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"Reshaping Globalisation: A New Order for International Financial Markets"

Heribert Dieter

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Reshaping Globalisation: A New Order for International Financial Markets
Heribert Dieter*
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Abstract

Since the Mexican crisis in 1994/95, a large number of developing countries and emerging markets have been hit by financial crises. Argentina is the last country that is suffering from dramatic economic problems. The main cause of these crises are the deregulation and liberalisation of financial markets that have been associated with the current model of globalisation. This model is not sustainable: Is has contributed to massive economic problems in the developing world without providing the promised rewards in form of higher growth and reduced poverty.

In this paper, the three main areas that influence the shape of financial markets are discussed and improvements are suggested: Firstly the exchange rate regimes of developing countries, secondly the shape of international credit markets and the asymmetric relationship between creditors and lenders and thirdly the main institution that provides partial governance, i.e. the International Monetary Fund.

International financial markets have gained in importance, but they still lack many of the features that characterises the national financial sector. If globalisation shall be continued, we need those governance structures, e.g. a lender of last resort, at the international level.

The reform agenda suggested in this paper is comprehensive, but rather evolutionary. Markets need rules and regulations, and today these are often not existent at the international level.

Key words: Financial crises; financial markets; exchange rate regimes; bailing-in of creditors; IMF reform

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1. Introduction: Why regulate? 4
2. Tobin Tax and Spahn Tax: Powerful tools or a nuisance? 12
3. Exchange Rate Regimes: Is the Bipolar View correct? 17
3.1. The currency board 19
3.2. Experiences in Argentina 21
3.3. Flexible exchange rates: The better option? 27
3.4. The South African case: Why did the exchange rate of the Rand collapse? 28
3.5. Dollarisation and Euroisation: An expression of desperation? 31
3.6. Intermediate exchange rate regimes 32
3.7. Monetary regionalism: A new strategy for stable exchange rates? 37
4. Bailing-in of creditors and other measures to stabilise financial markets 39
4.1 Rollover-options 39
4.2. Collective action clauses 42
4.3. Emergency funds of private lenders 43
4.4. Capital controls for crisis prevention 45
4.5. Capital controls for crisis resolution 46
4.6. Sovereign insolvency and its regulation 49
5. Reform of the International Monetary Fund 53
5.1 Crisis prevention: Is surveillance sufficient? 55
5.2. IMF conditionality: Too much or not enough? 57
5.3. The IMF as a lender-of-last-resort 58
6. The Financial Stability Forum 62
7. Conclusions: A new order for international financial markets 67
8. References 70

Abbreviations:

ATTAC	Association pour la Taxation des Transactions Financières pour l'Aide aux Citoyens
BCBS	Basle Committee on Banking Supervision
BIZ	Bank für internationalen Zahlungsausgleich
BMZ	Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung
CCL	Contingent Credit Line
CGFS	Committee on the Global Financial System
CPSS	Committee on Payments and Settlements Systems
FATF	Financial Action Task Force on Money Laundering
FSF	Financial Stability Forum
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
IOSCO	International Organization on Securities Supervision
LTCM	Long-Term Capital Management
Mercosur	Mercado Comun del Cono Sur
OECD	Organization for Economic Cooperation and Development
OFC	Offshore Financial Centre
SRF	Supplemental Reserve Facility
UDROP	Universal Debt-Rollover Options with a Penalty
WEED	World Economy, Ecology and Development

1. Introduction: Why regulate?

The financial crises of the past eight years have intensified the debate on a new international financial architecture. Since the Mexican crisis in 1994 and 1995 the financial markets have frequently been hit by severe crises. Since 1945 there has been no decade with as many financial crises as the 1990s. The turmoil also affected countries which were, prior to the crisis, considered to be model pupils.

The Asian crisis was particularly striking. That crisis was not limited to one economy, but affected an entire region. Furthermore, there were virtually no warnings in advance. Both this inability to forecast and the dimension of the biggest economic crisis since World War II (Bill Clinton) have caused concern. But since 1998 several other financial crises hit developing and

transformation countries. The crisis in Russia in 1998, the Brazilian crisis in 1999, the Turkish crisis in 2001 and finally the default of Argentina show that financial markets are characterised by frequent instability. The Argentinean case in particular demonstrates the risks associated with the implementation of a currency board, a system staunchly defended by the International Monetary Fund in the aftermath of the Asian crisis.

For developing countries the volatility of capital flows is a particularly worrying aspect. While in 1996 more than $ 230 billion of private capital (net) was flowing to developing countries and emerging markets, in 2000 these flows were reduced to a mere $ 0.5 billion. Even more problematic is the development of bank credit. In 1996, the net flow of private bank credit to all developing countries was $ 26.7 billion (net), in 2000 there was a net *outflow* of $ 148.3 billion (see Table 1). In 1997 and 1998, public inflows partly filled the gap.

Table 1: Capital Flows to Developing Countries and Emerging Markets 1993 to 2002 (billions of US-Dollar)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Private capital, net	139.1	147.5	205.5	234.4	119.1	69.1	58.6	0.5	-1.4	71.0
Direct investment, net	57.6	81.4	97.5	120.0	145.8	155.9	153.1	147.3	162.7	158.2
Portfolio investment, net	87.6	112.8	43.8	87.8	48.1	-2.0	31.7	1.5	-0.2	24.0
Bank credit, net	-6.1	-46.8	64.2	26.7	-74.8	-84.9	-126.2	-148.3	-163.9	-111.2
Public capital flows, net	50.3	5.5	24.1	0.1	62.2	55.4	9.5	1.4	19.6	-3.5

Source: IMF World Economic Outlook, October 2001, p. 9. Data for 2001 and 2002 are estimates of the IMF. A minus indicates an outflow of capital.

For developing countries and emerging markets, these trends are problematic. These difficulties are not only caused by outflows of capital. In the event of substantial capital inflows these often contribute to an unwanted overheating of the economy. After the dismantling of capital controls in many developing countries and emerging markets, the central banks of these countries are confronted with a dilemma. To reduce the trend towards overheating, the central bank ought to raise interest rates. In the absence of capital controls the rise of interest rates in an emerging market frequently encourages banks and companies to increase their borrowing abroad. This in turn increases the vulnerability of the entire economy in the event of a change in sentiment, i.e. when lenders abruptly stop rolling over existing debt.

However, the reversal of capital flows to an emerging market is the more dramatic event. For banks, companies and the government a massive reversal of capital flows represents a task that is hard to shoulder. In such a situation the short maturities of loans, chosen because of lower interest rates on short-term credit, backfire. Entire economies can be forced to repay a substantial part of their foreign debt within weeks. In the event of instability, private lenders tend to panic and thereby they put fuel into the fire. Once the fire is lit, both lenders and investors tend to rush to the exit at the same time. It should be noted that such a panic also puts enormous pressure on the exchange rate. If domestic borrowers are forced to repay their loans, most of the time denominated in foreign currency, the dramatically rising demand for foreign exchange forces the central bank, in the case of fixed rates, to use its foreign reserves In the case of flexible rates it directly weakens the exchange rate.

The development of such a situation is partly the responsibility of the OECD-countries. In the Basle Accord of 1988, short-term interbank credit was given a risk factor of only 20 percent (see Nunnenkamp 2001, p. 24). In other words: The regulation of banks in OECD-countries encouraged interbank lending on a short-term basis and discouraged long-term credit. Volatile short-term flows were given a preference, whilst those types of capital flows that are least problematic for a developing country were made more costly.

These developments are somewhat surprising. The supporters of a comprehensive liberalisation of financial markets had promised a different result. The liberalisation of capital markets should have led to substantial advantages for developing countries. The cost of financing an investment in a developing country should have been lower due to the use of cheap foreign savings. The competitiveness of companies should have risen. Instead, what we witness is at best a mixed blessing. Phases of higher efficiency are followed by periods of financial crises. On balance, the cost of this liberalised system to developing countries appear to be higher than the benefit. This assessment is underlined when the reversal of capital flows to all developing countries and emerging markets is considered: These economies do not get the capital they need, yet they suffer from the disadvantages of liberalised financial markets (see Table 1).

It is necessary to make a differentiation. There are different types of capital flows with differing levels of risk. The most problematic capital flows are foreign credits with a short

maturity. Significantly less risky are foreign credits with a maturity of several years as well as foreign direct investment (see Griffith-Jones 1998, p. 38f). The latter category in particular has shown very little volatility over the last years. From 1993 to 2002, foreign direct investment to all developing countries has risen steadily and has never been affected by a sharp decline (see Table 1).

When financial crises in developing countries and emerging markets are analysed, the argument that these crises are the result of mistakes of domestic economic policy is used frequently. For instance, the former First Deputy Managing Director of the IMF, Stanley Fischer, characterised the Asian crisis as ”mainly homegrown”. Without a doubt, domestic economic policy always contributes to a currency and credit crisis. But these mistakes are less relevant than the faults of international financial markets. If domestic economic policy were the prime cause for trouble, one would have to ask why the same economic policy was responsible for the preceding economic boom. The financial crisis of the last years have mainly affected economies that had enjoyed long periods of economic prosperity prior to the crash.

The Asian crisis in particular falls into this category. Before 1997 very few observers very questioning the solidity and sustainability of the economic boom that Southeast and East Asia had been enjoying for many years. If these voices existed at all, they were limited to academic circles. But even there virtually nobody can claim to have forecasted the Asian crisis. However, financial markets were even more naive. Although it is easy to identify warning signals, at least with the benefit of hindsight, markets did not take notice. As late as spring 1997 optimism dominated. Banks were eager to lend to Asian borrowers. When the tide turned, however, virtually all creditors tried to limit their exposure at the same time. Yesterday’s winners were today’s losers. The same reasons that were given for the rapid economic rise of Asian countries were now claimed to be the reasons for the crisis.

A particular point was the judgement that so called crony capitalism was the source of the crisis. Before 1997, the close relationship between banks and borrowers was identifiedconsidered to be particularly efficient. In the crisis this relationship suddenly was given as one of the prime reasons for the crisis. But crony capitalism is neither the main reason for the rise of Asian economies nor for their decline. Furthermore, crony capitalism is a

phenomenon that is not limited to the developing world. The case of Enron as well as the collapse of the state-owned Landesbank Berlin are recent examples for crony capitalism in supposedly well-regulated developed economies.

It is appropriate to compare the wisdom of investors in Asia with the intelligence of investors that created the internet bubble in share markets. In both cases early warning signals could have been seen. Investors did not consider rational forecasts, but rather fuelled a widespread mania. Many investors in internet shares wished they had never touched that market.

However, despite similar blind euphoria in both cases, an important difference remains: The bursting of the internet bubble has resulted in a loss of paper fortunes, but it has not caused real economic harm. Quite the opposite happens in financial crises in developing countries: After those bubbles burst, the result often is mass unemployment, and in some case, for instance Indonesia, even hunger crises and the collapse of state authority.

The prominent role that public money had to play in the solution of problems that have been created by private players has frequently and rightly been criticised. When private borrowers and private lenders have caused a financial crisis, it is neither logical nor acceptable that public funds are used for bailing-out private risk-takers. For that is what they ought to do: Take a risk, and make a profit, or, sometimes, a loss. The current financial architecture lacks structures that force private lenders to face the consequences of their activities. The international financial system needs incentives and rules for the private solution of private debt crises.

A further problem is the asymmetry in international financial relations. Developing countries and emerging markets have been forced to open their own economy both for imports from OECD-countries as well as for banks and other providers of financial services. At the same time, the markets of OECD-countries remains closed precisely in those areas where developing countries are competitive. The most prominent example is the agricultural sector of most OECD-countries. The former Chief Economist of the World Bank, Joseph Stiglitz, rightly accuses the United States of having been the major force in the opening of financial sectors because of the competitiveness of its own industry in that field (see. Stiglitz 2001).

The proposals for a re-regulation of international financial markets that I will discuss focus on the creation of a global regime for these markets. A solid framework for these markets is the aim. In national financial markets we do have these conditions since many years. All national financial markets of OECD-countries are highly regulated. For instance, there are detailed procedures in the event of a bankruptcy of a borrower. In national markets, no lender can escape his obligations and has to contribute to the orderly solution of a bankruptcy. Furthermore, national financial systems do have a powerful lender-of-last-resort, the central bank. In the event of a crisis, these lenders-of-last-resort provide the financial sector with its essential fuel, liquidity.[1]

Developing countries and emerging markets do not have access to those instruments. They do not have developed, deep financial markets. Therefore companies have to borrow abroad for financing of investment. But the current system does not provide these countries with sufficient support in the event of a crisis. Rather the contrary: In the past, financial crises were often abused. Countries had to implement measures that were in the interest of the financial industry of OECD-countries, but against the interest if the affected developing country.

The recent debate on the Tobin tax has shown that those responsible for shaping globalisation have not made their job properly. Promoting globalisation carries a big obligation with it. The increasing integrated global economy needs global rules and regulations. Policy makers have to realise that behind the calls for a Tobin tax stands the recognition that governments have promised a lot immediately after financial crises, but have delivered very little so far.

After the most recent financial crises even representatives of the financial sector called for government intervention. The provision of rules and regulations is a task for governments, not for the private sector. The chief economist of Deutsche Bank, Norbert Walter, called the provision of rules and regulations for international financial markets a duty of national governments. One could also describe the provision of a framework for international financial markets as a global public good. A stable international financial system is characterised by

[1] A good example for the function of the large central banks is their reaction after September 11. Both the American Federal Reserve and the European Central Bank provided markets with liquidity. On September 11, the Fed helped financial markets with $ 80 billion of liquidity, which were supplied through both the discount window of the Fed and open markets operations. The ECB supported the Fed's efforts by supplying Euro 69.3 billion on September 12 and a further Euro 40.5 billion on September 13 (see The Financial Times, 1 October 2001, p. 2).

both non-rivalry and non-excludability: Consumption of this good does not reduce its availability for other countries; and no country can be excluded from using that public good. It can only be provided by the collective effort of national governments, yet the non-provision causes costs for all players, both private and public, in all countries. A stable international financial system would be a benefit to all economies. However, although virtually all countries would benefit, the stabilisation of the international financial system also creates losers. Those that are currently making a profit from either speculation or from providing insurance against speculation would suffer, and these players are resisting change in the system. Although this applies primarily for the foreign exchange markets, similar points can be made with regard to the credit markets.

It should not be forgotten that today's liberal economic order has not been created by market processes without decisive influence of public actors. Quite the opposite: A coalition of public and private players have jointly pressed for the liberalisation of financial markets. The creation of global financial markets was the strategy of an alliance of players. Private preferences for liberalised markets were transformed into government policies for the dismantling of barriers for financial markets (see Underhill 2001).

In comparison to the system of Bretton Woods, operational from 1945 to 1971, today's system reflects a change of priorities. In the Bretton Woods system, the interests of the financial sector were subordinated under the wider interest of societies for a stable development of the economy. Also, the experiences with unregulated markets in the 1920s were still sufficiently well-remembered to encourage policy makers to limit the power of financial markets. In other words: The liberalisation of financial markets from the beginning of the 1970s was not only a push for more efficiency of the financial sector, but is also reflected the increased political influence of the financial sector and a declining interest in a steady development of the entire economy.

The reform of the international financial system should reach the three following goals: a) Both the frequency and the depth of financial crises should be reduced. b) Creditors should systematically be integrated in both crisis prevention and in the solution of crises. c) The financial sectors of developing countries have to be strengthened in order to reduce the need for borrowing abroad.

Reaching those goals would make a contribution to the development of a more stable and more just world economy. If this stabilisation is not achieved, the current liberal economic order might be at risk. Similar to the developments that followed the Great Depression much more than financial markets could be at risk. Countries may decide to isolate their economies from the world market. The collapse of the multilateral trading order may be the consequence. If financial markets are not providing the benefits that the proponents have been promising, the retreat from the global economy appears to be possible. The recent reactions that followed the collapse of Argentina give an indication: The discussion may have already begun.

