Preliminary

Reforming the International Monetary System

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Use the free Adobe Acrobat Reader to view Charts 1-3.

1. It is an honor and a pleasure for me to be invited to give this second David Finch lecture at Melbourne University. I first met David and Helen Finch at an MIT-organized conference on the Japanese economy, held -- for convenience -- in Hawaii in 1979. Later, at the end of 1984, when I was working for United States Secretary of State George Shultz on the stabilization of the Israeli economy, I turned to David for advice on how to do that. Since the political economy of the Israeli stabilization was so fascinating, I was keeping a diary at the time, so I can report the impression David made: "Finch was quietly impressive: much common sense, absolutely no posturing." On that occasion, David not only advised me how to deal with the Israeli economy, but also made another suggestion: "... he asked whether I'd like to spend time at the Fund: you could have much more real influence there than at a University ... I said maybe when I turned fifty." It was the beginning of a friendship that I greatly prize.

David Finch believes passionately in public service, especially international public service. During his remarkable thirty-seven year career in the IMF he worked on the most important international economic issues of the time -- including the reform of the international monetary system following the breakdown of the Bretton Woods system. My guess from conversations with him is that he most enjoyed leading the mission on the IMF program with Britain in 1976. As Director of the famed ETR Department, he rose to the highest possible staff position in the Fund. And then he resigned on an issue of principle, and this only added to his reputation.

Since I joined the Fund four years ago, I have been fortunate to continue to have the benefit of David's advice. Characteristically he says what he has to say -- whether in writing or in person --quietly, but firmly. His advice carries weight not only because of his experience and his wisdom, but also because there is never the least question about what motivates him -- his concerns for the operation of the international economy, and his concerns for the IMF.

In that same spirit, he has endowed this lecture, and I am proud to have the opportunity to talk on a subject close to David's heart -- the reform of the international monetary system.

2. Since the Mexican crisis, since the East Asian crisis, but even more since the Russian

crisis, it has been widely agreed that the international financial system needs to be reformed. Or, in the language we have all heard so often, we need a new international financial architecture. But why? There are two important reasons:

- Because international capital flows to emerging markets are too volatile, and because that volatility subjects recipient countries to shocks and crises that are both excessively frequent and excessively large;

- Because there is too much contagion in the system -- a point that was argued by many during the East Asian crisis, but which became incontestable after the Russian devaluation and unilateral debt restructuring spread the crisis to Latin America.

As we discuss various proposals for reform, we need to find cures for both the excess volatility that affects individual countries and the contagion that is one of the mechanisms through which excess volatility is propagated.

3. It is reasonable to ask how we know that capital flows are too volatile and that contagion is excessive.

- The volatility of flows is remarkable (see Charts 1 and 2) and so is the volatility of spreads (see Chart 3). Could we establish that these levels of volatility are excessive? Well, as we know from the work on excess volatility of the stock market, it is hard to establish that proposition definitively. But the pictures go a long way towards making the case.

- Excessive contagion is even harder to establish, particularly because when contagion strikes, there is typically method in the madness, namely, the contagion usually hits weaker economies harder than stronger economies -- so that it is always possible to argue that the countries most affected by contagion deserve it more than countries less affected.

There seems to be a particular problem in establishing excess volatility and contagion if there are multiple equilibria, as I believe there are. One reason to worry about volatility then is that excessive volatility in the capital markets can push countries into bad equilibria. Simply put, when a country's policies and institutions are subjected to massive pressure by a reversal of capital flows, they may crack, thereby seeming to justify the reversal of flows that produced the crisis.

4. The vision that underlies most proposals for reform of the international financial system is that the international capital markets should operate at least as well as the better domestic capital markets. To say this is to drive home the point that volatility and contagion cannot be banished, for asset prices inevitably move sharply, and there are significant correlations among the prices of assets, particularly in related industries. Rather, the hope is to reduce volatility in the international capital markets, to reduce the frequency and intensity of emerging market financial crises, and to reduce the extent of contagion.

We should also note that in hoping to reduce the excesses in international capital flows, we are implicitly arguing that at times -- for instance in 1996 -- foreign capital inflows to some emerging market countries have been too large and spreads too low. It is likely that many of

the reforms that will be introduced in the next few years will raise the average level of spreads, and make foreign borrowing on average more expensive for emerging market borrowers. That will not necessarily be a bad thing.

5. The reforms that are being discussed at present will not create an entirely new system. Rather they consist of a number of measures to be implemented by the different participants in the international system which, taken together, should repair and modify the existing system and make it perform more efficiently. The proposed changes will require action by three key sets of players in the international system: **first**, *governments and the private sector in emerging market countries*; **second**, *governments and the private sector in the leading industrialized countries where the capital flows originate*; and **third**, *international institutions*. These changes should influence the behavior of borrowers and lenders in the international system, and reduce the frequency and extent of crises. But crises will nonetheless inevitably occur, and we will need to discuss *crisis management*, how to do better when crises break out. And finally I will talk about how to get from here to there, about how and how quickly the elements of a new system are likely to be put in place.

I. The recipient countries

6. In discussing what the recipient countries -- the emerging market countries -- need to do to make the system operate better, I will focus on: first, macroeconomic policies, including the choice of exchange rate system; second, strengthening the banking system and the financial system more generally; third, provision of better information; fourth, strengthening corporate finance including bankruptcy laws; and fifth, measures to deal with potential reversals of capital flows. We need also to ask what can be done to make all this happen.

7. First, the basics, sound macroeconomic policies. There is not much controversy over what constitutes sound macroeconomic policies in normal times, even if we recognize that it is much easier to recommend virtue than to practice it, and also that policies that markets find acceptable in normal times may rapidly become unsustainable when the markets turn hostile.

