Mr Grenville looks at the international reform agenda and focuses on bailing-in the private sector

Talk by Mr Stephen Grenville, Deputy Governor of the Reserve Bank of Australia, to the World Economic Forum 1999 East Asia Economic Summit, held in Singapore on 20 October 1999.

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I would like to leaf with you through the photo album of a baby, whose name is euro. He is now nine. In the two years since the Asian crisis broke, there has been quite a bit of rethinking. As time went on, there was a growing acceptance that - whatever the mistakes and deficiencies of domestic policy - the problem was wider in scope: something was wrong with the international financial framework. If the crisis could be distilled down to two principal elements, it was the deadly interaction of huge and volatile international capital flows with fragile domestic financial sectors.

It would be nice to say that the international community has now worked out what needs to be done, and are on the way to doing it. In practice, there is a greater consensus about what needs to be done, but a fair shortfall in actually implementing it.

What are the specific achievements?

- With the Financial Stability Forum and the G20, there are the makings of a more representative set of forums, more appropriate than the G10-type groups for discussions of this type. If all countries are to be subject to the "Golden Straitjacket" - the rules imposed by the international marketplace - then the process of setting those rules should be more democratic.
- The early emphasis was on *transparency*. A higher degree of transparency has been achieved in the *official* sector. This is a distortion of the original concept, which was that markets would work better if there was greater transparency *all round*, i.e. including from major private sector players. But, by-and-large, progress has been made.
- Until the near-death experience of LTCM in August 1998, there had not been any widespread acknowledgement of the role of hedge funds in exacerbating the problems. As LTCM pulled back from the brink, the urgency to address the question of hedge funds faded somewhat, but it looks like there will be some progress, at least in learning what hedge funds do.
- And when it comes to the reform of domestic policies, there is now a wide measure of agreement that very considerable resources need to be put into ensuring financial stability and the health of the financial sector, and that there were aspects to exchange rate management in the crisis countries which made them more vulnerable.

So on all of these issues, there has been a fair degree of progress on the financial reform agenda. But today, I want to talk about one aspect where there has been a bit of progress in changing thinking, but not much in terms of actual action - this is in *bailing-in the private sector*.

The case for addressing this problem seems overwhelming. To illustrate with reference to just one component of private capital flow, the annual average inflows of bank-to-bank capital into the five badly-affected Asian countries was around US$50 billion. In the nine months following the crisis, the outflow was US$70 billion. It was the speed of this capital departure which was so devastating, and was reflected in such dramatic falls in the exchange rates. The starting point is to identify the nature of the problem. The reversals of capital flow had all the hallmarks of a bank run - the sudden change of opinion and the perfectly rational desire to get out ahead of the crowd (or at least not to be left behind). The case for doing something about it is threefold:

- Mexico in 1994/95 was a successful example of how to deal with the equivalent of a bank run. As Bagehot advised a century ago: the authorities should "lend freely". But it is not realistic (nor, many would argue, desirable) to go on repeating this formula for succeeding crises. The

US$50 billion package which was put together for Mexico was, substantively, far greater than anything made available for the Asian crisis countries - Mexico was seen as a unique once-off event, affecting America's vital interests. So if the funds are not available to fully meet the bank run, then somehow the runs have to be avoided or greatly lessened;

- to bail-in the private sector seems fair. The private-sector inflows have, invariably, come at interest rates which embody a significant risk premium and it seems eminently fair that, where a risk premium has been paid, the lenders should be faced with the consequences of their actions when things do go wrong. It is fair, too, that the authorities impose some modifications to private contracts. Bail-outs are, after all, bail-outs of the creditors at least as much as they are bail-outs for debtors, and the authorities are putting taxpayers' money on the line to achieve a socially-more-optimal outcome. This gives them the right to have a big say in the arrangements;

- bailing-in would also directly address the problems of moral hazard. In the Mexican bail-out, creditors were paid back quickly in full by the rescue package, and this left a legacy of moral hazard. Whatever existing problems of moral hazard had existed before Mexico, these were substantially exacerbated by what was otherwise a very successful rescue. Unless private sector creditors pay some price when things go wrong (either in terms of delayed repayment or some kind of "hair-cut"), then the market will not make the correct risk assessments, nor will capital be allocated in the right way and, most serious of all, we will get repeats of these enormous and disruptive influxes of capital, with the resulting problems.

There has been quite a bit of progress in shifting the debate on the desirability of bailing-in the private sector. When the IMF convened the Tokyo meeting in August 1997 following the Thai crisis, the chairman made it clear that bailing-in the private sector was not only off the agenda, but could not be put on the agenda. The IMF has now moved a long way on this, exploring the issues in great detail, and searching (through experience in a number of individual countries since then) for practical ways to achieve this.