As long as seven years ago, after the Mexican crisis, prominent economists already asked whether the liberalisation of the international financial markets has gone too far. In particular, both the speed and the scope of liberalisation were criticised. The risk identified was a backlash that could also affect world trade, a far more important field (see Griffith-Jones 1998, p. 188).

In this paper I do not intend to propose a grand strategy for the re-regulation of international financial markets. Instead, I am looking at a number of specific proposals that can make a contribution towards more stable financial markets. Firstly, I am discussing a proposal for a tax on currency transactions, the so-called Tobin tax. Secondly, I am looking at the current discussion on currency regimes. Both a rigid currency board, applied in Argentina, as well as a totally flexible exchange rate regime, used in South Africa, display major weaknesses. The currency board contributed to Argentina's drift into economic depression. But completely flexible rates are no alternative either, as the case of South Africa shows. For developing countries and emerging markets, the discussion on the appropriate exchange rate regime will gain fresh momentum after the Argentinean crisis. Dollarisation, intermediate regimes and monetary regionalism are the options available to those countries.

Thirdly, I will look at measures that force lenders to participate both in crisis prevention and crisis resolution. The current order has neglected these issues. The risk management of private lenders has frequently been insufficient. Even more problematic is the fact that private lenders could try to avoid making a contribution toward the resolution of a financial crisis in a developing country. Both rollover-options and collective action clauses in bond issues can make a contribution towards reaching these goals.

Fourthly, I will look at two institutions that are of utmost importance for the international financial markets, the International Monetary Fund (IMF) and the Financial Stability Forum (FSF). Although the IMF continues to be the single most important institution that governs financial market regulation, the FSF might play an important role in the future: It appears to be easier to discuss financial market regulation in smaller circles before proposing them in the IMF. I will also discuss the question whether the IMF should be transformed into a global lender-of-last-resort.

2. TOBIN TAX AND SPAHN TAX: POWERFUL TOOLS OR A NUISANCE?

In recent months, an old proposal by James Tobin has been making the headlines again. Many critics of globalisation hope that the introduction of a Tobin tax would solve two problems at the same time: The tax would stabilise exchange rates and simultaneously provide a source for financing development in the South.

After the collapse of the Bretton Woods system, Tobin had suggested a small tax on currency transactions. The idea was to make speculation against currencies less attractive by increasing transaction costs. Tobin's proposal is based on earlier suggestions by John Maynard Keynes, who had advocated the use of taxes for the stabilisation of financial markets. In 2001 both the French and the German heads of government supported the careful evaluation of the instrument. Numerous non-governmental organisation, amongst them WEED in Germany and ATTAC, have made the introduction of the Tobin tax a central element of their reform proposals. Despite the widespread support that the Tobin tax enjoys, it does not appear to be an instrument that can provide the expected results.

The central weakness of the Tobin tax is that all international movements of capital are implicitly considered harmful. Thousands of useful and entirely harmless transactions are put into the same category with destructive speculative movements of capital (see Flassbeck/Noé 2001, p. 1367). This is unnecessary and leads to additional cost that negatively affects international trade. The argument that such a small tax will not harm trade is not convincing when taking today’s mode of transnational production into consideration. A product and the associated payments will cross the borders of national economies a few times before the end product reaches the customer. Therefore, a Tobin tax would have a cumulative effect.

Furthermore, doubts remain whether the Tobin tax can reach its primary goal, i.e. the avoidance of severe currency crises. Speculators that wish to attack an exchange rate will not be discouraged by a tax of 0.1 to 0.25 percent. When profits of 30 percent and more are expected, such a small tax does not have any effect (see Nunnenkamp 2001, p. 16; Frenkel/Menkhoff 2000, p. 66). Two recently published studies by the European Commission and the German Ministry of Economic Co-operation and Development come to the same conclusion. The main goal, the stabilisation of exchange rates, will not be achievable with the Tobin tax (see Commission of the European Communities 2002, p. 44; Spahn 2002, p. 4).

On a more general level, it is not clear whether raising transactions costs is a powerful instrument against speculation. For example, consider real estate markets. Transaction costs vary from country to country, but they are quite high everywhere. According to the logic of the Tobin tax, real estate markets should be characterised by very few speculative excesses. There is no empirical evidence that supports such a judgement (see Shiller 2000, p. 227).

Stock exchanges with higher transaction costs do also not show any signs of greater stability compared to exchanges with lower transactions costs (see Shiller 2001, p. 227). An example for a stock exchange with relatively high transactions costs is, surprisingly, the London Stock Exchange. Since 1694 the government collects a so-called stamp duty at a rate of 0.5 percent, to be paid by the buyer of a share. This transaction tax today is the oldest tax collected in the United Kingdom. The revenue from this form of taxation are considerable. In the fiscal year 1999-2000, the British Treasurer collected more than Euro 5 billion from this stamp duty. This is a fourfold increase from 1994-1995. Despite the relatively high level of taxation, the London Stock Exchange has been as volatile as any other exchange in Europe. The reduction of speculation cannot be demonstrated with this example.[2]

The Tobin tax, however, would do harm to those that bet on small movements of the exchange rate. But these small movements are not a problem. They do not cause harm for the real economy. And they are not easily dispensable. This arbitrage function secures uniform prices and provides liquid markets. A Tobin tax could eventually even have destabilising effects for exchange markets. A reduction of the level of liquidity by reducing turnover can

[2] Not surprisingly, there is a movement that calls for the abolition of the stamp duty. See their homepage at www.StampOutStampDuty.co.uk.

rise the volatility of exchange markets (see Paqué 2001). This is particularly so in the case of developing countries, where turnover is quite low already (see Commission of the European Communities 2002, p. 44). A current example for the negative consequences of the reduction of liquidity in exchange markets is the South African case: In October 2001 the South African government wanted to curb speculation against the rand and introduced measures to limit the trade in foreign exchange. These measures contributed to the collapse of the exchange rate towards the end of 2001 (see also the chapter on exchange rate regimes).

Finally, it cannot be ignored that the successful implementation of a Tobin tax probably requires its world-wide introduction. Even if just one financial centre in every time zone would not participate, this could result in a cost disadvantage for the other financial centres that would have the Tobin tax. In the medium and long run, this could lead to a relocation of currency trade to those financial centres that would note participate in the collection of the Tobin tax.

A Tobin tax, that shall be collected in a sustainable way, i.e. without creating incentives for the relocation of currency trade, requires a multilateral approach. It would have to be collected at least in all major financial centres. Therefore the question has to asked whether it is plausible to expect US participation in the near future. Without the Americans such a concept does not make sense. At this point in time, however, American participation appears to be very unlikely. September 11 did not change the unwillingness of the American government to regulate markets, apart from their demonstrated readiness to subsidise their own industries and punish successfully restructured steel companies with the introduction of protectionist measures. But in financial markets, the American preference for entirely unregulated markets persists.[3]

However, some reservations have to be made. The experience of the financial markets in London have shown that the stamp duty has not resulted in a reduction of London's importance as a financial centre. The stamp duty has neither reduced volatility in the market nor has it contributed to the departure of financial sector companies. A Tobin tax that would only be levied in one part of the world would probably not lead to the immediate relocation of

[3] A minor exception is the campaign against money laundering. But this is only a small element of financial sector regulation and should mainly be seen as a contribution to the fight against terrorism.

currency trading to other parts of the world. If the European Union would impose that tax at a low rate and the USA would not, the Tobin tax would not change much. Currency markets would not be stabilised, but the Tobin tax would not do much harm to European currency trading either. The main point here is the level of taxation: The higher the tax rate, the greater the risk that relocation of currency trading will eventually occur.

Although there are both conceptual and political reasons for questioning the usefulness of a Tobin tax, the debate about it is nevertheless beneficial. Governments do have a responsibility for shaping globalisation and for the order of financial markets in particular. Globalisation has not led to powerless governments. Rather, policy makers have for a long time ignored their responsibility for the regulation of markets and have hoped for their self-regulation. The growing resistance against unregulated and liberalised financial markets and also the debate on the Tobin tax may encourage the governments in OECD-countries to carefully evaluate the economic and political advantages of improved regulation.

On the other hand, the debate on the Tobin tax may also have exactly the opposite effect. The debate distracts attention from the real problems of international financial markets and the willingness to consider complex economic problems might be reduced (see Flassbeck/Noé 2001, p. 1368). This danger is evident both in policy making circles and in the anti-globalisation movement. The temptation appears to be high: By imposing a Tobin tax ist supporters hope to achieve both the stabilisation of financial markets and to gain a massive source for the financing of development. Miraculously two of the most pressing problems of the global economy will be solved at the same time. Unfortunately, neither will be achieved with a Tobin tax. Without going into a detailed discussion I would like to point out that other instruments, e.g. on aviation fuel, appear to be far more realistic: they promise to provide a stable flow of money and can be implemented much more easily (see Commission of the European Communities 2002, p. 91).[4]

Finally one has to take into consideration that the introduction of the Tobin tax would be the model case for the re-regulation of international financial markets. With the Tobin tax the attempt would be made to regulate financial markets much more than in the past. Therefore

the proposal for a Tobin tax carries a particular burden. If the Europe-wide or even the world-wide introduction of a Tobin tax would not generate the expected results, both with regard to stabilisation and to providing money for financing development, the Tobin tax would have caused more harm than good, because the re-regulation of financial markets would have been discredited.

In view of the substantial weaknesses the Tobin tax shows in its original form, modified variations have been proposed. Paul Bernd Spahn has suggested a two-tiered tax. The first level would cover all currency transactions and would be exactly like the original Tobin tax with one difference: The tax rate should be extremely low, i.e. between 0.005 and 0.02 percent. This part of the tax would only provide some revenue. The stabilisation of exchange rates shall be achieved with the second tier. The idea of Spahn is that a country first of all has its exchange rate float within a pre-defined exchange rate band. Around the central exchange rate, administratively set, the exchange can fluctuate freely within a band of, say, ± 3 percent. Outside this exchange rate corridor a high tax of between 50 and 100 percent would apply (see Spahn 2002, p. 21-28). This tax should be implemented unilaterally by all those transformation countries, developing countries and emerging markets that wish to stabilise their exchange rate (see Spahn 2002, p. 27).

Spahn appears to have made a very convincing proposal. Both aims of the Tobin tax, the stabilisation of exchange rates and the generation of revenue, appear to be achievable. The ability to implement it unilaterally, i.e. without consent of the USA or the IMF, is another major advantage. However, as often, if something looks too good to be true it probably is. The Spahn tax requires preconditions which, if provided, will make the implementation of the Spahn tax unnecessary.

The critical point is the spatial reach of the tax. The currency of any country is not only traded in its own financial markets, but also in other financial markets and, quite important, in offshore financial centres. To avoid that currencies are affected by speculative attack, one would have to limit the trade of the currency to those financial markets that can be reach by a country's jurisdiction. These are only the country's own financial markets. Only there the

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[4] However, even a fuel tax collected within the European Union would create certain problems, e.g. the treatment of aircraft flying to intercontinental destinations: If the tax were too high, there would be an incentive to refuel

Spahn tax can be levied. In other financial markets and in particular in offshore financial centres the implementation of the tax requires the consent of the authorities in charge for those markets. It is hard to see why, say, the British authorities should implement a tax in London that is used for the stabilisation of the Brazilian Real. And it is even more farfetched to expect that from an offshore financial centre. The consequence is that for the successful implementation of the Spahn tax one would need capital controls. But if a country implements capital controls, it does not need a Spahn tax, because capital controls as such offer a sufficient protection against speculation. In other words: Without capital controls, the Spahn tax would not work, and with capital controls it would not be required.

Considering these limitations, one could also imagine that a Spahn tax ought to be levied by those companies that operate as clearing houses for international currency trade. But the problem again is that this would be beyond the jurisdiction of a given country. A private company registered in a third country cannot be forced to levy the tax of the country that wants to stabilise its exchange rate. Even if the clearing house could be forced to do so, this would only create an incentive to establish a competing company, with a differing legal construction, to be set up in order to avoid the Spahn tax.

The bottom line is: Neither the Tobin tax nor its modified version, the Spahn tax, can contribute to the stabilisation of exchange markets. Consequently, it has to be asked in which way developing countries and emerging markets can stabilise their exchange rates. This question has gained further importance after the collapse of the Argentinean currency board.

3. EXCHANGE RATE REGIMES: IS THE BIPOLAR VIEW CORRECT?

The dramatic economic crisis in Argentina has refocused our attention to the issue of exchange rate regimes. In 1991, Argentina had pegged its exchange rate to the US-Dollar at a rate of one to one. The instrument used was a currency board. After initial success the Argentinean economic policy ran into a deadlock from 1998 on. The exchange rate regime did not permit an adjustment to the new economic circumstances that had been dramatically changed by the Asian crisis and the devaluation the Brazilian real. Needless to say that the exchange rate regime was not the only cause of Argentina's catastrophic economic situation,

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the aircraft just outside the EU.

but the inflexibility of this currency regime has impeded an appropriate response to the external shocks caused by the Asian and the Brazilian crisis.

After the financial crises of the 1990s, the International Monetary Fund and prominent economists have suggested that developing countries and emerging markets should choose between two corner solutions: They should either opt for a currency board or for a flexible exchange rate. All intermediate exchange rate regimes were dismissed as being too risky. In 2002, this bipolar view itself now has to be re-examined.

The reason is not only the trouble in Argentina. The other corner solution, a fully flexible exchange rate, has proven to be very dangerous for advanced developing countries as demonstrated by the South African case. From 2 August 2001 to 2 January 2002 the Rand fell vis-à-vis the Euro from 7.2 Rand per Euro to 11.1 Rand per Euro.[5] The Rand lost more than half of its value against the Euro and the Dollar without a plausible economic explanation. The macroeconomic data of South Africa do not provide a cause for the devaluation of the Rand. However, the consequences of a devaluation of this magnitude are substantial. To name just two consequences: The service of debt denominated in foreign currency is becoming much more burdensome and the risk of a so-called imported inflation rises dramatically.

Both corner solutions show substantial weaknesses. If these exchange rate regimes are difficult to implement, it has to be asked which options remain for economic policy in a developing country. Three solutions will be considered: Firstly, developing countries can forego the right to have an own currency and can use the money of another country. This can be dollarisation or euroisation. Secondly, countries can select intermediate regimes between a hard peg and a flexible rate. This is the main recommendation of a recent proposal of the OECD: "Don't fix, don't float" is the programmatic title of a book that was published well before Argentina collapsed (see Braga de Macedo et al. 2001). Thirdly, countries can engage in monetary regionalism: A group of countries can, similar to the countries of the Eurozone, establish their own regional currency union.

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[5] See Deutsche Bundesbank, Zeitreihe WT 5648, www.bundesbank.de/de/statistik/zeitreihen/html/wt5648.htm.

3.1. The currency board

Three elements are characteristic for a currency board: A fixed exchange rate vis-à-vis the anchor currency, e.g. the British pound or the Dollar; the unlimited convertibility of the local currency into the anchor currency and thirdly the complete coverage of the domestic money supply with currency reserves (see Cohen 1998, p. 52).

The concept of a currency board is not new, but rather more than 90 years old. The idea was first developed by British colonial authorities. In 1912 the British established the "West African Currency Board" for the colonies Gambia, Gold Coast (Ghana), Nigeria and Sierra Leone. The model was subsequently also implemented in other British colonies. By guaranteeing a fixed exchange rate, trade with the colonies was put on a stable monetary foundation. Not only trade was strengthened by the fixed exchange rate but also capital transactions. British banks could treat overseas territories as if they were a part of the United Kingdom (see Cohen 1998, p. 52f).