But there is a major question about the exchange rate regime that countries should adopt. Nearly a century of controversy has produced no clear answer to the question of which exchange rate or monetary regime is best. While the theory of the optimal currency area provides some clues, a country's history -- particularly its history of inflation -- is a critical consideration in determining its choice of regime. And whatever exchange rate system a country has, it is likely at some time to wish it had a different one.

It is a fact that the major external crises that have taken place in the last two years -- in Thailand, Korea, and Indonesia, and in Russia -- have affected countries with more or less pegged exchange rates. Further, the assumption that the exchange rate was stable profoundly affected economic behavior in these countries, especially in the banking system, and contributed to the severity of the post-devaluation crises.

At the same time, we should not forget that several countries with fixed rates, particularly Argentina and Hong Kong, have succeeded in holding the line, and that some with flexible rates, among them Turkey, South Africa, and Mexico, have been severely affected by the global economic crisis. Nor should we forget that many countries benefitted from fixing the

exchange rate as part of the process of stabilizing inflation, and that the fear of devaluation is often the best discipline on weak governments.

Nonetheless, we are probably entering a period in which the greater risks of a clearly defined external financial crisis that are present when the exchange rate is fixed will lead to the choice of more flexible exchange rate systems. If countries choose to fix, they may well want to do so definitively, through a currency board, rather than through a less credible normal peg, assuming of course that the necessary preconditions are in place. In the longer run, if EMU succeeds -- and it will succeed -- we are likely to see a shift towards currency blocs, with more currency unions and fewer currencies.

8. Second, banking and financial systems. In 1995, the Managing Director of the IMF described the Mexican crisis as the first crisis of the twenty first century -- and he said also that we could be sure the next financial crisis would be a banking sector crisis. A weak banking system has indeed been at the center of the most recent financial crises. Thanks to the Basle Committee's *Core Principles* and to the IMF's *Toward a Framework for Financial Stability* we know much of what it takes to produce a sound banking system, not least a strong supervisory system. But it is not only regulations and supervision that are needed, so is competition, particularly foreign competition. This point is increasingly understood in Latin America, where foreign banks have been welcomed in this decade as a way of strengthening the domestic banking system. And at the same time as they work on their banking systems, countries need also to be strengthening the rest of the financial system, including equity and bond markets.

9. Third, provision of better information. After the Mexican crisis, many argued that the markets would have worked much better had they had the right information, including information on Mexico's reserves. This argument led to the creation of the IMF's SDDS -- special data dissemination standard -- a system which, after a two-year trial period, is entering full operation. The information contained in the SDDS would not have included a key fact in the Thai crisis, the central bank's forward commitments, and the SDDS will now be supplemented to include such data as well as information on external debt. While this reminds us that better data will never be sufficient, it remains true that better information on a country's policies, on the state of the economy, and on individual firms, should make the private capital markets more efficient.

10. Fourth, strengthening corporate finance, including bankruptcy laws. The virulence of the Asian crisis owes even more to excessive leverage by Asian corporations than it does to excessive leverage on the part of lenders. So long as the good times roll, high leverage is a winning strategy. If it is believed that borrowers are implicitly backed by government commitments, as must have been believed by many lenders in the Asian crisis countries, there is no great incentive for lenders to exercise caution. And then, if crisis strikes, heavy leverage increases the costs of finding a way out of the crisis, especially in the absence of good bankruptcy procedures. All this of course has become clear in the Asian crisis countries. While those countries put in place the right laws and workout procedures, it is important to try to ensure that similar problems do not arise in other parts of the world. Hence the needs to strengthen corporate finance around the world, and to put in place efficient bankruptcy procedures -- both laws and the courts to enforce them.

11. Fifth, dealing with potential capital flow reversals. The first line of defense in dealing with capital flow reversals, aside from macroeconomic policy and exchange rate responses,

is to use the foreign exchange reserves. There has been surprisingly little emphasis in discussions of the present crisis on the fact that the countries with very large reserves have done better in dealing with the crisis than those with small reserves. But that is a fact, and it is very likely that countries seeking to draw the lessons of the present crisis will decide they should hold much larger reserves than before. This is already happening in the case of Korea -- and it will not be the only country to move in that direction.

Several countries, most notably Argentina, have put in place precautionary lines of credit from private sector lenders. This is a useful supplement to the holding of reserves, and could possibly be cheaper than increasing reserves. Along similar lines, the official sector could help make supplementary reserves available to countries facing a crisis. I will return to this subject when discussing the role of international financial institutions in the reform of the system.

How about using capital controls to moderate capital flows? This approach has been taken by Malaysia, and has had support from leading academics. But it is surprising how few countries have intensified capital controls in the present crisis. The IMF's attitude to controls on outflows has been that these should be removed gradually, as a country's macro economy, balance of payments, and financial system strengthen. The most advanced countries have fully liberalized capital flows, and that is where all countries should ultimately be heading -- but not prematurely. With regard to inflows, we see no case for controlling long-term inflows, particularly of foreign direct investment, but can see the disadvantages of surges of short-term capital, both inflows and outflows, and therefore can support market-based controls, along Chilean lines, that are intended to discourage short-term inflows. While it may be tempting to impose controls on capital outflows to deal with a short-term crisis, as Malaysia has done in this crisis, the longer-term consequences are likely to be adverse. Indeed, policy makers in Latin American countries that generally had such controls in the 1980s have all rejected that approach this time around, emphasizing that controls were inefficient, widely circumscribed, and had cost them dearly in terms of capital market access. The IMF staff will be re-examining the experience with capital controls as part of its work on the reform of the international system.

