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Getting it Right: What to Reform in International Financial Markets

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Introduction

Several reports on reforming the international financial architecture have been, are being, and will be produced by multilateral organizations, think tanks, freethinkers, and G-*n* task forces, with *n* taking values between 7 and 33.[1] The question is whether any of the initiatives will solve the important problems in international financial markets and be implemented before a temporary cease-fire on the financial battlefield is misinterpreted as the end of the war.

This paper provides an overview and assessment of reform initiatives, both those currently on the table and those that are not but we think should be. The intent is to clarify the logic behind these proposals and assess them from a Latin American perspective. Our discussion is based on the extent to which reform initiatives alleviate the problems we identified in the companion paper "What's Wrong with International Financial Markets," (Fernández-Arias and Hausmann, 1999). The overall conclusion is that the current approach to reforming the international financial architecture is not appropriate for the task and a paradigm shift is required.

An initiative may obtain a bad grade for many reasons. First, it may have only a negligible impact on the workings of the international financial architecture, i.e., it fails to address a substantial problem. Second, it may have a significant impact on financial markets but narrowly fit the interests of capital-exporting countries, as opposed to the needs of emerging markets. In both cases, proposed reforms would miss a historical opportunity to shape international financial institutions to support economic development. Finally, and most importantly, proposals may be counterproductive from a developmental perspective.

We are concerned with the possibility that an initiative may have a negative developmental impact because nearly all of the proposals currently under active consideration or experimentation entail smaller capital flows to support development in emerging markets. This outcome comes as a result of fighting moral hazard or as an expedient to reduce financial instability. In terms of the clusters of distortions identified in our companion paper (Fernández-Arias and Hausmann, 1999), we are concerned that some alleviation of the distortions underlying the Theories of Too Much may severely aggravate the distortions behind the Theories of Too Little or Theories of Too Volatile.

There is a good chance that our reservations regarding the initiatives currently being advanced in international fora owe more to our Latin American perspective than to purely technical differences in assessment. Our assessment is based on the efficiency of

[1] Eichengreen (1999) provides an interesting survey of the main proposals on the table, and *The Economist*, (1999) gives a very useful summary discussion on the topic. To name some of the initiatives on the table: Bergsten (1998), Bergsten and Hennig (1996), Calomiris (1998), Camdessus (1998), Edwards (1998), Fischer 1999), Garten (1998), Government of France (1998), Government of the United States (1999), G-7 (1998), G-10 (1996), G-22 (1998a, b, c), G-30 (1997), Kaufman (1998a,b), Kenen (1998), Lita *et al*. (1998), Meltzer (1998), Naciones Unidas (1999), Raffer (1990), Rogoff (1999), Sachs (1998), Soros (1997, 1998), Stiglitz (1998).

the proposed reforms: the deeper financial integration goes, supporting high returns in capital-scarce emerging markets, the better. It is clear, however, that an efficient architecture entails financial support from developed countries from time to time when things go wrong. From this alternative perspective, it would make sense to prefer reforms that limit financial risks, even at the cost of efficiency. The current bias in favor of reforms that limit capital flows may be better interpreted in this way rather than on efficiency grounds.

In this paper, we analyze the degree to which the initiatives effectively address the distortions in each of the three clusters of theories. In the case of conflicting effects across this three-way typology, we refine the ambiguous assessment that would follow by weighing the tradeoffs involved. This evaluation methodology demands the consideration of the relative importance of each type of distortion for the problem at hand, for which we use the conclusions of the companion paper mentioned above.

A key advantage of this joint analysis across distortions is that it makes explicit what economists refer to as the second-best theorem: the elimination of any one specific distortion may fail to improve welfare in the presence of remaining distortions. In fact, the single most important problem with the way the debate on reforming international financial architecture is being conducted is its partial, even unilateral, approach to problems. But we must remember that reducing any identified distortion is not necessarily good policy and that successfully alleviating a specific undesirable symptom is not necessarily the manifestation of a welfare improvement. This is always the case when there are multiple distortions.

