest rates fell sharply.

The story of private sector involvement in resolving Brazil's crisis is highly illuminating on the delicate balance of confidence and psychology that permeates capital market relationships. Perhaps the most remarkable aspect of this story is that Brazilian authorities from the start were extremely reluctant to become involved in any arrangement that had the appearance of a 1980s-type rescheduling or concerted lending operation. Like Mexico, Brazil had simply paid too dearly during the 1980s to rebuild its credit reputation and reenter capital markets to be willing to throw away the credibility it had built up by suddenly putting the squeeze on creditors.

A luncheon for senior representatives of major banks in New York in November, 1998, illustrates the point. At this event, organized by Citigroup's William Rhodes, a key figure in the restructuring programs of the 1980s and early 1990s and in Korea's 1998 loan conversion program, Brazilian Finance Minister Pedro Malan and IMF Deputy Managing Director Stanley Fischer set forth the new Brazilian program. At the end of the presentation, most participants expressed willingness of their institutions to hold credit lines. But there was no explicit request by the Brazilian authorities for them to do so in an organized fashion.

By late January and through February and early March, nonetheless, Brazil was in acute currency crisis. Many analysts were convinced that Brazil's public debt was spiraling out of control. Continued payments pressures had pushed currency overshooting even further (with the end-February rate about 5 percent below that at end-January). The time had come when a crucial boost to confidence was needed in the form of a more organized response. In March, in conjunction with a revised IMF program and in an environment in which a congress shocked by the currency collapse had finally moved to take important fiscal measures, the international banks agreed to a voluntary arrangement providing for the maintenance of trade and interbank credit lines, amounting to some $25 billion.

There was some ambiguity in the extent of the arrangement, which some announcements specified as holding through July but some individual bank participants instead emphasized was strictly contingent on Brazil's meeting its policy obligations. Nonetheless, there was a strong boost to confidence from the signal that the international banks would hold lines, and the currency began to regain some of its losses. Brazilian authorities coordinated with the IMF in maintaining updated data on exposure of international banks, information that was communicated to national banking authorities, but it would appear that this process at most played an informational role giving some measure of assurance to banks in various countries that their counterparts in other countries were continuing to honor the initiative, rather than serving as a vehicle for heavy-handed enforcement by the official sector.[9] Once again there was no legal restriction against banks' running down their credit lines, nor any corresponding exchange controls. Once again, some of the smaller banks exited.

By April 1999 Brazil had begun a surprisingly prompt response to capital markets. Several large Brazilian firms had reentered the international bond market, and by end-April the government had issued a sovereign Eurobond for $2 billion (at a spread of 675 basis points). Consider a counter-factual in which instead Brazil, the IMF, and the G-7 had all decided in October of 1998 that Brazil should ask its bondholders and bank creditors to reschedule their claims, along the lines of 1980s debt reschedulings but this time embracing some rescheduling of bonds, or an exchange operation for them. It is almost inconceivable that if Brazil had chosen this course, it would have been back to the market by April of 1999. Brazil is perhaps the clearest case for the superiority of voluntary arrangements for private sector involvement in crisis resolution over dirigiste alternatives. Brazil's authorities were right to be highly reluctant all along to be seen as seeking any type of a coercive rescheduling.

Debt Workouts in More Severe Cases

Mexico, Korea, Brazil, and to a lesser extent Thailand serve as the classic cases for successful adjustment and restoration of confidence and market access, made possible by large official intervention, forceful domestic policy corrections, and (in Korea and Brazil) some arrangement for voluntary or quasi-voluntary private sector participation. Some other conspicuous cases have been less successful, largely because they were further along to the right along the horizontal axis (insolvency probability) of the Bagehot curve. In some underlying sense the proper way to organize private sector "involvement" is less interesting in such cases, as from the private creditor's viewpoint this is broadly a question of "choosing one's poison." Most of these cases involve some form of rescheduling or exchange of instruments, and these involve a discontinuous breach of a key threshold in terms of credit reputation rather than slightly more intense versions of the voluntary arrangements. Even so, there is interest in identifying what types of approaches may be less unfavorable than others. The common thread among the workout cases is a more profound domestic political incoherence than in the illiquidity cases

[9] Such information sharing has the property of overcoming the key obstacle to collective action in the "prisoner's dilemma" negative-sum game, the fact that each prisoner questioned in isolation does not know whether his accomplice has confessed.

discussed above, even though political strains played important roles in those crises as well.

Indonesia

Although Indonesia had many financial and macroeconomic distortions of its own, its financial crisis was sparked by contagion, as the country was forced to let the exchange rate fall 14 percent in August 1997 one month after Thailand devalued. The crisis was slower to develop, but ultimately much more profound than those of regional neighbors. Within a year the currency had lost 85 percent of its value. Although a modicum of stability had been restored by then, political disarray and recurrent bouts of currency instability have continued since. As an example of the salience of political factors, an exodus of capital of ethnic Chinese families and businesses as the Suharto era came to a close was a major source of pressure. Similarly, regional separatist strife, intense factionialism, and doubts about whether Suharto-related interests will cede power peacefully, have hindered restoration of confidence.

