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Crisis costs and debtor discipline: the efficacy of public policy in sovereign debt crises

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Abstract

Recent debate on the reform of the international financial architecture has highlighted the potentially important role of the official sector in crisis management. We examine how such public intervention in sovereign debt crises affects efficiency, ex ante and ex post. Our results shed light on the scale of capital inflows and the implications for debtor country output of such a regime. The efficacy of measures such as officially sanctioned stays on creditor litigation depend critically on the quality of public sector surveillance and the size of the costs of sovereign debt crises.

Keywords: Crisis management; International financial architecture

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1. Introduction

There has been considerable debate on the reform of the international financial architecture in the aftermath of recent crises. Academics and policy makers have advocated a number of measures to prevent crises, or at least limit their frequency and severity. They include improvements in national balance sheet management to avoid severe currency and maturity mismatches, the provision of contingent credit lines for emergency official finance, and the development of codes and standards to allow better-

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informed decisions by debtors and creditors.[1] By contrast, progress on public policies aimed at improving the process of *crisis resolution* has been slower, reflecting the difficulties inherent in promoting co-operative solutions between a sovereign debtor and its international creditors. Nevertheless, a broad consensus may be developing around the central objective of international crisis management, namely the restoration of confidence and the normal flow of private capital to the debtor.

There has also been a measure of agreement on the circumstances under which crises arise. The academic literature on financial crises has typically identified two main (and separate) causes.[2] First, inconsistent government policies and/or external shocks can bring about a secular deterioration in a countrys fundamentals leading, for example, to an unsustainable build-up of debt or the exhaustion of foreign exchange reserves, thereby triggering a crisis. Second, crises may reflect a coordination problem among creditorsthe actions of creditors can be mutually reinforcing as they "race for the exits". The important role of creditor beliefs is therefore highlighted. Pessimistic expectations can become both self-generating and self-fulfilling.[3] Reflecting these two lines of thinking, public policy approaches to crisis management have recognised the possible need for debt restructuring in cases where crises arise from poor performance and policy, laying stress on the important role of official finance in support of credible policy adjustment. And they have sought to limit investor panics by seeking to coordinate private creditors, for example by agreeing to roll over obligations coming due.

In practice, crisis management is likely to require a judicious mix of private sector involvement and official finance.[4] But the method of achieving this mix is far from clear-cut. On one view, there is a danger that too rigid a set of rules would act as an unhelpful constraint. Crises arise for different reasons and differ in form, so should be approached on a case-by-case basis. An alternative viewpoint is that too much discretion increases uncertainty about possible outcomes in the event of a crisis. For example, lack of clarity regarding the amount, timing and conditionality of official sector lending may compound the disorder in the workout process. If guidelines create an expectation of orderly crisis management, this may reduce the likelihood of sharp reversals in capital flows in circumstances where debtor fundamentals are perceived to be poor.

Some policy makers have increasingly begun to advocate more active official-sector involvement in international financial crisis resolution.[5] For example, King (1999) stresses the need to avoid the costs of disorderly liquidation by creditors following a sovereign default and suggests that, in the absence of formal mechanisms, bodies such as the IMF could provide support to a country that has temporarily suspended payments to its creditors. Such support might take the form of lending into arrears and/or assisting in the workout process to ameliorate problems of creditor coordination. More recently, the

[1] An overview of the policy debate is offered in Drage and Mann (1999).

[2] See Krugman (1979), Obstfeld (1996), and Chang and Velasco (1998). Flood and Marion (1998) offer a comprehensive survey.

[3] Recent work by Morris and Shin (1998, 2001) on the co-ordination problem underlying financial crises shows how fundamentals and beliefs intertwine. The policy implications, for sovereign liquidity crises, of this approach are examined in Chui et al. (2002).

[4] See, for example, Summers (2000).

[5] An overview of the policy debate on standstills and stays is provided in IMF (2000).