For example, the objective of reducing the moral hazard induced by official guarantees to international private capital flows would be served by curtailing official financial support to countries in distress. However, such financial support would be extremely beneficial in the event of a liquidity crisis and financial contagion. The overemphasis on moral hazard would lead to counterproductive policies if the latter distortions are preponderant. Similarly, reducing the incidence of crises by impeding capital flows to a sufficient extent may be a counterproductive policy once the deleterious growth effects of lower capital integration are factored in.

In this paper, we concentrate on a number of core initiatives that characterize the main angles of the debate. We omit other initiatives not because they are without use or importance, but because they are either uncontroversial or propose changes that are more decorative than foundational, i.e., they take too many walls and windows for granted. For example, we do not discuss standards on transparency because we see them as uncontroversial but also of limited impact.

For each core initiative examined in this paper, whether currently on the table or proposed for consideration, we first identify which of the main distortions, identified in the companion paper, it addresses. This correspondence between initiative and distortion provides a clear relationship between the problems diagnosed and the solutions reviewed.

We then assess the initiatives by weighing the benefit concerning the distortion they are designed to alleviate and the possibly unintended effects concerning other distortions.[2]

We group the initiatives examined in this paper into three sets and review them in turn. The first two sets of initiatives involve the provision of financial support triggered after an emergency arises. First, we consider initiatives concerning the unilateral provision of financial support by the official sector. Second, we consider initiatives in which the private sector is also given a role in providing financial support. Finally, the third set of initiatives refers to reforms to the financial institutional framework in which international capital flows to emerging markets take place. They encompass standards and regulations applicable to financial systems, both national and international, as well as monetary and currency arrangements in emerging markets.

Official Financial Support

The main idea behind initiatives concerning official financial support is the need for the function of lending of last resort at the international level. The clearest case for such an initiative is that in which crises in emerging markets result from a sudden lack of liquidity, i.e., liquidity crises. Liquidity crises are usually addressed through the provision of last-resort lending. In fact, simply the existence of such a lender may be sufficient to prevent destructive runs and panics. The basic argument for international versions of a lender of last resort is the same argument used in a domestic context: by promising in advance to provide financial support in case of unexpected need in which fundamentals are right or will be right, (liquidity) crises are prevented. In fact, financial panic rationalized by the damage in fundamentals that a massive financial withdrawal (a "run") would generate cannot exist when there is a commitment of ample support that would avoid such damage.

We have argued in Fernández-Arias and Hausmann (1999) that liquidity crises have been prevalent in recent crisis episodes, which would explain the unpredictability of the collapse in fundamentals, a key problem to address in the future. From this point of view, a central problem in the world may be that the globalization of financial flows in the context of original sin (i.e., the inability to borrow long term in a country's own currency) has overwhelmed the capacity of national central banks in emerging countries to credibly provide enough last-resort lending to prevent liquidity crises. Therefore, to us international lending of last resort suggests itself.

What are the effects of this initiative on other distortions? Successful lending of last resort reduces private default risk, but this is not necessarily a source of moral hazard. This is a legitimate reduction in risk obtained from removing an inefficient risk factor, i.e., the panic equilibrium. This does not open a gap between social and private risks. In fact, lower expected risks will give rise to more capital flows that will be applied efficiently. Therefore, this initiative in the context of liquidity crises would be good all around.

[2] We also compare initiatives that are mutually incompatible.

If, on the contrary, a lending of last resort facility is available to insolvent countries, i.e., countries unable to pay even after all liquidity constraints are removed, then the crisis will not be avoided and the facility may incur losses. Moreover, critics who argue that the recent financial turmoil is not associated with liquidity crises think that the provision of last-resort lending would only serve to bail out private creditors, exacerbating moral hazard problems and thereby aggravating rather than resolving the situation.

It is worth keeping in mind this distinction between liquidity and solvency crises, which is key for the evaluation of this and other initiatives (for a formal analytical framework see Fernández-Arias 1995). We begin by analyzing the liquidity crisis case, which is the central case in our diagnosis, and then discuss the solvency crisis case.