This exchange rate regime, developed in colonial times, quickly lost importance after World War II. The advantage of monetary stability was less important. Currency boards were condemned as symbols of the suppression of developing countries by colonial powers. Apart from the British colony Hong Kong currency boards were no longer used. The were considered to be relicts of a bygone era. The renaissance of this exchange rate regime started with introduction in Argentina in 1991, Estonia 1992 and Lithuania 1994 (see Cohen 1998, p. 53). The main protagonists of this concept were the IMF and the American Ministry of Finance (see Braga de Macedo et al. 2001).

Supporters of this exchange rate regime stress that currency boards provide credibility, transparency, low rates of inflation and monetary as well as fiscal stability. By eliminating exchange rate risk, interest rates can be very low, which in turn supports economic development (see Edwards 2000, p. 27).

It is true that currency boards can, in specific circumstances, provide monetary stability for a country. However, the price for that stability is substantial. The following points should be considered:

- A country with a currency board forgoes its own, independent monetary policy.

- In a currency board, the central bank does not have any instruments to influence economic development. It has no direct influence on the domestic interest rate.
- The domestic interest rates in a country with a currency board by definition are higher than in the country providing the anchor currency. Otherwise investors would have no incentive to hold the domestic currency rather than the anchor currency. Furthermore, the interest rates are not only higher than in the country providing the anchor currency, they may also rise when this is utterly unwanted. In the event of a recession at home, rising interest rates in the anchor currency country may deepen or at least prolong the existing recession.
- The central bank has no influence of the provision of liquidity for the domestic financial sector, because domestic money supply cannot be raised if the reserves of foreign currency are not rising. This has two consequences: Firstly, in the event of a crisis the central bank cannot encourage the domestic financial sector to lend more freely by implementing a loose monetary policy. Secondly, the central bank cannot act as a lender-of-last-resort, i.e. a crisis in the domestic banking system cannot be fought by the central bank. It cannot provide liquidity for it has no control over money supply.
- The exchange rate cannot be adjusted when external shocks induce just that. In the event of a devaluation of the exchange rate of a major trading partner vis-à-vis the anchor currency deteriorates the competitive position of the domestic enterprises. To restore the competitive position, prices in the domestic economy have to be reduced. A major element is the reduction of wages to a significantly lower level. This, however, is a formidable task for any economy. Not only is a reduction of the level of wages difficult, it also requires a long implementation period.
- When selecting an anchor currency, careful choices have to be made and trade flows have to be considered. Ideally, the anchor currency should be that of the main trading partner.

Since the reserve bank can no longer act as a lender-of-last-resort, instruments have to be developed that result in the provision of liquidity in the event of a crisis. Argentina has addressed this problem in three ways: Firstly, the local banks were asked to hold very high reserves. They had to hold 21 percent of deposits in international reserve currencies either in accounts at the Argentinean central bank or with the New York branch of Deutsche Bank (see Braga de Macedo et al. 2001, p. 24). Secondly, the central bank had negotiated substantial

liquidity credit lines with major international banks.[6] Thirdly, the liberalisation of the financial sector had led to an increase of the influence of foreign banks. These, in turn, would have had access to liquidity provided by their parent companies. Out of the eight largest banks in Argentina, seven are owned by foreign banks (see Edwards 2000, p. 30).

It has been demonstrated that a currency board is a complicated type of exchange rate regime that requires comprehensive measures to make it sustainable. In comparison with the frequently discussed alternative, dollarisation or euroisation, a currency board has some advantages: The symbolic value of an own currency remains, and the country does not have to give up seignorage, which can be as much as 0.5 percent of GDP (see Cohen 1998, p. 54).

3.2. Experiences in Argentina

Argentina had introduced a currency board under finance minister Domingo Cavallo in March 1991. After years of hyperinflation not only the Argentinean government, but also many economists considered the introduction of a rigid exchange rate regime a necessary cure. After the hyperinflation of the 1980s there were virtually no other options left for Argentina.

Table 2: Inflation and Growth in Argentina 1983 to 2000

	1983-92	1993	1994	1995	1996	1997	1998	1999	2000
Annual change of consumer prices in percent	346.3	10.7	4.2	3.4	0.2	0.5	0.9	-1.2	-0.9
Change of real GDP in percent	1.7	6.3	5.8	-2.8	5.5	8.1	3.8	-3.4	-0.5

Source: International Monetary Fund, Economic Outlook, October 2001.

The "convertibility plan" reduced inflation from 5000 percent in 1989 to 4 percent in 1994. Despite today's problems, the strategy to reduce inflation with the introduction of a currency board was a just and adequate measure. The high growth rates achieved in 1993 and 1994 confirm that monetary stability can make an important contribution to economic growth.

This phase of prosperity, however, did not last long. In 1995, Argentina was faced with a massive external shock. Already then it was obvious that the inflexibility of a currency board

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[6] The sum of these credit lines amounted to 10 percent of all deposits in the Argentinean financial system (see

prevented an adequate response of monetary policy to a change in the external economic environment. The Mexican crisis, which broke out in December 1994, resulted in the abandoning of the fixed exchange rate regime in Mexico. The crisis spread to the rest of the continent, quickly being called the Tequila crisis. The inflexibility of the currency board immediately was a burden. Although trade with Mexico is not relevant for Argentina, the country could not escape the turbulence caused by Mexico. Argentinean economic policy had no tools to fight the shock.

Already then it could and should have been asked what the consequences of a change in the exchange rate regime in Brazil would have been. The fact that this was not done is partly due to the fact that economic recovery commenced quickly. Argentinean economists as well as the IMF should have realised that the time for an orderly departure from the currency board had come. This was particularly important since trade with Brazil had grown dramatically.

Table 3: Argentinean foreign trade 1992-2000 (in billions of US-Dollars)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Exports	12.2	13.1	15.7	21.0	23.8	26.4	26.4	23.3	26.3
Imports	14.9	16.8	21.5	20.1	23.8	30.5	31.4	25.5	25.1
Exports to Brazil	1.7	2.8	3.7	5.3	6.6	7.8	7.8	5.6	6.8
Exports to the USA	1.3	1.3	1.7	1.5	2.0	2.0	2.0	2.6	3.0
Exports To the EU	3.8	3.7	4.1	4.3	4.6	4.0	4.6	4.7	4.6

Source: International Monetary Fund, Directions of Trade Statistics Yearbook 1992-1998 and 2001.

The exchange rate regime contributed to the massive increase in foreign trade. From 1992 to 1997 exports more than doubled. Exports to Brazil grew strongly. Form 1992 to 1997 they almost grew fivefold. Whilst their share in total exports was only 13.9 percent in 1992, that ratio had grown to 29.5 percent in 1997. This rapid growth of trade was the direct result of the creation of the Mercado Comun del Cono Sur (Mercosur). In 1991, Argentina, Brazil, Paraguay and Uruguay had created a custom union, which turned out to be one of the more successful regional integration projects in Latin America.

Brage de Macedo et al. 2001, p. 24).

The growth of exports to the USA, however, was limited. In 2000, only about 10 percent of exports went to the United States. The advantage of a stable exchange rate regimes was of limited use to Argentinean exporters. At the same time, exports to the European Union developed much better. The stagnation of exports to the EU from 1996 correlates with the rise of the Dollar vis-à-vis European currencies and the Euro.

The second external shock for the Argentinean economy has been the Asian crisis, which caused trouble for a range of developing countries, including neighbouring Brazil. In early 1999 the Brazilian government had to give up the previously fixed exchange rate of the Brazilian real, which subsequently lost half of its value against the Dollar. The fuse of the bomb that has now exploded was lit. The dynamic increases in the fastest growing market stalled. The devaluation of the real and the weakness of the Euro led the Argentinean export economy into crisis.

After this second external shock the only possibility to restore competitiveness was a lowering of wages and prices. Generally speaking, these adjustments took place in Argentina, if only at a very slow pace. The speed of improvement was far too low to drag the economy out of its complicated economic crisis.

This development highlights a major weakness of a currency board: If that regime shall be sustainable, labour markets have to be very flexible. In other words: Wages have to be reduced drastically in the event of a severe external shock. In Argentina, this was impossible because unions are strong and redundancies expensive. High non-wage labour costs also contribute to the low downward inflexibility of wages.

The obvious lesson from this experience is that exchange rate regimes cannot be designed without careful consideration of both trade flows and socio-economic conditions of a country. In the case of Argentina the rigid exchange rate regime caused harm for two reasons: Firstly, only a very small part of exports went to the US, the country that provided the anchor currency, and a much greater part went to Brazil and the EU. Secondly, labour markets in Argentina were not nearly as flexible as they should have been for a sustainable currency board.

Supporters of a currency board have been suggesting that it will lead to a reduction of interest rates. For Argentina, this should have resulted in a lowering of interest rates to the level of the USA. However, empirical evidence does not support this claim. Throughout the existence of the currency board, the spread between bonds denominated in pesos and similar Dollar bonds has been above 500 basis points, i.e. 5 per cent. The spread frequently was above 10 per cent, towards the end of 2001 even more than 20 per cent (see Braga de Macedo 2001, S. 24). These high interest rates made a return to economic growth difficult if not impossible. In the absence of inflation, real interest rates of 25 per cent had to be earned. Needless to say that this would have been a tough task for any economy, let alone for one which had lost its competitive edge due to an overvaluation of its currency.

But it would be unfair to argue that national economic policy and the ill-designed exchange rate regime were exclusively responsible for the crisis. The International Monetary Fund has to bear a substantial part of the responsibility for the economic drama that Argentina is confronted with. Firstly, the IMF supported the currency board far too long. At the latest after the devaluation of the real in 1999 the IMF should have made proposals for an orderly departure from the currency board. Secondly, the IMF as always demanded a restrictive fiscal policy which deepened the crisis. A pro-cyclical economic policy that lowers government expenditure in the midst of a crisis is not wise. The failure of the austerity policy prescribed by the fund was followed by a call for even stricter austerity (see Krugman 2002). This shows also that the IMF is unwilling to learn from past mistakes: During the Asian crisis, the IMF has made the same mistake. Countries had to simultaneously lower government expenditure and raise taxes. The pro-cyclical fiscal policy that the IMF called for caused severe economic harm both in East Asia and in Argentina.

The IMF has asked for a reduction of government expenditure at a time when Argentina was already virtually cut off from international financial markets. This policy recommendation was accompanied by fresh money from the Fund. In 2000, the IMF lent $ 40 billion to Argentina, followed by another $ 8 billion in August 2001. The combination of these two policies was inconsistent. The Fund should have either provided credit for a stimulation of the domestic economy, but without the call for a tight fiscal policy, or the IMF should have stopped lending earlier and should have made it clear that overcoming the crisis would require tougher measures.

Up to now the focus was on the problems related to the implementation of a currency board. A mayor disadvantage of a currency board, however, is the astronomical cost of giving up the currency board during a severe economic crisis. This is evident when looking at the choices that the Argentinean government had to make. They could choose between dollarisation, i.e. giving up their currency all together, or letting the exchange rate float. Dollarisation would not have solved the problem of weak demand and high foreign debt, but would instead have created new, additional problems.[7] Shifting to a floating exchange rate regime can also create a number of new economic nightmares.

The first issue concerns the change from the old fixed exchange rate to the new rate. This is not a problem if both debt and claims are exchanged at the same rate. If, like in Argentina, savings shall be exchanged at a better rate than debt, the banks have a shortfall.[8] The value of their own claims is reduced, whilst their liabilities stay the same (in Dollar terms). As a consequence, many banks in Argentina face bankruptcy. The foreign banks also suffer a shortfall, and although they could be re-capitalised by their parent company, it is hard to see that this would be a reasonable procedure. If foreign banks would have to cover the cost of the asymmetric exchange of debts and claims, this would constitute a massive tax burden for them.[9]

A reduction of the debt burden for both the Argentinean government and the local companies is desirable. However, the cost of such a measure, whichever form it has, will eventually have to be covered not only by foreign holders of Argentinean debt, but also by Argentinean savers. They will have to face a reduction in the real value of their assets. This constitutes a major burden for the economy. After many years of hyperinflation, the citizens had developed a certain trust in the stability of their currency, and of the domestic financial system. Now, these hopes have not been fulfilled. Argentineans are bitterly disappointed that once again they have lost their savings. It is very unlikely that this shock will be overcome quickly. Instead, it will be entirely rational not to keep any savings in Argentina, but deposit them elsewhere. Capital flight will again be a feature of daily life in Argentina. This, in turn, will make the financing

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[7] See also the section on dollarisation.

[8] President Duhalde had suggested such an asymmetric exchange of debt and claims because he claimed Argentineans should not become the victims of the financial system (Frankfurter Allgemeine Zeitung, 7.1.2002, p. 14).

of investment out of domestic sources very difficult. Both for savings and for credit, Argentina will in the future depend even more on other financial markets rather than its own. It appears that the currency board has destroyed more faith in the financial sector than the hyperinflation of the 1989s. Furthermore, it is hard to envisage a rapid return to both a credible monetary policy and to a path of economic growth under these circumstances.

But there additional problems of monetary policy following the devaluation of the peso. Servicing the country's foreign debt is now even harder. Although the exports of Argentina may rise, the cost of debt service expressed in peso has risen substantially. In 2001, the country had an external debt, both public and private, of about $ 145 billion. With the old exchange rate, this was 54.1 percent of the country's GDP of $ 268 billion. Even with the exchange rate of February 2002, about 2 pesos per Dollar, the picture has changed dramatically. GDP is reduced by half, but external debt has remained the same. $ 145 billion is now 108 percent of GDP. And a few weeks later, in early April, the current exchange rate of 3 pesos per Dollar has raised the relative burden of the foreign debt even higher to roughly 160 percent of GDP. Argentina will under no circumstances be able to pay back its external debt completely.

Despite this very negative assessment, the currency board cannot be evaluated without due consideration of the early successes. This exchange rate regime initially worked well and enabled the country to overcome the hyperinflation of the 1980s. However, the Mexican crisis of 1995 demonstrated how vulnerable Argentina has become because of its rigid exchange rate regime. The numerous mistakes and mishandlings in Argentinean economic policy cannot be attributed to the currency board. But this exchange rate regime can only be sustained if a number of conditions are guaranteed, e.g. the downward flexibility of wages and a very disciplined fiscal policy. Such a demanding exchange rate regime is not a good recommendation in particular for developing countries with democratically elected governments. Currency boards were designed for colonies, not for independent economies.

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[9] Consequently, the EU finance ministers warned the Argentinean government not to put too great a burden on the banks. The financial sector could not cover an unreasonable share of the cost of the devaluation (Financial Times, 22.1.2002,. p. 6).

3.3. Flexible exchange rates: The better option?

The experience of Argentina shows that fixed exchange rates are hard to maintain even in a currency board. Other types of more or less fixed exchange rate regimes, e.g. a crawling peg or a crawling band, are similarly difficult in a longer period. In virtually all recent financial crises, fixed exchange rates that had to be abandoned played an important role. In Mexico, the crises in Thailand, Indonesia and South Korea as well as in Brazil, fixed exchange rates were given up soon after the pressure started to built up. The bipolar view, developed after theses crises and asking for either a currency board or flexible exchange rates, suggests that other exchange rate regimes are crisis prone and not sustainable. But how crisis prone and sustainable is a regime of fully flexible exchange rates?

The assessment of exchange rate regimes cannot be made without identifying the primary goals. The first and foremost goal is the facilitation of international trade. Export and import of both goods and services should be supported by the exchange rate regime. The second goal is the promotion of investment. Both foreign direct investment as well as domestic investment financed from foreign sources, either by credit or by bonds, should be assisted. Third, macroeconomic stability, in particular of the domestic currency, should not be undermined by the exchange rate regime. Reaching moderate inflation shall not be made impossible.

