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AN ALTERNATIVE APPROACH TO FINANCIAL CRISES

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INTERNATIONAL FINANCE SECTION

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PRINCETON, NEW JERSEY

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AN ALTERNATIVE APPROACH TO FINANCIAL CRISES

In a world of increasingly integrated financial markets and high capital mobility, the loss of market confidence in a country or currency may give rise to a severe financial crisis that has significant international effects. Priority should therefore be given to preventing such a loss of confidence.

Because crises lead to the abandonment of complacency, they often provide an opportunity for reform. This essay suggests ways to improve the policy response to speculative attacks so as to limit the risk and scope of the crises they cause, to the benefit of the countries directly affected as well as the international economy.

1 The IMF's Current Approach to Financial Crises

The purposes of the International Monetary Fund (IMF) are set out in Article I of the Fund's Articles of Agreement (IMF, 1993). The IMF should facilitate international monetary cooperation, encourage the expansion and balanced growth of international trade, promote exchange-rate stability and a multilateral system of payments, mitigate maladjustments in the balance of payments, and provide resources under adequate safeguards to facilitate the correction of such payments imbalances. As James Boughton (1997, p. 3) points out, however, "although the intention was that the availability of the Fund's resources should prevent countries from experiencing financial crisis, in practice, the institution has often found itself helping its members cope with crises after they occur."

In recent years, four countries have requested support from the IMF following sudden reversals in market confidence: Mexico, in early 1995, and Indonesia, Korea, and Thailand, in 1997. Abrupt reversals of this sort have created a new kind of problem for emerging-market countries and for the IMF itself. Indeed, in characterizing the Mexican crisis as "the first financial crisis of the twenty-first century," the Fund's managing director recognized that it was different from earlier financial crises, thus implying that it called for a different response from the

The views expressed in this essay are personal and should not be attributed to any institution with which the author has been affiliated.

IMF (Camdessus, 1995; the same characterization has been used by the U.S. Treasury; see Boughton, 1997, p. 4).

How has the IMF responded to this new problem? It has taken the view that "a financial crisis calls for a similar response as any other balance of payments problem except that the response should be quicker and possibly much larger than in a more traditional case" (Boughton, 1997, p. 6). In other words, the Fund has sought to provide, both directly and with the assistance of individual governments, an amount of financing sufficient to restore market confidence in the affected country. In each case, the financing has been provided within the framework of an adjustment program. This combination of financing and adjustment has been meant to restore confidence by insuring that the country's authorities are taking the steps necessary to correct the problems that have "caused" the loss of confidence and are following policies that will permit a return to a sustainable growth path.

In all four of the recent crises, the Fund provided resources in the credit tranches under stand-by arrangements, with very large, front-loaded access. The size of the stand-by arrangement and the degree of front loading reflected judgments about the amounts of financing necessary for the restoration of confidence, given strong adjustment measures and the financial resources made available bilaterally by other participants. In reaching such judgments, an estimate was made of the amount of short-term debt, public or private, that might not be rolled over if confidence was not restored within a short period of time. The Fund's responses appeared to rest implicitly on the supposition that:

- a loss of confidence is invariably caused by poor policies on the part of the affected country and can thus be reversed by forceful adjustment measures;
- the crisis should be allowed to erupt and should then be resolved by an economic program backed by large-scale financial support;
- foreign creditors and investors should, in any event, be protected from market risks.

These three assumptions are dubious. Let us consider each in turn.

Reasons for the Loss of Confidence

The assumption that a reversal of confidence is necessarily or normally caused by poor government policies is contradicted by recent experience. Although Thailand had a large current-account deficit and the baht was probably overvalued, most of the other emerging-market

economies that came under attack, including Hong Kong, Singapore, South Korea, and Taiwan, had much stronger current accounts. In fact, sudden shifts in short-term capital movements often appear to be less dependent on economic fundamentals than on speculators' appetites for profit and their often incorrect interpretations of both national and international political events. In other words, they resemble more closely the currency crises modeled by Maurice Obstfeld (1986, 1995) than those modeled earlier by Paul Krugman (1979).

This is not to suggest that all was well in the Asian economies that came under attack. Their extraordinary economic success had given rise to overoptimism, which had in turn led to excessive levels of investment, usually highly leveraged, and to unsustainable increases in asset prices. The financial statements of firms, moreover, often lacked transparency, and the practices and supervision of the banking systems were far from satisfactory.

These structural weaknesses played a part in aggravating the crisis once it erupted, but they had existed for many years without preventing the rapid economic growth that was so widely praised by private investors and international institutions. Hence they cannot by themselves explain the deep crisis of confidence experienced by the Asian countries.

More generally, it is widely recognized in the literature, and commonly in Fund papers, that capital flows to emerging economies are often volatile for reasons that have little to do with country risk. Among the more widely accepted economic reasons for such volatility are that:

- Exogenous and unanticipated changes in financial conditions in the industrial countries can produce severe destabilizing effects in capital-importing countries, unrelated to their policies or creditworthiness. Industrial countries usually base their economic policies on domestic considerations, with little regard to the international repercussions of their actions. On several occasions, they have generated higher real interest rates and exchange-rate fluctuations that have increased the cost and sharply diminished the availability of international financing to developing countries.
- Capital inflows, including commercial-bank lending, have been markedly procyclical, reflecting macroeconomic conditions in both capital-exporting and capital-importing countries. Capital flows come from the former when low levels of domestic activity or low rates of interest depress returns. Capital flows come most readily to the latter when economic and business prospects are good, and less readily when the economy contracts or when uncertainties arise. Thus, capital

markets themselves tend to undermine the creditworthiness of countries. As the Bank for International Settlements (BIS, 1983, p. 130) stated some time ago: "It may be useful to imagine what would happen in a national context if during the recession banks were suddenly to cut off the flow of new credits to the corporate sector and to begin closing off existing short term credit lines. The inevitable result will be a financial collapse, which will frighten even soundly managed firms, including banks. . . . Such a financial collapse would therefore not permit any easy inferences with respect to the quality of the pattern of bank lending and of corporate investment before the outbreak of the crisis, whereas the conclusion could safely be drawn that something had gone seriously wrong with the macro-economic management of the economy."