Lending of Last Resort

Lending of last resort would be perfect in liquidity crises. The challenge then is to recreate the function of lending of last resort at an international level in the real world. The obvious move is to create a global lender of last resort or, more specifically, to reform the IMF so that it could better play this role. Making the IMF a global lender of last resort is an idea that was originally discussed at the time of the Bretton Woods conference in 1944. In spite of the eloquence of John Maynard Keynes, the American representatives were not willing to provide the institution with the ability to print money. After all, the world was adopting a dollar standard and the United States was not about to renounce sovereignty over the management of its own currency.

Since then the political-economy problems of providing a global lender of last resort have been insurmountable, but for other reasons. First, there is reticence to create a powerful global institution that may not be fully accountable. Second, there is the fear that taxpayers in industrial countries would be asked to pay for bailouts in emerging countries. These fears could probably be addressed through the right governance structure and the use of collateral to protect taxpayers from undue risk, although in the international context collateral always remains limited by sovereign risk. The idea has gained the support of Stanley Fischer (1999), the second in command at the IMF. However, as *The Economist* (1999) concluded in its recent review of global architectural initiatives, there is very little support for anything this ambitious at the global level. But we must remember that appetites may change as the costs of the alternatives become more obvious.

A second-best option is to mimic last-resort lending by using extant institutions. In the absence of a global lender of last resort, the IMF and other International Financial Institutions (IFIs) face a daunting task in dealing with potential liquidity crises.[3] Current rescue packages may not be adequate because, unlike last-resort lending, they are not committed ex ante but are negotiated after a crisis has occurred. In fact, to a large extent

[3] We will later consider the possibility of a regional lender of last resort as an alternative possibility.

the debate has moved towards crisis prevention and lending of last resort because of the dissatisfaction with crisis resolution through rescue packages tried in recent crises. It is useful to recapitulate the reasons why rescue packages had problems in order to discuss the advantages of an alternative facility closer to the idea of last resort lending.

It is key to have financial support available before a crisis. Once a financial crisis erupts, experience shows that it quickly develops into a meltdown with enormous output losses. Reasons for this may reside in the incomplete financial markets and hard-to-enforce contracts in developing countries (see Calvo and Fernández-Arias 1998). For example, inadequate bankruptcy laws can lead to socially costly disruptions when activity is suspended until property rights are re-established. These distortions are intensified by the breakdown of "implicit" contracts across firms (inter-firm credit and supply/demand relations when there is asset specificity) and between employer and employees at times of crises.

Interestingly, this diagnosis implies that a financial crisis sets off a chain of destructive events that would not be undone if financing returned to its original level. Hence, even though the provision of emergency support would be beneficial, it would not restore the unbroken network of relations that the market requires. This pessimistic outlook may help explain the relative failure of the rescue packages for most of the crisis countries in recent years. Although these packages generally were very large, coming close to offsetting in size the initial negative financial shocks, they did not come close to erasing the devastating real impacts.

Part of the problem may be caused by the fact that support is tranched and conditioned on the achievement of some future changes. This makes support contingent on actions that investors may consider uncertain. This may explain why in the case of Mexico the ample commitment to provide liquidity did not in itself stop the run. In fact the support was fully disbursed and the private sector withdrew, thereby disrupting the specificity involved in credit relations and in private information.

This failure calls into question the traditional rescue package strategy. Experience with recent crises, from Mexico to East Asia, suggests that this strategy is insufficient to avoid enormous damage to the wellbeing of the countries involved or to prevent the contagion from spreading internationally.

The following principles for an alternative strategy mimic the classical principles of lending of last resort (Bagehot 1873) in an international context within the institutional constraints (for details, see Fernández-Arias, Gavin, and Hausmann 1998). The first and governing principle is to strengthen mechanisms designed to prevent a liquidity crisis or lack of financing. To work, these programs must be applied only when the economic fundamentals are sufficiently sound for there to be reasonable expectation that market confidence and access can be restored and held. This will also require that financial support be of sufficient critical mass to dampen or forestall a liquidity crunch capable of triggering a crisis.