It is quite obvious that flexible exchange rates pose a substantial risk for developing countries. First of all trade is affected. If the exchange rate fluctuates wildly, exporters and importers either have to accept these changes or they have to hedge their business. The latter means that they have to buy exchange rate stability from suppliers of that insurance. These are mainly big international banks. Hedging, however, is quite expensive for exporters and importers. The greater the volatility of the exchange rate, the higher the cost of hedging.

Looking at this problem from a different angle, one can argue that a stable exchange rate is a public good that should be provided by governments. In a regime with flexible exchange rates, the cost of stabilising exchange rates has to be covered by private actors, the ex- and importers, who have to hedge their deals against exchange rate fluctuations. These costs reduce the competitive position of exporters on world markets compared to a system in which governments do provide that stability. Although flexible exchange rates are less problematic in developed countries with strong, competitive companies, for the developing world this is a

problem. Flexible exchange rate regimes make the integration of developing countries into world markets significantly more difficult.

With regard to foreign debt and foreign direct investment, flexible rates are also problematic. A lack of capital is a common feature of developing economies. In most cases, investment has to be financed by using capital from abroad, either in form of credit or direct foreign investment. When borrowing abroad, domestic investors have to cover the exchange rate risk, because virtually the entire foreign debt of developing countries is denominated either in Dollar or in another OECD-currency. If the exchange rate deteriorates, the debt service rises. But even in the case of foreign direct investment the instability of the exchange rate can influence investment behaviour negatively. Although the foreign investor covers the exchange rate risk, the result of a weaker exchange rate is that in order to achieve an expected return in dollars, the profit in domestic currency has to rise. If that rise in profit cannot be achieved, the likeliness of further investment will probably be reduced.

Finally, volatile exchange rates endanger macroeconomic stability. In the event of a substantial devaluation, the likely consequence is imported inflation: The domestic price level rises if imports get dearer. Imported inflation can wipe out previous successful programmes of macroeconomic stabilisation.

3.4. The South African case: Why did the exchange rate of the Rand collapse?

A recent example for the problems that can result from flexible exchange rates is South Africa. Since 1994, the country has implemented comprehensive measures of deregulation and liberalisation, including the dismantling of capital controls. The Rand floats freely.[10]

For more six months in 2001, the South African economy was hit by a sharp drop of the exchange rate vis-à-vis Dollar and Euro. Since the beginning of 2002 the Rand has recovered a bit. A declining exchange rate as such is not new: In January 1990, the exchange rate was Rand 2.56 to the Dollar. From then, the nominal exchange rate declined slowly, but steadily. However, in itself this is not a problem, since South Africa had a higher inflation rate than the US. The real exchange rate remained relatively stable.

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[10] See IMF Annual Report 2001, p. 125.

In 2001, the speed of devaluation increased dramatically. On 2nd January, 2001, the exchange rate was Rand 7.56 to the Dollar and on 2nd July 8.01. At the end of December 2001, the South African currency was only traded at over 12 Rand to the Dollar.[11] With such a strong devaluation, the macroeconomic data of South Africa should provide at least a partial explanation. However, this is not the case.

Table 4: South Africa's macroeconomic development 1999-2002

	1999	2000	2001	2002
Real GDP, annual change in %	1.9	3.1	3.5	3.0
Consumer prices, change against previous year in %	5.3	5.3	5.5	4.3
Balance of budget, in % of GDP	-2.3	-2.0	-2.3	-2.0
Balance of current account in % of GDP	-0.4	-0.1	-0.8	-1.1
External debt in % of GDP	29.6	29.4	32.0	34.1
Debt service in % of exports	15.8	13.8	12.3	9.1

Source: Deutsche Bank Research, Perspektiven Südafrika, Februar 2001. Data for 2000 are estimates, for 2001 and 2002 forecasts of Research.

The macroeconomic data do not provide a hint: Neither with regard to economic growth nor with regard to inflation is South Africa's economy in an alarming constitution. South Africa's foreign debt is not alarmingly high. The country's fiscal policy is prudent: At 2% of GDP, the budget deficit is even low enough for the strict criteria of the Treaty of Maastricht. Therefore, it is entirely justified that the South African President Thabo Mbeki denied that the Rand's weakness has anything to do with problems in the real economy.[12]

Economist are confronted with a riddle. Without a doubt, South Africa is confronted with massive economic and social problems. The entire region is suffering from instability and political problems in neighbouring countries, e.g. Namibia, Angola and Zimbabwe, are unsolved (see Dieter/Melber/Lamb 2001). The Aids pandemic is a huge burden for the economy. However, all these problems are not new, but well known for a long time.

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[11] Data from the US Federal Reserve Bank, www.federalreserve.gov/releases/H10/hist/dat96_sf.txt.
[12] Financial Times, 11th January 2002, p. 13.

Explanations for the Rand's weakness have to be found elsewhere. Firstly, the weakness of the currency could have been the result of a sudden and collective drop of investor confidence due to the recent political developments in Zimbabwe. In particular the absence of free and fair elections could have caused a change of investor's perspective. Thus, the weakness of the Rand would have had less to do with economic and political developments in South Africa and more with the trouble in Zimbabwe. The currency would function as a barometer for investor sentiment.

Although this explanation can claim a certain plausibility, second thoughts remain. South Africa's government has no decisive influence on developments in Zimbabwe. The comparatively solid macroeconomic policy of South Africa would be less important than political developments in the neighbourhood. The bottom line would therefore be that developing countries with flexible exchange rate regimes do not only have to provide good governance and democratic regimes in their own territory, but also in the entire region if they want to have stable exchange rates.

A second explanation can also claim some plausibility. To curb already existing pressure on the Rand, in October 2001 the South African central bank introduced measures that should have made speculation more difficult. As a result, the amount of foreign exchange traded was reduced. Unexpectedly, these measures made the Rand more vulnerable against speculation, because selling pressure had a higher impact. The limitations on currency trading also resulted in a reluctance of exporters to exchange foreign currency into Rand, and this subsequently led to a reduced demand for Rand.[13]

Presumably both factors have contributed to the devaluation of the currency. This, however, does not make the consequences of the lower exchange rate less severe. The Rand today is probably the world's most undervalued currency.[14] The repercussions for South Africa's economy are dramatic. Three consequences have to be considered: Servicing foreign debt will become more difficult, foreign investors will expect a higher return in domestic currency for their investments and inflation will rise. However, the undervaluation of the currency also has

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[13] Financila Times, 11th January 2002, p. 13.
[14] Following the Economist's surprisingly accurate Big Mac index, the Rand at the end of 2001 was traded 68% below its real value (The Economist, 22.12.2001, p. 134).

two advantages: The competitive position of exporters rises and on the domestic market competition with importers is made much easier.

The example of South Africa shows that flexible exchange rates are not a simple solution for developing countries and emerging markets. Although flexible exchange rates have fewer disadvantages than currency boards, they still display enough faults. Both currency regime render the national economic policy toothless. In both cases the dependence on external influences compared with other exchange rate regimes rises dramatically. Whether a depreciation in neighbouring Brazil or political trouble in the region, the effects for the domestic economy are severe. These two exchange rate regimes cannot be the standard solutions for developing countries.

3.5. Dollarisation and Euroisation: An expression of desperation?

Following the collapse of the Argentinean currency board, some economists have suggested the complete disposal of an own currency and have proposed the introduction of the Dollar as the only legal tender (see Hanke/Schuler 2001). Exchange rate risk would be completely eliminated. A number of countries have chosen this path for quite some time: Panama is using the US-Dollar, Liechtenstein has opted for the Swiss Franc, Monaco for the French Franc and now the Euro. Up to 2002, Andorra used both the French Franc and the Spanish Peseta as legal tender. Both El Salvador and Ecuador have decided to give up their national currencies and have declared the US- Dollar as the only legal tender. In Kosovo and Macedonia, the Euro has been introduced. But these countries are all small and, from an economic point of view, insignificant. For large countries, there are a number of good reasons why an own currency should not be given up:

- An own currency can contribute to the development of a spirit of community, which my be beneficial for the political stabilisation of a territory.
- Without an own currency one loses the so called seignorage. This profit from coinage can reach substantial levels. In the case of Argentina, seignorage has been about $ 780 million per annum (see Deutscher Bundestag 2001, p. 30).
- Without own currency an economy cannot be managed by the government. In particular the inability to develop an own interest rate policy is causing harm.

- Without an own currency it is impossible to insulate an economy from the rest of the world. Without a monetary border the creation of an independent economic policy cannot fully succeed.
- Using foreign currency makes a country subject to potential blackmail. Since the provision of liquidity is not guaranteed, an economy can be severely damaged if the government of the country that provides the legal tender interrupts supply. In the case of dollarisation a dependence on the goodwill of the American government is created. In 1988, Panama had to learn that this dependence can be dangerous.[15]
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The bottom line is simple: If political and economic independence is desired, then the adoption of another country's currency is not advisable.

3.6. Intermediate exchange rate regimes

The debate on the appropriate exchange rate regime for developing countries and emerging markets has gained momentum after the collapse of the Argentinean currency board. Before looking at the remaining options, I would like to point out that stable exchange rates in the periphery of the world economy are hard to achieve as long as volatility continues to exist between the Dollar, the Euro and the Yen. In a number of recent financial crises, in particular the crises in Asia and in Argentina, fluctuations of exchange rates in the core of the world economy played an important role. In Asia, the countries that had tied their currencies to the Dollar suffered a severe blow to the competitiveness of their companies when the Dollar appreciated against the Yen and the European currencies. In Argentina, the continuing strength of the Dollar reduced the competitive position of exporters and import competing domestic producers.

Without a mechanism for the stabilisation of exchange rates between Dollar, Euro and Yen, developing countries will not be able to provide stable exchange rates of their own currencies. However, currently the call for at least an exchange rate band does not receive a lot of support

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[15] The Reagan Administration decided that deposits of Panama in American banks would be frozen. A transfer of dollars to Panama was prohibited. The shock was severe: Most banks had to close and the entire economy suffered from an acute shortage of liquidity. The attempt of the government to quickly create a new currency to substitute the Dollar was not successful. The economy was demonetised. Within one year output declined by 20 per cent (see Cohen 1998, p. 45).

on both sides of the Atlantic, let alone in Japan, which has more dramatic economic problems to solve.[16]

If both currency boards and fully flexible exchange rates are excluded, a number of intermediate regimes are available. Both corner solutions, however, have one thing in common: central banks have to be rather passive in both systems. In all intermediate regimes, the central bank has a much more prominent role to play and is more or less actively trying to influence the exchange rate.

[16] Nevertheless, 11 out of 29 experts of a working group of the American Council on Foreign Relations supported the call for a target zone between the major currencies. Among those advocates of more stable exchange rates were the economist Fred C. Bergsten, the former chairman of the Federal Reserve Bank, Paul Volcker, and the hedge fund manager and successful speculator, George Soros (see Council on Foreign Relations 1999, p. 129).

Table 5: Exchange rate regimes

Type	characteristics	main advantages	main disadvantages	examples
1) without own currency/ dollarisation	complete adoption of a foreign currency as legal tender	monetary stability	no monetary autonomy, loss of profit from coinage	Ecuador, Panama, Palau
2) currency board	fixed exchange rate, convertibility in anchor currency, domestic money supply is completely backed by foreign reserves	monetary stability, sustaining profit from coinage	loss of monetary autonomy	Argentina (1991-2002), Bosnia, Brunei, Bulgaria, Hong Kong, Estonia, Lithuania
3) fixed exchange rate with a single anchor currency	exchange rate fixed to one currency within a narrow band and infrequent adjustments	monetary autonomy can be sustained	without capital controls risk of instability, appreciation of anchor currency worsens competitive position of companies	China, Iran, Malaysia, Namibia, Trinidad
4) fixed exchange rate with a currency basket	Fixing of exchange rate to a basket of currencies	stable real exchange rate can be provided	without capital controls risk of instability	Botswana, Morocco, Latvia, Tonga
5) fixed exchange rate with exchange rate bands	co-operative regime	stable exchange rates within the system, adjustments possible, flexibility vis-à-vis other currencies	without capital controls risk of instability	European Monetary System (until 1998), Denmark
6) crawling pegs	frequent adjustments of the exchange rate using one indicator, e.g. the different inflation rates of domestic and anchor currency	stable real exchange rate can be provided	without capital controls risk of instability, need for macroeconomic discipline	Bolivia, Nicaragua, Zimbabwe
7) crawling bands	exchange rate bands with frequent adjustments	stable real exchange rate can be provided	without capital controls risk of instability, need for macroeconomic discipline	Israel, Uruguay
8) managed floating	central bank tries to managed the exchange rate without using specific indicators	stable real exchange rate can be provided	without capital controls risk of instability, need for macroeconomic discipline	Jamaica, Slovenia, Norway
9) flexible exchange rate	central bank only monitors the development of the exchange rate	markets determine the development of the exchange rate, no risk of costly an unsuccessful intervention	high cost of hedging for exporters and importers	Australia, Brazil, Eurozone, Chile, Indonesia, USA

Source (for examples): International Monetary Fund Annual Report 2001, S. 124f.

The seven intermediate exchange rate regimes have a common disadvantage: They do not work very well if capital flows are fully liberalised. With high, volatile capital flows, central banks have problems to stabilise exchange rates. The underlying dilemma is described in the impossible trinity of international finance. Monetary policy tries to reach three goals at the same time: independence of monetary policy, unrestricted flows of capital and stable exchange rates. However, it is impossible to reach more than two goals at the same time. Monetary policy can only choose between the following three options:

- Either a stable exchange rate and an independent monetary policy. This option requires the use of capital controls.
- Or unrestricted capital flows and an independent monetary policy. In this case the exchange rate will have to be flexible.
- Or unrestricted capital flows and a stable exchange rate. The central bank gives up an independent monetary policy and concentrates its activities on the stabilisation of exchange rates (see Frenkel/Menkhoff 2000, p. 11ff; Fischer 2001, p. 8).

The first option describes the system of Bretton Woods. Capital controls were a central element of that monetary regime. These controls are necessary to enable the implementation of an independent monetary policy. For instance, in the absence of capital controls the lowering of domestic interest rates would lead to an outflow of capital with subsequent pressure on the exchange rate. Bretton Woods was a stable financial system for more than 20 years. Moreover, Bretton Woods was a period of rapid economic growth of the global economy. Another example is China, which also generated exceptional growth over a long period of time. During the Asian crisis China could maintain its fixed exchange rate vis-à-vis the Dollar primarily because of the tight capital controls it implements.

The second case describes our current system in the OECD outside the Eurozone. Exchange rates fluctuate and capital flows are more or less unrestricted and national monetary policy enjoys a certain autonomy, at least in the larger OECD-countries.

The third case is plausible from an economic point of view, but not politically. The reason is that in such a scenario, monetary policy has to give absolute priority to the stabilisation of the exchange rate. The consequence is that the central bank may have to raise interest rates even if that is counterproductive for the domestic economy. In democratic societies very few interest

groups would support such a monetary policy. Both trade unions and employers' associations are not willing to accept a stable exchange rate as the primary target of monetary policy. Also, many sectors of an economy are not affected by changes in the exchange rate and would therefore not support a policy that ignores the consequences for the domestic economy.

Before the First World War, such policies were implemented under the gold standard. The participating countries made the stability of the exchange rate an absolute priority of their economic policy. In the three core countries of the gold standard, i.e. France, Germany and the United Kingdom, the gold reserves and the convertibility at a given exchange rate were defended regardless of the short-term cost for the domestic economy (see Eichengreen 2000, p. 51). The political opposition against these policies was limited, mainly because trade unions were too weak to argue their case: Full employment was not yet on the political agenda.