12. What can be done to encourage emerging market countries to implement the recommended measures? In the first instance, countries should see it as in their own interest to undertake measures to increase the efficiency of their capital markets and the resilience of their economies to external shocks. Second, the development of international standards should give countries both the information about what needs doing and -- if adherence to the standards can be monitored and certified -- a further incentive to adopt them. Some standards have already been developed: the Basle banking standards; the Special Data Dissemination Standard; international accounting standards; and a set of standards for security markets developed by IOSCO. The IMF is also developing guidelines for monetary policy and for fiscal policy, to which countries will be able to subscribe. Efforts need to be made to develop an international bankruptcy standard. While the development of these standards is difficult, it will be even more difficult to monitor and/or enforce adherence to them. IMF surveillance will have to contribute to this effort.

It would be an important incentive for the adoption of these measures if the terms of foreign lending depended on the extent to which companies and countries have implemented the recommended policies. While the risk aversion of market participants can be relied on to make that happen in the next few years, when the memory of this crisis is fresh, it cannot be

guaranteed to continue when the exuberant phase of the next cycle is reached. Regulators in the capital exporting countries could contribute by basing provisioning requirements for lenders on the extent to which recipient countries and companies are meeting the international standards.

II. The originating countries

13. The advanced industrial countries set up the international economic system in which the world has operated and prospered for the last fifty years, and they have the primary obligation to maintain and improve it. That commitment was put to a major test during the past year, when there were questions as to whether the United States would support the IMF quota increase. There were similarities between this decision and that on United States membership in the League of Nations -- but fortunately the outcome this time was positive. And as the flurry of proposals and suggestions that are emerging from various G's, including the G-7 and G-22, proves, the industrialized countries are seized with the problem of reform of the international system.

14. Global prosperity is impossible if the industrialized economies, which account for over two-thirds of world output, are not prospering. At present, the United States and Europe are both meeting that obligation. The recent cuts in U.S. interest rates have helped turn around a short period of near-panic in the global economy, and cuts in European interest rates have also contributed to the recent revival of confidence. But the situation in Japan continues to give cause for concern.

15. The industrialized economies, like the emerging market countries, need also to ensure that they maintain healthy financial, and especially banking, systems. Until recently the Basle capital adequacy standards have been widely accepted, but there has been some questioning of this approach, and we can expect further consideration of how best to supervise banks in the rapidly changing financial markets in which they work. We should not take too much comfort from the absence of major banking sector difficulties in the United States and Europe in the last few years of macroeconomic stability and asset market booms, for these are not the circumstances that test the strength of bank balance sheets and management. And we should be worried by the extent of losses suffered even by highly respected banks following the Russian meltdown.

16. The contagion following the Russian crisis undoubtedly owes much to the heavily leveraged positions taken by many participants in the Russian financial markets. This -- coupled with both the controversy over the role of hedge funds in the Asian crisis, and the case of Long Term Capital Management -- has forcefully raised the question of whether and if so how to regulate hedge funds. Among the aspects of the LTCM case that stand out are: the extent of the company's leverage; the extent of its use of derivatives; and the fact that leading banks lent to LTCM apparently without being well informed of either its activities or its other sources of financing. In its recent communique, the G-7 agreed to examine more closely the operations of hedge funds and other financial institutions. This is a welcome development. Late last year the IMF undertook a study of the role of the hedge funds in the East Asian crisis, and concluded that many other institutions, including some investment banks, were engaged in the same activities. It is therefore sensible to broaden the scope of any potential information provision or regulation to include these institutions when they engage in hedge-fund like activities.

Among the questions that will have to be considered -- and it is a question that the Russian contagion raises to the top of the agenda -- is whether ways can be found of limiting the leverage available to such institutions, or indeed to any institution. We should not underestimate the difficulties of regulating hedge fund activities -- even if only by requiring them to provide more information about the positions they take -- particularly given the existence of offshore banking and financial centers.

But we do need to pursue this problem extremely vigorously.

III. The international financial institutions

17. What more should the IFIs be doing? We need to improve surveillance, including of short-term capital flows; help ensure the adoption of banking standards and monitor their implementation; help design other relevant standards, encourage their adoption, and if possible report on their adoption; improve the information provided to the markets and to the public more generally; and consider changes in our lending practices, including through the provision of guarantees and possible precautionary or contingency lending.

18. The IMF staff reports regularly to its Executive Board on the state of member countries' economies. These Article IV reports are generally of high professional quality -- something to which I can attest as a former outsider to the Fund -- but they are not made public. The Fund has gradually been making public more information about its activities, including through the publication of both PINs -- public information notices -- which are based on the Chairman's summing-up of the Board discussion on Article IV reports, and some policy papers. A country can block the publication of the PIN, but it cannot edit it except for market-sensitive material. In the eighteen months since the PINs were introduced, an increasing percentage of countries have agreed to their publication, with over two-thirds of countries now agreeing. (Similarly, in the last year many letters of intent, the document in which a country describes to the Fund the economic program it will be pursuing, have been published.) The Fund has long published the *World Economic Outlook* and the *International Capital Markets Report*, which contain the staff's analyses of the global economy and global capital markets, respectively.

Surveillance needs to be strengthened in two key respects. First, the monitoring of international capital flows needs to be improved. This requires much better data than are now available. Until recently, the best data on short-term international capital flows, which are provided by the Bank for International Settlements, were available only twice a year, with a six month lag. This meant that a foreign exchange crisis could arrive and depart well before these data would even have provided a warning sign. The BIS is now moving to quarterly data, with a one-month lag. This will contribute to better monitoring of short-term flows, although it would be preferable to have the data available monthly. Within the IMF we use a separate data base to monitor medium and long-term international capital flows monthly, and we need to consider how best to use the results and make them publicly available.