A key feature of Indonesia's external debt was that the bulk of debt to private creditors was owed by the domestic private sector: banks and corporations.[10] This meant that when domestic firms faced extreme losses, as they did with the shocks from sharp currency devaluation and to some extent high interest rates, the question was not so much whether the Indonesian government would orchestrate a special arrangement (even though it did) but whether foreign creditors could effectively realize what was left of their claims by pursuing domestic bankruptcy procedures. It soon became evident that lax bankruptcy laws and, especially, enforcement, meant that the latter course was not effective.

In October, 1997 the government abandoned its long-time policy of avoiding IMF support and entered into an agreement providing a total of about $34 billion, of which $10 billion was from the IMF, $8 billion from the World Bank and ADB, $5 billion from Japan and Singapore, and $3 billion from the United States. By early 1998 the government was widely seen as not delivering on its policy adjustment commitments, however, and instability intensified through May when Suharto resigned. The policy slippage meant that by mid-1998 only about $4 billion in official disbursements had actually occurred (IIF, 1999a, p. 54). In 1998 GDP fell by 13 percent.

Private sector involvement in resolving the crisis was unlikely on a voluntary basis under these circumstances. One key government decision was whether to guarantee domestic bank debt, including to foreign creditors. After severe capital flight following closure of 16 banks in November, 1997 with minimal guarantee of depositors and creditors (a decision urged by the IMF, apparently in its concern to avoid moral hazard seen to have occurred in Thailand), the government was forced to guarantee the rest of bank obligations.

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[10] At end-1997 the government owed $60 billion in external debt, but this was almost all to official sources ($19 billion multilateral, $41 billion bilateral). In contrast, domestic corporations $66 billion, and banks, $17 billion (IIF database).

Still, the bulk of private foreign claims was on corporations. Here, the government made the key decision that it would not socialize the debt (unlike the partial socialization of similar private obligations in Mexico in the early 1980s under FICORCA). Instead, it set up an umbrella organization for private debt workouts (Jakarta Initiative and INDRA) offering only a minimal mechanism for hedging exchange risk on repayments. Although in principle this detached posture was unexceptionable and was consistent with minimizing moral hazard, when applied in a socio-juridical context of minimal capacity for creditor bankruptcy recovery, and following a government-sponsored temporary pause in debt servicing in early 1998, the result in practice was widespread default and prolonged arrears. Even so, about half of foreign claims on domestic corporations were on subsidiaries of multinational firms, and this half has largely been serviced. Of the other half, owed by Indonesian firms, the great bulk still remains in default, despite frameworks providing for mediation and some tax and other incentives for restructuring. The weakness of bankruptcy mechanisms, and hence lack of debtor incentive to reach agreement, has been the basic reason.

With the eventual help of substantial foreign assistance, reduced political uncertainty after presidential elections in the third quarter of 1999, and higher oil prices, the Indonesian economy managed to halt the plunge of output by 1999 and returned to modest growth in 2000 (but with output still far below 1997 levels). The environment of lingering defaults means, however, that rather than returning quickly to normal capital market access, Indonesia has continued to face negative net flows of bank and nonbank lending (IIF, 2000b).

Russia

Russia's crisis in August 1998 was much more the consequence of protracted failure to address structural economic distortions than a sudden liquidity crisis precipitated by external contagion. A succession of IMF programs of economic adjustment and reform starting in 1992 had failed to address the core problems of chronic fiscal weakness, large capital flight, weak property rights, and dominant influence of interest groups ("oligarchs"). Foreign investors had nonetheless pursued the high returns in ruble treasury bills (GKOs) and a surging stock market through mid-1997, in part because of the belief that G7 governments could not afford politically to let Russia fail. Increasingly these returns, and especially IMF programs premised on continued private foreign financing of large fiscal deficits, had "Ponzi scheme" characteristics of unsustainability. Thus, by mid-1998 treasury bills were yielding over 60 percent even though the official exchange rate crawl was minimal.

Pressure on Russia began to mount in the fourth quarter of 1997 as some contagion from East Asia did contribute to a decline in equity and government bond prices, and by the first half of 1998, a drop in oil prices aggravated prospects. It became increasingly doubtful that the government would be able to roll over its short-term external debt, which was more than twice as large as external reserves. In July a new IMF agreement was reached, providing for $17 billion in support, but even the first

tranche was curtailed because the Duma had failed to pass key fiscal reforms. Some in private markets also doubted the seriousness of the program, in part because it delayed fiscal adjustment until the following year and was premised on continuation of private capital inflows. As capital market pressures continued Russian authorities sought additional support, but G7 authorities were unprepared to do more because of the absence of a sufficient Russian political consensus for reform. In mid-August the government devalued the ruble, unilaterally restructured its domestic (GKO) debt, suspended payments (and soon defaulted) on former Soviet debt (which had already been rescheduled in 1997), and froze payments on private sector external debt and forward exchange contracts.

The workout that followed was lengthy and often acrimonious. The government seemed to give preferential treatment to domestic holders of GKOs, for example by allowing domestic banks to use them as collateral against new loans from the central bank. By mid-1999 negotiations had developed within a "London Club" framework, with the commercial bank structure from the past somewhat extended to include investment banks. Such financial institutions as asset managers and mutual funds, which held a sizable amount of the obligations, were not at the negotiating table.