The bottom line is: Stable exchange rates and an independent monetary policy are only achievable with capital controls.[17] For developing countries and, to a degree, emerging markets there are many reasons why they should not liberalise capital flows completely. Whereas the contribution of stable exchange rates to the economic growth of an economy is well documented, liberalised capital flows do not always have the same positive effects. Selective restrictions of capital flows should be the norm, not the exception, for developing countries.

The support for such restrictions should not be put on a level with protectionism in trade, quite the opposite. The American economist and staunch supporter of free trade, Jagdish Bhagwati, immediately after the Asian crisis declared that free trade suffers from frequent financial crises. Liberalised trade is supporting economic growth, whilst the same cannot be said about unrestricted capital flows (see Bhagwati 1998, pp. 7-12).

Although these policies can be implemented unilaterally, it would be positive if the IMF would support their implementation. Without such support, many countries will be reluctant to return to capital controls, partly because their implementation will, at least in the medium

to long term, require the support of the IMF and the major financial centres. National capital controls can be implemented much better if international co-operation on the control of capital movements will be strengthened. As long as this does not exist, the illegal export of capital is no big risk. If the money is not detected at the border, there is no future risk for the exporter of capital. In case receiving countries would also have to report the import of capital, the sustainability of capital controls would greatly rise.

The recent move of OECD countries to discipline offshore financial centres is a step into the right direction. If offshore financial centres can no longer be used to hide the financial resources of terrorist, this also means that capital flight from developing countries could, at least theoretically, be controlled more easily. Needless to say that this would constitute a major policy shift in Washington, which still appears to be politically unrealistic. Beyond the fight against terrorism there is little will to limit the freedom of the owners of capital.

3.7. Monetary regionalism: A new strategy for stable exchange rates?

The introduction of the Euro has motivated other regions to consider the benefits of regional monetary integration. The creation of a joint currency only eliminates exchange rate risk between the participating countries and not vis-à-vis third countries. But this additional stability is important enough to make monetary regionalism a promising project. Outside of the European Union, discussion on the creation of a joint currency has started in East Asia, in the Mercosur, the Gulf Co-operation Council (GCC) and the Eurasian Economic Community.[18]

Both the Asian crisis and the current disaster in Argentina have demonstrated the need for monetary co-operation. In East Asia, up to the crisis many policy makers had the illusion that they could integrate their economies into the world market without having to co-operate on a regional level. Furthermore, until the crisis erupted policy makers had no incentive to expect a dramatic collapse of their economies with the subsequent need to ask the IMF for assistance.

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[17] Stanley Fischer, for many years the most important figure in the IMF, accepts this conclusion and asserts that the implementation of capital controls permit a stable exchange rate. In Fischer's opinion , the problem is the declining efficiency of capital controls. Over time, the evasion of capital controls rises (see Fischer 2001, p. 10).

[18] The Eurasian Economic Community comprises Russia, Belarus, Kazakhstan, Tajikistan and Kyrgyzia. In spring 2002, the governor of Kazakhstan's central bank suggested a single currency (International Herald Tribune, 24 April 2002, p. 19).

Today, the views have changed: The elite in East Asia see the need for monetary regionalism in East Asia, although the exact shape of the integration process is far from clear.[19]

In the countries forming the Mercosur, there has been a discussion on the need for monetary co-operation for some time. At the end of 2000, the participating countries agreed on joint convergence criteria. Following the model of the treaty of Maastricht, the countries developed a plan for the years 2002 to 2005 and agreed on maximum levels for inflation (less than 5 percent), government debt (less than 40 percent of GDP) and allowed deficit in the public sector (3 percent of GDP at the most). The associated countries Chile and Bolivia have accepted these convergence criteria (see Frankfurter Allgemeine Zeitung, 18 December 2000, p. 18). Needless to say that these plans are an illusion. There will not be any monetary co-operation in the Mercosur before Argentina has not reached somewhat safer territory. It would be foolish to further weaken the Mercosur for the sake of rescuing Argentina. Even though a solution for Argentina is hard to envisage at this stage, policy makers in the region have continued to put the creation of a joint currency on their agenda. For instance, for the Mercosur Summit in February 2002 the issue was put on the program (see Handelsblatt, 21 January 2002, p. 6).

The creation of a joint currency is not a simple, technical task. The preconditions for the successful implementation of monetary regionalism are high. Before a common currency can be introduced, a number of intermediate stages have to be taken. These are both economic measures to generate convergence as well as political measures to create intra-regional policy networks (see Dieter/Higgott 2002; Kim/Ryou/Wang 2000). Against the background of the financial crisis of the recent past, it seems plausible to expect that a number of regions will follow the example of the European Union and will decide to give up their own currency in favour of a regional currency, despite substantial difficulties (see Fischer 2001, p. 17). Considering the existing alternatives, monetary regionalism appears to provide substantial benefits at a reasonable price.

After Argentina, the decision for an appropriate exchange rate regime for developing countries and emerging markets has to be answered in a more differentiated manner. If countries do not want to use capital controls, it appears that only flexible exchange rates are sustainable in the

[19] For a discussion of the changing nature of regionalism in East Asia see Dieter and Higgott 2002.

long run. However, the experience of South Africa has clearly demonstrated that flexible exchange rates are causing severe trouble for an economy: The uncertainty about future exchange rates makes international trade more expensive, shortens the time horizon of the private sector and consequently reduces investment and growth perspectives.

Exchange rate regimes that are supported by selective capital controls currently are more recommendable for many developing countries than the so called corner solutions (see Braga de Macedo et al 2001, p. 24). If countries wish to benefit from the integration into international financial markets and at the same time want stable exchange rates, the only option is monetary regionalism. However, the implementation of such a far reaching scheme will take quite some time.

4. BAILING-IN OF CREDITORS AND OTHER MEASURES TO STABILISE FINANCIAL MARKETS

4.1 Rollover-options

In some of the recent financial crises currency and credit crises have fuelled each other. The cancellation of credit contracts has led to an outflow of capital and put the exchange rate under pressure. Therefore, the stabilisation of the debtor-creditor-relationship is directly linked with more stable exchange rates.

The bailing-in of creditors has long been discussed, but there is no convincing solution yet. So far, the experience with the management of debt crises is not satisfying. In many cases the restructuring of debt saved creditors from facing the consequences of their risky lending. In these cases, a part of the bill was paid by those banks that showed a prudent lending behaviour, but an even greater sacrifice had to be made by the citizens of the affected countries. In many cases, the poorest people were punished for the irresponsible activities of foreign creditors.

Although the bailing-in of creditors has been discussing with increased intensity in recent years, there is no substantial regulation of this issue up to now. One problem in this context is the divergence of the American and the European position in the IMF. The USA insists on a case-by-case approach, whereas the Europeans favour a rules-based arrangement. The European proposal is obviously more transparent than the American one. The latter's

approach reflects the desire to decide according to American preferences and interest.[20] The European proposal is driven by a motive that favours regulation over ad hoc measures. Also, the European approach takes into consideration the need for a clear set of rules for international financial markets. It is necessary to fix the procedure for the event of a credit crisis when the deal is done, rather then when the crisis hits.

To discuss the bailing-in of creditors in the financial turbulence is a second-best solution. Far better is the construction of measures that enable the debtors themselves to activate stabilisation measures. In 1999, two British economists have made an interesting proposal. William Buiter and Anne Sibert suggested the introduction of Universal Debt-Rollover Options with a Penalty (UDROP). The idea is pretty simple: Debtors have the option to roll-over a credit upon maturity and extend the repayment period for three or six months. The price for this unilateral roll-over, the penalty, is set when the credit contract is signed. The aim of UDROP is to avoid liquidity crises caused by creditor panic (see Buiter/Sibert 1999). Creditor shall be given the option to find shelter until orderly market conditions have been resorted. Until the markets have calmed down, the country under pressure can, at a calculable price, demand the deferral of payment.

UDROP shall cover all credit denominated in foreign currency. They shall cover both private and public credit intake with short and long maturity. Overdraft credit shall be covered as well (see Buiter/Sibert 1999, p. 3).

This concept has number of convincing advantages. Firstly, UDROPs are a type of low-impact regulation that requires very limited government involvement. The state sets rules and supervises their implementation, but it is not involved in the precise arrangements the two parties of the credit contract set for themselves. As in other fields, financial markets are forced to accept government regulations. Secondly, UDROP can be implemented without a global consensus on the matter, which is hard to achieve at the moment. Instead of waiting for the creation of a global lender-of-last-resort, UDROP would immediately make a significant contribution to the reduction of the likeliness of liquidity crises. Thirdly, UDROP have a

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[20] This, however, is nothing new. In the debt crisis of the 80s the USA followed a very arbitrary policy. For instance, in 1988 Argentina violated IMF conditions several times. To secure interest payments to American commercial banks, the US-Administration intervened in the IMF and the World Bank and managed to organise fresh credit for Argentina despite the various breaches of agreed conditionality (see Raffer 1990, p. 308).

positive, stabilising effect on exchange rates. In particular in a regime of flexible exchange rates, the sudden and unexpected outflow of foreign currency to pay back foreign loans can put the exchange rate under severe pressure. If, due to the extended maturity of the loans, fewer debtors have to pay back their loan at the same time, the chance of a more stable exchange rate rises.[21]

The UDROP concept tries to address a weak point of unregulated financial markets. In the event of a crisis a debtor does gain time, a precious good in such times. Beyond this advantage the need to set the price for the use of the option when the deal is done is a positive side-effect. It forces both debtors and creditors to evaluate the risk of a credit more carefully. In the past, lenders too often ignored those risks, assuming correctly that the IMF would bail them out in the event of a crisis. With the introduction of UDROP, it could be made clear that there will not be a public bail-out any more. Consequently, both parties to a credit contract would have to evaluate risk thoroughly.

Finally, UDROP can also be implemented in an entire region and can be a building bloc of a monetary and financial regional integration process.[22]

However, UDROP also have substantial disadvantages. It can be expected that borrowing abroad will initially become more expensive.[23] This is not necessarily a bad thing. Borrowing domestically becomes cheaper relative to borrowing abroad. Domestic borrowing is much less dangerous for an economy than borrowing abroad, since by definition there is no exchange rate risk for domestic credit.

Another potential disadvantage of UDROP is that they can lead to the delayed acceptance of economic problems in an economy. If the crisis is more severe, i.e. the borrowers are confronted with a solvency and not a temporary liquidity crisis, then the solution of the problem might be delayed. However, this argument is quite weak. Assuming that lenders evaluate credit risk thoroughly, there still might be a delay of bankruptcy in some cases, but not in entire economies.

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[21] The same logic applies to fixed exchange rates. A central bank will quickly reach the limits of its foreign reserves if, due to a panic, too much foreign currency is required at short notice.
[22] For the details of the concept of monetary regionalism see Dieter 2000.

Overall, the advantages of UDROP are convincing. The limited disadvantages do not discredit the concept. Although these rollover-options are no panacea for the avoidance of financial crisis, they could make a significant contribution to the stabilisation of financial markets without confronting the markets with an excess of regulation. If, however, an international lender-of-last-resort could be created, UDROP would not be necessary any more.

4.2. Collective action clauses

Bonds have become much more important on international financial markets. Before the debt crises of the 1980s, capital flowing to public borrowers in developing countries primarily was in the form of bank credit with medium maturity, i.e. of a couple of years. The capital was typically provided by bank consortia. In 1980, that type was borrowing represented almost 100 percent of new debt of public borrowers from developing countries. Within the next 20 years bank credit lost much of its importance, and the bond market grew rapidly. At the end of the 90s, the percentage of bank credit in all lending to developing countries had fallen to less than 20 percent, the remainder filled by bonds (see Lipworth/Nystedt 2001).

The growing preference for bonds was partly based on the assumption that this type of debt would be more difficult to restructure than conventional bank credit. Bond holders assumed that sovereign states would try practically everything to avoid default since that would be a messy and costly affair: With thousands of bondholders involved, such a restructuring could not be arranged as simple as a restructuring of a conventional bank loan with only a dozen of banks involved. In the 90s, the preference for bonds spread further. Private borrowers from developing countries started to emit bonds on international financial markets instead of borrowing from banks.

This shift from loans to bonds has created new problems in the solution of debt crises. The large number of bondholders involved in any restructuring makes a co-ordination of their decisions very complicated.

Against this background it is obvious that bond contracts have to be made more crisis-proof. The most important proposal is the introduction of so-called collective action clauses. The

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[23] In the medium and long run, foreign borrowing could become cheaper, because the introduction of UDROP could stabilise the financial system of a country, which would in turn reduce risk premiums.

primary objective is to stop lenders from accelerating the maturity of a bond. Without such clauses, the is a continuing risk that bond holders ask for a premature repayment of their bond: In the event of a temporary liquidity problem, with the consequent delay of interest payments, bondholders can demand the immediate return of their money. It is these calls for repayment that may cause a temporary problem to be transformed into a full-blown financial crises.

But the problems with bonds go further. In the event of a solvency crisis, the debt of a borrower will have to be restructured. This requires a partial debt forgiveness. If there are no collective action clauses, each and every bondholder will have to approve a proposal for debt restructuring, and without unanimity the solution of the debt problem can be delayed for a long time. Collective action clauses can solve the problem: If a certain majority of bondholders approve, this decision will have to be accepted also by the dissenting minority.

Collective action clauses have already been in introduced in the UK. Bonds emitted in Great Britain can be restructured if at least 70 per cent of the bondholders agree to the restructuring. Luxembourg has also made collective action clauses a compulsory element of bond emissions.[24]

For the emission of bonds from developing countries, New York is more important than the European financial centres. Therefore, it is most important that collective action clauses will be the norm in bonds emitted in New York. In other words: Collective action clauses should be introduced in all major financial centres.

4.3. Emergency funds of private lenders

An emergency fund of private lenders could contribute to the solution of debt crises. Such a scheme appears to be useful particularly because it would be a *private* solution: Borrowers and lenders would take precautionary measures for the event of a credit crisis. In contrast to the current system, in which a public institution, the IMF, is called to the rescue when a crisis hits, a private emergency fund would not depend on public money. A similar, but not identical proposal has been suggested by George Soros: An insurance should cover the risk of a

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[24] In early 2000, these collective action clauses made the restructuring of three Ukrainian bonds emitted in Luxembourg simple. Another Ukrainian bond emitted in Frankfurt without collective action clauses could only be restructured using the sales teams of four investment banks that had to identify each and every single bondholder (see IMF 2001).

borrower running into trouble and a loan becoming non-performing. Banks and other lenders could insure their risk with the payment of a fee (see Noland 1998). The difference between an emergency fund and an insurance is that the latter covers a precisely defined case, whereas the former would provide a broader safety net.

Although both ideas look promising, their implementation will be difficult, at least on a voluntary basis. Such systems would perhaps work immediately after a crisis, but not for a long period of time. The longer since the crisis, the lower the incentive to pay the extra cost for the insurance or the fund. The arising cost would reduce profits, and there is not a high probability that lenders will accept this premium for a long time. Furthermore, the banks' own risk assessment departments would either become obsolete or under-utilised. Finally, such schemes would reduce competition between the banks. The ability to assess credit risk better than the competition separates stronger from weaker banks. A voluntary credit insurance would consequently be more often used by weaker banks, which would result in relatively high premiums. These, in turn, would lower the willingness to buy such insurance.

