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Summary of Recommendations

The current crisis is for those concerned with the operation of international financial markets what the collapse of the Eastern Bloc was to Sovietologists. It has forced old models of the international financial architecture to be abandoned and prompted some radical new thinking. The UK government proposes merging the IMF, the World Bank, and the Bank for International Settlements (BIS) to create a single superregulator of financial markets. The French propose vesting additional decision-making power in the Interim Committee of finance ministers, which oversees the operation of the IMF, with the goal of enhancing accountability, allowing the institution to respond more quickly to crises, and not incidentally giving Europe a counterweight to the disproportionate influence enjoyed by the US Treasury as a result of its physical and intellectual proximity to the Fund. The German government has mooted the idea of target zones for exchange rates to prevent currencies from misbehaving. The Canadian government proposes providing for an IMF-sanctioned pause or payments standstill to be invoked in the event of financial difficulties. George Soros proposes an international debt insurance corporation, Henry Kaufman an international credit-rating agency, Jeffrey Garten an international central bank, Jeffrey Sachs an international bankruptcy court. The one thing that these proposals have in common is their impracticality. They have not a snowball's chance in hell of being implemented. They all assume a degree of intellectual consensus and political will that simply does not exist.

My goal here is different. It is to provide a set of practical, pragmatic proposals for reforming the international financial architecture that actually have a chance of being implemented. While more ambitious schemes at least have the merit of focusing attention on the nature of the problem, they have little chance of making the world a safer place in the time frame relevant for practical policy analysis.

My conclusions and recommendations fall under three headings: crisis prevention, crisis prediction, and crisis management.

Crisis Prevention

For financial crises, as for health maintenance, prevention is the better part of cure. There is little disagreement about the steps needed to minimize the incidence of crises. Better information on the economic and financial affairs of governments, banks, and corporations will strengthen market discipline (encourage lenders to ration credit to borrowers who fail to take the steps needed to maintain their financial stability) and help policymakers to identify the need for corrective action. Upgrading the supervision and regulation of financial markets and especially banks will strengthen the weak link in the financial chain. Exchange rate flexibility will encourage banks and corporations to hedge their foreign exposure, enhancing their ability to withstand unexpectedly large exchange rate changes.

Although some progress has been made in these areas, much remains to be done. A first area requiring a major international initiative is international financial standards. In a world of integrated financial markets, international financial stability is impossible without domestic financial stability. Stabilizing the financial system consequently requires institutional reforms extending well beyond policies toward external trade and payments. That it requires rigorous disclosure requirements and effective supervision of banks and corporations borrowing on financial markets is now agreed on. Some will argue that this is as far as the international community and the IMF should go in intruding into the internal affairs of countries. I argue that they must in fact go further—that the need for domestic institutional reforms with implications for the stability of international financial markets extends beyond this point. It extends to the use of internationally recognized auditing and accounting practices so that lenders can accurately assess the financial condition of the banks and corporations to which they lend. It extends to effective creditor rights, so that claimants can monitor and control the economic and financial decisions of managers. It extends to investor protection laws to prevent insider trading, market cornering, and related practices in whose absence securities markets will not develop. It extends to fair and expeditious corporate bankruptcy procedures, without which debt problems can cascade from borrower to borrower. While these are problems for individual countries to address as they see fit, whether they arrive at an adequate solution is also of pressing concern to the international policy community, given the scope for financial problems to spill contagiously across borders.

This is an ambitious agenda for reform. The fact of the matter is that neither the IMF nor any other international organization has the resources to provide every emerging market with advice on each item on this list. The IMF in particular needs to acknowledge its limited administrative capacity. Instead of trying to solve all problems by itself, it must therefore encourage the promulgation of standards of acceptable practice by private-sector bodies with expertise in these areas (the International Accounting Standards Committee, the International Corporate Governance Network, and the like) and by international committees of national regulators (e.g., the Basle Committee). National arrangements may differ, but countries participating in international financial markets all must meet minimally acceptable standards. But while relying on private-sector expertise, the IMF also needs to take ownership of the resulting standards. It should therefore collaborate with these private-sector bodies in the design of the relevant standards, bestow official status to the standards they promulgate, monitor countries' compliance, encourage information on that compliance to be disseminated to the markets (doing so itself if and where necessary), and condition its lending on steps to comply. In other words, both IMF conditionality (for program countries) and market discipline (for other countries) should be relied upon to encourage adherence to these standards.