It would have to be said that the private sector, generally speaking, is still some distance away from sharing this view. I have described their general attitude as being one of "bewildered resentment" at the idea of compulsory bailing-in in the course of an orderly debt arrangement: they talk in terms of "consenting adults", who have freely made a contract which no-one else should rend asunder. The curious thing, when we hear them talking about the sanctity of contracts, is that the idea of domestic bankruptcy is routinely accepted as an *in extremis* response when things go wrong - and this is, after all, exactly the circumstances in which a bail-in would be envisaged.

What are the elements of a bail-in? Just as with domestic bankruptcy, there are two critical elements: someone in authority needs to "blow the whistle" (i.e. declare the bankruptcy a legitimate one). This cannot, of course, simply be the debtor acting alone - you cannot expect the protection of some form of bankruptcy simply by declaring it yourself, and similarly a country claiming to be unable to pay its debts will need something more than its own word to convince the international community that it is not unnecessarily defaulting on its debts. The second element is that you need some method of "closing the door" - ensuring that, once the bankruptcy has been declared, no creditors get any preferential treatment, but instead "sit around the table" to work out a fair division of the assets which remain.

One way of moving forward on this issue is to confine and define the issue more specifically. If we were to take the Asian crisis as our benchmark, then the most important element is to bail-in the *bank-to-bank* debt. Why is this the proper focus of attention? The short answer is that most other types of debt were resolved in ways that may not be satisfactory, but at least did not exacerbate the crisis greatly. Sovereign-to-sovereign debt has an existing forum of resolution - the Paris Club. Debt of non-bank borrowers - to a considerable degree - experienced a *de facto* stand-still and at least did not exacerbate the outflows (although it had big effects in harming confidence and needs to be resolved if normal business relations are to be restored). This left the bank-to-bank outflows as the principal problem - the US$70 billion of outflows mentioned earlier. Domestic banks had the local-currency liquidity to make the repayment because they were guaranteed by the government. While ever the foreign exchange markets were open, therefore, they were in a position to repay. The issue cannot be resolved simply by removing bank guarantees: no government, anywhere, will stand idly by while a systemic problem destroys its banking system, so absence of guarantees (no matter how vigorously asserted) is simply not credible.

The Asian crisis gave us an example of the sort of thing that might be done - the Korean bank rescheduling of December 1997/January 1998. This had the two necessary elements - "blowing the whistle" and "closing the doors". The blowing of the whistle took place when foreign exchange reserves were, essentially, exhausted. The closing of the doors took place in a very low-key way: there was no formal declaration of any capital controls, but the Korean banks could obtain foreign exchange only by going to the central bank, so the central bank could strengthen the banks' bargaining position vis-à-vis the creditors by simply not making foreign exchange available to them. The outcome looks to have been a good one, from the point of view of debtor and creditor. As soon as the rescheduling was made public, the climate in financial markets markedly improved. Who, among the creditors, could now complain, as they received the certainty of getting their money back plus a higher interest rate? Looking back on it, the only element that might, with hindsight, have been done differently - and this is the forward-looking lesson that might be learnt from this experience - is that there might have been a case for a "hair-cut".

These issues are far from settled and there is certainly no acceptance on the part of the private sector, in general, that they should be bailed-in. But, having shifted its position quite a bit over the past couple of years, the IMF is working quietly and steadily to establish precedents - and case studies - for how this might occur. The present focus is on a number of cases where the private sector holds sovereign debt, with Ecuador providing perhaps the most interesting example. There is a belief that the Fund, if not actually encouraging Ecuador to force another rescheduling, has accepted this as the way to go. This is still quite a big step away from the sort of rescheduling of bank-to-bank private debt that would have been relevant in the Asian case. But at least this is moving in the right direction. We all should support these efforts.

Will this, together with the other changes which have been made to the international architecture, be a sufficient change to do the job? If "doing the job" means that future crises will be averted, clearly not. But the real issue is not whether crises can be averted, but whether we have done as much as possible. On this, it would be easy to share the views of Dr Sakakibara who says that it will take a couple more crises before we put in place an adequate system of international financial architecture. I have an open mind on this, partly because a lot can be done within the existing architecture to make it much more stable. The biggest contribution would be for the capital-receiving countries to put great effort into strengthening their own financial systems, and their legal and accounting frameworks as well. This will take quite a bit longer than might have been apparent from the reform timetables laid down for a number of these countries - it is a matter of decades or even generations, rather than a year or two. But quite a bit can be done, within a relatively short time horizon, to make these economies much less vulnerable than they were. As well, there is now a better understanding of the balance between the benefits of foreign capital flows and their dangers. This will not do away with crises - nothing can. But it would make them less common.