BUFF/00/42

March 27, 2000

Summing Up by the Acting Chairman
Involving the Private Sector in Resolving Financial Crises—
Experience and Principles
Executive Board Meeting 00/31
March 22, 2000

Executive Directors continued from their earlier discussions on involving the private sector in the resolution of financial crises and in assisting member countries to return to balance of payments viability. They reviewed the Fund's recent experience with countries for which private sector involvement had been an issue, and discussed a proposed framework which, building on this experience, could help guide decisions on issues associated with private sector involvement. They considered that the staff paper made a useful contribution in clarifying the issues involved.

Prevention

Directors reiterated that prevention remains the first line of defense against financial crises. Recent experience confirms that consistent macroeconomic and exchange rate policies, debt management, and prudential supervision of financial systems are all critical elements of a policy framework designed to manage vulnerabilities and thereby reduce the frequency and mitigate the severity of crises. At the same time, policies designed to improve the environment for private sector decision-making can also be expected to contribute to reducing buildups of vulnerability. Improvements in the transparency of both the public and private sectors, as well as efforts to promote the adoption of and adherence to standards, should facilitate risk management on the part of investors. Directors also noted the importance attached by private market participants to regular contacts between the authorities and market participants, as a means of ensuring regular provision of information on economic developments and policies, and maintaining lines of communication both in good times and when possible difficulties in the member's economic situation begin to emerge.

Recent Experience

Directors noted that two recent cases of efforts to secure private sector involvement through the restructuring of international sovereign bonds had been encouraging. In these cases, debt exchanges had been arranged successfully, and disruptive litigation had not been a problem. They noted that while it is premature to assess whether litigation might ultimately become an issue, it appears that in recent cases the risks were not as great as previously thought. Directors stressed that successful debt exchanges involved the recognition by creditors of the limited debt-servicing capacity of the debtors involved, and of the unpalatability of alternative outcomes. Directors also noted that the precise form of the recent debt restructurings depended on the structure of the payments falling due as well as the

particular country circumstances, and did not necessarily involve comparable treatment of all debt or maturities.

Involving the Private Sector in Crisis Resolution

Directors reviewed the experience to date in a number of cases of crisis resolution which had involved the private sector. They saw merit in continuing to work toward an operational framework for securing private sector involvement, building on the principles and framework articulated by the G-7 Finance Ministers in their report to the Köln Economic Summit, which would be a first step in responding to the request made by the Interim Committee in September 1999.

Directors noted that flexibility would be required in handling individual cases; the form of continued private sector involvement would depend on the case, as would the methods used to ensure it. Directors agreed that the financing of the adjustment program of a member coping with a financial crisis would normally be based on the expectation that private sector exposure to the country would either be maintained above some level, or begin to be rebuilt soon after the emergence of a crisis. In some cases, reliance would be placed primarily on the Fund's traditional catalytic role, with the strength of the Fund-supported adjustment program enhancing market confidence and therefore expected to lead to the restoration of spontaneous private capital inflows. In cases where greater assurance was needed, the catalytic role of the Fund would have to be supplemented by measures to improve coordination among creditors.

Directors noted that assessing the appropriate means of securing private sector involvement in individual cases raises complex issues, and will require considerable judgment. Directors considered that a range of issues would have a bearing on the approach to private sector involvement in individual cases, including the size of the financing requirements, both during the program period and over the medium term; the prospects for a spontaneous return to capital market access; the availability of tools for securing appropriate private sector involvement; and the desirability of minimizing possible spillover effects on other countries. Directors recognized that reaching these judgments would require addressing complicated analytical issues.

Directors agreed that the basic principles underlying the Fund's approach toward private sector involvement should be to allow the Fund to support effective balance of payments adjustment programs leading to sustained growth and medium-term viability, while providing adequate safeguards to maintain the revolving character of Fund resources. These principles, in turn, require that programs with member countries be fully financed. In addition, it is important that the availability of official financing, insofar as possible, not create moral hazard by providing incentives for inappropriate lending or borrowing. Directors stressed that, in making operational a framework for private sector involvement:

- contracts should be honored to the extent possible;
- members should seek cooperative solutions to emerging debt difficulties;

- no one category of private creditor should be regarded as inherently privileged relative to others; and

- the approach taken in individual cases should reflect a member's specific circumstances, including the composition of outstanding debt instruments, and should be based on a substantive analysis of the member's medium-term balance of payments prospects and debt sustainability.