Russia reached agreement with the London Club by early 2000, in a context of increased political cohesion with the replacement of Mr. Yeltsin by Mr. Putin, and on the strength of the sharp upswing in world oil prices and hence Russia's fiscal prospects. The present value of former Soviet debt was cut by about 30 percent (but upgraded to government debt instead of obligations by Sberbank). Critics of the process pointed to the lengthy negotiations that had been required. However, the negotiation process did require that the Russian authorities formally take into account the views of the creditors, or at least some of them. In contrast, the "unilateral exchange offers" in other recent cases (Ukraine, Ecuador) did not do so.

By the third quarter of 2000, Russia's economy had shown surprising strength, with GDP likely to grow 6 percent or more for the year. Spurred by import substitution, growth the previous year had reached 3 percent growth, following the economy's 5 percent decline in 1998. Russia also managed to avoid the hyperinflation some had feared in the event of devaluation and default, as a consequence of severe wage compression, a freeze in utility prices, tight economic policy, and the fact that a collapse of domestic banks contributed to curbing the money supply. The economy's recovery in 2000 was closely linked to that of oil prices, however. Large capital flight has continued (at rates of $20-25 billion annually in 1998-2000), and net private capital inflows – which reached a peak of $37 billion in 1997 – collapsed to near zero by 1999 and less than $2 billion (mainly direct investment) in 2000. Although more fundamental factors such as insufficient enterprise restructuring would have constrained Russia's economic performance in any event, tougher conditions on earlier international support to prompt faster reform and – especially – a more cooperative approach to external debt restructuring might have left Russia in a much stronger economic position, and one much less dependent on strong oil prices.

There is little doubt that Russia's default in August 1998 marked a negative watershed for emerging markets more generally. For the first time in the decade, a major emerging market economy defaulted and sought sovereign debt forgiveness, rather than merely entering a period of illiquidity and taking forceful adjustment measures to restore confidence. The spillover is evident in lending spreads. Thus, the JP Morgan EMBI+ index of spreads on Latin American bonds, which stood at about 500 basis points in mid-1998, surged to 1500 basis points in August 1998 with Russia's crisis, and did not fall below 1000 basis points until November 1999 (IIF database).

As for lessons from Russia for private sector involvement, the main one was that even geopolitical salience was no assurance against collapse. Any lessons about the optimal approach to post-default workout are at best ambiguous. A more fundamental lesson is that the most certain way to assure private sector involvement in crisis resolution – unilateral default – is also the worst way to do so, if the country seeks early reentry to capital markets.

Ecuador

Ecuador's persistent political problems were not unlike those of Indonesia and Russia. One president was ousted by the legislature in 1997 on grounds of "mental incapacity;" another was deposed in a brief military coup in early 1999. There have been sharp political divisions among interior ("altiplano"), coastal, and indigenous-group interests. In the past two years, there have been four different finance ministers.

Spillover from Russia in late 1998 compounded Ecuador's economic difficulties that year from El Nino weather damage as well as low commodity prices. A growing fiscal deficit and legislative resistance to fiscal correction added to the adverse investment climate. As external credit dried up, the currency depreciated sharply, external reserves fell about two-thirds from mid-1998 to early 1999, and interest rates reached 80 percent and more (compared to inflation that reached about 40 percent). With increasing problems in the banking sector, by March 1999 the government froze bank deposits.

It was in this environment of economic unraveling that the International Monetary Fund appears to have chosen to make Ecuador a guinea pig[11] for a more aggressive approach to "bailing in" private creditors. There had been escalating political pressure within industrial countries to stop "bailing out" private creditors, and the public sector appears to have been tempted to try out new approaches on smaller countries where the systemic consequences would be limited if the outcome proved adverse.

Arguably, Ecuador might have been able to avoid default on Brady and Eurobonds. Out of $1.7 billion in principal due on public sector external debt over 2000-2001, only $38 million was payable on Brady bonds and none on Eurobonds (Ecuador, 2000, p. 83). Of the $1.5 billion due in interest, $606 million was payable on Brady bonds and $110 million on Eurobonds. So these two sources of private claims comprised

[11] This is the term one of the more senior members of the Board of Directors of the IMF used in private discussions more than a year later.

only 23 percent of public external debt service due over this period. In contrast, principal and interest payments to the IMF and other multilaterals accounted for 54 percent, while those owed to governments represented 16 percent. Debt service to commercial banks and on suppliers' credits comprised the remaining 7 percent.

Public debt service due on Brady and Eurobonds in 2000-01 amounted to only about 6 percent of prospective earnings on exports of goods and services, and a forceful adjustment program coupled with IMF support and Paris Club relief might have sufficed to turn around private investor confidence. However, by the second quarter of 1999, Ecuadoran authorities appear to have been under the impression that IMF and Paris Club support would only be forthcoming under circumstances in which Brady and Eurobond payments were also restructured.[12] In terms of what is on the public record, in effect the IMF blessed the concept by approving in principle a September, 1999 stand-by agreement with Ecuador that was premised on the cash-flow outlook that included the restructuring of these instruments.

