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Managing Director's Statement on Private Sector Involvement in the Prevention and Resolution of Financial Crises
Executive Board Meeting 00/89
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1. International capital markets have become by far the most important channel for transferring savings to finance growth and investment in the developing world. These markets offer the prospect of promoting a more rapid rise of living standards in developing countries. But such financing can also be the source of destructive volatility. Recognizing this, I believe the Fund and its members must work together more actively with financial market participants, so as to ensure that markets can deliver their potential most effectively, and to make crises less frequent and less severe.

2. Our work to ensure that the private sector is fully involved in preventing and resolving crises is thus one, but only one, part of a much more general effort to ensure the smooth functioning of markets and their ability to absorb shocks. This latter objective should occupy a central place among the Fund's objectives. Much of the work on the architecture of the international financial system is devoted to this. Crisis prevention must be the key objective. It goes hand in hand with work to ensure that the markets make their investment decisions on a better informed basis and in a way that will promote the stability of the debtor.

3. To contribute to better informed capital markets, the Fund has been working on several initiatives.

- The development of codes in the area of the Fund's core competence, and the promotion of the observance of codes in other areas through ROSCs should lead to better practices in member countries.

- Increased transparency in the Fund's work with its member countries provides a new source of reliable information and commentary to market participants.

- My initiative to create a Capital Market Consultative Group (CMCG), which holds its first meeting next week in London, should improve the two-way communication between the Fund and the markets.

- The promotion of a more active dialogue between debtor countries and their private market creditors should contribute to better informed investment decisions.

4. Other actions are directed more explicitly at crisis prevention.

- Surveillance under Article IV now pays greater attention to assessing the vulnerability of members to financial market difficulties and crises, and this is supplemented by the increased emphasis given to financial sector surveillance, particularly through the FSAP/FSSA process.

- The Fund has, and will continue to be, actively encourage members to put in place mechanisms that could be helpful, both in limiting crises but also in better managing those crises that still occur: these include assured private sector contingent lines of credit, collective action clauses in sovereign bond contracts, and efficient and predictable bankruptcy regimes.

- Lessons concerning the need for fixed and relatively inflexible exchange rate regimes to be buttressed by an appropriate balance of monetary and fiscal policies so as to make emerging markets less prone to crises.

- We are working to ensure that capital accounts liberalization takes place only in appropriate sequence with measures to strengthen domestic financial systems so as to limit the emergence of vulnerability to financial crises.

5. Greater clarity about crisis management should reinforce our work to reduce the incidence of crises, as well as reduce their virulence. There is large measure of agreement on the main principles that should guide the international community in the handling of a crisis. I shall list them here.

- Any effort to resolve crises must be based upon the full commitment by the member concerned to address the fundamental causes.

- Official resources available to finance a country through a crisis are limited.

- Responsibility for negotiation with creditors lies squarely with debt countries.

- Properly functioning capital markets require that creditors bear the risks they take.

- Action taken in a crisis should not undermine the obligation of debtors to pay their debts in full and on time.

- The expectation of official financing should not, to the extent possible, be such as to create the moral hazard that could destabilize the system.

- No one category of private sector debt should be inherently preferred in resolving a crisis.

- Much more dialogue and greater transparency between creditor groups is needed to facilitate comprehensive and equitable solutions to crises.

- Crisis handling techniques should lay the basis for a country to return to appropriate capital market financing in the future.

- Solutions to the crisis of one country should seek to minimize the adverse effects on the access of other countries to international capital markets.

- The Fund has a central role in facilitating orderly crisis resolution.

6. Not only do we have broad agreement on the main principles that should guide our handling of a crisis, we also have a large measure of agreement on the broad operational framework that we will apply. Nevertheless, we cannot now foresee exactly how future crises will unfold. Countries differ widely in the form and extent of their involvement in international capital markets, in their integration with other countries, in their domestic economic and financial structures, and in the circumstances under which their debt was incurred—all of which are material factors in a crisis. The principles I have listed can conflict with one another, and judgment must be used in resolving such conflicts. And then there are hard analytical issues to be faced before such judgments can be made. While these principles and the associated framework go a long way to specifying the "rules of the game" that market participants have called for, we need to retain operational flexibility to react to the response of the private markets in the context of specific crisis situations.

7. The framework lays down the approach that will be taken to ensure that private market creditors are effectively involved in the resolution of financial crises. It builds on the experience gained in handling financial crises and on the extensive discussion of the issue inside the Fund and in other fora.

- If a member's financing requirements are moderate, private sector involvement should be ensured primarily through the Fund's traditional catalytic approach, or in other words, the strength of the member's program and its financial endorsement by the official community should be such as to ensure that market confidence is restored and exposure maintained.

- If the immediate need for Fund and other financing is large, the Fund would still rely primarily on the catalytic approach for continued private sector involvement, provided that the member has good prospects for rapidly regaining market access on appropriate terms. There will need to be strong justification of this approach, however, in cases of exceptional access to Fund resources.

- If the member has a large need for financing but its prospects for regaining market access in the near future on appropriate terms are poor, private sector involvement will probably have to be ensured through more concerted techniques as part of the international community's response. This applies even more clearly to a member with an unsustainable debt burden.

8. As I mentioned, there are difficult issues of judgment to be made in applying this framework. The size of the financing needs and the member's prospects for rapidly regaining

capital market access are two sides of the same coin, and require a judgment concerning the markets' reaction to a member's policies and the official community's support. Similarly, the assessment of the member's medium-term prospects in the midst of a crisis also requires much judgment, particularly as the prospects themselves may depend on how and how rapidly the immediate crisis is resolved. More work needs to be done on the analytic underpinnings of such judgments.

9. In those cases where the catalytic approach is likely to be ineffective in ensuring private sector involvement, more concerted techniques will have to be used. The precise techniques will depend on the structure of the balance of payments pressures facing the member, and should be designed and implemented in cooperation with creditors to the extent possible. In recent cases, techniques have ranged from voluntary agreements with international banks to maintain exposure levels, in some cases buttressed by moral suasion from supervisory authorities, to the restructuring of debt instruments. These actions often involve some form of standstill on contractual debt payments, either with the explicit agreement of the creditors involved or without it. Given the need to move quickly in support of a member's program of adjustment, an action that will tend to preserve value for creditors, the Fund may have to act before agreement is reached with creditors and while the member is in default on some obligations under negotiation. In such cases, the Fund will be prepared to lend into arrears. It is expected that debtors and creditors will reach agreement on the handling of obligations through negotiations with each other, and within the broad envelope agreed between the member and the Fund.

10. We have made much progress in putting in place a more robust system for the Fund to play its central role in arranging the response to crises. We have a broad measure of agreement on a framework for handling cases that goes some way to answering the markets' call for more predictability in the response of the official community. For its part, the private sector has come to recognize that it will be required to make a financial contribution in crisis resolution. Experience with handling several recent cases has shown that market participants have recognized their interest in the maintenance of liquidity support, and that, when necessary, bonds can be effectively restructured. This is a major advance in our strategy to better balance the roles of the official and private sectors in times of crisis. To complement the framework for handling crises, the Fund is restructuring instruments of financial support for its members.