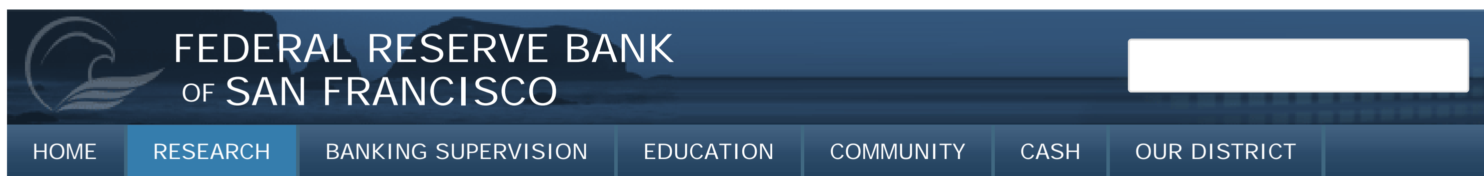

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Country Crises and Corporate Failures: Lessons for Prevention and Management?

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The recent wave of financial crises in emerging markets—Mexico in 1994-1995, Asia in 1997-1998, Russia in 1998, and Argentina in 2001—has exacted a considerable toll in terms of lost output and welfare and at times even posed a threat to the stability of world financial markets. As a result, many policymakers and economists have focused on the lessons to be learned from these experiences—lessons both in how better to prevent crises in the first place and in how to manage crises once they occur.

These country lessons also have a lot in common with some lessons from recent high-profile U.S. corporate failures—Long-Term Capital Management (LTCM), Enron, Global Crossing, and Kmart, to name a few. One common thread is that, in market-based economies, country crises and corporate failures are inevitable. The hard truth is that markets impose consequences for both bad policies and for bad luck. Bad policy at the corporate level may be anything from misguided plant expansion plans to "crony accounting"; bad policy at the country level may range from inappropriate exchange rate targets to "crony capitalism." Bad luck at the corporate level can be a tornado in Texas or an earthquake in California that disrupts businesses; bad luck at the country level can be a worldwide investor panic that indiscriminately sucks the capital out of emerging market economies, punishing the innocent as well as the guilty.

This *Economic Letter* discusses the lessons that apply to country crises and corporate failures and illustrates that the lessons on prevention share many similarities, while the lessons on crisis management have some interesting and complex differences.

Lessons in prevention

The three basic lessons for preventing problems are pretty similar for both countries and corporations.

First, improve the quality and transparency of information provided to markets. At the corporate level, recent concerns about disclosure practices have led firms, like GE, IBM, and others, to offer clearer information about balance sheets and earnings in order to bolster their credibility. At the international level, recent crises have led the International Monetary Fund (IMF), the Bank for International Settlements, and others to lean on emerging markets to be more transparent about their policy intentions and more timely in providing data.

Second, improve the effectiveness of monitoring by regulators. For firms, the near-meltdown of LTCM prompted the Federal Reserve to look more carefully at the exposure of U.S. commercial banks to hedge funds. More recently, concerns about "creative accounting" are likely to affect the way the Securities and Exchange Commission monitors corporate business practices. For countries, the IMF and other bodies are developing international standards, codes, and best practices in such areas as corporate governance and bank regulation. A good example in the latter case is the latest work revising the Basel Accord guidelines on bank capital adequacy.

Last, but not least, corporations and countries both have a better chance of surviving the market's punishment for bad policy and of weathering spells of bad luck by improving their underlying fundamentals. At the corporate level, the shake-up among dot-coms has reminded us of the importance of reliable earnings. At the international level, recent experience has shown that countries do better if they pursue credible monetary and fiscal policies, reduce their short-term foreign borrowing, and strengthen their financial systems. The need to maintain good fundamentals has become particularly important as countries have liberalized their economies and become more sensitive to market forces.

Managing crises and failures

When it comes to managing crises and failures, there are more differences than similarities between countries and corporations. A key similarity is the set of goals. One goal is to permit the restructuring of debt financing in times of economic weakness—in other words, to give a firm or a country an orderly way to reorganize activities and adjust the terms of debt contracts, so as to avoid the premature liquidation of assets and also to balance its interests against those of creditors. A second goal is to limit the possibility of wider contagion effects of individual crises and failures. Though the goals are similar, the way crises and failures are managed at the corporate and country levels is very different.

Corporate failures. In dealing with corporations, U.S. bankruptcy laws—particularly Chapter 11—are designed to achieve the first goal, namely, permitting debt restructuring so as to balance the interests of the firm against those of its creditors. Specifically, Chapter 11 allows firms to apply for breathing room from creditors, obtain infusions of new working capital, and submit a plan of reorganization to a bankruptcy judge It also addresses the so-called "collective action" problem in getting creditors to accept the plan. The collective action problem arises when a deal that is in the best interests of the creditors as a group gets blocked by individual creditors who want more for themselves. Chapter 11 handles this by allowing a deal to go through if it is accepted by a supermajority—usually two-thirds—of the creditors, or by the judge.