The notion of restructuring Brady bonds seemed curious at the time. It involved questions of equity, considering that holders had already forgiven 40 percent of their original claims when Ecuador reached a Brady deal with foreign banks in 1995. It also raised questions of public sector memory, considering that the instrument itself had been designed to resolve the 1980s debt problem through a promise of exchanging a new secure instrument for earlier bank claims, trading off part of the claim in return for the reduced risk.[13] The official sector decision to sanction Ecuador's default and restructuring of Bradies represented, consciously or otherwise, a decision to exterminate this type of instrument as a credible option for use in future crises.

At the end of August 1999 Ecuador did default on part of its Brady debt, and a prompt move by holders to "accelerate" quickly derailed the hope that this debt could for a time be serviced out of its rolling interest collateral, with the effect of escalating the default to all types of Brady debt as well as Eurobond debt. In part because Ecuador's economic policies were in disarray and the IMF program was delayed, far from enjoying a respite the country experienced an intensifying economic crisis. By March, 2000 the new finance minister had declared the decision to default a "catastrophic error."[14]

The impact on emerging markets more broadly was modest at worst, although the default did appear to widen the spread between Brady bond spreads and those on other obligations. In broad terms, the capital markets treated Ecuador as a quarantined case rather than a harbinger for such countries as Brazil and Argentina. Nonetheless, the episode has left a sour taste among many in the private sector that has curbed the appetite for lending to countries where there could be "international financial institution risk"

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[12] Based on numerous discussions, including one with a ministerial-level Ecuadoran official.

[13] Brady bonds typically forgave 35-40 percent of original claims, in exchange for a 30-year bullet principal guarantee using US Treasury zero-coupon bonds as collateral, along with collateral against 12 to 18 months interest due. The collateral has typically been in escrow with the New York Federal Reserve Bank.

[14] Reuters: Market News Service, 28 March 2000.

because of potential Paris Club pressure for "comparability" or IMF pressure for private rescheduling where multilateral claims bulk large.[15]

The particular workout modality eventually chosen by Ecuador, once it had made the decision to default, was the unilateral exchange offer. In this approach, the country and its investment banking advisors informally take soundings of major holders of the bonds in question to arrive at an "offer" they consider has a good chance of being accepted by a critical mass of, say, 85 percent or more. This "exchange of instrum circumvents the array of difficulties likely to be involved in an attempt to enter into negotiations with bondholders on rescheduling the obligations due under the existing instruments.

In Ecuador's case, the exchange offer was designed "to provide participants with a significant pick-up in market value over the current trading prices of their Existing Bonds" (Ecuador, 2000, p. 3).[16] It involved a 40 percent cut in the face value of Brady bonds, but with a significant offset of a partial immediate cash payment. Thus, $3.9 billion in new bonds (mostly 30-year), plus cash payments of about $1 billion (of which about one-third was of arrears), were exchanged for $6.6 billion in (mainly) Brady and Eurobonds.

Although the exchange offer was well received, as some 97 percent of holders accepted (well above the 85 percent threshold sought by the government), questions remain about this modality. Some substantial institutional holders of the bonds were not consulted in the preparation of the exchange offer. Like other exchange offers, it was essentially "preemptive" in nature, with only two weeks allowed for bondholders to respond to the offer. In such circumstances there is a "take it or leave it" dynamic that tends to make the high incidence of acceptance somewhat misleading as an indication of creditor attitude.

By the time of the exchange, Ecuador had made a somewhat more promising start on its program of dollarization than might have been expected, and a new IMF program had been adopted (in April). Including other multilateral lending, the support program amounted to $2 billion over three years, or 14 percent of one year's GDP. High oil prices have also helped the economy. However, unless the country's internal political environment shifts toward greater coherence, making possible more sustained fiscal adjustment and progress on banking sector and other structural reforms, Ecuador could face renewed difficulties despite the debt restructuring and official support. For their part, private creditors would seem unlikely to return to the country soon, having been burned twice.

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[15] Referring to the recent "bail-in risk," a representative of a major asset management company stated to the 2000 Annual Membership Meeting of the Institute of International Finance that his institution was no longer willing to undertake exposure in countries where IMF and Paris Club claims are relatively large, and observed that the heightened risk from official bail-in pressure had done major damage to second-tier emerging market economies.

[16] In the event, market prices of Ecuador's Brady bonds rose on average by about 20 percent following announcement of the offer.

Pakistan, Romania, Ukraine

Three other recent cases warrant review as instances in which the public sector has pressed governments to restructure obligations to private creditors, or otherwise to press them to participate in crisis resolution.

In early 1999 the Paris Club told *Pakistan* that its comparability of treatment principle would require that Pakistan restructure its sovereign bonds in order to obtain rescheduling of bilateral debt. These included a total of about $600 million in notes due in 1999 through 2000. At the time there was concern that this prospective first instance of Eurobond rescheduling would cast a severe pall on the international bond market. As it turned out, Ecuador's default preceded Pakistan's exchange offer. Although both probably had some adverse effect on international bond markets, the effect was at most modest.