- Market behavior is often characterized by informational asymmetries and contagion effects. Country-risk analysis, which is far from perfect, is often characterized by "herding" behavior. Recent episodes of financial-market turbulence show that a country can lose its creditworthiness overnight, leaving the authorities little time to react. In a number of cases, this sudden loss of creditworthiness may be unjustified. Countries face abrupt changes in the cost and availability of capital when unexpected events, such as large macroeconomic or financial shocks in a neighboring country, trigger sudden shifts in market sentiment. As market liquidity dries up, the country may face excessive adjustment costs. Moreover, as we have seen repeatedly in Latin America, and more recently in Asia, there is a tendency to judge a country's creditworthiness on the basis of its regional location or stage of development, rather than on its own merits. When one country in a particular group experiences payments difficulties, markets often suspend new credits to all countries that are in the same region or that have similar characteristics.

The bandwagon effect, which abruptly reduces liquidity across the board, can disrupt the economies of capital-importing countries and seriously destabilize the international economic and monetary system. In many cases, the restoration of creditworthiness is unduly delayed as investors hold back and wait for economic recovery, a stance that prolongs the recovery itself and makes it more uncertain. Bank regulatory agencies and credit-rating agencies, which are cautious by nature, may wait to assess compliance with the economic program over a period of, say, a year before revising their appraisal.

The Costs of the Current Approach

Too often, the current approach to financial crises seems to imply that the best way to deal with a crisis arising from a loss of confidence is to let the crisis erupt and then try to restore confidence by an abrupt change in economic policies and substantial financial support. This approach is unsatisfactory, because a crisis can inflict great damage quickly.

Typically, a crisis of confidence leads to a run on the country's currency, which provokes a massive devaluation—by 115 percent in Mexico in 1994–95, for example, by 228 percent, 96 percent, and 87 percent, respectively, in Indonesia, Korea, and Thailand in 1997, and by 135 percent in Russia in 1998. Such devaluations go well beyond any that might conceivably be desirable or necessary to restore a country's external accounts to sustainable balance. To describe them as egregiously inappropriate, however, is not to imply that exchange-rate adjustments should not be made when needed or that fixed exchange rates are preferable to floating rates.

The sequel to such devaluations is well known. As domestic prices of tradables adjust to reflect their international prices, inflation rises sharply and domestic interest rates follow. Wages typically lag behind, leading to a fall in consumer demand. Uncertainty, falling demand, and higher interest rates combine to cause a fall in investment. As these events lead to a decline of gross domestic product (GDP) and rising unemployment, the country falls into a recession.

All theories would advise an expansionary fiscal stance at a time of recession. The fiscal policy at the center of Fund-supported programs, however, invariably requires fiscal retrenchment and is thus markedly procyclical (Gavin and Haussman, 1997). Retrenchment is, in any case, the only response available to the authorities once access to noninflationary sources of finance has vanished. To opt for fiscal expansion financed by money creation could lead to a collapse of confidence in the viability of the public finances and could deepen the crisis.

The conjunction of sharp currency depreciation, inflation, recession, falling real incomes, higher unemployment, rising interest rates, and falling asset values almost inevitably leads to a banking crisis. Mortgage holders, who typically account for 20 to 25 percent of bank portfolios, are often unable to make their mortgage payments, which have become a multiple of those originally envisaged. The value of the real estate offered as collateral, moreover, has fallen far below the value of the loan it guarantees. Many firms also face payments difficulties as sales

fall and debt service rises in response to higher interest rates or the dramatic increase in the domestic value of their dollar-denominated debt resulting from the exchange-rate depreciation. The banking crisis in turn hinders economic recovery, as credit becomes scarce and the need to support banks adds to the burdens on the public finances.

The Mexican experience illustrates the heavy costs of a financial crisis triggered by a loss of market confidence. Asian countries that have recently suffered financial crises are starting to face similar problems. It is estimated that in 1998, Indonesia's economy will have shrunk by about 15 percent, Thailand's by over 8 percent, South Korea's by 7 percent, and Malaysia's by 5.5 percent. Other countries in the region will have also suffered declines in growth rates.

In 1995, after the sudden interruption of capital inflows in late 1994 and early 1995, economic activity in Mexico contracted by 6.9 percent in real terms. This was the sharpest decline since the Great Depression six decades earlier. It was reflected in a marked rise in unemployment, which, coupled with an upturn in inflation, lowered the country's standard of living considerably. Gross domestic product posted marked declines in every quarter of 1995, compared to the corresponding quarter of the previous year. The worst drop occurred during the second quarter, when GDP fell 10.5 percent below the second-quarter level in 1994. Large decreases continued during the third and fourth quarters, although, at lower rates of 9.6 and 6.6 percent, respectively (Banco de Mexico, 1995b, p. 13).

The diminished availability of foreign resources in 1995 caused a marked decrease in aggregate demand that was passed on to production. Domestic absorption—the sum of private and public consumption and investment—fell by 15.9 percent. This contraction was only partly offset by larger exports of goods and services. Therefore, real aggregate demand declined by 10.2 percent in 1995, measured at 1980 prices (Banco de Mexico, 1995a).

Average industrial wages in 1995 were 44 percent below their 1994 level and rose only modestly in real terms in 1996. The decline in wages, coupled with the rise in unemployment, brought about the most severe fall in private consumption, 12.9 percent, ever recorded in Mexico. Expenditure on durable goods fell by 45.7 percent, and sales of nondurable goods declined by 8.3 percent.