The bottom line is: On a voluntary basis, neither of those schemes is looking attractive. But what about a compulsory credit insurance? Theoretically, this would offer a fine alternative. If lenders or borrowers would have to prove insurance cover before an international loan contract or a bond offer could be implemented, financial markets would be more stable. Similar to the compulsory insurance any car has to have that is driven in public space, any potentially risky loan or bond would have to be accompanied by a safety net. Such an approach is theoretically plausible, but in practise it will be very difficult to implement such a scheme. The first problem is that such a compulsory insurance would have to be introduced in virtually all important financial markets. In principle, this problem is similar to the difficulties the Tobin tax would cause: It is either implemented everywhere, or it will not work. The coverage of financial centres that enforce a compulsory insurance would have to be even more comprehensive: If, say, the insurance of a $ 1000 million loan would cost one percent per annum, this is already a powerful incentive to use another market for the issuance of a bond or for signing the loan agreement. The second argument is that the financial sector industry will certainly restrict any effort that forces them to insure their business. It is hard to envisage support for such schemes from the major banks as well as from other influential players in financial markets.

From the perspective of a developing country or an emerging market, such schemes are not without contradictions. For domestic companies, it would make borrowing abroad more expensive than borrowing domestically. On the other hand, it could be argued that from the perspective of a developing country's government such a scheme would be a very positive measure since it would both reduce the risk of a credit crisis and make borrowing domestically more attractive. However, it appears that other measures that can be implemented much more easily, e.g. controls on capital inflows, are the better alternative.

4.4. Capital controls for crisis prevention

The slow progress with regard to the development of more stable international financial markets underlines the need for crisis prevention on a national level. A classic example are Chile's restrictions on capital inflows.[25] The aim of these measures is to limit the inflow of short-term, so-called hot money which can be withdrawn from a country in a panic. Favouring long-term inflows the risk of a sudden withdrawal of capital shall be reduced.

After the severe financial crises of the 1970s and 80s, Chile introduced a universal reserve requirement (URR) in 1991. Initially 20, later 30 percent of a credit or a bond from abroad had to be deposited free of interest for one year at the central bank. After one year, the reserve was handed back. Since the reserve requirement tried to cover more or less all portfolio inflows, the government effectively reached two goals: Firstly, short-term inflow were disadvantaged. This was the primary effect of the URR: Inflows with a longer maturity, which are significantly less dangerous than short-term inflows, were favoured. Secondly, the URR also strengthened the domestic financial system. Local banks and other financial intermediaries benefited from the URR, which in effect worked like a tax on borrowing abroad. Borrowing domestically was made more attractive.

The results of the Chilean policy are convincing. The first observation concerns Chile's economic stability in the 1990s. Despite several financial crisis in the region, Chile was not severely hit. The main reason is the changed composition of capital inflows: In 1989, only 5.0 percent of inflows had a maturity of more than 12 months. Eight years later this ratio had risen to 97.2 percent. This was achieved without decoupling Chile from international financial markets: From 1989 to 1997 capital inflows grew from $ 1.52 to $ 2.89 (see Edwards 2000).

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[25] Another country using similar measures is Slovenia.

The coverage of the URR was smaller than expected: Only 40 percent of inflows were subject to the URR. Two reasons are responsible for this: Firstly, some inflows, e.g. foreign direct investment, were excepted from the URR. Secondly, the regulation showed loopholes (see Massad 1998).

Universal reserve requirements are an efficient tool, but they cannot be implemented by all developing countries and emerging economies. They work in economies that demonstrate a solid economic and fiscal policy and that possess an efficient administration that is able to implement these capital controls. However, in economies with an erratic and unstable economic and fiscal policy a restriction on inflows cannot provide miracles (see Edwards 2000, p. 25). Nevertheless, in particular for countries experiencing rapid economic growth accompanied by massive inflows of capital, these restrictions on capital inflows offer an interesting concept worthwhile exploring.[26]

4.5. Capital controls for crisis resolution

Whilst many economists have now accepted limitations of capital inflows as appropriate measures to enhance the stability of the economy of a developing country, there is no consensus with regard to the use of capital controls to fight financial crises. Many observers assume that the introduction of capital controls within a crisis worsens rather than improves the situation of a country in trouble. Contrary to this assessment of many, the experience of Malaysia gives a divergent perspective.

On 1 September 1998, the Malaysian government introduced comprehensive capital controls. These measures were taken more than one year after the Asian crisis had begun. Therefore, the mainstream conclusion has been that Malaysia introduced the capital controls far too late at a time when the crisis was overcome in any case. Also, it is often said that neighbouring Thailand recovered without introducing capital controls: With or without capital controls, Malaysia was about to overcome the crisis anyway.

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[26] In the past, OECD-countries have also used this measure. Germany implemented a URR from March 1972 to September 1974. The rapidly growing German economy was suddenly confronted with a massive inflow of capital, primarily from oil producing countries. The Bundesbank reacted with the introduction of the "Bardepotpflicht". However, in the world's third largest economy the administration of capital inflows proved to be rather complex and time-consuming. Also, the economic crisis of 1974 reduced the inflow of capital anyway. The reserve requirement was scrapped two-and-a-half years after its introduction (see www.bundesbank.de/lzb-rs/de/publikation/pdf/festschrift.pdf, November 1997).

In contrast to this view, Kaplan and Rodrik have come to a different assessment. The starting point of their analysis is to ask whether the situation in Malaysia was indeed about to improve anyway. Unexpectedly, the instability on Malaysian financial markets grew in the first eight months of 1998. One indicator used is the level of interest rates, which grew for credit in offshore markets denominated in Malaysian Ringgit from 6 percent in January 1998 to 23 percent in August 1998 (see Kaplan/Rodrik 2000, p. 20).

Table 6: Capital controls in Malaysia

Regulations introduced on 1 September 1998	
Exchange rate	Fixing at RM 3.80 per US-Dollar
Selling/Buying of Ringgit	Approval required for non-residents
Selling/Buying of Ringgit denominated assets	All operations have to be made by approved domestic intermediaries. This was the effective closure of offshore markets for Ringgit
Exchange of Ringgit held by non-residents in external accounts	Required permission of central bank
Current account transactions	No limitations
Trade credit	Was provided to non-resident exporters of Malaysian goods
Domestic nationals	Limit of Ringgit 10.000 per travel abroad
Foreign nationals	Limit of Ringgit 1.000 when leaving the country
Non-residents	Requirement to hold on to investments in Malaysian securities for at least 12 months
Non-resident correspondent banks and stockbroking companies	Ban on the provision of domestic credit
Changes from 15 February 1999	
Moratorium on repatriation of investments: All capital having entered Malaysia before 15 February 1999 could be repatriated subject to a graduated tax on capital	a) 30% if repatriated within 7 months after entering Malaysia; b) 20% if repatriated between 7 and 9 months c) 10% between 9 and 12 months d) no tax if repatriated after one year or later
Funds entering Malaysia after 15 February	Capital was free to enter and leave, but the profits were taxed: 30% if repatriated within one year; 10% after one year

Source: Kaplan/Rodrik 2000, P. 10.

Against this background, i.e. the measurable increase in instability, the result of the measures introduced by Malaysia has to be seen in a different light. The country was not about to overcome the crisis anyway, but was able to avoid a further economic slump with the help of

capital controls. The exchange rate was stabilised and the domestic interest level could be lowered to a level that encouraged domestic investment. Furthermore, the capital controls did not affect foreign direct investment or foreign trade (see Kaplan/Rodrik 2000, p. 11).

The controls had an interesting component: The ban on the provision of domestic credit to non-resident banks and stockbroking companies had the effect of limiting the possibility of speculation against the Ringgit: If speculators cannot borrow in the targeted currency, they are not benefiting from a devaluation (see table 6).

The rapid transformation of the ban on the export of capital to a tax was another wise move: It effectively reduced the severity of the capital controls less than six months after their introduction and replaced them with a graduated tax. Foreigners could subsequently repatriate their capital, but a tax incentive was provided to encourage longer periods of investment. An important differentiation was also introduced: In the case of capital that had been invested in Malaysia before 15 February 1999, the tax was levied on all capital, in the case of capital invested after that date only profits were taxed (see table 6).

A further remarkable point is that the capital controls were only used for a short period of time. In contrast to early assessments of the IMF, the introduction of capital controls did not lead to a de-linking of Malaysia from international capital markets. Malaysia was able to return to international capital markets as early as May 1999, less than one year after the imposition of the controls. The country successfully placed a bond with a volume of $ 1.0 billion.

The Malaysian experience shows that capital controls can play an important role in the effort to overcome an acute financial crisis (see Eichengreen 1998). Needless to point out that capital controls are not a panacea and that they have to be implemented in a thoughtful manner. In contrast to capital controls on inflows, which can be used for many years, these emergency measures should probably not be implemented for a long period of time, especially in countries which previously had already fully liberalised capital flows.

However, the Malaysian case is an important lesson for the IMF. When the fund was involved in formulating a rescue package, the introduction of capital controls never played a role. The

IMF's choice always were austerity measures and the use of high interest rates to attract foreign capital. This approach has proven to be ineffective and in many cases harmful to the affected economy. In contrast to the traditional approach of the IMF, Malaysia has clearly demonstrated that there are alternatives.

4.6. Sovereign insolvency and its regulation

The liberalisation of capital flows has until now not been accompanied by structures at the international level that are considered indispensable in national financial markets. One of the components missed most is an approach for sovereign debt restructuring to manage the bankruptcy of a public borrower.

The idea for an international bankruptcy court is not new at all. In the mid-1980s proposals were made for the transformation of national insolvency procedures to the international level (see Raffer 1990).

American regulations can be used as a blueprint. In the USA, municipalities can declare themselves bankrupt according to Chapter 9 of the US insolvency law. [27] Three conditions have to be met: Firstly, the municipality must be insolvent or unable to pay back its debts as they mature. Secondly, the municipality must demonstrate the willingness to repay the debt. Thirdly, the municipality must either have obtained the support of creditors in each class of debt or must have tried unsuccessfully to work out a plan (see Raffer 1990, p. 302).

In an international context a neutral court could be set up to solve the insolvency. The arbitrators of the court should be nominated by both creditors and debtors, each party providing the same number of members of the court. Out of that group a chairperson should be elected, giving him or her the decisive vote (see Raffer 1990, p. 304).

As in national bankruptcy procedures, the aim an international insolvency procedure is to enable a fresh start for the heavily indebted country. The partial debt forgiveness shall lead to

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[27] Although some authors, e.g. Jeffrey Sachs and Thomas Kampffmeyer, have suggested the use of Chapter 11 of US bankruptcy law, this not entirely plausible: Chapter 11 is made for private companies, not for territorial entities. Chapter 9 is the more feasible approach: It protects the municipalities' governmental powers. This is the main reason why Chapter 9 seems better suited for sovereign borrowers (see Raffer 1990, p. 302).

a sustainable level of debt, i.e. an amount of credit that enables the borrower to pay interest and redemption.

A number of arguments against such a proposal can be made. One possible criticism is that sovereign insolvency is much less important today than it was a decade ago. International borrowing is increasingly happening between private lenders and private borrowers, public borrowing from non-official source plays an ever-decreasing role. However, this argument does not hold water. There are still quite a few countries that are unable to meet their payment obligations, for instance quite a few African countries as well as Argentina. Also, past debt crises, e.g. in Chile in 1982 or in South Korea in 1997, have seen the socialisation of private debt: Governments are regularly forced to take over private debt in order to maintain their countries integration into international financial markets. In other words: Debt that was private before a crisis often becomes public debt with the subsequent need for orderly debt restructuring. Finally, the disciplinary effect of an international bankruptcy procedure should not be underestimated. Without such a procedure, lenders could assume that there would be an international bail-out. These assumption in turn reduced the willingness for a sober evaluation of credit risk.[28]

After many years of silence on this issue, the IMF surprised the financial world with a far-reaching proposal. The Deputy Managing Director of the Fund, Anne Krueger, in November 2001 suggested the creation of an insolvency procedure under IMF leadership. In the explanation of the need for such a scheme, Krueger used remarkably blunt language. She criticised investors that used aggressive legal tactics to secure their economic advantage. Krueger labelled a particular investor as a vulture company. These entrepreneurs, Elliott Associates, in 1997 had bought Peruvian credit on secondary markets for $ 20.7 million. In October 1995, Peru had declared a restructuring of their debt and had enjoyed IMF support. In the course of the debt restructuring, this debt should have been exchanged for Brady bonds.[29] Elliott Associates, however, demanded the payment of the full nominal value of the loans, $ 56 million, and applied for a enforceable legal document to have Peruvian assets confiscated

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[28] Raffer supposes that there would never have been a debt crisis in the 1980s if an international insolvency procedure would have been introduced in the 1970s (see Raffer 1990, p. 310).

[29] Brady bonds were developed in 1989. They were created out of restructured bank loans, which were turned into bonds, in other words a securitisation of the old bank loans. The name was taken from the then US Minister of Finance, Nicolas Brady. Brady bonds in most cases have a long maturity period and different types of interest payments.

both in the USA and in Belgium. Elliott wanted to seize money that had been earmarked for payment to Brady bond holders. The Peruvian government did not have sufficient time to fight the already issued enforceable legal documents. The prime concern was the risk that Peru would have defaulted on payments of Brady bonds, which would have discredited Peru's already damaged reputation. Against this Background, Peru decided to pay (see Krueger 2001).

Krueger's proposals, aptly characterised as a bombshell by the Financial Times, follow the concept of an international bankruptcy procedure. Countries with an unmanageable debt burden shall, after IMF approval, stop payment of interest and redemption. During this standstill period the countries shall, if necessary, use capital controls to avoid capital flight.

Anne Krueger expects the mechanism to have a disciplinary effect on lenders. The sheer existence of a procedure to manage the bankruptcy of a sovereign borrower would, in Krueger's opinion, cause a more careful evaluation of risk. If this would lead to a reduction of capital flows to developing countries, this would be a welcome side-effect, in particular if this reduction would have been caused by improved risk-management (see Krueger 2001).

The proposal is both surprising and welcome. After long hesitation the IMF has accepted that regulations are necessary for the bailing-in of creditors in the resolution of financial crisis. However, the implementation of this proposal is a distant prospect. The following points have to be considered:

- The proposal requires the change of the IMF's articles of agreement. Three fifths of the member countries and 85 percent of the voting rights are required for such a move. Since the USA holds more than 17 percent, this proposal needs American consent. Since this change would not be considered a new treaty, there would not be a need for a two thirds majority in the US Senate, a simple majority would do.[30] However, the House of Representatives would also have to pass it.
- The Krueger proposal will not only require an amendment of the IMF's articles of agreement, but it will also have to be incorporated in national law. This is no small hurdle. Krueger herself admits that the necessary limitation of the right of a creditor to take the

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[30] The underlying international treaty is the "Bretton Woods Agreement Act", which was passed in 1944 (see Kenen 2002, p. 12).

borrower to court would have to be universal, i.e. world-wide. Otherwise creditors would sue borrowers in those countries where legal action would still be possible.