In November, 1999, Pakistan offered to exchange its bonds for others to mature in 2002-2005, bearing 10 percent interest. More than 95 percent of holders accepted the exchange offer by the closing date in late December. One reason for the favorable response is likely to have been that the exchange did not seek forgiveness.

Pakistan's use of the exchange offer modality was informative, because its bonds were under UK law and so could have been rescheduled with consent of a qualified (high) majority of holders. In contrast, bonds under US law typically require unanimous consent. As discussed below, the issue of requiring qualified majority rescheduling clauses in bonds has been one of the more prominent in the debate on involving the private sector; yet it seems to have been irrelevant in actual practice in the Pakistan case.

Romania managed with great effort (exchange rate depreciation and fiscal tightening that induced resident capital reflows) to pay off some $700 million in Eurobonds due in the second quarter of 1999. However, the IMF program re-started in July of that year had as a condition that the country mobilize $450 million in new private sector inflows. This was not in the context of Paris Club comparability, because Paris Club debt was small and there was no rescheduling in prospect. Instead, the condition reflected the intensifying pressure at the time for inducing private sector "burden-sharing."

After release of an initial tranche of about $80 million, the IMF program was suspended in September because Romania only managed to arrange about $100 million in a one-year club loan from 14 banks, far below the target, and also over disagreement on the 2000 budget. However, by June 2000 the IMF agreement was renewed, with the IMF citing "the large reduction in the current account deficit, the sharp correction in the fiscal deficit" as grounds for the reinstatement of the $535 million stand-by program. At the same time, the government paid off the club loan of June 1999, and announced it would also pay off another club loan of $64 million dating from December 1999.[17] Repayment without announcement of other new initiatives for private support signaled

[17] Reuters: Rompres 6-13-00; Rompres 6-27-00.

that the new IMF agreement was no longer conditioned on a burden-sharing target for private sector involvement. This may have represented a straw in the wind indicating that the IMF considered its series of small-country experiments in this direction during the preceding year as less than successful.

In early 2000 in the face of a severe external payments problem reflecting in part persistent fiscal imbalance, *Ukraine* suspended payments on its external debt except that owed to multilateral institutions, and announced its intention to restructure debt to private and bilateral creditors. In early February the government announced an exchange offer to convert $2.8 billion in bonds falling due in 2000-01 into new bonds with 7 years' maturity, 2 years' grace, and bearing 10-11 percent interest. The offer gave holders until mid-April to respond. The response was favorable and met the 85 percent threshold.

Workout lessons

The first feature that stands out in the list of workout cases just reviewed is that, in contrast to the four success cases examined in the previous section, underlying economic strength and creditworthiness was generally far weaker. This amounts to an informal empirical verification of the Bagehot curve notion relating intervention policy to *illiquidity versus insolvency*: large, temporary official lending works to restore confidence when underlying creditworthiness is strong and the problem is a transitory shock; the opposite outcome of forced rescheduling is likely to be unavoidable where underlying creditworthiness is weak.

Table 2 provides evidence that supports the intuitive sense that the list of debt reschedulers and bond exchangers is populated by weaker economies than the list of countries that achieved a quick turnaround without major rescheduling. The table reports the country risk rating of the economy in question in the most recent semi-annual compilation of the magazine *Institutional Investor* prior to the financial crisis in question. Running from zero to 100 (and with the United States rated typically at about 93), these ratings are based on a weighted survey of approximately 100 banks, asset management companies, and economists.

As expected, the average rating for the four success cases of major international support stands considerably higher, at 53.7, than that for the six workout cases,[18] at 29.8. The only anomaly is the case of Indonesia, where the relatively high rating probably represents the fact that many of the *Institutional Investor* survey respondents were referring to sovereign rather than general country risk; and Indonesia has not defaulted on its sovereign debt.

A crucial lesson from this dichotomy between two classes of country crises is that policymakers should not conflate workout-type solutions with market-resilient countries. Remedies officials consider appropriate for an Ecuador would likely be inappropriate for

[18] Romania is not technically a workout case as it did not reschedule or exchange, but it is classed with the workout group here because it too was subject to an international official attempt at enforcement of private sector burden sharing.

a Brazil, because Ecuador's problem was much closer to insolvency while Brazil's was closer to illiquidity.

Table 2
Institutional Investor Country Risk Rating

Country	Date	Rating	Global average
Mexico	Sept. 94	46.1	37.5
Thailand	Mar. 97	61.1	40.1
Korea	Sept. 97	69.7	41.0
Brazil	Sept. 98	38.0	41.1
average		53.7	n.a.
Indonesia	Mar. 97	51.6	40.1
Russia	Mar. 98	31.2	41.2
Ecuador	Mar. 99	25.5	40.1
Pakistan	Mar. 99	20.4	40.1
Romania	Mar. 99	31.2	40.1
Ukraine	Sept. 99	18.7	41.5
average		29.8	n.a.

Source: *Institutional Investor*, various issues.

Among the workout experiences, an important pattern that seems to be emerging is the debtor preference for the "*unilateral exchange offer*" over rescheduling of the existing instrument, at least where the debt is primarily in bonds. Pakistan, Ecuador, and Ukraine exchanged new instruments for outstanding bonds. Russia used the alternative approach of a London Club negotiation, but much of its debt in question was to banks.