Gross fixed capital formation decreased by 30.9 percent in 1995. Its two components, private and public investment, declined by 33.9 and 18.9 percent, respectively. Spending on domestic capital goods fell sharply, by 29.4 percent, particularly for purchases of transportation

equipment (93.5 percent). Spending on imported capital goods fell by 35.3 percent. In order to attain the fiscal balance envisaged in the program, public-sector spending was reduced by 8.4 percent in real terms, further contributing to the decline in economic activity.

The crisis gave rise to a sharp increase in the nonperforming assets of the banks. The Mexican authorities estimate the cost of the bank-rescue programs to have been about 15 percent of GDP, or US$62 billion, and private estimates run even higher. Despite major bank-recapitalization efforts, however, the banking system remains fragile and fresh credit is scarce because the level of nonperforming loans has not declined as expected.

What began as a speculative attack against the Mexican peso, which might have been defeated, developed into a crisis of confidence that caused an economic collapse having grave social, political, and redistributional consequences. The costs of the banking crisis will have to be paid for many years to come.

The Mexican recession was deep, but it was also brief, thanks to structural reforms undertaken in Mexico during the last decade, to a favorable external environment that permitted an export-led recovery, and to the Mexican government's determination to pursue the IMF-supported economic-recovery program. A strong recovery occurred in 1997, with gross national product (GNP) growing 7 percent. Nevertheless, in reviewing what has generally been considered a very successful adjustment, one cannot help asking whether the high cost was really inevitable. Could Mexico have been provided with the opportunity to correct maladjustments in its balance of payments "without resorting to measures destructive of national or international prosperity" (IMF, 1993, Article I)?

Financial collapses make deflations and depressions possible because they destroy the confidence on which economic activity depends. The Fund's approach to financial crises, which is based on tight credit, higher interest rates, and fiscal retrenchment, does not help avoid recessions and banking crises. It therefore increases uncertainty and compounds the problem. Yet, as we shall see, the Fund could help avoid financial crises by helping to sustain confidence at critical moments.

The Protection of Foreign Creditors and Investors

A notion implicit in the strategy followed in recent Fund-supported programs is that foreign creditors and investors should be protected from market risk. This view, which was implemented in the early 1970s during the Chilean banking crisis, surfaced again during the recent

crises. The rescue packages provided to Mexico, Indonesia, Korea, and Thailand by the Fund and the authorities of certain industrial countries have been tailored to meet all payments to foreign creditors falling due in the short term, thus protecting them from losses. This raises the issue of moral hazard.

Under market rules, investors take risks and may gain high returns or suffer heavy losses. When risks have materialized, however, large groups of investors have been saved from their mistakes by the champions of the market. Their gains have thus been private, but their losses have been socialized and absorbed by the capital-importing countries.

2 An Alternative Approach to Confidence Crises

An alternative strategy for managing confidence crises could be developed that would:

- regulate capital flows to emerging markets,
- eliminate the protection of portfolio investors,
- establish debt restructuring and "bankruptcy" procedures, and
- develop a new policy on the use of Fund resources to break the mass psychology of financial markets.

The precise mix of policies to be applied would, in each case, be determined by the prevailing circumstances, the quality of economic policies followed by the country in question, and the availability of financial support.

Regulating Capital Flows to Emerging Markets

In a competitive model, free capital movements are assumed to promote efficient resource allocation in a manner parallel to that derived from free trade in goods, to achieve a superior intertemporal pattern of consumption and thus to enhance welfare. Economic theory admits exceptions to this rule, however, whenever distortions invalidate the assumptions necessary to sustain a "first-best" competitive equilibrium. The idea is simple: if the economy is seen to suffer from a distortion, welfare may be improved by the judicious introduction of another distortion. This is the "theory of the second best" (Dooley, 1966, p. 640).

Recent experiences of market volatility in the new global, electronically linked, markets, which led to very costly crises in Mexico, Asia, and Russia, have made the potential costs of massive speculative flows difficult to ignore or underestimate. Indeed, the experiences of the

crisis countries show that the costs imposed by free capital movements in global markets have not been given adequate weight, and they give rise to questions about market distortions that merit careful consideration:

- Can market failures, such as price distortions in goods and labor markets, the irrational behavior responsible for much of the recent massive speculation, and the encouragement of inefficient patterns of consumption and investment in economies receiving large capital inflows, justify intervention to limit portfolio capital inflows (Dooley, 1966)?
- Can speculative attacks on a currency become self-fulfilling and succeed even if a government has followed fully sustainable policies prior to the attack? Are emerging-market economies particularly vulnerable to these attacks?
- Can certain kinds of capital controls protect countries from, or reduce the risk of, unwarranted massive currency depreciations triggered by contagion or mass psychology in the financial markets?
- Does the existence of multiple equilibria in financial and exchange markets justify capital controls?
- Can a distinction be made between the liberalization of long- and short-term capital flows?
- Can the gains from improved resource allocation and economic efficiency associated with free capital movements be largely obtained through direct foreign investment without running the risks inherent in allowing free movements of volatile portfolio capital?
- Can the benefits of opening financial services to foreign competition be obtained without full freedom for portfolio flows?
- Should the particular conditions of each country be considered—that is, should a distinction be made between countries that are awash with domestic savings and countries that have low savings rates?
- Should countries with weak financial systems delay the full liberalization of capital movements?

If the answers to several of these questions are affirmative, the assumed gains from free capital mobility will have to be balanced against the very real risks such mobility poses. Some form of regulation or control on inflows of short-term capital seems necessary to protect emerging-market economies from the devastating financial crises

caused by massive capital movements. The full liberalization of capital movements now propounded by the Fund and many others may be inappropriate in current circumstances and, perhaps, for a long time to come (Rodrik, 1998).

It is remarkable that the October 1998 *Report of the Working Group on International Financial Crises* (the Willard Report), which examines issues related to the stability of the international financial system and the functioning of global capital markets, does not address the questions raised above, despite the fact that the devastating Asian financial crisis has spread to other continents and could cause a worldwide recession. The Willard Report rightly stresses that debtor countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time. It has little to say, however, about the ways in which countries can protect themselves against massive capital outflows or unilateral interruption of access to markets following shifts in market sentiment.