If the decision is made to require hedge funds and others to publish more information on their activities, the Fund should also take on the responsibility of reporting frequently on the aggregate movements in hedge fund positions.

In monitoring international capital markets, the IMF also needs to develop better contacts with market participants worldwide. While some in the private sector have suggested that such meetings should be regarded as an opportunity to exchange information and impressions, the main role of the public sector on such occasions is to listen carefully.

Second, surveillance would be improved if we could publish more IMF staff reports, especially Article IV's. This would not only provide more information to the public, it would also improve the product by ensuring that Fund analyses become subject to external appraisal. However, the issue is not straightforward. Board members opposed to publication are typically from non-industrialized countries. They argue that they are far more vulnerable to Fund criticisms than are the advanced industrialized countries, and that they would accordingly be less willing to be fully frank in their discussions with staff during the Article IV consultation if the reports were to be published. One approach, which the management of the Fund favors, is to allow countries that want to publish their Article IV reports to do so. As in the case of PINs, they could be edited only for market-sensitive information.

19. The Basle Committee on Banking Supervision, the IMF, the World Bank, and the regional development banks all work on aspects of the banking system. The institutions will have to collaborate in their efforts to improve the quality of banking systems around the world. In the emerging international division of labor, it seems likely that the BCBS will continue to take responsibility for formulating banking and supervision standards, and that the IMF's primary role will be to monitor the adoption and implementation of these standards during its regular Article IV surveillance work. This is no small task, and one that has to be approached with a sense of realism about what can be achieved through a visit of no more than a few weeks each year to a country. The Fund will have to hire more people who have experience in banking supervision, and will also have to develop procedures for follow-up when initial visits raise concerns about the banking sector or the supervisory system in a particular country. The Canadians have proposed a system of peer review, in which supervisors from other countries evaluate the work of their peers in each country, and it may well be possible to draw on experienced active supervisors for assistance in Fund surveillance. Whatever happens in this area -- and to repeat the warning -- we should not create unrealistic expectations by exaggerating what can be achieved through intensified surveillance, for banking sector problems have emerged even in countries with the most sophisticated supervisory systems.

20. As previously noted, international standards exist or are being created in other important areas. The Fund is developing monetary policy and fiscal policy guidelines, and others are developing standards for accounting, securities markets, and so on. The Fund has been asked to check on their adoption and include a *transparency report* in its Article IV surveillance. Here too, in thinking about this approach, we should neither overestimate what the surveillance process can deliver, nor underestimate the importance of raising national and international consciousness about these issues.

21. Since I have already covered several aspects of the international effort to improve the provision of information to the public, let me turn next to consider potential changes in IFI lending practices. Following the suggestions of President Clinton and the G-7, the IMF is working to introduce a new contingency lending facility. This facility, inspired by the massive contagion in the international system in recent years, would make available potentially large sums of money to countries following good policies. The money would be

lent at much shorter terms and higher interest rates than normal IMF funding; in this, as other regards, the design of the new facility reflects the time-honored principles of the lender of last resort. Although the facility will not be ready in time for the announcement of the Brazilian support program, several aspects of the design of the Brazilian package will reflect features that should be present in the new structure.

There has also been a good deal of attention in this crisis to the possible use of guarantees from the multilateral development banks to enhance the access of countries to the international capital markets. The World Bank and ADB have already provided such guarantees to Asian countries. The use of guarantees makes sense in a crisis when capital market access dries up, but should not become a regular feature of borrowing by emerging market countries. Some consideration is also being given to using MDB guarantees to help countries put in place precautionary financing of the Argentine type.

IV. Crisis management

22. Most of the changes that we have discussed so far relate to the behavior of the system in normal or pre-crisis times. They are intended to make capital flows less volatile, and to help make asset prices better reflections of the underlying returns and risks. If they succeed, the system will become less crisis prone, but however well the international system works, crises inevitably will occur. And we need to strengthen the capacity of member countries and the system to deal with crises.

23. How? In the first instance, countries should pursue responsible policies and defend their economies in the face of adverse external developments. If policymakers do not take action, and turn to the IMF for help only when the country is already deep in crisis, for instance with its reserves almost totally depleted, they cannot expect a smooth landing. Precisely how to defend the economy will vary according to the circumstances, including the exchange rate regime, but it is typically necessary to raise interest rates and, if the exchange rate is flexible, to allow it to take some of the strain; a contractionary fiscal policy will also generally have to contribute. Many of these changes, especially of fiscal policy, should have been made well before crisis threatens. But a country under attack and willing to defend the economy should not be expected to bear the entire burden of adjustment. That is one of the critical agreed rules of participation in the international economy: among the purposes of the International Monetary Fund, set out in Article I (v) is

> "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

24. IMF lending is most likely to be effective when a country turns to the Fund relatively early, with time to develop a program, preferably one that has been formulated by the country itself. In IFI language, the most successful programs are those *owned* by the country. Of course, country ownership -- as in the current case of Brazil -- is the ideal. But there have unfortunately been many cases in which a country gets into trouble because its policymakers are weak (either politically or technically or both) and then turns to the Fund for help. We cannot refuse to help in these circumstances, at a minimum by offering advice, sometimes by lending. Nor should we refuse to help, for our ultimate responsibility is to try

as best we can to help the people who live in member countries. Sometimes policymakers are clearly unwilling or unable to take needed actions and the Fund should not lend for failure is inevitable; but there are also circumstances in which policymakers seem committed to a program that looks likely to succeed, and we should lend even though success is not guaranteed. In all circumstances we need to take as many precautions as we can to ensure the success of a program, for instance by lending only after critical policy actions have been implemented, and by backloading the financial support. But we have to recognize that in the real world there is a tradeoff between not lending until conditions are perfect and "providing reassurance to countries" by lending.