The remarkable speed with which the unilateral exchange offers have been completed shows that there is a major historical difference between dealing with bond defaults today and in the last major episode – the 1930s. Electronic communication today means it is easy to obtain prompt replies from thousands of bondholders, whereas lengthy delays were a problem in the 1930s.

A potentially serious problem with the unilateral exchange offer, however, is that so far it does not seem to have been implemented in a manner that provided for widespread consultation with major holders. To some extent the risks associated with the lack of consultation have been mitigated by making the offer more attractive than terms consistent with the going secondary market price. However, lack of consultation would seem to increase the eventual risk of lawsuits. It is too early to tell whether legal challenges will prove to be a drawback of the unilateral exchange offers.

One aspect of the rapid acceptance of the exchange offers has perhaps been that much of the debt in question had already been sold off to vulture funds and other

speculative investors. For them, any increase in the terms from the secondary market price equivalent might have been viewed as attractive. In terms of policy, however, it would be inappropriate to give much emphasis to this consideration as a basis for judging exchange offers (especially those involving forgiveness) as favorable outcomes. Essentially, the fulfillment of the obligation should be judged against its original value, not against the level to which it has fallen under distress.

Another pattern seems to be that the *quarantine effect* has dominated the contagion effect of small-country bond restructuring on the international capital market. There had been legitimate concern by mid-1999 that the official sector's seeming insistence on bond rescheduling in Pakistan and Ecuador would cause severe adverse spillover to the bond market generally for emerging market economies, because as a class bonds had not yet entered into significant restructurings. This de facto exempt status had reflected the small portion of debt owed in bonds in the Latin American debt crisis of the 1980s, and hence the practice in that episode of rescheduling bank claims but not bonds. As it turned out, the Ecuadorian default and Pakistan's exchange did not cause a sudden and severe fallout for emerging market bonds globally. However, as suggested above, the persistence of relatively high bond spreads suggests that the official sector pressure that contributed to the spread of restructuring to bonds may have slowed the pace of recovery in emerging capital markets.

The seeming *ease of bond exchanges* also contradicts the great concern in much of the debate on crisis resolution about the need for changes in official practice and even legal structure to deal with what had been perceived as severe obstacles to bond rescheduling, including such mechanisms as collective action clauses in bonds and "stay of litigation" powers for the International Monetary Fund. These issues are addressed briefly below.

Rules, case-by-case determination, and principles

One of the central issues in international policy on private sector involvement in crisis resolution has been the debate on whether there should be clearly codified rules about how the private sector should participate, and what the public sector will be prepared to do, or whether each episode should be handled on a case by case basis. Broadly, the Canadians and Europeans have tended to favor a rules-based approach, and US authorities, the case-by-case approach.

The search for rules of crisis resolution seems primarily to reflect the political backlash against what appeared to be large public support programs that bailed out private creditors. The type of rules that some in the official sector seem to have in mind are of the following sort: IMF and official support should not exceed normal magnitudes of, say, two- or three-times IMF quota; private creditors should reschedule if the Paris Club reschedules; private creditors should somehow contribute new money, or at least not be receiving net repayments, when public lending is taking place; and so forth.

There is an inherent problem in spelling out rules for private and public sector involvement in crisis resolution, which is essentially the problem of "time inconsistency." The crux of the problem is that rigidly preannounced policies may adversely distort future behavior, even if those particular policies might be appropriate to apply in an actual contemporaneous event. In central banking, for example, authorities are loath to spell out in a pre-codified set of rules that they will (or will not) support banks that are "too big to fail." If they specifically say they will do so, the result will be a marginal distortion toward ever larger and fewer banks. If they specifically say they will not do so, they encounter a problem of credibility loss when and if they in practice do so. Thus, it is difficult to imagine an effective set of rules written in advance that would have authorized the Federal Reserve Bank of New York to press large institutions to support Long Term Capital Management in 1998 lest its collapse severely destabilize markets.

In short, rules will tend to be unduly constraining or send potentially perverse signals affecting future behavior. In contrast, debt crisis resolution has traditionally been handled on a case by case basis. This was the watchword of debt strategy in the 1980s, even if de facto a great majority of the case outcomes wound up looking very much like each other. Case-by-case meant nothing guaranteed, but nothing excluded. Its framework allows for the "constructive ambiguity" that is helpful in central banking intervention.

A rules-oriented strategy could also undermine the Eaton-Gersovitz conditions for sovereign lending. If the rules book turned out to look like a relatively accomodating official framework for sovereign default, the consequences might be a few rounds of relatively comfortable defaults followed by a long stretch of minimal capital flows to emerging markets.

The appropriate resolution of this policy debate would seem to lie in recognition that: a) the case-by-case approach is inescapable; b) it should nonetheless be applied within a broad framework of principles; and c) efforts to spell out "rules" applying these principles are likely to be subject to the time inconsistency problem and should be avoided.