Directors considered that the framework of propositions suggested by the staff for private sector involvement, in conjunction with the principles listed in the preceding paragraph, constituted a useful start, but pointed to several problems in making it operational, including the difficulty of the underlying analytical judgments. Under the proposed framework, private sector involvement would be ensured primarily through reliance on the Fund's traditional catalytic role:

- if the member's financing requirements are moderate, or

- if the financing requirements are large, but the member has good prospects of rapidly regaining market access on appropriate terms.

More concerted forms of private sector involvement would be required:

- if the financing requirement is large and the member has poor prospects of regaining market access in the near future, or

- if the member has a debt burden that appears unsustainable in the medium term.

Directors called upon the staff to continue work on the analytic underpinnings and operational issues involved in making the framework operational.

The Fund's approach toward a given case requires a decision on how much financing the official sector is willing to make available in support of a strong adjustment program. Most Directors noted that the availability of Fund financing beyond that provided through the regular access policy was quite limited, and that while the Supplemental Reserve Facility is available under specified circumstances, care should be taken to avoid creating the impression that the Fund, or the official sector as a whole, would fill all financing gaps. At the same time, the difficulty of determining ex ante the precise distribution between official and private sector financing was noted. Some Directors considered that there should be the presumption that private sector involvement will be secured, should the Fund's financing in relation to the member's quota exceed some limit. Other Directors, however, considered that the size of the financing requirement was only one factor in deciding on concerted involvement and placed more stress on the need for a strong program that would ensure the rapid restoration of market confidence and limit the risk to official resources.

In cases in which reliance is placed primarily on the Fund's catalytic role, Directors noted that if the assumptions about the return to market access prove to be wrong, possibly because the Fund's catalytic role was slow to bring desired results, the risks to the program's

financing and the Fund's resources would grow, unless there was a switch to more concerted forms of private sector involvement. To justify the strategy of relying on the Fund's catalytic role, it is crucial that the authorities' program be directed toward rebuilding market confidence, and the removal of any factors that inhibit the right sort of capital inflows, and that the authorities be fully committed to its sustained implementation. Some Directors considered that a reduction of official financing might be needed in certain cases to ensure an appropriate balance in the contribution of the private and the official sectors.

Directors also agreed that when a member had an unsustainable debt burden, private sector involvement in a broad restructuring or reduction of that burden would be required. They recognized, however, that the determination of whether a debt burden was unsustainable was inevitably a judgmental exercise, and it could take time for the member and its creditors to reach agreement on the extent of the problem and its solution. In such cases, the Fund would be prepared to lend into arrears to private creditors under its established policy, in support of a strong adjustment program and provided the member was negotiating with its creditors in good faith.

Where private sector involvement was required, Directors agreed that its precise form would have to be decided on a case-by-case basis. Some Directors considered that the approach to be taken in individual cases should seek to avoid prohibitive increases in the future cost of financing for the country concerned. Directors took note of the staff's views that, in general, efforts would be concentrated on the debt payments associated with the immediate financing problem, and would thus not necessarily be comprehensive across all classes of private instruments. However, experience suggested that comprehensiveness within an asset class can often contribute to a successful outcome. Directors also considered it particularly important that no one category of private creditor be regarded as inherently privileged.

Directors recognized that only limited progress had been made in lifting institutional constraints to debt restructuring. They encouraged the establishment of creditor committees as needed and on an ad hoc basis. Directors also saw merit in incorporating collective action clauses in international sovereign bond contracts. They welcomed efforts on the part of the United Kingdom in this regard and the recent clarification of the legal status of such clauses by the German government. Directors considered that temporary and voluntary market-based standstill arrangements could be desirable in some circumstances to minimize the risk of disruptive litigation. Some Directors considered that the staff should continue to explore issues related to a modification of Article VIII, Section 2(b).

Directors confirmed that there is a role for the Fund staff in informing creditors of the status of negotiations with the Fund and the member's economic situation, including its adjustment program and payments capacity, provided that that was acceptable to the member concerned. Nevertheless, it was important to maintain the principle that the Fund is not a party to the negotiations between a member and its creditors.