

## CREDITOR PANICS: CAUSES AND REMEDIES

By Jeffrey D. Sachs  
Harvard Institute for International Development  
[jsachs@hiid.harvard.edu](mailto:jsachs@hiid.harvard.edu)

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Emerging market financial crises are characterized by an abrupt and significant shift from net capital inflow to net capital outflow from one year to the next. By this standard, we find 10 cases of significant financial crisis among the middle-income developing countries in the past four years: Turkey 1994; Venezuela 1994; Argentina 1995; Mexico 1994-5; Indonesia 1997-8; Korea 1997-8; Malaysia 1997-8; Philippines 1997-8; Thailand 1997-8; Russia 1998.<sup>1</sup> It is the contention of this paper that such crises typically reflect a three-stage process that hits a developed country engaged in large-scale international borrowing. In the first stage, the exchange rate becomes overvalued as a result of internal or external macroeconomic events. In the second stage, the exchange rate is defended, but at the cost of a substantial drain of foreign exchange reserves held by the Central Bank. In the third stage, the depletion of reserves, usually in combination with a devaluation, triggers a panicked outflow by foreign creditors holding short-term claims. The trigger in most cases is the devaluation itself, resulting from the exhaustion of reserves. The panicked outflow of short-term creditors leads to macroeconomic overshooting, characterized by sharp economic downturn, typically followed by a nearly equally sharp recovery. Various dimensions of the macroeconomy are involved in this overshooting: real GDP (see Table 1 and Figure 1 for Argentina and Mexico); the real exchange rate, real interest rates, and net capital flows (see Table 2 for Argentina and Mexico); and stock market valuations (see Figure 2 for Argentina and Mexico).

Some observers have attributed these crises to currency devaluation, since the panics have almost always followed a movement in the currency. As a result, those observers have generally concluded that devaluations should be avoided at all costs, since the panics have almost all followed currency devaluations. In this short note, I suggest a very different point of view: that is it not the devaluation, but rather the defense of the exchange rate preceding the crisis that opens the door to financial panic. In my view, the devaluation by itself is not harmful. The harm comes from the depletion of foreign exchange reserves. The devaluation which follows the depletion of reserves usually alerts the market to the exhaustion of reserves, a state of affairs which is not fully apparent to many market participants before the devaluation takes place. When the devaluation occurs, short-term interbank credits in particular become subject to an abrupt, self-fulfilling loss of confidence. In summary, the devaluation signals the depletion of reserves; the depletion of reserves signals the inability of the Central Bank to act as a lender of last resort vis-à-vis foreign creditors; the short-term foreign creditors flee in panic; and the

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<sup>1</sup> For further details on many of these cases, see S. Radelet and J. Sachs (1998) "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects." *Brookings Papers on Economic Activity*, 1: 1-90.

macroeconomy collapses as a result of the creditor flight. The rest of the paper describes this sequence of events, and draws some policy conclusions from it.

### **Balance of Payments Crisis**

The starting point of the emerging markets crises in recent years is a balance of payments crisis, that is, the exhaustion of foreign exchange reserves following the defense of a pegged exchange rate. In most cases, the sequence of events is as follows. First, macroeconomic shocks change the full-employment equilibrium ratio of tradable goods prices  $P_t$  to nontradable goods prices  $P_n$ , a ratio we define as the real exchange rate  $R (=P_t/P_n)$ . Second, the gap between the prevailing  $R$  and the  $R$  consistent with “internal balance” (i.e. with full-employment equilibrium) leads to speculation against the currency. Third, reserves are depleted in the defense of the currency.

We know from standard macroeconomic theory that the real exchange rate consistent with internal balance appreciates ( $P_t/P_n$  falls) when the following events occur: (1) a terms of trade improvement; (2) a reduction of world interest rates, leading to increased net capital inflows; (3) a reduction of country risk, leading to increased capital inflows; (4) fiscal expansion; (5) other positive wealth effects (e.g. a natural resource discovery); (6) a rise in investment spending signaling increased confidence about future productivity. The real exchange rate consistent with internal balance depreciates ( $P_t/P_n$  rises) when the converse conditions apply.