The principles for private-public sector involvement in crisis resolution, in turn, would seem to include the following broad precepts. First, private sector participation should be on as voluntary and market-oriented a basis as possible given the circumstances. Second, optimal public sector involvement may sometimes involve much larger, temporary support than traditionally envisioned in IMF programs, and can appropriately be extended at higher lending prices (as in the IMF's new Supplementary Reserve Facility). Third, a judgment of the country's position along a continuum between a pure liquidity problem, on the one hand, and a fundamental insolvency problem, on the other, should be the main determinant of whether large temporary official support is offered or whether instead primary reliance is placed on restructuring private sector claims. Fourth, no one type of private claims (such as bonds) should automatically enjoy exempt or senior status, although such factors as whether the claims have already been restructured (e.g. Brady bonds) or whether their disruption would

undermine economic activity (e.g. trade credits) should be taken into account in designing an equitable and effective restructuring package. Fifth, private creditors bear responsibility for their own risks and do not expect the public sector to make good their losses. But sixth, the public sector should act forcefully when it is in a position to orchestrate a positive-sum outcome that benefits the economies in question and helps minimize creditor losses (and maximize chances of return to voluntary capital markets) at no or minimal expected cost to taxpayers. Seventh, where debt restructuring is unavoidable, the sovereign obligor should consult fully with the creditors.

Other principles can no doubt be added. In evaluating either principles or more detailed rules, it is important to go through the counterfactual exercise of seeing whether the global economy (and that of the country in question) would have been well served if the proposed approaches had been enforced in each of the major crisis episodes of the recent years. It would be counterproductive to adopt for the future rules that would have made things worse in the past, because similar episodes could once again confront policymakers and they would then be forced to choose between disregarding the rules and causing suboptimal outcomes.

Further considerations

This paper has outlined the evolving structure of emerging capital markets, set forth the conceptual framework for policy toward involvement of the private sector in crisis resolution, reviewed the major crisis episodes of the late 1990s as well as the spate of more recent small-country workouts, and considered patterns as well as implications for the debate on rules versus case-by-case approaches. A handful of specific issues warrant further comment to complement this review.

Future evolution of lending structure

There are increasing signs that the shift in emerging markets lending from banks toward bonds will continue. It is telling that even if the crisis economies are excluded (five East Asian economies, Russia, and Brazil), net bank lending to the other emerging market economies plunged from about $30 billion annually in 1996-97 to close to zero in 1998-2000 (Cline, 2000a). In contrast, net bond and other nonbank lending to the non-crisis economies held up well, at an average of about $35 billion annually in 1998-2000 compared to about $43 billion in 1996-97. Similarly, the most recent forecasts of the Institute of International Finance (IIF, 2000b) place non-bank flows to major emerging market economies still ahead of net bank flows in 2001 (at $36 billion versus $16 billion, respectively), even though the rebound of the latter will finally turn them positive after three years of negative net flows.

There are two structural reasons why this shift may continue. First, increasingly the large international banks appear to be concluding that shareholder value is better served by concentrating on fee-based income of an investment-bank nature (e.g. helping launch and sell securities) than by traditional balance-sheet lending. Although not

limited to emerging markets, this phenomenon contributes to the shift away from bank claims toward bonds in these markets. Second, the inherently high leverage of banks (whose tier-1 equity capital is only 4 percent of risk-weighted assets under the existing Basel rules) makes them potentially more subject to retrenchment in sectors where risk is perceived to have increased than is the case for less-leveraged investors. The interaction of the escalation of perceived risk in emerging markets lending with the degree of leverage may help explain why bank lending to the non-crisis emerging market economies fell off much more than did nonbank (mainly bond) lending in recent years. As the heightened perception of emerging markets risk seems unlikely to disappear soon, the leverage consideration could continue to constrain bank lending to these markets.

Despite this likely evolution, banks could continue to play a key role in helping resolve short-term liquidity crises through initiatives to maintain credit lines, as in the Korean and Brazilian cases. The share of banks in short-term debt (including trade credit) is likely to remain considerably higher than their share in longer-term debt, and as noted the longer-term repayments owed to bondholders do not tend to be the proximate problem in short-term liquidity crises. Continued evolution toward bonds would, however, increase their role in resolution of more intransigent crises where longer-term restructuring is necessary.

Bond clauses, stay of litigation

This in turn raises the by now familiar issue of whether public policy should require the inclusion of "collective action" or rescheduling clauses in bonds, to facilitate their restructuring if needed. Some (e.g. Portes, 2000) have emphasized that this is the key reform needed in emerging markets lending.

Recent experience seems to suggest, however, that the traditional arguments for this reform may no longer be compelling. Prompt communication to numerous, dispersed holders has effectively been carried out in the bond exchanges, suggesting that technology has superseded some of the informational and organizational problems of the past in bond restructuring. The exchange offers have also not been held up by rogue bondholders, and the approach of providing a new instrument in exchange for the existing bond appears so far to have successfully circumvented the difficult challenges that would have to be overcome in formal rescheduling discussions even where a qualified majority rather than unanimity is required.