Jagdish Bhagwati (1997), a champion of free trade and an authority on trade and development, argues that capital markets "are very volatile. Suddenly expectations can turn around. You may be very healthy but suddenly you catch pneumonia. And then you may have to do unspeakable things to your economy just to regain that confidence because you are now hooked to the system. Markets may do something when you have done nothing wrong and you may have to do something wrong in order to convince the markets that you are doing something right! I would put off (capital account) convertibility for quite a while" (see Bhagwati, 1998, for more on this view). Bhagwati observes that many countries have grown satisfactorily without capital-account convertibility, including Japan, the countries of Western Europe, and, most recently, China. "In my judgement," he states (1997), "it is a lot of ideological humbug to say that without free portfolio capital mobility, somehow the world cannot function and growth rates will collapse."

The liberalization of capital flows and the integration of financial markets generally benefit the world economy, because they provide wider opportunities to both borrowers and lenders. They have, however, allowed major crises to erupt and to spread very rapidly as financial markets in emerging-market economies have swung between periods of excess and periods of severe shortages of capital. Financial-market volatility and overreactions pose new and difficult challenges for which both national financial authorities and the international community are unprepared. Indeed, these problems are often difficult to foresee and to resolve, even when they are fully understood.

A prudent approach would be for each country, possibly in consultation with the IMF, to determine the level of capital inflows that it can absorb without experiencing undue pressure on domestic prices or its current-account balance. Capital flows beyond that level could be discouraged by, for example, requiring that capital inflows remain in the country for a minimum of, say, one year or that a fixed fraction be made in the form of a non-interest-bearing deposit. Countries such as Chile and Colombia have, for a number of years, successfully applied such requirements to limit portfolio capital inflows, thereby obtaining a balance between short-term investment and foreign direct investment that has reduced the volatility of the overall capital flow.

Changing expectations and divergent macroeconomic conditions in capital-importing and capital-exporting countries give an unpredictable character to private capital flows. Thus, a country or group of countries may experience periods of both excessive and inadequate liquidity. In order to reap the full benefits of the liberalization and integration of international financial markets, ways must be found to limit the risks posed by this volatility.

Other suggestions have been made to deal with this problem. Countries receiving substantial capital inflows have been urged, as a precaution, to channel a significant proportion of such inflows into their international reserves. Some have, in fact, done this. Nearly half of the $1.2 trillion in net capital flows entering emerging markets in search of high returns have been accumulated by those countries as international reserves. But those reserves have, in turn, been largely reinvested in low-yielding instruments, mostly treasury bills, in industrial-country markets. The difference between the high yield demanded and earned by investors from industrial countries and the low yield earned on reserves is an implicit cost borne by the public in the emerging-market countries. This is thus a very costly form of self-insurance. As with other forms of self-insurance, it could advantageously be replaced by less costly group insurance. The IMF, the BIS, or some other credible organization should be able to pool a share of the international reserves of countries in various regions and with various risk profiles to provide the emerging-market countries with less expensive insurance. Given its universality and purposes under the Articles of Agreement, the IMF would appear to be the institution best suited to provide this service. This could be done in one of two ways: (1) The IMF might hold and invest a pool of reserves deposited with it by emerging-market countries; this would not require any change in quotas or rules of access to the Fund's own resources; it would require rules of access to the pooled reserves; (2) some reserves

should be used to enlarge the size of the IMF itself (that is, make the reserve-tranche subscriptions required for a quota increase); this would require a big increase in quotas and liberalization of access, and it would also require that all countries agree to the quota increase, not just the emerging-market countries.

The Willard Report suggests another way of reducing the need to accumulate reserves. Countries may seek to insure themselves against a shortage of liquidity by arranging contingent credit facilities with a consortium of banks, to be drawn in periods of market turbulence. Such facilities could provide access to supplementary liquidity at a cost less than that of holding an equivalent quantity of reserves. Like reserves, these facilities could help prevent crises by enhancing market confidence. As the report recognizes, however, such facilities might not provide significant amounts of new money in the event of a crisis. Banks participating in a line of credit to the Mexican government resisted an increase in their country exposure by refusing to grant new credits to Mexican firms.

The provision of credit enhancements or guarantees by the World Bank or other multilateral development banks was also mentioned by the report. But these would generally count against the country lending limits of the institutions and would also count against their capital and reserves. Such a strategy would therefore not solve the problem of access to financial markets.

The negotiation of financial arrangements to insure against volatility in the prices of key exports may be useful in a number of cases. The usefulness of such arrangements, however, is limited to commodities for which there are well-developed futures markets. Furthermore, most emerging-market countries are largely exporters of manufactures, rather than primary products, and their export revenues depend on the expansion of their markets. For these countries, an international recession will typically lead both to a fall in demand for their products and to reduced access to external financing.

The same objection applies to the proposal that emerging-market countries issue bonds linked to the prices of key commodities, a measure that would reduce or postpone interest or amortization payments under unfavorable circumstances.

Finally, it has been suggested that options be added to sovereign bonds or credit lines allowing a debtor to extend the maturity of a loan for a specified period at a predetermined spread. Unfortunately, no consideration has been given to the probable impact such options would have on the cost of financing or on access to financial markets.

Because financial markets react to perceived risks from expected developments, including political developments, they are prone to contagion. A change in expectations, however unwarranted, can therefore cause very large capital outflows. Accordingly, the "new" techniques of self-insurance considered above, which would make only marginal adjustments in financial flows, could be expected to make only a limited contribution to the stability of emerging-market economies.