But there remains the question of whether these two incentive mechanisms will be enough. Only a fraction of IMF member countries are subject to a program at any point in time, and there are good reasons to question whether market discipline will be applied promptly and systematically. This creates an argument for reinforcing these other incentives to comply by having national regulators key capital requirements for foreign lending to whether the IMF rates the borrowing country as in compliance with the relevant international financial standards. The decennial review of the Basle Capital Accord currently underway is an appropriate occasion to implement this regulatory discipline.

A second area requiring a major new initiative concerns banks and capital flows. Recent experience has demonstrated too well that badly managed banks and open international capital markets are a combustible mix. The obvious way of reducing this danger is to strengthen banks' risk-management practices and supervisors' oversight and regulation of those practices. Everyone agrees on the need for banks to better manage credit and currency risk, on the dangers of connected lending, on the need to insulate supervisory authorities from political influence, and on the need to raise bank capitalization as a way of giving bank owners and managers a financial cushion and something to lose.[1] But the sad truth

1. See Goldstein (1997), BIS (1997), and Folkerts-Landau and Lindgren (1998).

in all too many countries is that banks have a limited capacity to manage risk and that regulators have limited capacity to supervise their actions. In a sense, this limited capacity is the very definition of a financially underdeveloped, or less-developed, or developing economy. In such countries, moreover, capital requirements in theory and capital requirements in practice are two very different things, given the inadequacy of auditing and accounting standards. The political realities in many emerging markets are such that bank capital is all too rarely written down. This means that revising the Basle Capital Standards to key capital requirements to the source of banks' funding as well as the riskiness of their investments is unlikely to prove effective. If bank capital is not written down, in other words, how can capital requirements deter excessive risk taking?

In an environment with these characteristics, free access to foreign finance, short-term finance in particular, is incompatible with financial stability. Foreign funding gives banks gambling for redemption and otherwise seeking to take on excessive risk an additional way to lever up their bets. Government guarantees for banks regarded as too big to fail encourage foreign investors to provide those funds. But a blow to confidence may prompt these foreign investors to flee at any time, and the short maturity of their loans provides ample opportunity for them to get out. Their rush for the exits can precipitate a crisis that brings down both the banking system and the currency. This creates an argument for limiting or taxing bank borrowing abroad as a third line of defense against banking-system instability in countries where the first and second lines of defense—banks' own risk-management practices and regulatory supervision, respectively—do not suffice. And where banks can circumvent these measures by having the corporations do the borrowing and pass on the proceeds to them, broader measures may be required. Financial stability may have to be buttressed by a Chilean-style tax to limit short-term foreign borrowing by all domestic entities.

The international policy community must become a stronger advocate of these measures. The IMF should make unambiguous its support for the approach. The US Treasury needs to overcome the "Wall Street complex" that renders it reluctant to embrace such policies. Doing so requires that both of them more clearly articulate the exact circumstances under which such measures are warranted. This means understanding that capital-inflow taxes are necessary as a third line of defense against financial instability in countries where the first and second lines of defense are underdeveloped. In practice, this means that they are necessary in most "underdeveloped" countries. With time, of course, underdeveloped countries will develop. Their financial markets will deepen, and their macroeconomic and regulatory institutions will grow more robust. With these institutional preconditions in place, they will graduate to the club of mature markets, at which point restrictions on international financial transactions can come off. But until then, cautious steps in the direction of capital-account liberalization, which are inevitable given the desire to liberalize domestic financial markets and given ongoing changes in information and communications technologies, should not extend to the removal of taxes on capital inflows.

Crisis Prediction

However extensive progress is in these areas, crises will still occur. Sudden reactions to new information, or new interpretations of old information, can still precipitate sharp market moves. Such is the nature of financial markets, or so suggest hundreds of years of financial history. Only placing the markets in a regulatory straitjacket can prevent this. And severe repression means forgoing the benefits of domestic financial liberalization. It is a route that virtually no country is prepared to go.

Observations such as these have encouraged the official community to invest in early-warning indicators of currency and banking crises in the hope that they will see what is coming. Unfortunately, these models will have about as much success in predicting financial crises as geologists' models have in predicting earthquakes. Earthquakes and financial crises are products of complex nonlinear systems whose parts interact in unpredictable ways. Consider the following entirely realistic example. The government will devalue the currency only if it fears that the interest rate increases required to defend it will irreparably damage a weak banking system. But the banking system will weaken to this point only if investors withdraw their deposits from the country because they anticipate a devaluation. Thus, it is equally possible that everyone will wake up in the morning to a strong currency and a strong banking system or to panicked depositors and an incipient devaluation. There is no way of predicting which of these outcomes will obtain.[2] Whether speculators attack depends not only on the weakness of a country's banking system but on how much a government cares about further aggravating this problem when deciding whether to defend the currency. And the only thing more difficult to measure than a government's resolve is investors' assessment of it.