25. Over the years the IMF has continued to reform and refine the design of the programs it supports, and its lending instruments. That process will continue as the new contingency facility is introduced, and as the lessons of experience under recent programs are drawn. The greater role of the capital account in recent than in earlier crises is already shaping this thinking, for instance in designing programs and facilities that will reassure the markets that a country can have access to liquidity providing it stays on track with its program.

26. In the last few years, no question in crisis management has received greater attention than that of how to bail in the private sector. There are at least three reasons: moral hazard; economic necessity; and political necessity. The moral hazard concern is that a successful Fund loan -- a bailout, in language that is as often as misleading as it is vivid -- will lead investors to exercise less caution than they should, in the belief that the Fund will always be there to ensure that they are repaid. The language is misleading in implying that the primary purpose of a Fund loan is to bail out the investors rather than help the country deal with a crisis "without resorting to measures destructive of national or international prosperity". It is also misleading in that most investors in all the recent crises have suffered very large losses. Nonetheless, the moral hazard concern is valid, and it is one good reason to seek to bail in the private sector. Economic necessity is an equally valid reason: the plain fact is that capital flows have become so large that the official sector often does not have enough resources to stabilize an economy without private sector participation. And there is also a political necessity to involve the private sector, for the public at large and its elected representatives insist that the private sector should do its part in solving financial crises.

A number of approaches that have been taken in the past, and some new ones, are being considered for use in future crises. First, in the debt crisis of the 1980s, IMF financing was generally not provided until a critical mass of financing was available from the commercial banks. The authorities in creditor countries generally made it clear to the banks that they were expected to agree on a reasonable financing package. This approach was easier when the banks were the main creditors and when the country did not have market access -- the situation that confronted Latin American countries for much of the 1980s. When there are other creditors, an appeal to the banks, or anticipated friendly persuasion by the official sector, could lead to more rather than less outflows as the non-banks pull out.

As we draw the lessons of the 1980s, we should not forget that the debt strategy took most of that decade to succeed, and that countries did not generally regain market access until the end of the decade when the Brady Plan was introduced. Further, we should note much greater reluctance by regulatory authorities in this decade to put pressure on banks to take actions that could weaken their balance sheets, an action that regulators see as inconsistent with their primary responsibility of maintaining the soundness of the financial system. Of course, if all that is being done by coordinating a bank response is to deal with the free rider

problem, then this particular objection would carry less weight.

But we should put a great deal of weight on the likelihood that the formalization of a requirement that the banks, or any other set of creditors, always be forced to share the financing of IMF programs, would be destabilizing for the international system. If such a condition were insisted on, the creditors would have greater incentive to run at the mere possibility of a crisis. This is a case where a measure that would make it easier to deal with a crisis that has already broken out, would also make crises more likely. In the present crisis, countries that have approached the IMF have been concerned that a formalized rollover could hinder future market access, at a time when they believe the adjustment policies they are pursuing, with official support, should be sufficient to reassure investors and lead them to roll over credits voluntarily. This is a real dilemma, one that suggests we should not conclude that the banks will have formally to agree to roll over their debts as an accompaniment to every IMF loan. Rather, we need a differentiated approach that depends on the circumstances of each country: sometimes a formal approach may be a necessity, as in Korea at Christmas in 1997; at other times less formal discussions could serve better; and on occasion, if a country enters a program sufficiently early, there might not be any need to approach the creditors.

A second approach to involving the private sector has already been discussed, the precautionary arrangements of the Argentine type.

Third, after the Mexican crisis, the G-10 deputies suggested that bond contracts should be modified to permit a country to reschedule payments in the event of a crisis. A crisis could be defined either by a set of objective indicators (including possibly an approach by the country to the IMF for assistance) or by a formal declaration by the IMF. This approach could be extended to other contracts as well. Some developing countries object that changes in bond contracts would make borrowing more expensive for them, but that would in this case reflect a more appropriate pricing of risks.

Closely related is a fourth approach, the suggestion, associated with last year's Finch lecturer, Jeffrey Sachs, that the system needs the ability in effect to declare a country bankrupt, and to provide an orderly framework for a debt workout. For instance the IMF, representing through its Executive Board the governments of all 182 members, could be given the power -- no doubt with a special majority -- to declare a stay on payments by a member in difficulty. This would provide time for the country to work out a restructuring of its debts with its creditors.

There is a certain ambiguity in saying "the country" in this formulation. If the government is the debtor, then it is the government that would work out the restructuring with its creditors. If the debtors are in the private sector, then they would be expected to operate within the bankruptcy regulations of their country; if they were able to make payments in local currency, the stay would probably permit a delay in the transfer of those payments into foreign currency. There has been a tendency in foreign exchange crises for the government to take over private sector debts. That happened in the Korean crisis. But that is a potent source of moral hazard that should be strongly discouraged.

The bankruptcy approach deserves further consideration and elaboration. A few years ago it seemed doubtful that legislatures of some industrialized countries would give an international organization the power to interpose itself between the creditors and foreign

debtors, in effect to change the terms of contracts. For instance, in some recent crises, the creditors have had a powerful legal weapon in the form of cross-default clauses on loans. If a stay were imposed, the cross-default clause would lose its sting. These are weighty changes, but legislatures may be more receptive to change after the experience of the last few years.

Fifth, and also related, the IMF has recently decided that it may make loans to countries in arrears to private creditors holding securitized debt (beyond just commercial bank lenders), provided the country is trying to resolve the problem, including through appropriate adjustment policies.