Eliminating the Protection of Portfolio Investors

A forthright approach to the problem of crisis management requires adherence to a principle that is commonly endorsed but rarely applied: investors must share the risks arising from the volatility of capital flows—a volatility to which they contribute. Under current arrangements, neither the market nor any international organization or insolvency procedure imposes discipline on creditors holding foreign-currency claims. Instead, the IMF and a small number of industrial countries protect them from market forces. Because this allows investors to undertake virtually risk-free operations, they need not act prudently. (Investors in equities, however, which in some sense come closer to foreign direct investment, have taken large losses, not only because of the currency devaluations but also because of sharp falls in equity prices.)

Investors must be made aware of the impact their actions have on the economies of the countries in which they invest and given incentives to act in a socially responsible manner. If a sudden massive reversal of capital flows, a run on a country, were to cause a financial crisis, the authorities—in consultation with and under the supervision of the IMF—must be able to force foreign-currency creditors to take certain losses or, by analogy with bankruptcy procedures, must be able to impose specific limitations on the running down of foreign-currency claims, so as to schedule capital withdrawals in a manner consistent with the country's ability to pay without seriously disrupting economic activity.

Establishing Debt Restructuring and "Bankruptcy" Procedures

When should a country receive large-scale financial assistance? When should it be allowed to impose limits on debt payments to private creditors or to resort to a kind of bankruptcy procedure? Some broad guidelines might be suggested:

- Countries prefer large-scale official financial assistance because it maintains a country's access to markets and avoids disruptions in payments and economic activity; creditors prefer it because it

helps them avoid capital losses as well a loss of liquidity. The unconditional provision of large-scale support to all countries and investors regardless of their policies, however, would certainly give rise to moral hazard. Ample official financial support should therefore be limited to those countries that Fund surveillance has found have sound fundamentals and prudent policies. This rule should encourage countries to pursue wise policies and induce creditors to be selective about where they place their money.

- Portfolio investors should not be protected in any way if their transactions are seen to be destabilizing. Indeed, speculative capital flows, defined as short-term flows seeking to make gains by interest-rate arbitrage or by betting on capital gains from an anticipated exchange-rate adjustment, would not receive protection. Such flows could be discouraged by requiring either that a portion of the capital be put in a non-interest-bearing deposit or that the capital remain in the country for a minimum of one year.
- Countries that do not qualify for large-scale official support could nevertheless be eligible for the rescheduling of their external debt. This would be done in a manner consistent with their expected payment capacity, provided the country undertakes to follow good policies as agreed with the IMF. The country would be entitled to reschedule debt-service payments at a level consistent with sustaining a reasonable level of economic activity and pace of development. Creditors would be aware that such a country was subject to the risk of rescheduling and would act accordingly.
- Bankruptcy procedures, involving outright debt reduction, would be available only in cases of excess debt or "debt overhang," where as a result of a deterioration in the terms of trade or for some other reason, a country is unable to reconcile meeting its debt payments with a reasonable level of economic activity and pace of development. The bankruptcy procedures would be accompanied by the policy conditionality considered necessary to put the economy on a sound basis and would aim at restoring the viability of the country's economy.

It must be acknowledged that reaching debt-rescheduling agreements is likely to be far more difficult today than it was in the 1980s, because sovereign debt has shifted in composition from syndicated bank loans to sovereign bond issues.

In the negotiations leading to the restructuring of sovereign debt in the 1980s, creditors could not fail to notice that the legal and practical

difficulties of restructuring publicly issued sovereign bonds were incomparably greater than the difficulties of rescheduling syndicated bank loans. Bonds were consequently exempted from the restructuring exercises—an action that was the equivalent of recognizing their seniority over syndicated bank debt. This decision certainly contributed to the rapidly increasing importance of sovereign-bond issues by emerging-market and other developing countries in the 1990s. Bond issues by nonsovereign borrowers also rose sharply during these years. In 1990, international bond issues by developing countries and transition economies amounted to $7.8 billion out of a total of $52 billion in new borrowing; by 1996, bond issues represented $102 billion out of total of $124 billion. The reasons for anticipating much greater difficulty in restructuring sovereign-bond debt are that:

- Although syndicated loans use "sharing clauses" and other incentives aimed at encouraging creditor banks to cooperate in the negotiation of debt-rescheduling agreements, bond covenants include no sharing clauses, so that a bondholder who engages in litigation can keep all that he recovers.
- Bond covenants normally include an "acceleration" clause under which, in the event of default, the whole of the unpaid principal may be made payable immediately by bondholders holding only a small proportion of the total issue.
- Creditor banks participating in syndicated loans can be subjected to pressure by the regulatory authorities to participate constructively in debt-rescheduling agreements. Bondholders, however, are a heterogeneous group, and few of them can be subjected to pressure or moral suasion.
- Bonds are traded in the secondary market and held by investors who are not only less homogeneous but also more dispersed than those holding syndicated loans. They include individuals as well as nonbank financial institutions and have a wide diversity of interests that are difficult to reconcile.

In addition to making it more difficult for a debtor to negotiate, these considerations have encouraged creditors seeking a stronger legal position vis-à-vis their debtors to shift from syndicated loans to sovereign-bond issues, and this is one reason for the rapid growth of bond issues after the debt-rescheduling exercises of the 1980s. But if a cooperative rescheduling of sovereign-bond debt is particularly difficult, what are the possibilities of reaching a solution through a bankruptcy procedure?

Bankruptcy procedures appear on the statute books of most countries in order to protect insolvent debtors from creditors who may otherwise seize their assets. Under these procedures, courts may mandate a suspension of debt payments, or even fix workout periods for restructuring, to enable a heavily indebted enterprise to continue its operation, provided its operating value exceeds its liquidated value. In exchange, creditors may either replace the management of the firm or impose some form of supervision over its operations, including conditions relating to the kinds of transactions it may undertake and limitations on the kinds of payments and expenditures it may make.