Second, there must be certainty that the support provided—whether a guarantee, a loan, or a line of credit—will be available immediately when funds are needed. Otherwise the prevention capability of the facility is diluted. Access should be automatic, either on demand or on the basis of immediately verifiable criteria. Consequently, the conditionality applied in such operations must not impede timely disbursements, and disbursement conditions must be replaced by conditions of approval.

Third, these "conditions of approval" mean that support should be offered selectively to countries able to meet a series of preconditions. Importantly, this selectivity would translate into positive incentives for policy, an extra benefit of such a facility. Their economic fundamentals and their economic policy commitments must be compatible with warding off a crisis and conform to prudential standards and efforts to reduce financial vulnerability. Regular review by the IMF will be needed to ensure compliance over time. If conditions are not met, a delayed exit mechanism must be implemented in order to ensure that it does not trigger a crisis. Such an exit strategy may involve the negotiation of a traditional support program such as a stand-by program or and Extended Financing Facility (EFF).

Fourth, IFI support will be more effective if it is supplementary to market mechanisms and can be leveraged through the private sector. In other words, this initiative is designed to *bail in* the private sector.[4] To do so, official international cooperation is essential for achieving the necessary critical mass.

Finally, disbursed loans, including guarantees that have been called, should be relatively short-term and repayable early without penalty. They should carry sufficiently high interest rates to ensure they will be drawn upon only when there is a financing shortfall. On the other hand, the loans' commitment fee, whether a guarantee or a line of credit, should be priced to reflect the financial cost of such commitment since low fees would provide further incentives not to draw down the loan unless a real need exists. These facilities should be designed as prudential planning tools: abstention from disbursement would be normal and should not be discouraged through artificially high commitment fees.

For concreteness, it is useful to compare the facility we just outlined with the contingent credit line (CCL) facility recently approved by the IMF, which Mr. Camdessus has described as a Copernican revolution in the Fund because it inverts the model from after-crisis support to crisis prevention. In this facility, countries pursuing sound policy that also meet a number of financial and reporting standards would enjoy financial support in the form of a credit line that can be drawn on if they fall victim to panic or contagion. As in our proposal, CCL can be seen as a variant or substitute for a lender of last resort for countries in which good collateral (which is difficult for a sovereign to produce) is replaced by the requirement of a healthy economy.

[4] Private sector participation is a non-essential but highly desirable feature. The issue of private sector involvement is discussed at length in the following section.

A key problema with the Fund version of the CCL facility, however, is that from the point of view of a country, the committed support is not certain and its delivery may take time; either of these qualities may render the mechanism ineffective against panic. This is because delivery is mostly not automatic at the country's choice but requires final approval depending on the Fund's assessment of the situation. There are also problems related to the transition into the new Copernican world as the current rules make ineligible those countries with active traditional programs such as stand-by agreements with the Fund. We favor setting country eligibility criteria on the basis of preconditions and allowing automatic withdrawal.

Another important difference is that in the Fund's CCL there is no involvement of the private sector, while in our proposal the private sector would cofinance. The absence of the private sector means smaller resources and, perhaps more importantly, less accountability. In fact, cofinancing with the private sector introduces market discipline through eligibility and pricing to ensure that the facility does not become a subsidy in disguise. (Broader implications of private sector involvement are discussed in the next section.)

Finally, it is important to implement this facility in a way that eligible countries are regarded as the strongest of the pack, rather than those seeking potential help for some good reason unknown to the market. Otherwise, even an objectively good facility may be in low demand, a problem reminiscent of the Groucho Marx joke about not wanting to belong to a club that would not have you as a member. Whether expectations are positive or negative depends to a large extent on the rules of the eligibility game. For example, if countries need to apply individually and run the risk of not being accepted expeditiously, interest will tend to be low. If, on the contrary, IMF produced a list of eligible countries and allowed them to join en masse (e.g., automatically extending the facility privilege as a matter of course), chances are that belonging to the club will be regarded as a prize.