- When considering the necessary support for the implementation of a bankruptcy court, the lack of support in the USA is the biggest hurdle. The American finance minister Paul O'Neill has not supported the IMF initiative, but has given preference for a "decentralised, market-oriented approach" (Financial Times, 24 April 2002, p. 12). The Bush administration prefers collective action clauses, which it considers a substitute for a bankruptcy court. Even if the government would support the scheme and would be willing to propose legislation, it would have to be passed by Congress. In the current climate, characterised by fierce opposition against any multilateral treaty that limits the rights of American citizens and companies, it is hard to envisage the necessary majorities on Capital Hill.
- It is yet unclear where the insolvency court is supposed to be located. Krueger sees the IMF in the best position, but not all countries might find this increase of power for the IMF an attractive perspective.
- The development of a catalogue of criteria which have to be fulfilled in order to declare a country bankrupt is complex. Should this be a universal set of criteria or would preference be given to a case-by-case assessment of insolvency? In practice, a uniform catalogue would invariably be subject to intense debate: Is the situation already bad enough to declare bankruptcy or is a sovereign debtor simply unwilling to mobilise domestic resources for debt service? If the consequences of the declaration of bankruptcy are too positive, i.e. if the borrower would benefit through substantial debt reductions, this might be the trickiest part of the proposal. To avoid moral hazard the easiest solution would be the application of the severity of domestic bankruptcy to the international level: If the bankruptcy court would have the right to seize assets of the bankrupt sovereign borrower, the incentive to ask for the declaration of bankruptcy would very limited indeed. In other words: As long as there is no strong disincentive to activate the bankruptcy court, the risk of an abuse of this tool cannot be discussed away. To find the right balance between criteria that enable an early solution of the problem and criteria that are too strict is a high hurdle.
- During the standstill measures have to be taken that help to avoid a repetition of the economic imbalance. Which economic policy is appropriate for this situation? The old question of conditionality for IMF lending comes back into the discussion.

- Finally, the opposition from the financial sector should not be underestimated. The introduction of a formal bankruptcy procedure not only introduce an element of the rule of law into the relationship between debtors and creditors on the international level, but it would also limit the ability of creditors to enforce their claims. It is entirely plausible to expect the financial world to oppose such a limitation of their hitherto quite large power. It is therefore not surprising to see the vitriolic comments from Wall Street on the Krueger proposal.[31]

The development in the coming years will show whether this proposal will be implemented. Anne Krueger has doubts that the IMF member countries will strongly support the proposal. Nevertheless, she argues that the introduction of a formal bankruptcy procedure would be a price worthwhile to pay for a more stable and therefore more prosperous world economy (see Krueger 2001).

A final point on this issue: Considering the difficulties that have to be overcome before these procedures could be implemented, the attention might indeed better be focused on other measures that can be implemented by a single country a by a regional integration group, e.g. UDROP or monetary regionalism. When the substantial hurdles that would have to be overcome are observed, and when the current unwillingness of the major players to support multilateral regulation is seen, the prospects for these far reaching new regulatory arrangements appear to be bleak indeed.

5. REFORM OF THE INTERNATIONAL MONETARY FUND

Concerning the shaping of the international financial markets, the International Monetary Fund still is the most important multilateral institution. Not only in financial crises, but also in the process of the further development of financial markets there is no other organisation with a comparable importance. Considering the enormous influence the IMF has and taken the severe mistakes of the IMF in the recent financial crises into account, it is no surprise that many observers are asking for a substantial improvement of the Fund's performance. The latest and perhaps most serious addition to the choir of IMF-critics is Nobel prize winner

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[31] The Wall Street Journal fiercely attacks the proposal: "Private creditors would have to cope with an even more powerful political actor" (The Wall Street Journal, 24 April 2002, p. 10). The IMF is considered to be "a

Joseph Stiglitz, who published vitriolic attacks on the work of the Fund (see Stiglitz 2002, 2001 and 2000).[32]

The main reasons for criticising the Fund are:

a) The economic consequences of the IMF's work are too frequently negative. In particular in the Asian crisis the Fund has probably done more harm than good. Instead if helping to overcome the crisis, the IMF deepened it (see Dieter 1998; Stiglitz 2002). But failure is not limited to the Asian crisis: In other countries, namely the transformation countries, the Fund also preferred simple liberalisation strategies which did not deliver good results. Most recently, the IMF's work in Argentina has been called into question: Argentina's unsustainable exchange rate regime was supported far too long.
b) Although the IMF has been criticising governments in developing countries for the lack of transparency in their economies, the Fund itself has been characterised by an extreme lack of transparency. The IMF was a "secretive institution" (Jeffrey Sachs). The agreements of the Fund with its member countries were not published. The decision making processes were obscure. Discussions in the executive board were not published.
c) The interests of creditors dominated the work of the Fund. The main purpose of IMF programmes was to insure repayment of loans and bonds (see Stiglitz 2001, p. 14). The IMF has been a creditor cartel that did not give enough consideration to the needs of its weaker and less powerful member countries.
d) The conditionality of the Fund's programmes was excessive. The countries hit by a financial crisis had to implement too many and too detailed conditions. The Managing Director of the IMF, Horst Köhler, has taken a very critical position on conditionality.[33]

Following some intensive debate after the Asian crisis, the discussion today is somewhat less polarised. Very few observers today ask for the closure of the Fund. Also the other extreme, the creation of some sort of a global central bank, is not often proposed any more. There has been significant progress with regard to the IMF's transparency: Today both the Fund's programmes as well as the internal discussions can be followed on its homepage. However, as the heated discussion following the publication of Joseph Stiglitz' latest book shows, there are

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bureaucracy in search of a new missions. The bankruptcy court is only the latest, and among the worst" (ibid.).

[32] Martin Wolf has supported some of the criticism in Stiglitz latest book. Both the IMF standard policy to raise interest rates and the big bailouts orchestrated by the IMF also find Wolf's disagreemnt. He argues that the bottom line in the evaluation of the Fund's work is not the quality of the rhetoric of the IMF's officials, but the economic success. And there the record is not looking good (see Financial Times, 10 July 2002, p. 19).

still enough issues that need further analysis and there is a lot of room for improvement in the work of the Fund.[34]

5.1 Crisis prevention: Is surveillance sufficient?

Crisis prevention has become one of the new areas of work for the Fund. After the IMF, as virtually everybody else, did not see the Asian crisis coming, there now is an attempt to improve the forecasting capacity of the Fund as well as its ability to stabilise an economy before a financial crisis breaks out. Horst Köhler in particular tries to focus the Fund's work on crisis prevention.

Apart from the fact that crisis prevention has always been a central element of the IMF's mandate, the focus on crisis prevention has an immediate appeal, at least at first.[35] But at closer inspection, the tools that shall be used to prevent financial crises from developing appear to be too weak. The Fund emphasises that better transparency and an improved surveillance of the development in financial markets would be sufficient. In other words: The Fund assumes that a better knowledge of financial flows and of debt levels will be sufficient to avoid severe financial crises.

The first problem here is: There are no reliable forecasting models available. Either too many financial crises are predicted that never happen or the models are not able to detect even major crises. Prognosis that can be used by policy makers is not available. Frenkel and Menkhoff have emphasised that the Asian crisis would not have been predicted even by the most elaborate models (see Frenkel/Menkhoff 2000, p. 29).

A number of reasons are responsible for this dilemma. Firstly the forecasting potential of the indicators used is limited. For instance, we do not exactly know which level of foreign borrowing has to be considered unsustainable. Secondly, we are confronted with the continuous emergence of new types of financial crises, which makes forecasting difficult.

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[33] In a speech delivered to three parliamentary committees of the German Bundestag in April 2001, Köhler identified the reform of conditionality as one of the greatest challenges to the Fund.

[34] The Chief Economist of the IMF, Kenneth Rogoff, chastised Stiglitz' bitterly for his book. In an open letter, Stiglitz was accused, amongst other things, for his criticism of the former Deputy Managing Director of the IMF, Stanley Fischer (see www.imf.org/external/np/vc/2002/070202.htm).

[35] In Article IV, Section 3 of the IMF's Articles of agreement, this focus can already be found: "…the Fund shall exercise *firm surveillance* over the exchange rate policies of its members" (www.imf.org/external/pubs/ft/aa/aa04.htm#3, emphasis added).

Thirdly, the crises themselves produce a new situation, which complicates prognosis (see Frenkel/Menkhoff 2000, p. 32f). The IMF has looked at the issue and has concluded that one should not expect too much from currently available forecasting models. Some of them would provide valuable insights, but would at the same time often cause false alarm (see Berg/Patillo 2000).

Looking at the problems the private companies in the financial sector have faced illustrates the problem. The American hedge fund Long-Term Capital Management (LTCM) had amongst the members of the board two Nobel Prize winners, Robert Merton and Myron Scholes. LTCM not only used very complex models to speculate with derivatives, but also employed a sophisticated system of risk management. Despite presumably cautious assumptions, the system proved to be inadequate: In September 1998, LTCM was insolvent (see Dunbar 2000, p. 190).

As long as we do not have reliable forecasting models, the better surveillance of financial markets will not be able to make a significant contribution to improved crisis prevention.

Furthermore, one has to ask what the IMF ought to do if it would see a financial crisis coming that has so far been ignored by financial markets. A range of options would be available to the Fund, but none of them is convincing and all have severe side-effects.

a) The Fund could warn publicly that a financial crisis in country A is likely to happen. This in turn could lead to a panic on financial markets. Each player in the market would then have a motive to withdraw his money from that market, which has officially been declared dangerous. Some pension fund managers might even have to liquidate their investment in a particular economy once those heavy warnings have been issued by the IMF. With an early public warning a situation might be created that would not have emerged had the IMF not publicly warned.
b) The Fund could warn the affected government secretly and recommend a tightening of economic policy. But this is also not an easy option: Which instruments should be used if the IMF diagnosis is that a country with a booming economy borrows to much abroad? For instance, should the government in the affected country *raise* interest rates? As long as capital markets remain open, raising domestic interest rates in an economic boom may

further destabilise the situation, because banks and private borrowers then have an additional incentive to borrow abroad, rather than domestically. If, on the other hand, the government would *lower* interest rates, this would fuel the boom even further and could easily lead to a situation where inflation becomes a severe problem.

c) The IMF could directly warn certain market participants. But the problem here is that the IMF cannot limit the dissemination of economically relevant information to a limited circle of market participants, since they would then have an unfair competitive advantage.
d) The IMF could regularly evaluate credit risk and could publish the results of his findings. This would mean that the IMF has become an agency for the evaluation of credit risk. In that case the cancellation of any public financial support for the Fund would have to be demanded, because these services can be supplied by private rating agencies. There would not be a need for an additional, publicly funded monitoring body.

Early warning systems are neither easy to construct nor is it clear what ought to be done in the event of a looming crisis. The experience with the currently existing models shows the problems associated with forecasting. The bet on early warning systems only is a risky strategy. Better knowledge of developments on financial is useful, but not sufficient.

5.2. IMF conditionality: Too much or not enough?

The IMF has already changed its position on conditionality. Since September 2000, the so called Interim Guide on Streamlining Conditionality is used. In the past, the IMF forced the adoption of conditions that had nothing to do with the acute financial crisis. Instead, creditor countries used the opportunity to ask the debtors countries for changes of their national economic policies. These conditions were regarding questions of market opening, but also of human rights or environmental affairs. The American Congress in particular used "Congressional Directives" to influence the work of the Fund. But these attempts to abuse the Fund's position in a financial crisis were not limited to the official side. Non-governmental organisations also used the IMF and financial crises for the promotion of their specific agendas.

This is a perilous point. For instance, the argument has been presented that a conditionality demanding democratic reform and the implementation of human rights is good for the affected country, because it promotes stability and in the long run this will promote economic

prosperity. Although this might be possible in some cases, as a general rule it appears to be mislead, for it ignores one of the main conclusions of development co-operation. Reforms have to be developed in the affected country, they cannot be imposed on a society. Country ownership, as the World Bank calls it, is central to any successful and sustainable reform programme. All measures have to fit the societal and historic context of an economy. The people in the affected countries know best where the weaknesses and where the strengths of their societies lie. They know which elements of a reform package might be politically to sensitive and which might lead to an unwanted de-stabilisation of society.

The reform of IMF conditionality has not been completed yet. It appears likely that the list of conditions for an IMF programme will become shorter. A simple test will make the choice of conditionality easier: Would a larger OECD-country be forced to accept the same conditions?[36]

5.3. The IMF as a lender-of-last-resort

Apart from crisis prevention, the management of financial crises continues to be the second pillar of IMF-activities. The lower number of conditions belong to this task. The most important point, however, is the provision of liquidity in a crisis. In future crises, should the Fund provide liquidity faster and more generously than in the past?

After the Asian crisis, the Fund has created new instruments in particular for liquidity crises. The Supplemental Reserve Facility (SRF) was introduced in1997, followed by the Contingent Credit Lines (CCL) in 1999. SRF is a credit facility that can be used by countries that are confronted with an unexpected disruption in the markets ("a sudden and disruptive loss of market confidence") that leads to a current account crisis. The SRF can only be used by countries that implement measures which are considered by the IMF as strengthening the confidence of markets.[37] The CCL are supposed to work as a defence shield against so called contagion effects from financial crises in other countries. The provision of liquidity shall help to reduce the spreading of a crisis. Pre-qualification is compulsory.[38]

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[36] Martin Feldstein has suggested this type of conditionality testing soon after the Asian crisis (see Feldstein 1998).

[37] SRF credit has a maturity of 12 to 30 months. The interest rate is the basic rate of the IMF plus a spread of 3 to 5 percent (see IMF Survey Supplement, Vol. 30, September 2001, p. 12).

[38] The interest rate charged on CCL credit is lower than on SRF. (see IMF Survey Supplement, Vol. 30, September 2001, p. 12).

The importance of these aspects is underlined when the recent financial crises are more carefully considered. At least some of these financial crises were deepened, if not caused, by a sudden squeeze of liquidity. The affected economies were temporary illiquid, but not insolvent. South Korea was such a case. After the provision of liquidity the economy recovered rapidly, a V-shaped development of the crisis. In such cases, the delayed provision of liquidity leads to an avoidable deterioration of the economic situation. In the same context, the already mentioned rapid reactions of the big central banks after September 11 underline how important the provision of liquidity is if an unwarranted panic on financial markets shall be avoided.

If one agrees that liquidity should be provided faster and more generously, it has to be asked in what form this liquidity should be provided. Three options are available:

a) As in the past, the IMF could provide fresh liquidity only up to a certain, pre-set level and could ask for the implementation of conditions.
b) Alternatively, the IMF could provide liquidity if countries have pre-qualified. This is the approach chosen for the CCL. The problem is that up to now no country has applied for the CCL.[39]
c) The third possible solution would be to expand the IMF and to turn it into a global lender of last resort. In this case, member countries could go to the IMF and could draw liquidity without limitations and conditions (see Fischer 2000).

The third option is both the most radical as well as the simplest option. It would create in the international field an institution that is considered indispensable: One function of central banks is to operate as national lenders of last resort.[40]

In the 19th century, Walter Bagehot has defined what a lender of last resort should do: It should lend freely, at penalty rates, against good collateral (see Fischer 2000, p. 9). In an

[39] One can only speculate why member countries have not yet applied. An important aspect most probably is that financial markets may already interpret the application of a country for CCL as a sign of a looming financial crisis. Instead of strengthening a country, CCL might lead an economy into turmoil in financial markets. Therefore the British government has demanded an improvement of CCL conditions to make their use more attractive (Financial Times, 30 November 2001, p. WE 2).

[40] Of course, the IMF can by definition not become a true lender of last resort. This would require the Fund to be able to create liquidity, which it cannot. However, a Fund that has substantial resources at its disposal can operate as a quasi lender of last resort. In practice, this differentiation might not be of great importance.

international context, economies would gain access to liquidity if they would be willing to pay interest rates above market rates and if they would be able to provide collateral with a marketable value.

Stanley Fischer, First Deputy Managing Director of the IMF until summer 2001, has highlighted the need for liquidity in a financial crisis and has underlined the need to understand the dynamic of a financial crisis. In an economy with an open capital account, the national central bank cannot provide the foreign currency that is needed by both the public and the private sector, because even a well equipped central bank only has limited foreign reserves. In such a situation, only an international lender of last resort can help.

Fischer explains his call for the creation of an international lender of last resort with the increasing volatility of international capital flows and with contagion effects that could be witnessed during the past crises. The instability of international financial markets caused by unfounded panic can, so Fischer argues, be eliminated by the existence of an international lender of last resort (see Fischer 2000, p. 16).