Overvaluation of the currency can arise in many contexts, but the aftermath of stabilization from high inflation has been a typical case, especially in Latin America. At the beginning of successful stabilization programs,  $P_t/P_n$  tends to decline. This occurs for several reasons. First, domestic investment spending recovers at the prospect of improved domestic productivity. The stabilization may also lead to a consumption boom, as a result of the elimination of the inflation tax (this occurred strongly in Argentina and Brazil). The banking sector becomes remonetized, often through the repatriation of flight capital. This remonetization restarts domestic bank lending. Additionally, the stabilization may trigger a reduction in the risk premium on international lending to the country, thereby increasing net capital inflows. All of these effects are typically transitory: the rapid rebuilding of the capital stock following a stabilization tends to be completed in a few years; the boom in net capital inflows abates; the remonetization is completed within a couple of years; and the initial consumption boom tapers off. As a result, the pressures that lead to the initial real exchange rate appreciation at least partly reverse themselves, leading to pressures for real depreciation. This pattern of appreciation followed by market pressures for real depreciation seems to have been the pattern in Argentina, Brazil, and Mexico. Stabilization was followed by an initial real appreciation, consistent with increased domestic spending and capital inflows. After a few years, however, the spending boom and capital inflows tended to abate, putting downward pressure on the real exchange rate.

As is well known, necessary adjustments to the real exchange rate can be met either by price movements or by nominal exchange rate movements, depending on the exchange rate

regime. The traded goods price is given by  $P_t = EP^*t$ , where  $E$  is the nominal exchange rate (in units of domestic currency per unit of foreign exchange) and  $P^*t$  is the world (dollar) price of tradable goods. The real exchange rate is then  $R = EP^*t/P_n$ . An appreciation can be brought about either through a nominal appreciation ( $E$  falls), or a rise in the price of nontradable goods  $P_n$ . A depreciation can be brought about either through a nominal depreciation ( $E$  rises), or a fall in the price in the price of nontradable goods  $P_n$ .

Experience teaches that an absolute decline in  $P_n$  is difficult to achieve in a short period of time. When the extent of needed real depreciation is large, therefore, financial markets tend to expect that policy makers will support the relative price change through devaluation (or market-driven depreciation) of the nominal exchange rate rather than by internal price deflation (i.e., the decline in  $P_n$ ). Therefore, when  $P_t/P_n$  is low relative to the market's estimate of the value consistent with full employment, there will almost inevitably be widespread expectations of a nominal exchange rate devaluation (or depreciation, if the currency is simply allowed to float).

Widespread expectations of depreciation can be difficult to resist, since in almost any economy, currency in circulation plus bank money ( $M2$ ) is considerably higher than foreign exchange reserves. This is the case even when forex reserves are sufficient to cover high-powered money (notes in circulation plus commercial bank reserves at the central bank), as is the case of currency board arrangements. Suppose that  $M2$  holders begin to convert their money into foreign exchange in expectation of a devaluation, and suppose that the central bank defends the exchange rate, by buying high-powered money and selling dollars. Suppose that the money multiplier is  $mm (= M2/Mh)$ , greater than 1. In principle, each unit of high-powered money withdrawn from the banking sector and converted into foreign exchange, results in the reduction of  $mm > 1$  units of  $M2$ . In principle, the central bank only needs forex reserves greater than  $Mh$ , rather than  $M2$ , in order to be able to stave off a successful attack on the exchange rate, since the reduction of  $Mh$  will lead to a multiplied reduction of  $M2$ .

This assumes, however, that the central bank will force the banking sector to shrink outstanding loans by a multiple of the initial withdrawal of funds. In practice, such a contraction of loans quickly leads to illiquidity of the banks, and therefore to incipient bank panics. In short, money multiplication (in which a unit increase of  $Mh$  leads to  $mm$  units of increase of  $M2$ ) is not quickly reversible, since the bank loans are tied up in nonliquid assets which can not immediately be called in by the banks. The result is that the central bank must provide liquidity to the banking system when net withdrawals are made from the banking system. As a result, if money holders begin to convert  $M2$  into foreign exchange, the central bank will need reserves nearly equal to  $M2$ , rather than merely  $Mh$ , in order to be able to defend the currency. Very few central banks have sufficient reserves to cover a wholesale withdrawal of funds from the banking sector. (To hold such a high level of reserves would also involve large opportunity costs, since reserves typically earn less than alternative investment opportunities available to the economy.)

The main implication is that a concerted attack on the currency, one that involves--or could precipitate--a massive withdrawal of bank money, is likely to succeed, no matter what the

resolve of the central bank. Markets understand this. Most currency pegs are therefore vulnerable to attack when the underlying real exchange rate is overvalued relative to the level consistent with internal balance. Even if the government tries, through a heroic credit squeeze and sky-high interest rates (which reached overnight rates of 500 percent per annum during Sweden's ill-fated defense of its currency in 1992), the banking sector can easily crack before the defense establishes credibility. There are exceptions, no doubt. Perhaps Argentina and Hong Kong will prove to have a more credible peg, as a result of the institutional arrangements of the currency board system. Both economies have demonstrated the willingness to "walk through fire" to defend the peg; and both countries have implicit external backers of the currency regime (the United States and the IMF in the case of Argentina; China in the case of Hong Kong). In any event, time will tell. If Brazil sharply moves the real, or China significantly devalues the yuan, both will experience another searing test of the exchange rate regime.