There thus would seem to remain considerable weight on the main reason to avoid mandatory bond rescheduling clauses: their inclusion could convey the impression that the international financial community would lean toward facilitating default. This would tend to undermine the Eaton-Gersovitz dynamic of default pain as quasi-collateral, and hence curb flows of new bond lending and increase spreads.[19] Instead, the flexibility provided by qualified majority bond rescheduling clauses could be obtained by

[19] See Cline (2000b) for an interpretation of the results of Eichengreen and Mody (2000) that concludes their empirical tests on US- versus UK-issued bonds should not alter this view.

sovereigns on a voluntary basis by the inclusion of such clauses at their own choice if desired, probably initially at a spreads premium.[20]

For the same conceptual reason, incorporation into the IMF's Articles the authority to impose a "stay of litigation", as suggested by former IMF Managing Director Michel Camdessus, would tend to undermine emerging capital markets. This innovation too would send a signal that default could be facilitated by the official sector. The same problem is inherent in most proposals to create some type of international agency to provide at the international level bankruptcy workouts analogous to those present domestically. Such proposals typically fail to recognize the fundamental difference between bankruptcy recovery potential where there is tangible collateral and where there is not.

Contingent lending arrangements

One of the instruments that at first looked promising as a mechanism for involving the private sector in crisis resolution has made little progress in the past three years: contingent lending arrangements. Under such arrangements, the country pays a commitment fee for assured access to credit up to an agreed amount in the event that the country wishes to draw on the credit. Mexico and Argentina have been the most conspicuous cases of such arrangements, but Mexico drew down its line of credit in September 1998 (to considerable acrimony from bank creditors who felt that by then the terms were too generous; for a discussion see IIF, 1999a, pp. 35-36) and has not replaced it.

The underlying calculus of contingency financing would seem compellingly advantageous for a country that could thereby reduce the probability of a financial crisis, simply because small changes in that probability would be operating on a large economic base (GDP). It may nonetheless be difficult politically to enter into contingency financing arrangements in which creditors insist on particularly high spreads if the line is drawn upon. Perhaps a more fundamental reason why contingent credit lines have not thrived is that many countries have shifted from fixed to floating exchange rates, and have run off the high short-term debt that was more typical prior to the crises of the late 1990s. An economy with a floating exchange rate and low short-term debt is less likely to need, or benefit from, additional liquidity from contingent credit lines. Correspondingly, it may be no accident that the principal such arrangement currently remains that of Argentina, which not only has a contingent line of about $7 billion with about a dozen banks, but also has a rigidly fixed exchange rate under its currency board.[21]

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[20] The call to G7 countries to include rescheduling clauses in their own sovereign bonds as a means of removing any special stigma to emerging market governments doing so seems highly unrealistic, and would be especially troublesome for such countries as Japan where public debt has escalated sharply relative to GDP.

[21] For its part the official sector Contingent Credit Lines facility created in 1999 for pre-qualifying countries vwith strong policies has remained dormant. The central problem seems to be that even after qualifying and signing up for the facility, a country might subsequently not be able to receive funds from it because at the time of request its policies would be judged to have deteriorated; or, worse, the country might be disqualified from the facility, prompting heightened market concerns upon notice of the

Conclusion

It has been said that farmers should know the difference between shearing their sheep and slaughtering them. Involving the private sector in crisis resolution is the art of knowing this type of difference. Too heavy a hand by the official sector to force private sector involvement can transit quickly into a once-for-all zero sum transfer from the creditor to the debtor followed by a persistent cutoff in future credit. The opposite extreme of complete laissez faire toward private creditors coupled with major official support invites public criticism that the official sector is bailing out private creditors.

Given the salient role of mobile capital in modern capital markets, it is crucial for authorities to distinguish between cases of transitory illiquidity and those of more protracted insolvency. In the former, the Bagehot principle of lending in large volume if necessary to stem a panic should be applied. It is encouraging that the International Monetary Fund now has the Supplementary Reserve Facility designed to do just this. In such cases of illiquidity, it may be necessary to enlist private creditor participation through such mechanisms as the arrangement of the international banks to maintain short-term credit lines in the second quarter of 1999 during Brazil's crisis. In general, the more voluntary and market-oriented this or other participation of private creditors, the better the chances for prompt reentry of the country into international capital markets. Where more severe debt problems make rescheduling or restructuring inescapable, more flexible arrangements such as exchange offers are likely to be preferable to mandatory reschedulings.

The cases of Mexico, Korea, Brazil, and to a lesser extent Thailand show that decisive international official support combined with policy adjustment and relatively voluntary mechanisms for private sector involvement can restore confidence and market access. In a series of smaller country defaults in 1999, however, the public sector seemed to be veering more toward mandatory approaches that could increasingly impose perceived "international financial institution risk" in these markets. Similarly, increasing calls for clear rules of action run the risk of failing to recognize the inherent need for creative ambiguity in official intervention, a lesson well known under central banking principles.

Although the emerging capital markets have managed to begin a recovery from the sharp retrenchment of 1998-99, it will be essential that public policy move in a sophisticated manner on the issue of private sector involvement in crisis resolution if these markets are to strengthen and provide the capital so crucial to global economic growth in the future.

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disqualification. It is unclear that changes adopted in the facility in September, 2000 (making the degree of monitoring less intensive than under other IMF facilities and providing more automatic access in the event of a crisis) will suffice to attract entrants, as the risk of disqualification remains.

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