Fischer's remarks are interesting for a number of reasons. At the end of his work at the IMF Fischer has admitted that capital flows are volatile and that there are contagion effects: Financial crises do affect countries that coincidentally are located in a specific region struck by a crisis or, even less predictable, that are considered to lie in the same category, e.g. are an emerging market. While such an assessment is not new for many observers of recent financial crises, for Stanley Fischer it is. In particular in the Asian crisis he continued to argue that the main reasons for the crisis are to be found in the countries themselves, not in the behaviour of players on financial markets.

The implementation of the proposal to create an international lender of last resort, however, is complicated for conceptual as well as for political reasons. The least complicated issue is the level of interest that has to be found: It has to be above the pre-crisis level, but below the level that commercial banks are charging in the height of the crisis.

Much more complicated is the provision of adequate collateral. For an international lender of last resort the identification of collateral that has a marketable value is not easy. For instance,

the level of future export earnings cannot be estimated easily. Exports of raw materials are the easiest option. There exists an example for such a procedure: In the Mexican bailout in 1995, the country had to give its future earnings from the export of crude oil as collateral.

Even if the identification of sufficient collateral would be possible, another point requires clarification: What will be done if the temporary liquidity crisis turns into a permanent solvency crisis? The international lender of last resort would then have to have to right to draw on the collateral. For such a proceeding, the existence of an international bankruptcy court or another institutionalised procedure would be necessary.

Apart from these conceptual problems enormous political obstacles would have to be overcome. If the IMF would be transformed into an international lender of last resort, this would constitute a major change in the character of the institution. The Fund would be converted into a co-operative bank in which the smaller stakeholders would have far reaching rights for the use of liquidity. The political influence of the larger OECD-countries and the US in particular would be reduced, because IMF lending could no longer be used to gain political and economic concessions from the country in financial distress. The Fund would be an institution that its member countries can use in the event of a crisis without having to surrender their sovereignty.

Although there is currently a greater tendency to shape international financial markets in a more impartial way than in the 1990s, the transformation of the IMF into a lender of last resort might be too much for most IMF countries. It would require that substantial amounts of money are transferred to the Fund and subsequently to member countries in trouble without conventional conditionality applying. For many governments this will be unacceptable simply because an abuse of these credit lines can, by definition, not be ruled out.

Nevertheless, from a theoretical perspective the call for an international lender of last resort is consistent: If capital controls are scraped and capital movements are liberalised, central banks loose important instruments that have to be provided at a global level. Consequently, one can argue that as long as there is no international lender of last resort, capital controls should

continuously be used.[41] Developing countries and emerging markets in particular should not completely liberalise capital flows into and out of their economies.

At the same time, the problems that are associated with the transformation of the IMF into a lender of last resort force groups of countries to develop their own regional liquidity funds. In particular East Asian countries have both increased their own reserves as well as started to develop a regional liquidity fund (see Dieter 2000; Dieter/Higgott 2002; Kim/Ryou/Wang 2000). Although the implementation of a regional liquidity fund is confronted with both economic and political problems in East Asia, the underlying idea remains valid: Every financial system needs a lender of last resort, whether its a regional or a global one.

6. THE FINANCIAL STABILITY FORUM

Apart from the IMF there are numerous other organisations discussing a reform of the international financial architecture. Unlike others the Financial Stability Forum (FSF) has gained both prominence and relevance.

The FSF was created in 1999 by the former President of the German Bundesbank, Hans Tietmeyer, one of the most prominent European central bankers. In the FSF, representatives of the G-7 countries, the Bank for International Settlements (BIS), the IMF, the World Bank, the OECD and other institutions exchange views and discuss possible reform. The first question is why this organisation was founded.

The regulation of financial markets continues to be primarily a national affair. However, the high degree of internationalisation of financial markets results in a need for co-ordinated regulation. In the FSF, proposals for regulation are discussed before implementation. Although the FSF has no decision making capacity and a weak mandate, it is a useful organisation. The soft institutional structure is required to enable co-ordination without strict sanctions. The FSF is a useful addition for the work of the Fund and national regulatory authorities.

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[41] In the absence of a global lender of last resort, rollover options can provide a partial substitute. See the section on rollover options.

Table 7: Members of the FSF

Members	Number
G-7 countries with 3 representatives each (Finance ministry, central bank, supervising authority	21
Other financial centres with one representative each (Australia, Hong Kong, Netherlands, Singapore)	4
IMF and World Bank with two representatives each	4
BIS and OECD one representatives each	2
International regulatory authorities (BCBS, IOSCO, IAIS) with two representatives each	6
Central bank experts (CGFS, CPSS) one each	2
Chairperson ad personam: Andrew Crockett	1

Source: Frenkel/Menkhoff 2000, p. 42; homepage of the FSF (www.fsforum.org).

The importance of the FSF has been underlined by the choice of chairperson, Andrew Crockett, who has gained a remarkable reputation as head of the BIS. The three working groups of the FSF have addressed the main problems that international financial markets face: hedge funds, offshore financial centres and international capital flows.

The discussion in the FSF on hedge funds has been extensive. What are these secretive investment vehicles? Hedge funds are institutions that collect investment capital from wealthy individuals as well as from institutional investors. Hedge funds aggressively manage these assets. In contrast to other investment funds that offer their services to a wide range of clients, hedge funds are not supervised by official authorities.

The first hedge fund was created in 1949 in the US. After the Great Depression investment funds were strictly supervised. An exception was made for funds that would service less than 100 investors and that would not advertise. Alfred Winslow Jones was the first who used this loophole in US regulation. The name was derived from the strategy employed: The portfolio not only contained shares that were considered to be particularly valuable, but also selling options for shares that were considered to be overpriced. This strategy resulted in the provision of a safety net in the event of a slump in the stock market – the fund was hedged (see Dunbar 2000, p. 120).

In the 1990s, hedge funds gained doubtful prominence by speculative attacks on currencies, for instance against the Pound in 1992. By forcing the depreciation of the Pound, the Quantum fund, managed by George Soros, is supposed to have made a profit of $ 2 billion. The bill was paid by British taxpayers, who were forced to finance the unsuccessful defence staged by the Bank of England.

The mechanism has been simple: Soros and other speculators borrowed extensively in Pound sterling, exchanged these into Deutsche Mark and expected that, upon maturity of the loans, they would be able to pay these back with fewer Deutsche Mark. Whatever remained was their profit. By changing Pounds into Mark, the downward pressure on the Pound was increased. The strategy is not only very profitable, but also free of risk: If the Pound would not have been devalued, the speculators could have simply paid back their loans. All they risked was the differential between borrowing in Pounds and credit interest for Deutsche Mark.

Evidently, hedge funds are of great importance for the stability of the international financial system. Primarily, this is caused by the fact that hedge fund frequently are market makers, i.e. they do not only passively benefit from a given development of the market, but instead they actively push the market in the desired direction.

Supervising institutions realised the dangers that hedge funds cause during the collapse of the Long-Term Capital Management (LTCM) in 1998. LTCM had, with capital of less than $ 5 billion, borrowed more than $ 125 billion and built up positions in derivatives markets of more than $ 1250 billion (see Huffschmid 1999, p. 93; Dunbar 2000, p. 190). The sheer volume of these positions could have had a systemic effect, i.e. the international financial system was in danger because of the collapse of LTCM. It was therefore not surprising that the American Federal Reserve Bank immediately orchestrated a privately financed bailout for LTCM.

The FSF's working group on hedge funds suggested ten measures that should reduce the negative influence of hedge funds. However, the obvious recommendation of putting hedge funds under the regulatory umbrella of national supervision, was not made. Instead, an improvement of transparency and greater openness should provide the same results. The working group also suggested an improvement of the risk management of lending banks, an

improvement of the risk management of the hedge funds themselves and a strengthening of banking supervision specifically for those banks that provide hedge funds with credit (FSF 2000).

However, the practicability of some proposals remains limited. For instance, it is suggested that hedge funds shall in the future report on their activities. The question is: How can a hedge fund registered in the Bahamas or the Cayman Islands be forced to follow these recommendations? In the past, it was a major advantage of hedge funds that they were not required to provide a report available to the public. A documentation of the strategies followed would reduce the main advantage of hedge fund, i.e. it would take away their cover.[42]

In 2002, hedge funds continue to represent a threat to the international financial system. A rather new trends is the increase of the spectrum of hedge fund investors. More and more pension funds, large commercial banks and insurance companies are becoming hedge funds' customers. Also, commercial banks advertise the use of hedge funds as investment vehicles. This is a worrying trend: If hedge funds gain access to more capital, they also have more leverage, and that makes the situation dangerous. The FSF should monitor this trend closely.
The FSF has also made proposals regarding the speculation against currencies. This is another non-starter. Why should hedge fund managers follow "good practice guidelines for foreign exchange trading"? Speculation against currencies has proved to be one of the most profitable businesses, and why should hedge fund managers give that up? Speculation against currencies can be very painful for the affected countries, but there is no solution for the ethical contradiction: The greater the drama, the bigger the profit for the hedge fund. In 2001, the guidelines were made somewhat more precise. The FSF acknowledged that manipulative practices in currency trading exist and that these were not acceptable (see FSF 2001). But without strict sanctions these recommendations are not worth anything. However, an important recommendation is given to the governments of developing countries and emerging markets: They should take precautionary measures, including capital controls.

In 2001, the FSF published a report on the progress that has been reached in the process of implementation. Some details are worth mentioning. So called macro funds, speculating on

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[42] It is only due to the collapse of LTCM that we know a bit more about hedge funds' activities.

certain macroeconomic developments, have lost importance. Both George Soros' Quantum fund as well as Julian Roberts' Tiger fund have either been closed or have changed their strategy. The simple reason was bad performance. The Tiger fund alone lost two thirds of capital between 1998 and 2000 (see FSF 2002).[43]

Also interesting is the fact that the ratio of capital to borrowing is sinking. In 1999, hedge funds borrowed 232 per cent of own capital, in 2000 this figure was reduced to 168 per cent (see FSF 2001).

The FSF's working group on offshore financial centres has taken a remarkably clear position. Offshore financial centres were branded as loopholes of the international financial system that made both the supervision of markets more difficult and created the risk of a collapse of the international financial system (FSF 2000). However, the recommendations of the working group are significantly less convincing than the preceding analysis. Similar to the rather vague approach of the working group on hedge funds, the closure of offshore financial centres is not recommended. Instead, greater transparency and better reporting are supposed to have the same effect.

September 11 has had a greater effect on the willingness of larger players to regulate the offshore financial centres than any of the economic crises. In summer 2001, the Bush administration objected to any measures against offshore financial centres. Secretary of Treasury Paul O'Neill denied that there was any need to interfere in the national regulatory approaches and objected to US participation in the OCED "Financial Action Task Force on Money Laundering" (FATF).[44]

Any attempts to stabilise the international financial system can by undermined by offshore financial centres in important fields, e.g. banking supervision. Consequently, these financial centres should be banned. The existing campaign against offshore financial centres should be

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[43] Between 1992 and 1998, the capital of hedge funds had increased 15-fold (see Dunbar 2000, p. 123).
[44] Joseph Stiglitz criticised this behaviour. Both O'Neill and his predecessor Larry Summers demanded more transparency from developing countries, whilst they protected at the same time the business of offshore financial centres as well as of hedge funds (Joseph Stiglitz, Sicherheit vor Terroranschlägen beginnt zuerst im eigenen Land, Handelsblatt, 10 October 2001, p. 10).

intensified.[45] One possible methods has been suggested by the German finance minister Hans Eichel: National supervising authorities should sanction the co-operation with banks from offshore centres (see Financial Times, 7 February 2002, p. 11).

Although many offshore centres are in small, independent territories, this is not always the case. Quite a few countries that have been listed by the OECD are under British or American administration or influence, e.g. the British Virgin Islands, the US Virgin Islands, the Isle of Man, Gibraltar, Jersey, Guernsey Sark & Alderley or a country like Panama have to be named here (see Financial Times, 26 June 2000, p. 16).

7. CONCLUSIONS: A NEW ORDER FOR INTERNATIONAL FINANCIAL MARKETS

For too long the call for a better regulation of international financial markets did not receive much attention. In virtually all OECD-countries deregulation and liberalisation enjoyed support. Financial markets in particular were left to themselves. This, however, was wrong: The internationalisation of financial markets is calling for the implementation of regulations that exist in all national markets at the global level. One example is the creation of an international lender of last resort, another the rules-based baling-in of creditors in the event of a financial crisis.

The shaping of globalisation is a task for the political sphere. It is unrealistic to expect markets to do this job. The governments of European Union countries in particular should accept this responsibility and should push a new order for international financial markets. The EU could play an important role in this field. The absence of a common policy in international financial affairs is, after the successful introduction of the Euro, much more obvious than before. Since many years, Europe is speaking with one voice in the area of international trade. This common policy partly explains why the EU has such a strong position in shaping the agenda on international trade. What a contrast to finance: Europe is hardly heard, primarily because it speaks with many voices.

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[45] Some European governments have already taken this approach. In 2001, the then French finance minister Laurent Fabius called for the strict regulation of hedge funds and offshore centres during the annual meeting of the G-20 (See Neue Zürcher Zeitung, 17 November 2001, p. 9).

What interest would the EU have in a more stable international financial system? Two reasons are obvious: Firstly is the EU the world's biggest trading power. Europe suffers more than other players from turbulence in international trade caused by financial crises. Relatively stable exchange rates and financial markets facilitate trade in goods and services. Secondly, the eastern enlargement of the EU will increase the risk of financial crises within the EU itself. A number of the transformation countries that will join appear vulnerable already. An international order that helps to avoids financial crises is therefore in the interest of the EU. However, until today the EU has not been willing to face this challenge.

Finding an international consensus an a new order will be difficult, mainly because the financial industry is unlikely to give up profitable opportunities without resistance. Just one example: Floating exchange rates enable banks to offer insurance against volatility. Companies can hedge their future earnings, but for this service the banks charge their clients. If exchange rates would be stabilised, banks would loose an important source of profit.

The USA continues to view most proposals for improved regulation with explicit reservations. Although the approach to some issues, e.g. to improve measures against money laundering, has changed, the big picture remains the same. By and large, the US does not support any measures that limit the ability of their financial sector to expand to other parts of the world. It appears entirely unrealistic to expect an American initiative for the re-regulation of international financial markets. Even the latest scandals on Wall Street, from Enron to WorldCom and Merck, will probably not affect the position of the Bush administration on the regulation of *international* markets. Some tightening of rules can be expected at the national level, but that is not what developing countries do need.

East Asian countries will not push an initiative for a new order in finance. Japan is too preoccupied with the solution of its own chronic financial crisis. Unable to sort out its own debacle, Japan is also not a shining example for other countries and therefore not destined to claim leadership in this field. All other players in East Asia, China included, simply lack the weight and influence that is required for the suggested reform.

If the EU were able to push the re-shaping of financial globalisation, this could be an element of a fairer world economic order that many have called for after September 11. No other player in world affairs is as qualified for this non-military leadership task as the EU.[46]

The project of establishing a new order in international finance is politically challenging. The resistance against such a project will undoubtedly be enormous. The financial sectors that have grown so dramatically in the last decade will not doubt oppose such an attempt. On the other hand, millions of people would benefit, and not only those in countries directly affected by financial crises. A reduction of the number and depth of financial crisis with their negative effect on the growth of the world economy would be beneficial to most countries.

[46] This position is shared by Peter Sutherland, former GATT Director General and now Chairman of BP. He claimed that in the process of developing global governance, the EU has to meet the challenge: "... the Europeans are very much in the frontline – geopolitically, politically, morally" (International Herals Tribune, 8. November 2001, p. 6).

8. References

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