No such procedure exists in the international context, and the leading creditor countries have recently rejected proposals for its establishment. The working party of the Group of Ten (G–10) deputies (1996, p. iv) concluded in 1996 that "there is a need for the principles and procedures for handling sovereign liquidity crises to take into account the new importance of debt in the form of securities and the growing likelihood that some such debt may have to be subject to re-negotiation in the future." Nevertheless, it declared that "the establishment of a formal international bankruptcy procedure would not be feasible nor appropriate under present circumstances or in the foreseeable future, . . . [because] sovereign debtors have not in the past had a strong need for legal protection against their creditors, nor could they be obligated to submit to the jurisdiction of a bankruptcy forum" (p. iii).

One cannot help but wonder at this view. The fact that sovereign borrowers have not needed legal protection in the past cannot, by itself, say much about the future, given the changed circumstances. The success of past rescheduling agreements involving bank loans is an outcome that will be difficult to replicate "in view of the importance of debt in the form of securities."

Indeed, the G–10 working party recognized this difficulty when it proposed the inclusion of new contractual provisions to facilitate cooperative solutions in future lending operations. The use of these new provisions would remain voluntary, however, and they may never be introduced, because they might appear to be at odds with the interest of creditors, who do not wish to see their rights or freedom of action restricted. To my knowledge, no such contractual provisions have yet been introduced. In addition, even if contractual provisions or "collective-action clauses" favoring a cooperative solution were introduced today, they would not cover currently outstanding sovereign-bond debt, which by some estimates may amount to $1 trillion.

The second reason given by the working party, that "sovereign debtors could not be obligated to submit to the jurisdiction of a bankruptcy forum," appears disingenuous. It does not allow for the possibility that debtors may voluntarily seek the benefit of such a procedure, which presumably would provide them with a predictable outcome, as well as protection from the imposition of excessive economic or social costs. It should be noted, moreover, that debtors must already submit to Fund programs in order to obtain external financing. The imposition of external supervision or policy conditions on the management of their economies would thus not normally represent an additional burden.

Bankruptcy procedures would reduce the debt stock only in exceptional cases, when a significant change in the terms of trade or some other circumstance made the debt burden unmanageable The international community would have to determine that the country's stock of debt must be reduced in order for the country to sustain a reasonable level of economic activity and pace of development. This is not likely to be the case for emerging-market economies with increasingly diversified industrial exports. These are economies that, even a few weeks prior to the onset of crisis, were generally regarded as being highly successful, with a favorable growth potential.

Arrangements to deal with the liquidity and insolvency problems of countries are as necessary to the normal functioning of the international economy as similar procedures are to the operation of a domestic market economy. Clear rules to regulate insolvency and debt relief, known to both debtors and creditors, will facilitate the prompt resolution of debt problems and encourage creditors to be more prudent about the risks they take. Such rules are all the more urgent, because the procedures that operated in the past to address the payments problems of countries with access to private capital markets are no longer available.

The negative stance of the G–10 working party toward such an arrangement seems to reflect a deliberate desire to retain an element of uncertainty with respect to the resolution of solvency and liquidity problems. Such ambiguity allows creditors a considerable degree of discretion to decide how and when they will respond but leaves debtors uncertain about where they stand, so that they will be fearful of the consequences of less-than-prudent behavior.

This "moralistic" attitude is out of place. Debt and insolvency problems are bound to arise in a market economy—sometimes for reasons that have little to do with the conduct of the debtor country. Because these

problems are inescapable and will have to be addressed, the international community should develop the appropriate legal and institutional framework at an early date and stand ready to deal with them.

The Willard Report underscores the desirability of a predictable legal framework to deal with the financial difficulties of troubled debtors in the domestic context. It emphasizes that strong insolvency regimes foster cooperation among creditors confronted with debtors in financial difficulty and that an orderly reorganization of a debtor's obligations is in the collective interest of creditors, insuring that the losses incurred by all creditors are not increased by the unilateral actions of a few. It commends the UNCITRAL Model Law on Cross-Border Insolvency, which, among other things, creates a procedural mechanism for the imposition of a moratorium on debt payments to protect the international assets of an insolvent firm. In addition, it identifies arrangements to keep the debtor in operation and to maximize its value for creditors as one of the key elements of an effective insolvency regime. Should not these basic principles be applied to countries falling into payments problems?

The Willard Report acknowledges that there has been some debate in recent years about the creation of a mechanism to regulate legal action by private creditors against sovereign debtors, so that in "exceptional and extreme cases," the debtor may temporarily suspend payments and be provided with a "breathing space" so as to permit an orderly, cooperative, and negotiated restructuring. It would probably be easiest to do this by amending Article VIII.2(b) of the Fund's Articles of Agreement to allow it to provide a mandatory stay to prevent the enforcement of judgments against a sovereign in the event of an interruption of debt payments. After having stressed the need for a strong regulatory framework to deal with the domestic and cross-border insolvency problems of firms, however, the report somewhat incongruously fails to take a position on the desirability of such an amendment or of any other innovation that might provide a framework for addressing the insolvency problems of countries. It simply states (p. 37) that "such an amendment would not appear feasible at the present time." How was this assessment reached? Can it be attributed to the desire of creditors to retain maximum discretion?

Like the earlier G–10 report (1996), the Willard Report stresses the desirability of adding certain collective-action clauses to foreign sovereign-bond issues so as to facilitate debt restructuring if ever required. These repeated recommendations notwithstanding, however, such clauses have not been introduced.

Because collective-action clauses are not likely to be spontaneously adopted by investors, consideration could be given to inducing their introduction. This could be done, for instance, by introducing a regulation requiring that after some future date, such clauses must be included in all foreign sovereign bonds placed in member countries of the Organisation for Economic Co-operation and Development and the Bank for International Settlements or bonds issued subject to the jurisdiction of their courts. Because the number of countries involved would be far fewer than the membership of the IMF, and legislation might not normally be required, the introduction of such regulations should be easier than amending the Fund's Articles of Agreement to give it jurisdiction over capital-account convertibility.

