

***“THE ROLE OF THE PRIVATE SECTOR IN CRISIS
PREVENTION AND CRISIS RESOLUTION”***

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It is a great pleasure for me to speak in Montreal on the occasion of the Reinventing Bretton Woods Committee. Global private capital flows increased tremendously over the last two decades and contributed to higher economic growth of the emerging markets, developed countries and thus the global economy.

The amount of private capital flows in emerging markets increased almost threefold during the last two decades. At the same time, the composition of private capital flows also changed. In total private capital flows, while the share of banking credits sharply declined, the share of portfolio investment grew rapidly.

Even though private capital flows are an important source of growth financing, they can also be a reason for severe financial crisis. Higher amount of capital flows creates higher possibility of a crisis emergence from the capital account. Additionally, the share of short-term funds among the total of capital flows has grown rapidly. The existence of higher amount of short-term capital flows increases countries' vulnerability to herding behavior of private creditors.

One of the lessons that we have learned from the recent financial crises in Mexico, South-East Asia, Russia and Brazil is that the private creditors' behavior, whether rational or irrational, may precipitate crisis and may lead to financial contagion. For instance, private creditors, although it could be sole rational behavior, may cause unexpected outcomes when acting collectively. A crisis in one country induces investors to sell off their holdings in the other emerging markets due to liquidity needs and fears of a possible crisis in those countries. This is in fact a rational behavior on individual basis, but collective action of creditors may precipitate the crisis.

On the other hand irrational behavior of private creditors due to information asymmetries may accelerate the evolution of a crisis.

Considering this fact, the international community decided to develop a framework for private sector involvement to reduce creditor runs during the crisis and, to facilitate the cooperative restructuring of external claims. Specifically, the international community tries to private sector bail in.

After the Tequila crisis in 1994, the private sector involvement in crisis prevention and resolution started to be discussed. However these discussions did not gain intensity. As we all remember, in 1999, this issue was brought to the agenda in G-7 Cologne Economic Summit and then both the G-7 Finance Ministers and G-20 Deputies prepared reports about the role of the private sector in crisis prevention and resolution. But we have not reached concrete solutions yet.

The efforts about private sector involvement will provide benefits to both debtors and creditors by creating more effective and long-standing international capital markets. In respect to **crisis prevention**, private creditors' involvement would limit excessive risk taking triggered by expectations of international rescues. Besides, the major aim of involving private creditors in **crisis resolution** would be to reduce creditor runs that worsen economic conditions during a financial crisis.

Successful developments in the involvement of private creditors in crisis prevention and resolution, which I will refer to in a few minutes, would greatly reduce reliance on financial assistance from official resources and will be a major step forward for burden sharing. In other words, all related and responsible parties will work jointly to prevent and resolve the problems.

In this framework, **we all agree that the highest priority should be given to crisis prevention measures** described as the adoption of consistent macroeconomic and exchange rate policies, sound debt management, and prudential supervision of financial system. Besides, I personally support the following views regarding the involvement of the private sector:

- Improvements in transparency of both public and private sectors can facilitate risk management on the part of investors and thereby lead to make sound investment decisions.

- Close and transparent relations between private creditors and debtors during good economic conditions may facilitate the private sector's financial support during the crisis.

- The adoption of international standards and codes can contribute to international financial stability as well as to take appropriate investment decisions by private creditors.

As far as the resolution of crises issue is concerned, the private sector's role during a crisis involves

lengthening maturity of debt instead of withdrawing or replacing them with the official resources. We are all aware that the IMF has been expected to take a major role in this area. In this respect, the IMF staff proposed a framework for private sector involvement. According to this framework, if the country's financing requirements are moderate, and even when the country can regain market access soon despite large financing requirements, **the private sector's support can be guaranteed through the Fund's catalytic role.**

On the other hand, in the case of large financing requirements and it is unlikely to regain market access soon, or a debt burden too large to be sustained in the medium term, **a concerted mechanism will be needed.**

When deciding whether the catalytic role of the IMF is enough or a concerted mechanism will be needed, the crisis economies should be analyzed case-by-case taking into account country-specific characteristics.

Meanwhile, I would also like to discuss the arguments about imposing limits regarding when the concerted mechanism is needed. Some of the IMF members propose that concerted mechanism should be applied when a country's financing requirement from the Fund exceeds the normal access limit of 300 percent of her quota.

Taking strong measures in advance about private sector involvement will negatively affect the borrowing cost of the

countries. Additionally, as I mentioned just before the crisis economies should be analyzed case-by-case. For that reason, since the financing requirement varies from country to country, it would not be appropriate to put a limitation.

In my opinion, private sector involvement should be based on preventive measures taken during good economic conditions such as close and transparent communication between debtors and creditors that will ease support during a crisis and adoption of international standards and codes that will lead to make sound investment decisions by private creditors.

Another widely argued topic is the use of collective action clauses, or more specifically, majority action clauses, in the sovereign bond agreements that can play an important role in facilitating orderly resolution of crisis. The collective action clauses make it possible for majority bondholders to change repayment terms, to limit the ability of individual bondholders to accelerate their claims, and to ensure that financial sources recovered by any one bondholder are shared by all of them.

In this respect, in January, the United Kingdom introduced collective action clauses into the U.K Treasury notes and in February, the German government disclosed the validity of collective action clauses in bonds of foreign issuers. In April, the Canadian authorities announced that they would

include collective action clauses in their future international bond issues.

Here, I would like to explain my view about the mandatory use of collective action clauses in the sovereign bond contracts. The mandatory use of collective action clauses may increase spreads of the emerging markets in the international capital markets as well as make it harder to get funds.

The reason is that the inclusion of collective action clauses in emerging markets' sovereign bond contracts will be viewed as an additional default risk that would more than offset the advantages of a more orderly bond restructuring process. This additional cost and reduction in international debt financing available to them will create negative outcomes on the emerging economies that are in need of financing.

On the contrary, voluntary use of collective action clauses could be encouraged as it may facilitate access to bond financing for some emerging market issuers.

Now, let me turn the other face of the mirror. What are the creditors' opinions about these developments? Since they are under consideration, their opinions about this issue are also important. For instance, it is expected that the collective action clauses by easing bond restructuring would make private creditors reluctant to lend.

In sum, I would also like to summarize four major steps that could greatly help to increase of private sector involvement in crisis prevention.

Firstly, all related parties should work together to determine principles regarding the role of the private sector in prevention and resolution of financial crisis. This collective work will support the sustainability of international capital flows. These principles should reveal the fact that all private creditors would be responsible from the outcomes of their investment decisions. Hence, they should not wait any bailout from the official community.

Second, the close cooperation between public and private sector in certain areas would be required. For instance, the public sector could help emerging markets in reinforcing their relations with the private creditors and in deepening of their financial sectors.

Taking this opportunity, I would like to thank the Managing Director of the IMF, Mr. Köhler for his commitment to “constructive engagement” with the private sector by forming a Capital Market Consultation Group. I believe that this process will be highly effective in crisis prevention and resolution.

Third, in the cases where the restructuring of the bonds is unavoidable, the restructuring process should be realized on a **voluntary** basis. This process should also be conducted through extensive consultations with the private investors.

Voluntary implementation would be more effective than mandatory implementation. In this respect, I believe that mandatory standstills and other coercive techniques are not appropriate and could have negative impacts on the spreads of emerging market countries.

Fourth, the restructuring of bonds should not increase risk premiums for the other emerging market countries, which have pursued sound macroeconomic policies. There may be differentiation between countries in line with the policies they implement.

Thank you all for listening to me.