The analysis would not be complete if we did not consider the case of solvency crises. Contrary to a liquidity crisis, in this case the solution does not involve only the provision of finance. In this case, reforms to strengthen fundamentals, including conditionality, are essential. In the absence of these changes, additional financial support would not re-establish confidence and would postpone needed reforms and deepen the inevitable crisis, diluting the market discipline that would otherwise be exerted when fundamentals turn riskier. Furthermore, it is important to consider the involvement of the private sector in order to arrive at an efficient plan of financial support; otherwise official support may end up being a bailout of private creditors with little benefit to the country. The anticipation of such a bailout would in turn create moral hazard. So it is clear that a lender of last resort is not the best answer and a different approach to official support ought to be applied.[5] We discuss mechanisms to deal with this more traditional type of

[5] Still, many of the lessons derived from recent experiences with liquidity crises are applicable. In particular, it would be desirable for a new generation of financial rescue programs to be put in place that would be activated before crises erupt. Contrary to liquidity problems, presumably, fundamental solvency

crisis in the following section, after reviewing the role of the private sector. Here, it is important to discuss whether the risk of applying last resort lending to solvency crises is so large as to make this initiative undesirable to deal with liquidity crises.

There are three main reasons why the initiative for official lending of last resort to prevent liquidity crises as outlined above is robust to the risk of application to situations of insolvency. First, our diagnosis indicates that in this era liquidity crises are prevalent and, therefore, the risk of wrong application is small. Therefore the extent of moral hazard generated by this facility is small and benefits would exceed costs. Second, there are ways to discriminate liquidity and solvency crises in order to reduce the risk of wrong application: the better the fundamentals before the crisis, the more likely it is that the crisis is of liquidity. Eligibility conditions to qualify for the facility based on sound economic fundamentals play the role of screening out insolvency and picking a pool of countries in which the likelihood of solvency crises quite small. These conditions, as well as the private sector participation in our proposal, serve to control moral hazard.

The third reason why official last resort lending is desirable, even if there is the risk of lending into insolvency, is simply that the alternatives are worse. The realistic, and possibly best, alternative is some version of rescue packages, the limitations and inefficiencies of which are discussed above. While this lender-of-last-resort role may be risky for IFIs, responding to crises with rescue packages is a costly and ineffective alternative. The merits of preventive operations are best judged when weighed against this benchmark. Yet another initiative currently under experimentation is to make rescue packages conditional on private sector burden sharing the burden in order to eliminate the moral hazard that would be created by unconditional support. In the next section, we discuss this initiative and propose an alternative approach to traditional solvency crises.

International Financial Contagion Facility

Finally, the case of international financial contagion is also a key area for initiatives involving official financial support. This case is similar to that of liquidity crises in critical dimensions. First, recent experience shows that, like liquidity crises, international financial contagion appears to be prevalent in this new era of international finance and is in fact another distortion underlying the Theories of Too Volatile. Second, from the point of view of the country the basic problem is not weak fundamentals but lack of financing, i.e., distorted risk spreads and lack of access to market. Over time financial contagion weakens fundamentals and may end up in a real (solvency) crisis. Third, financial contagion can be treated with a purely financial solution: the provision of financing is efficient and prevents the crisis. In the case of contagion it works not because it removes the panic equilibrium, but because it relaxes a temporary constraint distorting the normal equilibrium.

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problems can be detected in advance and are amenable to early action. Otherwise there should be a strong presumption that liquidity is the key issue.

The above parallels justify a facility similar to lending of last resort, but one that would allow countries affected by international financial contagion to counteract the cumulative effect of the credit crunch and prevent a full-blown crisis.[6] Once again, the risk is of financing a country with weak fundamentals that will fall into crisis even after contagion ceases. However, there is a large scope for accurately discriminating which countries should be supported. First, the widespread nature of contagion makes it quite apparent when countries are victims of this phenomenon; non-systematic effects should not be attributed to contagion. Second, even distorted by contagion, relative market indicators across countries, e.g., spreads, continue to reflect relative fundamentals and are reliable pieces of information (see Fernández-Arias and Rigobón, 1998). An official contagion facility should stand ready to support countries meeting the eligibility conditions. As before, participation of the private sector, discussed in the following section, would be a desirable feature.