Using Fund Resources to Break the Market's Mass Psychology

The essence of the problem of volatility in financial markets is that investors' responses to changing expectations sometimes resemble a crowd's reaction when someone shouts "fire!" in a theater. This behavior need not be irrational. Whether or not the fear is well founded in a weakness of a country's economic fundamentals, a run may start because the incentives are asymmetrical.

Faced with a disturbing event, rumor, or news item, the investor must decide if the information appears plausible and how the markets are likely to react to it. In the light of this assessment, the investor must decide whether to stay or leave. In reaching his decision, he must calculate whether a substantial number of other investors, or investors with substantial resources, will pull out of the country.

If he is one of the first to get out and there is no crisis, he will be seen as cautious and his losses, if any, will be minimal. If he stays on and there is a crisis, his losses may be enormous. An investment-fund manager will have an added incentive to "follow the herd," for any losses he suffers by doing so will be attributed to the market; if he deviates and loses, however, he will be held responsible.

The approach taken by the Willard Report toward this issue is helpful. Pursuing sound macroeconomic policies, increasing transparency, strengthening national financial systems, improving banking supervision, and, more generally, adopting the "best practices" will reduce contagion and, to the extent that these measures build confidence, will reduce market volatility. As important and positive as these measures are, however, they are unlikely to be sufficient to prevent future financial crises in a world of highly mobile capital and global capital markets. The Willard Report seems to recognize this when it

states that "the report should not be considered an agenda for addressing the problems currently being experienced in many emerging markets" (p. iii).

A country facing a loss of confidence must have a strategy of defence in place and readily available in order to stop a massive speculative attack before it leads to a panic devaluation and the devastating effects that can have on the economy. Yet the current Fund response to payments disequilibria was designed to address balance-of-payments crises resulting largely from significant fiscal or monetary imbalances. It is not well suited to dealing with confidence crises in today's financial markets, which often are not caused by such imbalances.

By emphasizing the contraction of demand and an increase in interest rates to strengthen the balance of payments, the Fund's strategy discourages investment, compounds the recessionary impact of the reversal in capital flows, and generally exacerbates the difficulties faced by firms, banks, and public finances. The strategy typically deepens the domestic crisis, because the problem is allowed to grow much larger and become more costly before it is resolved.

Given the volatility of capital flows, countries may face confidence crises that have little to do with their economic fundamentals. When markets are nervous, moreover, the country's authorities may be impelled to freeze their policy stance for fear that any policy shift will be interpreted as an admission of weakness and will unleash or intensify a speculative attack. If their position were seen to be strong, however, because they were known to have ample support from the IMF or other sources, they would be able to adjust policy confidently in response to changing circumstances.

A country facing a crisis of confidence, and having suddenly lost a significant proportion of its reserves, would consult with the IMF and might, if appropriate, suspend some debt payments temporarily—a measure akin to the suspension of trading in leading stock markets. It could thereby deal with the situation in an orderly manner, avoiding the exhaustion of its international reserves and averting a panic that could lead to an excessive devaluation, a collapse of economic activity, and a banking crisis. The payments position of the country would then be reviewed rationally by the international community, and an orderly solution to the problem developed. This solution would be based on an economic program receiving immediate Fund support, coupled, if appropriate, with a debt-rescheduling proposal.

It is likely that these two actions, stopping the speculative run and providing Fund support, would restore a large measure of confidence

to the markets. Although some investors might nevertheless assume that the loss of international reserves would trigger a suspension of payments and might try to pull out before that occurred, the risk of their exiting might seem less threatening to a country than the risk of a full-fledged run that would sweep the country into a deeper crisis. By taking pressure off the exchange market and thereby preventing the worst effects of a run, this mechanism would also reduce the amount of financial support the country might need from the international community. The very existence of such a plan, moreover, would discourage short-term capital from entering the more vulnerable countries, which might, in the event of a crisis, impose a suspension or limit on capital withdrawals.

An alternative strategy for dealing with financial crises would aim at preventing speculative attacks from developing into full-fledged payments crises. It would sustain confidence through the timely provision of sufficient financial support, coupled, if appropriate, with a policy reform package. Consider two scenarios: the case of a country with very good economic fundamentals and the case of a country with fundamentals that are generally good but that fall somewhat short of what is considered appropriate in the circumstances and that must therefore be adjusted to merit full international support. This would be the case of a country that has sound policies but that is faced with a change in circumstances, such as a deterioration in the terms of trade, a decline in the volume of capital inflows, or other adverse developments that weaken its external payments position and make it desirable to reduce aggregate demand or adjust exchange-rate policy (such as a move from a fixed to a floating rate).

A country with very good economic fundamentals could be provided with a readily available stand-by credit, to be used in the event of a significant speculative attack on its currency. The amount of the credit should be large enough to discourage speculators, say, the equivalent of no less than six months of imports and interest payments. The money would be available *in toto* at very short notice, and drawings would not be subject to tranching or prior performance conditions. The October 30th G–7 Declaration (1998, para. 3[viii]) points in the right direction by calling for the creation of "an enhanced IMF Facility which would provide a contingent short-term line of credit for countries pursuing strong IMF approved policies." It is a little vague, however, and does not go very far.

A country with generally good but partly problematic fundamentals would have two options. It might be prepared to adopt additional policy

measures before speculative pressures developed and thus move into the first category, becoming a country with good fundamentals. It might, instead, declare that it disagreed with the Fund staff about the desirability of additional measures and ask that the issue be submitted for resolution to the board of the IMF. If the country did not adopt the policy measures recommended by such a review and then came under an incipient speculative attack, the Fund would probably require not only that the country agree to the policy adjustments originally proposed by the Fund staff but that it go significantly beyond them in order to regain market credibility. Because the market would perceive that the country's position had weakened, the mix of support and policy adjustments would have to be stronger than would otherwise have been required. A similar situation might arise if a country with very good fundamentals did not respond with a suitable policy correction after suffering a political shock that undermined confidence. In exchange for the support received, the country would commit to undertake any further policy adjustments that might be appropriate over a predetermined period, normally not exceeding a month, after the resources were made available.