The second goal—limiting contagion—comes into play in special cases where the failure of a big firm or bank poses systemic concerns to the economy. In this case the government may act as a lender of last resort. The Treasury did this by bailing out Chrysler in the 1970s, and the Fed has done it occasionally, as in the aftermath of the 1987 stock market crash and the terror attacks of September 11. In addition, the government may act as a crisis manager to deal with systemic concerns in other ways. For example, in 1998, the Fed helped get LTCM's management and its major creditors to meet and catalyzed the firm's reorganization.

Country crises. Managing a crisis when a debtor country has repayment problems is very different from the corporate setting, because there is no equivalent legal procedure to provide breathing room and work out the problems, nor is there any clear lender of last resort.

In the country crises during most of the 1990s, the IMF and international development banks served as a quasi lender of last resort by providing some official financing—so-called "bailout" loans—in exchange for domestic policy reforms. These actions were accompanied by the hope that the debtor country and its creditors could work out some form of debt restructuring.

This approach has met with several criticisms. First, the string of recent crises has pushed the international system to the limit of funds available for bailouts. Second, this approach introduces moral hazard considerations that may reduce the incentive to prevent new crises, as politicians, borrowers, and investors all expect the IMF always to rescue them. Lastly, the debt restructuring process typically has been ad hoc, slow, and cumbersome.

To balance the legitimate need for funds against moral hazard concerns, some incremental changes have been implemented in recent years. These include setting up contingency credit lines to qualifying countries in advance of the possible need for funds and raising the cost of obtaining bailout loans.

Current efforts to improve the management of crises have focused on trying to smooth the debt workout procedure. The emphasis of this new approach is to encourage private creditors to restructure their loans to debt-burdened countries voluntarily. In other words, it tries to get the private sector to share more in the costs of resolving country crises. This approach is called "bailing-in" the private sector, or "involving the private sector."

Getting this new approach to work is very hard, however, because of the collective action problem, which itself has become even more complicated now that countries facing repayment problems typically have many more creditors to deal with. Back in the 1980s, emerging markets' borrowing was mainly syndicated loans from a small number of large banks, which could be easily corralled around a table by the IMF and cajoled into rolling over the debt and, sometimes reducing it. Even as recently as 1997 this approach worked when the IMF, the U.S. Treasury, and others got major foreign banks to roll over their loans to Korea.

During the 1990s, however, countries have come to borrow more by issuing bonds. For example, Argentina currently has thousands of bond creditors through more than 120 different bond issues outstanding, which are subject to multiple jurisdictions and laws. Working out an agreement among such large numbers of creditors can be a nightmare, since unanimous consent is generally required. Particularly disruptive have been the so-called "vulture investors" who buy up cheap, discounted country bonds in the secondary market and then threaten to hold up deals unless they get full payment. For example, a hedge firm, Elliott Associates, bought Peruvian debt at a deep discount for $11 million and successfully got back $58 million.

Two proposals are now on the table to remedy this collective action problem, one from the U.S. Treasury and one from the IMF. The Treasury plan involves modifying international bond contracts and still largely letting the markets solve the problem. Specifically, borrowers would write clauses into their bond contracts that would allow restructuring deals to go through if a supermajority of bondholders, say 75%, agree. This approach raises questions, though. Might the inclusion of these new bond clauses create the perception that it is easier for countries to default, resulting in higher costs of borrowing for emerging countries? What about older issue bonds without these clauses? What about bank loans that do not involve formal contracts?

The IMF plan relies less on the market and more on legal procedure. It would create a formal international bankruptcy procedure, sort of a "sovereign Chapter 11," that would cover all debt contracts. Under this procedure, a country with debt problems could do the equivalent of filing for

bankruptcy and receive a temporary timeout period—termed a "standstill"—during which it could stop paying its debts to all of its creditors. The country would then negotiate the terms of a new payment plan that is conditioned on domestic policy changes.

The IMF approach also raises a question. Who would play the international equivalent of a domestic bankruptcy judge? The IMF initially recommended itself, but creditors were concerned that the IMF might not fully protect their rights, especially since the IMF is itself a major creditor of many countries. As a result, the IMF has modified the plan to leave the final terms of any restructuring deal in the hands of a supermajority of creditors, with an independent panel of judges handling any loose ends. (Further details about the IMF and Treasury proposals are provided in the next issue of the FRBSF *Economic Letter*.)

Where do things stand now?

While we cannot expect to eliminate crises and failures from market-based economies, we can learn from experience. In fact, there already is evidence that progress has been made on learning how to prevent country crises better. For example, the crises in Brazil in 1999, Turkey in 2000, and Argentina last year have had relatively few contagion effects across borders. There is also widespread agreement that we need a new approach to manage and resolve country crises. The current debt renegotiation process is generally too cumbersome and costly for all involved. The Treasury and IMF proposals both draw on the principles of domestic corporate bankruptcy laws to provide a new approach. And both proposals head in the same direction: allowing country debtors and creditors to work out mutually beneficial deals in a more orderly and less costly manner. Though different, the two proposals are not mutually exclusive. In fact, the G-7 Finance ministers, including the U.S. Secretary of the Treasury, recently endorsed a two-track approach towards pursuing both plans.

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