27. Of the proposed changes to the international system, those to bail in the private sector are probably the most consequential. Something has to be done, and is indeed gradually being done in a case-by-case way in recent IMF programs. But we must beware of two tensions in the process. First, there is a tension between the desire to involve the private sector and the likelihood of contagion. The more certain it is that the private sector will be bailed in in a compulsory way, the greater the incentive creditors will have to run -- and this change would tend to produce more rather than fewer crises. A partial solution is not to develop a single formula for all IMF programs, but rather to ensure that private sector participation varies according to the circumstances of each case. The second tension is between two views of the current situation: the lender of last resort view that implicitly underlies the development of the contingency financing facility, that contagion and investor panic -- heading for the exits -- is an important cause of crises, but one that can be resolved by providing the assurance that creditors pursuing good policies and with reasonable external financial positions, will have the resources they need to reassure creditors; and the view that moral hazard is the critical issue.

V. What does this add up to?

28. Taken together, the proposed changes would reform the international system, but not create a radically new system. Nor is that necessary, for the present system has been instrumental in producing more prosperity for more people than ever before. By improving the quality of information, strengthening banking and financial systems, improving macroeconomic policies, and increasing the resiliency of economies, the proposed reforms should reduce the frequency and size of crises. At the same time, it is possible that by making more information available more rapidly, the reforms could even increase day-to-day volatility of asset prices.

29. In addition to reducing the frequency and extent of crises, the changes, specifically measures to regulate hedge fund-type activities, the contingency facility, and better information that should lead to greater differentiation among countries, should reduce -- but not eliminate --contagion.

VI. What lies immediately ahead?

30. The new machinery will be put in place gradually in the coming months and years. Some of the changes are already coming on stream, among them the *Basle Core Standards*, the SDDS, the Fund's Supplemental Reserve Facility, and soon the contingency facility. Other changes can be introduced only after further work has been completed, including work on the banking sector, the creation, implementation, and monitoring of standards, and

the regulation of hedge fund-type activities. The IMF staff has before it a formidable work program to take up, evaluate, and act on those of the many proposals of the Interim Committee, the G-22, and others, that relate to the activities of the Fund. We intend to move ahead and act, rapidly, while these issues are still on the front burner.

31. Thank you -- and thanks to David Finch for creating this lecture series and for his dedication over many years to making the international economy work better, thereby contributing to the well-being of millions of people, all over the world.

[1]First Deputy Managing Director, International Monetary Fund. This is a revised, but still preliminary, draft of material presented as the David Finch Lecture in Melbourne, November 9 1998.

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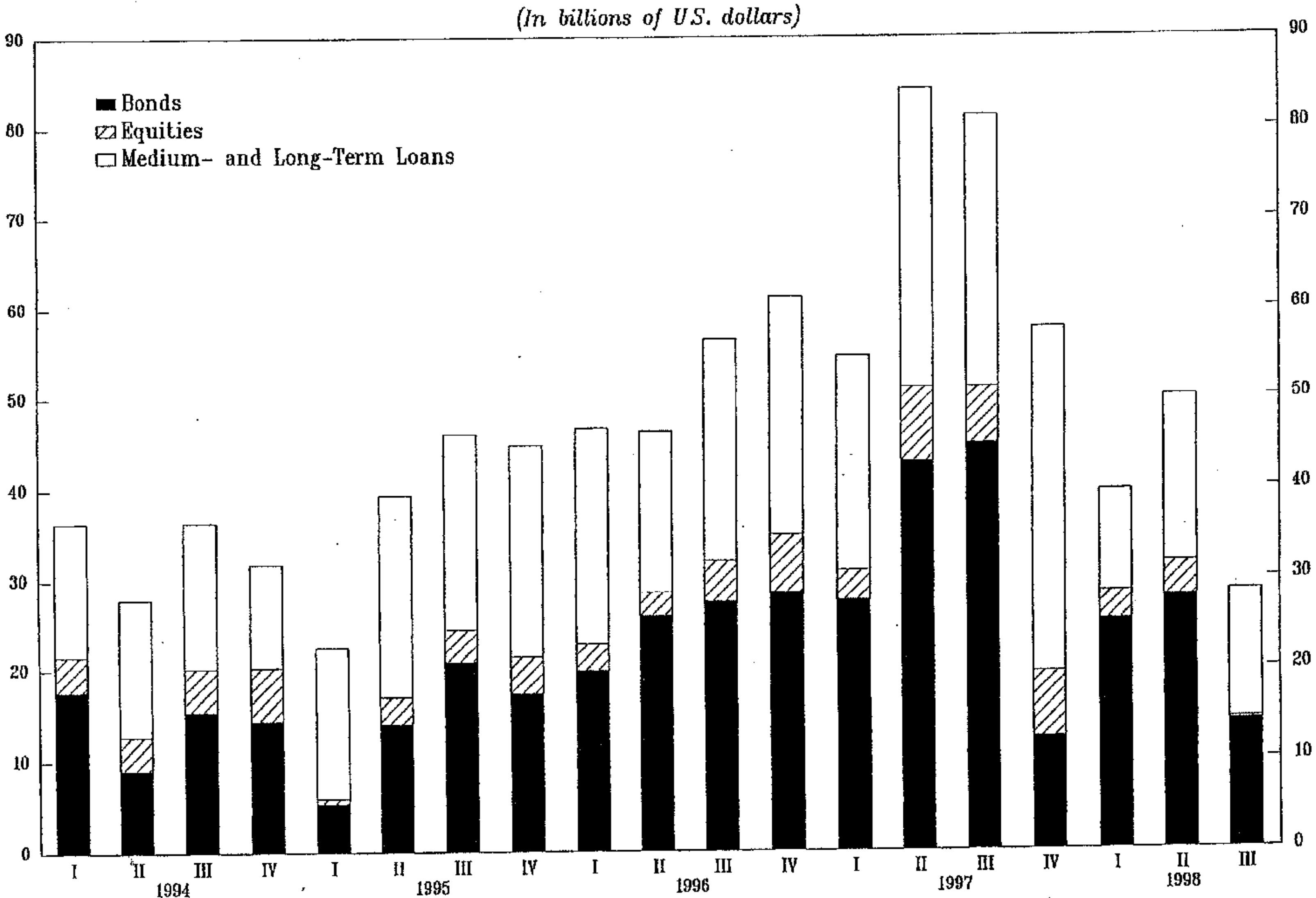
Chart 1.