It will not always be easy to distinguish clearly between those countries that merit international support and those that must make a policy adjustment before receiving it. In some cases, there may be need for negotiations and understandings between the country and the IMF as to when specific actions will be taken. If the Fund were to decide that a country did not qualify for early, substantial support, it would inform the country of the policy changes it must undertake in order to merit such support. This knowledge would put the country in a better position to respond quickly in the event of actual speculative pressures.

As a result of the weighted voting system by which creditor countries are assured a majority of votes on the Fund's board, IMF decisions to support countries are likely to show a bias in favor of caution. The IMF will normally require strong programs and will display greater concern for the balance of payments than for the level of economic activity. Although a better political balance on the Fund's board would be desirable, it must nevertheless be recognized that the board's conservative bias may enhance market credibility and that outcomes under the new mode of financing would still be much better than under the current situation, in which emerging-market countries normally receive financial support only after they have come under speculative attack.

The amount of financial support to be provided by the IMF under this scheme may be illustrated with reference to Mexico. Mexico's quota in the IMF is SDR1.7 billion, or about $2.5 billion. Mexican imports of goods in 1994 were $79 billion, and external interest payments amounted to $15 billion. Thus, providing the equivalent of six months of imports and debt-service payments would have required $47 billion, a sum somewhat larger than the financial package actually put together by the United States, the IMF, and Canada.

For the IMF to be able to provide a much-increased level of financial support and to remain credible, its size or its borrowing capacity would have to be substantially increased. Most of the Fund's resources, however, would—like the nuclear deterrent—remain unused. Indeed, if Fund support were timely, sufficient, and fully credible, its resources would be unlikely to be drawn or, if drawn, unlikely to be used to any considerable extent, because speculators would know they cannot win.

The Fund's role would be similar to that played by central banks when they act as lenders of last resort in the national context. Experience shows that when the central bank is openly prepared to support a bank facing a liquidity problem, a run on that bank is prevented and the amount of central-bank support required, if any, is much smaller than would otherwise have been the case.

Would a policy of readily available credit or "payment in advance" give rise to a problem of moral hazard? It seems very unlikely to do so. Recall that the chief recipients of capital from the markets are successful countries that generally follow sound policies, and that this support would be limited to countries that, in the view of the IMF, pursue generally good policies. Furthermore, a country that did not comply with its policy commitments to the IMF would, in all likelihood, become prey to a costly financial crisis, because it would probably suffer an outflow of capital and forfeit access to all forms of external credit. The political and economic costs of noncompliance would therefore be likely to be considerably greater than the costs of adopting the additional policy measures that the Fund would recommend.

The scheme could even lead to an improvement in the quality of policies pursued by an important and growing group of countries. As the IMF, in the normal course of surveillance or of Article IV consultations, suggested policy adjustments, a country wishing to have unchallenged and immediate access to Fund resources in the event of a speculative attack would be likely to adopt the suggested policy measures promptly. This would be a small price to pay to ensure that it would not fall prey

to a crisis of confidence. In the absence of such a scheme, the international community has only one clear way to address the risk of recurrent financial crises in increasingly integrated financial markets: the provision of financial support to countries undertaking unnecessarily costly adjustment programs after a crisis has taken its terrible toll.

Since 1952, the IMF has maintained that conditionality is required in order to maintain the revolving character of Fund resources and that it cannot insure that it is making its resources temporarily available to members unless it makes its lending conditional on the adoption of adequate macroeconomic policies. Implicit in this approach is the belief that because a payments crisis is the result of poor economic policies, a country will not be in a position to repay the IMF unless those policies are corrected. In holding fast to this view, the IMF has not sufficiently adapted its policies to the new nature of the financial risks faced by many emerging-market economies in a world of volatile capital.

Is conditionality required to ensure repayment to the IMF and thus "to preserve the revolving character of Fund resources"? Neither the World Bank nor the regional development banks have made similar demands on borrowing countries, yet no one imagines that repayment of their loans is less assured than repayment of drawings on the IMF. In practice, repayment is insured, not by project appraisal or policy conditions, but by the fact that no country would willingly risk the drastic consequences default would have for its access to all forms of credit.

As shown by the experience of France in 1992, international support can fend off a speculative attack and prevent a financial crisis in a country that has sound fundamentals. Thus, the liberalization of capital markets and the increased scale of international capital flows are recent phenomena that should be matched by an increase in the financial support available to countries. Because the flow of capital is crucially dependent upon the confidence of international investors, ample and timely financial support may prevent a crisis. Therefore the IMF should be ready to act quickly before countries fall prey to a speculative attack, rather than coming in after the crisis to pick up the pieces.

A purpose of the IMF (1993, Article I) is "to give confidence to member countries, by making the resources of the Fund temporarily available to them, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive of national or international prosperity." Surely, the avoidance of a financial and exchange-market crisis is an objective covered by this provision.

To conclude, timely international support, which could prevent a crisis and save a country from the high costs of crisis, in terms of output, inflation, and unemployment, should be available to countries with good fundamentals and sound economic policies. In certain other cases, support could go hand in hand with the adoption of an economic program designed to strengthen fundamentals. If speculators become aware that a country has the full support of the international community and that the chance of a successful speculative attack is therefore nil, they will not mount an attack on a currency. This outcome would be in keeping with the purposes of the IMF and the interests of the international community, which inevitably shares the costs and risks when a deep crisis occurs in one or several of the emerging-market economies.

As Keynes (Chandavarkar, 1984, p. 1) once said "this is not a Red Cross philanthropic relief scheme, by which rich countries come to the rescue of the poor; it is a piece of a highly necessary business mechanism which is at least as useful to the creditor as to the debtor." A development along the lines suggested in this essay would permit the world to benefit from the considerable contributions that the liberalization of international capital flows may make to world economic development, while reducing the risks posed by unbridled speculative capital movements.

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