It is not surprising, therefore, that there is typically less to these statistical models than meets the eye. The models that perform best rely on reversals in the direction of capital flows and sudden reserve losses, variables that are properly regarded as concurrent rather than leading

2. This is an example of a so-called second-generation model of currency crises, in which multiple equilibria may arise. This class of models is described in more detail in appendix C. As explained in chapter 6, multiple equilibria of this sort make it more difficult to predict crises with the precision relevant for practical policy analysis.

indicators of currency crises. These models are like Richter scales registering the severity of earthquakes: in other words, not reliable predictive devices.

None of this is to dispute that further work on the causes and consequences of financial crises will continue to improve our understanding of these complex phenomena, just as further research into the interaction of tectonic plates will deepen our understanding of earthquakes. But this is a far cry from saying that better economic models will allow us to reliably predict financial crises. There will always be surprises—unanticipated crises will still occur, notwithstanding forecasters' best efforts.[3]

The attractions of this intellectual game are such that it will continue to be played. But this is not where the international policy community's scarce intellectual and political capital should be expended. And there is an associated danger, namely, that early-warning exercises will produce an unwarranted sense of complacency in the official community. They may lull officials into false confidence that they know what is coming.

Crisis Management

If there will always be crises, there will always be the need to clean up after them. This is where the existing international financial architecture is most obviously deficient. The international community has two ways of responding to crises: running to the rescue of the crisis country with a purse full of funds or standing aside and letting nature run its course. For two years following the Mexican rescue and for a year following the outbreak of the Asian crisis, the IMF was subjected to a firestorm of criticism for bailing out governments and international investors. Its actions, in the view of the critics, only reduced the incentives for meaningful policy reform and, by shielding the private sector from losses, encouraged more reckless lending and set the stage for further crises. Then in the summer of 1998, Russia provided an alarming illustration of the alternative when it devalued and suspended debt service payments, with devastating impacts on the Russian economy and global financial markets. Confidence was destroyed; the country's access to international capital markets was curtailed; and financial markets were roiled in East Asia, Eastern Europe, Latin America, and even Europe and the United States. This is not an experience anyone wishes to repeat. One cannot avoid concluding that both alternatives—bailouts on the one hand, and standing back and letting events run their course on the other—are unacceptable.

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3. In addition, there is the danger of type II error—of warning and in the worst case precipitating crises that would not otherwise occur, a problem to which I return in chapter 6.

Avoiding both routine rescues and devastating defaults will require creating a more orderly way of restructuring problem debts. Under present circumstances, restructuring is too difficult and protracted. It *should* be difficult, of course, or borrowers would find it too easy to walk away from their debts. But the point here is that the difficulties of restructuring are greater in international than domestic markets and that this problem needs to be corrected. Capitalism without bankruptcy is like Catholicism without sin, it is said, but the sovereign bankruptcy option is simply too costly to contemplate under present institutional arrangements. Radical reform of those arrangements—that is, creation of an international bankruptcy court—is unrealistic. Discussing these ideas is a waste of breath. Yet, something must be done to create an acceptable alternative to massive international rescue packages.

In fact, a number of modest steps might realistically be taken to make international debt restructuring a viable option. Majority voting and sharing clauses could be added to loan contracts. This would prevent isolated creditors from resorting to lawsuits and other means of obstructing settlements that improve the welfare of the debtor and the vast majority of creditors. Other desirable changes to loan contracts include collective-representation clauses (making provision for an indenture trustee to represent and coordinate the creditors in the case of sovereign debts) and clauses providing that a minimum percentage of bondholders must agree for legal action to be taken. The addition of such clauses to bond contracts is the only practical way of creating an environment conducive to flexible restructuring negotiations. It can be done by legislators and regulators in the United States and the United Kingdom, the principal markets in which the international bonds of emerging economies are issued and traded, without ceding any jurisdiction or authority to a supranational agency.[4] This approach is therefore infinitely more realistic than imagining the creation of some kind of supernational bankruptcy court for sovereign debts that is empowered to cram down settlement terms.

In addition, standing committees of creditors should be created to provide better communication between lenders and borrowers, jump-starting negotiations and diminishing the information asymmetries that encourage the two sides to fight a protracted war of attrition. The IMF could lend to countries in arrears on their external debts so long as the recipients are making a serious adjustment effort and are engaged in good-faith negotiations with their creditors, providing the equivalent of the debtor-in-possession finance available to US corporations under Chapter 11 of the US bankruptcy code. Not only will this help to keep running the economy that is in crisis, but it will encourage the creditors to come to the bargaining table, again working to speed restructuring negotiations.