Private Market Financing for Emerging Markets, 1994 Q1 to 1998 Q3

(In billions of U.S. dollars)

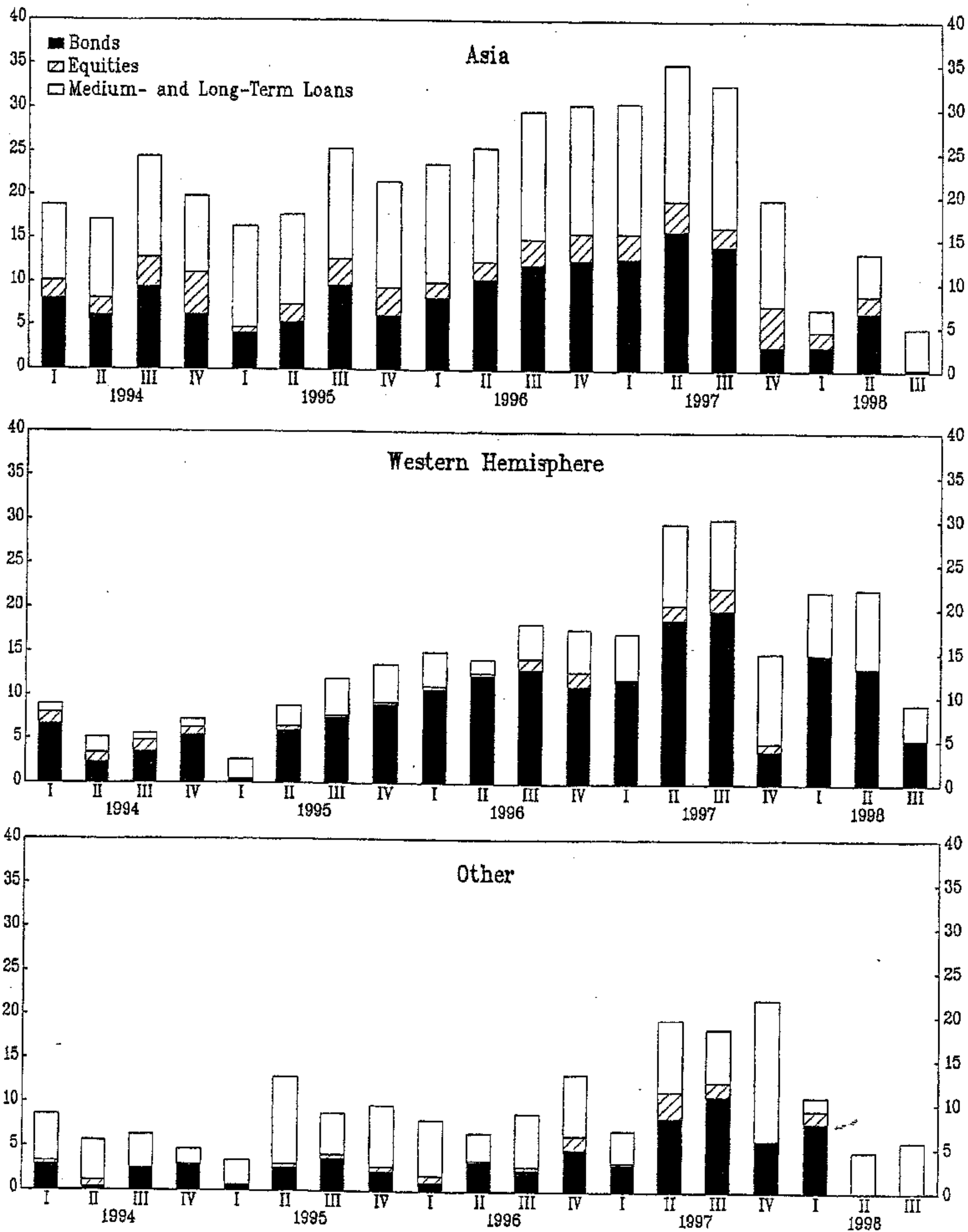


Source: Developing Country Bond, Equities, and Loans (DCBEL) database.

Chart 2.