### **Creditor Panic**

The essence of recent emerging markets crises is that the exchange rate defense, typically ending in a devaluation, has often been followed by a rapid and ferocious withdrawal of credits by foreign investors. The crucial argument of this note is that it is the panic, not the devaluation itself, which leads to the acute damage to the emerging market and to the creditors.

In emerging markets, the domestic economy (including banks, nonfinancial enterprises, and government) is heavily in debt to foreign investors, including international banks, hedge funds, and other investment funds. Much of this debt is short-term, i.e. with maturity under one year. Additionally, much of the debt has trigger clauses, such that repayment is immediately accelerated in the event of a contractual default by the debtor to other creditors. The borrowing, in general, has been converted into long-term, relatively illiquid investments. As a result, total short-term debt is often significantly greater than the available short-term assets that might be mobilized to repay creditors in the event of a withdrawal of new lending. As a rough measure, Radelet and Sachs (1998) compare the country's short-term debts to international banks with the forex reserves held at the central bank, shown in Table 3. When the ratio of debt to reserves is greater than 1, the country has proven to be particularly vulnerable to a creditor panic.

The central bank forex reserves are crucial since the central bank is widely, and rightly, understood to be the lender of last resort not only to the banks, but to the government and corporate sector as well, in the event of an external creditor panic. Suppose that foreign banks begin to withdraw credit lines from domestic banks, demanding repayment of outstanding loans. This immediately leads to financial distress in the banking system, since the banks have transformed the foreign loans into long-term investments. The bank may, to some extent, use liquid domestic assets to purchase dollars in the foreign exchange market, but even so, the bank is unlikely to have sufficient liquid assets on hand to meet a large-scale withdrawal of funds. Thus, the central bank will almost surely have to extend credit, either directly as foreign exchange loans, or as domestic credit which is then sold in the forex market. In the latter case, of course, the exchange rate will depreciate in the absence of official intervention.

Once forex reserves have been depleted, the central bank's lender-of-last-resort functions are deeply compromised, and understood to be so. Even if the central bank extends domestic credit (of which there is no limit!), the exchange market implications are likely to be dire in the event of a large, synchronized withdrawal of creditor claims. Indeed, such withdrawals will almost surely provoke not only an exchange rate collapse but also a suspension of debt payments if forex reserves are depleted and the stock of short-term debts being withdrawn is large relative to trade flows.

In these circumstances (depletion of forex reserves, a high level of short-term debt), the economy becomes vulnerable to a self-fulfilling run. Even if fundamentals are adequate to ensure long-term debt servicing without default, they are not adequate to guarantee short-run debt servicing in the event of a panic. Thus, a panic can unfold simply by the belief of creditors that it will indeed occur. In the past four years, such panics have been triggered mainly by three types of events:

- 1) the sudden discovery that reserves are less than previously believed;
- 2) unexpected devaluation (often in part for its role in signaling the depletion of reserves); and,
- 3) contagion from neighboring countries, in a situation of perceived vulnerability (low reserves, high short-term debt, overvalued currency).

It is interesting and important to stress that currency devaluation, following a long defense of the exchange rate, has typically been the most important trigger of subsequent panic. This seems to be the result of several factors. First, many investors have been caught off guard by the devaluation even when it has been widely discussed. These investors seem, incredibly enough, to have taken at face value, the solemn commitments of governments not to devalue. Second, the devaluations are often the signal that forex reserves are lower than publicly announced up to that point. In Mexico in 1994, the late-December devaluation "revealed" the steep loss of reserves in early December 1994. In Thailand, the July 2, 1997 devaluation was followed by public announcements that the Thai Central Bank had a large book of forward dollar sales. These dollar sales were not previously announced, and came as a large jolt to the market. In Korea, the December 1997 devaluation was the occasion for revealing that much of the Central Bank's announced forex reserves were actually illiquid claims on Korean banks, the result of preceding unannounced deposits of the reserves in offshore Korean banks experiencing a run on inter-bank loans (in effect, the Central Bank had been making unannounced extensions of credit to offshore Korean banks). Speaking in the most general terms, the collapse of pegged exchange rate regimes have also been viewed as improper "breaches of faith" with foreign investors, despite the fact that such devaluations were almost always the result of *force majeure*—that is, the depletion of forex reserves.

