



Argentines were reduced to bartering during the 2002 financial crisis.

Putting a Stop to Self-fulfilling Crises

How debtor countries might be able to avoid the loss of confidence that often precipitates a crisis

Daniel Cohen

FINANCIAL crises, like viruses, seem to mutate along with the remedies that are designed to resolve them. This article explores how crises have changed since the early 1990s and suggests that innovative approaches will be required to cope with them, such as making the IMF a lender of *first* resort.

During the 1970s, the current account deficits of developing countries were viewed as “equilibrium” phenomena that enabled these countries to absorb aggregate shocks smoothly. They were thus not a cause for great concern. According to this view, a country’s balance of payments represents the cash flow of an entity that, over time, must live within its means. That is, a country borrows when its income is low (compared with some benchmark) and repays its debt or saves when its income is high. Thus, it was thought, the excess world savings created by the oil price increases of the 1970s were efficiently recycled to the developing countries.

But in the 1980s, external debt became a bitter reality for developing countries. World

interest rates shot up, and, in response, lenders shortened repayment periods. Unlike in the 1970s, debt began to be viewed as potentially unsustainable. One after the other, most of the middle-income debtor countries had to reschedule their debts during the 1980s, with the frequency of reschedulings rising with the size of the debt. Countries whose debt reached 200 percent of exports had a 60 percent probability of needing to reschedule in any given year. If the debt rose to 250 percent, the probability reached 69 percent, and if the debt hit 300 percent, the probability shot up to 93 percent. Given these statistics, there was no question that debt eventually had to be written down (see Cohen, 1991 and 2001). Why it took almost a decade to reach such a conclusion is one of the most troublesome questions of the period (see Kenen, 1983, however, for an early warning).

New-style debt crises in the 1990s

The low level of interest rate spreads in the 1980s reflected the underestimation of risk by banks, which were the main international

creditors at the time. Until 1982, when Mexico suspended payment on its debt, interest rate spreads rarely exceeded 200–250 basis points over LIBOR (London interbank offered rate) because bankers generally did not expect countries to default. Although spreads on both Mexican and Brazilian debt rose in the few months before the debt moratoriums, syndicated bank lending in the 1970s (when spreads were low and the average real rate of interest on sovereign borrowing was actually negative) and early 1980s reflected no memory of the massive debt defaults of the 1930s. Lenders simply did not anticipate the debt crisis of the 1980s.

In the 1990s, however, an excess of confidence in the repayment of international debts was no longer the rule. The market environment became much more intricate and complex: corporate borrowers joined sovereign debtors, and bondholders replaced bank loan syndicates. Some crises were expected and some were unexpected—often, in each case, for good reason.

As the box shows, most Asian countries in 1997–98 had good fundamentals and low spreads (Type 1 crises). Thus, the crises, driven by a drop in confidence rather than by bad fundamentals, took everyone by surprise. Type 2 crises were the opposite: they were expected, as revealed by large spreads, and associated with large debt problems. Almost all Latin American countries

fell into this category in the 1990s. Russia (1998) was a Type 3 crisis. Although debt was nominally low, investors recognized political and economic instability and charged a high price. But the main novelty of the 1990s was that the combination of high debt and low spreads, which had characterized the Latin American debt crises of the 1980s, did not occur (see box, top left cell). Large disequilibria no longer went unnoticed by the markets, meaning that sovereigns increasingly had to live with higher spreads, and debt burdens became more onerous.

How to avoid self-fulfilling debt crises

If a large debt is bound to create high spreads, then could the reverse also be true? Could the high interest cost feed into more debt accumulation and, thus, higher risk and spreads, creating a process that can only end in a crisis? In a 2003 study with Richard Portes of the London Business School, I explore how the dynamics of debt were determined by the interest paid on the debt, the growth of the economies, and the primary surpluses of various countries. We find that the dynamics of debt are quite often significantly colored, although not entirely explained, by a lack of confidence in a country, as in Brazil in 1999 and Turkey in 2000. It has been argued, for example, that Brazil's financial difficulties were self-fulfilling. If Brazil had had access to a riskless rate, its debt dynamics would have been favorable, and, in fact, Brazil would have been a safe investment for creditors. But at the

risk-adjusted spread, it became a high risk.

The intuitive rationale for self-fulfilling debt crises is quite simple: the perception that a country is high risk raises spreads, which, in turn, raises the debt-service burden, generating a “snowball” effect that culminates in a debt crisis. If default, and the ensuing financial turbulence, reduces the repayment capacity of the country, then lenders that expect to be repaid nothing will create a crisis of their own and, indeed, receive nothing. Crises are self-fulfilling because it is the investors' reaction to a perceived risk that diminishes the repayment capacity of the country. This is less likely to happen in the case of corporate debt where default amounts to, say, simply changing a firm's management, instead of a costly process of economic distress.