4. Assuming, that is, strong leadership at the national level.

And when the problem is defaulted corporate and bank debts, the solution lies not in unrealistic designs for an international bankruptcy court but in strengthening national bankruptcy statutes, reinforcing the independence of the judicial system administering them, and harmonizing those laws across countries.

These recommendations are not new. New provisions for loan contracts and IMF lending into arrears were discussed in a Group of 10 (G-10) report issued in the aftermath of the Mexican crisis (1996). The need for creditors' committees was developed in a background paper for the G-10's deliberations commissioned by the Bank of England and UK Treasury (Eichengreen and Portes 1995). Unfortunately, those discussions were not followed by action. Officials imagined that the markets would be so impressed by their insights that they would rush to amend loan contracts, form creditors committees, and endorse IMF lending into arrears. Predictably, little happened over the subsequent two years. No country is prepared to be first to add sharing and majority voting provisions to its loan contracts for fear of sending a bad signal to the markets; this is something that can be achieved only if everyone moves together. The markets are reluctant to form standing committees of creditors for fear that deciding who will be on the other end of the line will make it too easy for the financially distressed to pick up the phone. These recommendations have now been repeated by the G-22 and the G-7, but words need to give way to deeds. Regulators, led by those in the advanced industrial countries, need to require that internationally traded securities include majority voting, sharing, nonacceleration, minimum legal threshold, and collective-representation clauses. The United States, the G-7, and the IMF need to press for the formation of creditors' committees. The IMF should test the market's reaction to lending into arrears when an occasion arises.

Even together, these measures will not create the ideal orderly workout system. But they are the only practical alternative to pie-in-the-sky schemes for creating global monetary and regulatory institutions and assuming a political and economic consensus that does not exist. If we wish to create a viable alternative to massive bailouts and devastating defaults, they are the only game in town.

Reforming the IMF

The IMF will still have a role to play following these changes in the international financial architecture. There will still be a need for it to provide financial assistance, ideally in conjunction with credit lines extended by commercial banks, to countries running fundamentally sound economic and financial policies but suffering a temporary loss of investor confidence. But it will have to become less of a fireman and more of a policeman. It will have to police countries' conformance with international standards in areas related to the operation of financial markets. This means working with private-sector bodies and international committees of regulators in establishing those standards, monitoring the compliance of its members, and informing the markets of their progress. It means conditioning its lending on their compliance.

In addition, the Fund will have to become increasingly active as the facilitator or coordinator of restructuring negotiations. As honest broker it will have to bring debtors and creditors together like the Federal Reserve Bank of New York did for Long Term Capital Management and its bank creditors in September 1998. But supplying a conference room and hinting at the need for accommodation will not be enough, given the special difficulties of restructuring international debts, sovereign debts in particular. In addition, the Fund will have to more forcefully encourage the parties to come to the bargaining table by lending into arrears. It needs to use its position at the center of the international financial stage to push for the institutional reforms needed to create a viable alternative to ever-larger bailouts. It will need to push for the creation of standing committees of creditors and, if necessary, provide incentives for their formation by making clear its willingness to meet with such committees when exceptional circumstances arise. It will need to lobby for the addition of innovative clauses in loan contracts designed to smooth the restructuring process and lend at lower interest rates to countries that adopt them.

All this presupposes that the Fund will take steps to enhance its own legitimacy. The institution has acknowledged most of the obvious needs and begun to move in the requisite direction by strengthening its surveillance of financial markets, promoting the dissemination of information, and releasing more documentation on its programs and decision-making process. But these are the uncontroversial decisions. The heavy lifting will be for staff, management, and directors to reach a consensus on what kind of macroeconomic and financial policies to recommend to its developing-country members, given the realities of today's immensely liquid and not always reliable capital markets. Countries need to do more to protect themselves against the dangers posed by those markets, and the IMF needs to do more to encourage them. As noted above, the Fund should actively encourage countries in which banks have limited ability to manage risk and regulators have limited ability to supervise their actions (in other words, the vast majority of its members) to use Chilean-style holding-period taxes to discourage excessive short-term capital inflows, and it should more forcefully press for the adoption of more flexible exchange rates by most of its developing-country members, especially by those with open capital accounts. The first measure is needed to prevent borrowers who might otherwise be regarded as too big to fail from levering up their bets, the second as an incentive for banks and corporations to hedge their foreign exposures so that they can cope with unexpected large exchange rate movements if and when these occur. These are not areas where there yet exists a consensus within the IMF or among its principal shareholders. The Fund and its members need to move swiftly to establish it.