Private Sector Involvement

Private markets have thus far tried to insulate themselves from sovereign risk with relatively rigid contracts, which lacked clauses that could be exploited to justify nonpayment. Yet a solution tailored to a willingness-to-pay problem may make crises triggered by an ability-to-pay problem more difficult to manage and more costly. It usually makes debt workouts quite messy and unnecessarily extends the period during which countries are cut off from international financial markets, a second problem underlying the Theories of Too Little. Hence, some authors have been proposing mechanisms to make such workouts more orderly without worsening the sovereign risk problem and without requiring the use of new public resources to take previously exposed creditors off the hook (see Eichengreen and Portes, 1997 and Eichengreen 1999).

If flexible contingent contracts are best, why is it that we seldom see them in the marketplace? One answer to this question is that their virtue is not fully internalized at the individual level, with the implication that a specific contingent contract offered would be too expensive for the borrower to accept. In a situation in which sovereign risk imposes an aggregate cap to payments to creditors, flexibility in one contract would shift payments to other contracts without contributing to flexibility in the aggregate. Whatever the reason for the market failure, it appears clear that any reform on this front will have to provide for very tight coordination among creditors. The mechanism for collective action is likely to be fundamental in any initiative involving private sector involvement.

In this section we review three classes of initiatives. The first class involves the flexibilization of private debt contracts, whether by changing the economic structure of the contracts to make them contingent or by softening the provisions relevant for renegotiation. The second class involves the international implementation of the function of bankruptcy court, to which every private contract would be subject. Finally,

[6] This kind of initiative has been put in practice under the misleading name of emergency financing, e.g., the 1998 $40 billion-plus Brazil package.

we review a third class of initiatives in which the official and the private sector would share financial support.

More Flexibility in Private Debt Contracts

There are two main types of proposals involving the incorporation of contractual provisions in private debt contracts. One proposal includes an option in favor of the debtor to reschedule payments at a premium (e.g., as explained by Buiter and Sybert 1999). The other proposal would include collective action clauses and other loan restructuring provisions in debt contracts that would facilitate renegotiation with bondholders (e.g., as explained in Eichengreen, 1999 for bond contracts).

In both cases, debt restructuring is achieved bilaterally between debtor and creditors, without the official sector intervening in any way. In the first case, the debtor obtains financing within the provisions of the contract (as opposed to according to a bankruptcy law or other higher order framework). In the second case, flexibility is achieved with collective action loan restructuring provisions that facilitate contract renegotiation (once again without the interference of the official sector), such as majority voting, as opposed to unanimity, and sharing clauses, as opposed to collective representation.

The basic argument behind these proposals is that debt contracts are too rigid and make countries prone to crises: the creditors' right not to rollover debt leads to either very inefficient adjustments or, frequently, contract breaching with uncertain consequences. Flexible contracts in which creditors can be forced to rollover debt under conditions in which they would otherwise not like to provide financing, as in the first type of proposal, can alleviate the costs of adjustment and, in the event of a potential liquidity crisis, prevent the problem altogether. Even if contracts are rigid, easy renegotiation, as in the second proposal (flexible implicit contracts), can achieve a similar payment outcome and, achieve the same objective. This point is particularly important for bonds, whose typical contract does not limit the suing rights of individual (or small sets of) bondholders and, consequently, leads to rigidity (either full payment or full default). The increasing importance of securitization in the 1990s has brought this concern to the forefront.

Not surprisingly, the best case for making private debt contracts more flexible is that of a liquidity crisis: the liquidity ensured by flexibility reduces or eliminates the potential for such a crisis and, therefore, has advantages both ex post and ex ante. The problem arises when the crisis is not of liquidity and flexibility simply means that creditors forego payments. The main concern is that flexible payments (either in the explicit contract or through renegotiation) may result in lower average payments, exacerbating the sovereign risk distortion, in which case the flexibility proposals entail an ex ante financial cost that may more than offset the ex-post advantage of flexibility. In particular, a key issue is the extent to which flexibility will be subject to abuse by the debtor and used to the creditor's disadvantage.