Based on this analogy, it can be shown that an efficient debt resolution mechanism eliminates the risk of a self-fulfilling debt crisis (Cohen, 2003). The intuition behind this

proposition is straightforward. A self-fulfilling debt crisis originates from the fact that the fundamentals that support the repayment capacity are eroded in case of outright default. When an efficient debt workout is implemented instead, the fundamentals are unaffected by the debt contract, and the risk of a self-fulfilling crisis disappears. This shows theoretically

the merits of an efficient debt resolution mechanism. Not only does it reduce the cost of crises but it can also prevent a crisis of confidence from emerging in the first place. This issue was at the core of the heated debate, beginning in the mid-1990s, over a bankruptcy court and the need for collective action clauses (see an account of the evolution of this idea in Rogoff and Zettelmeyer, 2003).

A lender of first resort?

How can a country escape the trap of a self-fulfilling debt crisis when it occurs (that is, when creditors doubt that an efficient solution can be found if a crisis occurs)? Brazil is trying to show the way. By demonstrating its willingness to service its debt despite high spreads, Brazil hopes to convince its creditors that it is a safe bet. This behavior has been rationalized by Cole and Kehoe (2000). A country may wish, against the odds of its creditors, to reduce its debt to get out of the “danger zone,” where self-fulfilling crises are possible. It would be a shame if this attempt failed only for a lack of time. It is with respect to this behavior that I have supported, in my work with Portes, the case for a lender of *first* resort.

Here is what that means. An IMF member country should be able to commit itself, in advance, to a “creditworthiness regime” (similar to a fixed exchange rate regime), enabling it to prevent its debt from ever mounting to unsustainable levels. This regime offers the country the means to act before the

1990s debt crises

Unlike in the 1980s, none of the 1990s debt crises involved high debt and low spreads.

	High debt	Low debt
Low spread	None	Type 1: Asian economies
High spread	Type 2: Latin America in 1990s	Type 3: Russia

Source: Cohen and Portes (2003).

snowball effect comes into play, because the debt buildup mechanism takes time, and therefore provides time, before the situation becomes truly explosive.

For the sake of simplicity, suppose that a country undertakes to borrow at spreads no greater than 300–400 basis points (but the benchmark could be with respect to the average of emerging markets). A country's commitment to the regime means that it will take all necessary steps to hold its indebtedness down to a level compatible with that level of interest rates. A program with the IMF could be signed early on—while the country still has access to world financial markets—and the IMF could lend the country the resources it needs while the program is being implemented. If the regime is credible—in other words, if investors are convinced that

rates will never go above that level—a self-fulfilling crisis is ruled out, in that the mechanism “coordinates” expectations at a low level. Moreover, and perhaps more important, this regime commits a country to a prudent strategy. The country avoids the widespread temptation to allow problems to accumulate before tackling them and, in so doing, avoids the risk of a crisis of confidence that could become intractable.

Conclusion

The path to the resolution of a debt crisis can be summarized as follows. If a debt is very large and must be written down, a haircut—a reduction in the principle that will be paid to creditors—must occur. Haircuts were unavoidable in the 1980s and became part of the Brady debt initiative (although this fact took too long to be acknowledged) and are usually associated with a bankruptcy regime. Such a regime is not currently available for sovereigns. If only a massive rescue can protect a country from a loss of confidence, as in Mexico in 1995 and the Asian countries in 1997, a big bailout is needed. Big bailouts require a lender of last resort, but it does not appear that there is sufficient support for the IMF to play that role.

If a country wants to take action to restore confidence, even when it still has some access to financial markets, the IMF could help buy time with liquidity and a program—in other words, it could serve as a lender of *first* resort. Unlike in the previous two cases, this is a task, we believe, that is within the scope of the IMF's mission. ■

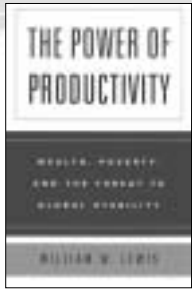
This paper draws on joint work of the author with Richard Portes (Cohen and Portes, 2003). It was completed while the author was visiting the IMF's Research Department.

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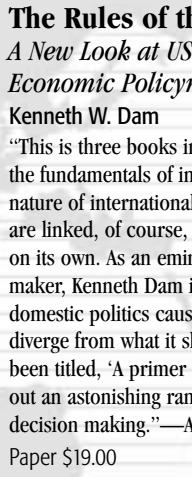
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