When the panic gains full force, the effects are devastating. The rational behavior of each short-term creditor is to demand repayment as rapidly as contractually possible, and to

suspend routine interbank lines which support letters of credit and other standard trade financing operations. Long-term fundamentals cease to play any role in investor thinking, since the logic of *saave qui peut* dominates in a creditor scramble in which creditors are serviced on a first-come, first-serve basis. The macroeconomic results are a huge overshooting: (1) debt is drawn down even when domestic investments (e.g. in working capital, letters of credit, etc.) have a rate of return vastly greater than the world cost of capital; (2) the real exchange rate depreciates sharply, far overshooting any real correction that needs to be made; (3) the current account swings wildly from deficit to outright surplus; (4) the banking system suffers illiquidity, and perhaps an ancillary panic by domestic savers; (5) market real interest rates soar to astronomical levels, as each borrower scrambles to mobilize funds to avoid default; and (6) partial default on forex obligations becomes almost assured. The key effects on macroeconomic contraction are: (1) the collapse of bank lending leading to a collapse of trade and production; and (2) the conversion of illiquidity into insolvency over the course of a few months, as loans become non-performing under the weight of reduced production and sales, and the crushingly high interest rates on working capital.

### **Policy implications and outstanding issues**

The main policy issues are: (1) how to prevent a balance of payments crisis that leads to a creditor panic; and (2) how to respond to a crisis that in fact occurs. On the first point, the logic of these crises points to three principal policies. First, flexible exchange rates dominate pegged exchange rates in almost all cases, since the central bank does not need to squander forex reserves in a defense of an overvalued currency. Even the successful peggers, Argentina and Hong Kong, do not escape the implications of creditor panic. Argentina suffered a decline of 7 percent of GDP in 1995 in the wake of creditor panic. Hong Kong will experience an unprecedented decline of around 4 percent of GDP in 1998. Second, short-term borrowing by domestic banks and government should be limited as a matter of prudential policy. There is simply no excuse for allowing a high level of maturity transformation of foreign short-term loans into domestic investments. Limits on short-term borrowing by banks should fall under the heading of prudential standards rather than capital controls. And yes, foreign loans should be treated differently from domestic loans, since the ability of the central bank to be a lender of last resort on foreign borrowing is inherently limited. Third, domestic banking regulation in the form of enhanced capital adequacy standards, and policies that encourage partial banking-sector ownership by foreign capital, take on special importance as ways of limiting vulnerability to foreign creditor panics.

With regard to policies in reaction to creditor panics, it is clear that the IMF has failed to function as a true lender of last resort, and probably inherently so. The IMF loans are much too small to cover potential outflows and therefore have done little to stop creditor panics. Indeed, provocative IMF actions have probably contributed to the panics. Moreover, the IMF's expertise, political legitimacy, and power within debtor countries are too limited to justify greatly expanded lending programs. More generous IMF lending under such conditions would

most likely exacerbate well-known and much debated problems of moral hazard and distributional inequities of current programs.

Remedies to creditor panic will therefore almost surely have to involve ways to improve the collective response of creditors to panic-prone situations, as in domestic bankruptcy law. This means finding mechanisms to achieve: (1) creditor standstills in the event of extreme financial distress hitting a national economy; (2) methods for raising fresh working capital in the midst of a creditor squeeze (analogous to debtor-in-possession financing under the bankruptcy law); and (3) methods for creditor-debtor bargains for stretching out loans, converting debts to equity, and writing down claims, in the event that a panic is followed by a solvency crisis.

There are many outstanding issues that bear much greater analysis.

- 1) Are creditor panics the result of perceived insolvency of the debtor institutions rather than mere illiquidity (as asserted in this note)?
- 2) Who are the creditors that actually pull the plug: commercial banks, as seems to be the case on published data; hedge funds and other non-bank financial institutions; domestic savers, perhaps operating through foreign investment houses?
- 3) To what extent do devaluations lead to crisis by signaling the depletion of forex reserves, or by provoking balance-sheet crises due to mismatches in assets and liabilities?
- 4) What are the economic forces that lead to currency overvaluation, and can these be resolved through domestic deflation as well as nominal currency adjustments?

**Table 1**  
**Financial Panics and Real GDP Change**

	<b>T-1</b>	<b>T</b>	<b>T+1</b>
Turkey 1994	8.1	-6.1	8.1
Venezuela 1994	0.3	-2.8	2.2
Argentina 1995	8.5	-4.6	4.2
Mexico 1995	4.5	-6.2	5.1
Indonesia 1998	4.6	-15.0	
Korea 1998	5.5	-5.0 to -7.0	
Malaysia 1998	7.8	-6.4	
Philippines 1998	5.1	-0.6	
Thailand 1998	-0.1	-5.0 to -8.0	
Russia 1998	0.9	-6.0	

*Source:* IMF. For T = 1998, GDP change is based on consensus market forecasts or official IMF forecasts.