Private Market Financing for Emerging Markets, 1994 Q1 to 1998 Q3

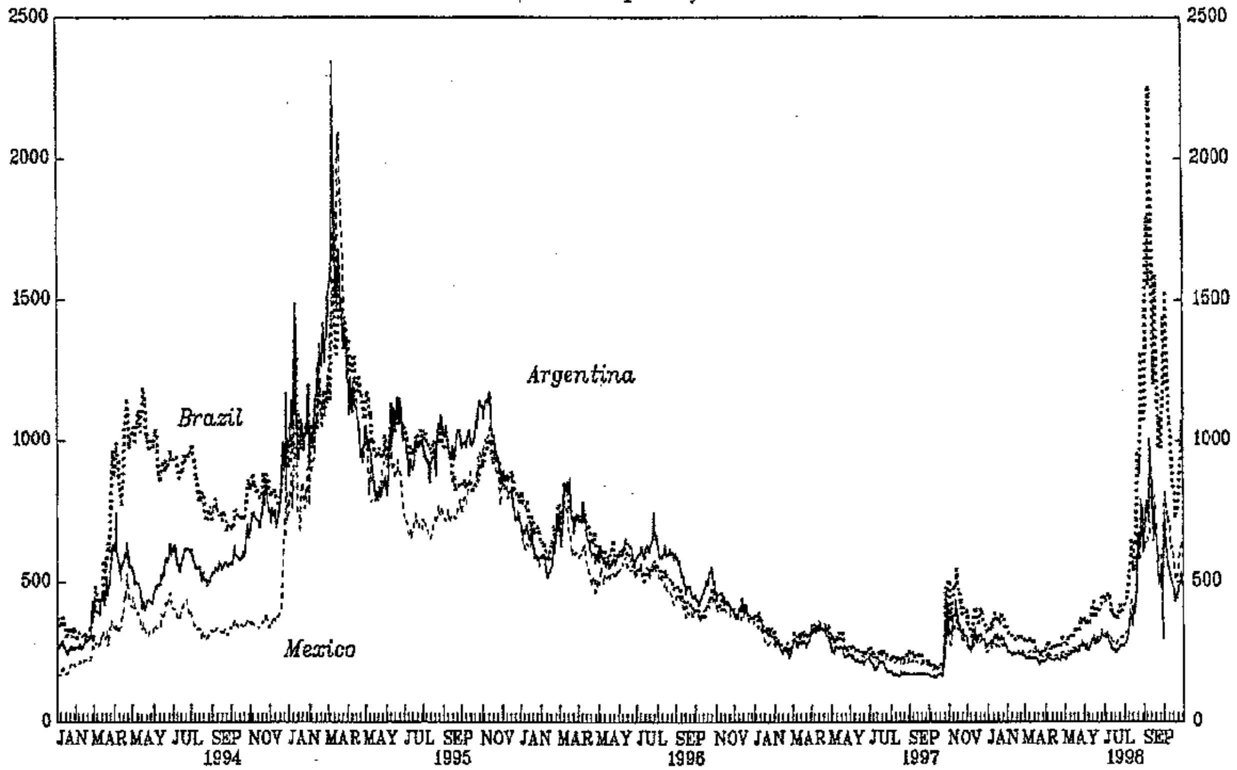
(In billions of U.S. dollars)

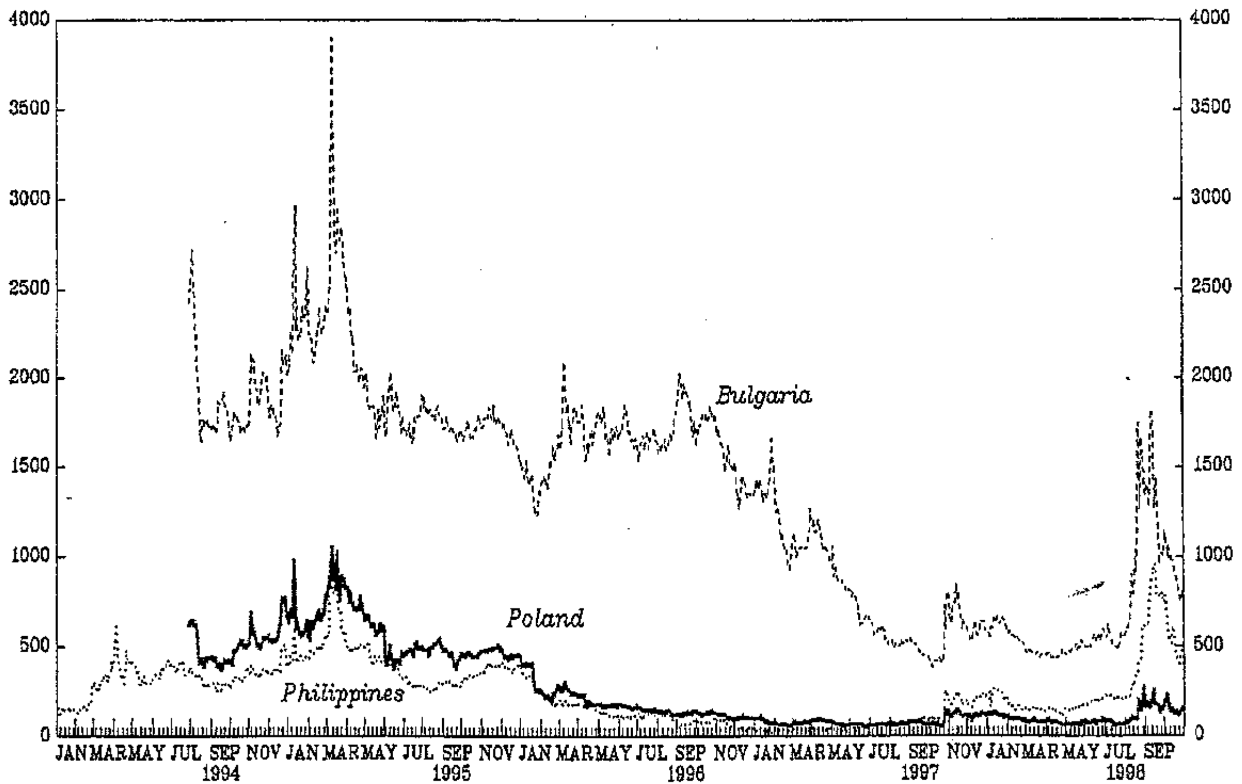


Source: Developing Country Bond, Equities, and Loans (DBCEL) database.

Chart 3. Stripped Yield Spreads for Selected Brady Bonds, January 1994 to October 1998

(In basis points)





Sources: Reuters, Salomon Brothers, and Fund staff estimates.