The premium for exercising the rollover option in the recent proposal by Buiter and Sybert is meant to control for opportunism, but it clearly has limited value because it would only screen marginally bad risks: those who do not plan to pay will not be discouraged by a premium. Easier renegotiation appears to have an ambiguous effect on expected payments: on the one hand, it may avoid complete default because it solves the collective action problem preventing a settlement for a partial payment, but on the other hand it allows the debtor to pay less than full payment by exercising the bargaining power granted by the new provisions. The balance is not clear: ex post, it is better to have flexibility; but lack of flexibility may provide better terms ex ante. This may become a serious problem if there is room to opportunistically manipulate flexibility ex-post.

The pro-renegotiation proposal makes bonds similar to loans. It is interesting how conventional wisdom is changing in this regard. It was once widely believed that too much flexibility to renegotiate bank debt during the 1980s debt crisis had spawned endless renegotiations. Now, in the face of a different kind of crisis, many analysts favor the reintroduction of flexibility.

The above favorable arguments assume that all debt contracts are somehow modified exogenously. In practice, there are serious implementation issues in coordinating collective actions of creditors. First, if only one set of contracts is modified, then it would become a second class of instruments, encumbered by options or right limitations without any specific redeeming benefit.[7] In particular, if only future contracts are treated, that would amount to adding adverse conditions to new financing, at least during a transition period. This comprehensiveness requirement extends to all classes of contracts because otherwise those exempted would free ride and drive flexible instruments out of the market, rendering the initiative ineffective; for example, if only loans were modified, bonds would be at a relative advantage and would tend to dominate the market. Second, there are difficulties with each emerging country unilaterally redesigning its contracts along these lines. Just as a prenuptial agreement would, a unilateral change might be interpreted negatively as a signal of lack of commitment. A more collective approach would provide governments and fiancées alike with cover regarding their honourable intentions. This would call for an international agreement on loan restructuring provisions.

So the bottom line is that we find these initiatives interesting in their attempt to make workouts more efficient but have serious doubts about their potential. First, even under ideal implementation, they are risky propositions because they may aggravate the sovereign risk distortion. Second, the collective action problems that need to be solved for their successful implementation, especially the comprehensiveness of treatment across instruments, appear quite severe.[8]

[7] Cross-default clauses across bonds would also imply that renegotiable bonds would be held hostage of any co-existing rigid bond.
[8] Furthermore, the evidence available on countries that issue renegotiation-friendly bonds under English law does not support the notion that this kind of bond flexibilization would yield a significant advantage.

International Bankruptcy Court

Another proposal is to create an international bankruptcy court, which would be modeled on the equivalent domestic institution. This court would authorize sovereigns not to repay or to prevent domestic borrowers from repaying when the country is deemed unable, rather than simply unwilling, to pay. This decision would stop legal action against the borrower in member countries, thus reducing the transaction costs and creating a real difference between unilateral sovereign action and an independent court decision. By transferring the power to authorize nonpayment to an independent court that does not have a willingness-to-pay problem, this arrangement provides more flexibility while keeping sovereign risk under control. Obviously the sovereign could still decide to violate the decisions of the international court, but it would forgo the protection against suit provided by the court. More importantly, it would allow those willing but eventually unable to repay to pre-commit to a more credible arrangement. Since an independent body will have declared the default to be "excusable" on the merits rather than a unilateral decision by a sovereign, trustworthiness in future dealings would be enhanced.

One question about this initiative is whether it is possible to gather sufficient political support from sovereigns to effectively empower the court. It is clear that, unlike a domestic bankruptcy court, the international version would not be able to replace management. It has also been argued that, realistically speaking, this court would not be able to go beyond imposing a stay on payments, which the sovereigns can already achieve by simply not paying. Nevertheless, unilateral default carries penalties of many kinds, explicit and implicit, private and official, as well as costly negotiations, which a legally binding stay on payments would eliminate.

To some extent, this proposal duplicates some of the functions the International Monetary Fund already performs. When a country gets in trouble, the IMF determines the amount of adjustment that is feasible or reasonable, calculates a financing gap, and coordinates with official creditors and commercial banks a financial plan to make the program consistent. By deciding how much the country can pay, it differentiates between ability and willingness to pay, thus solving the problem in a way similar to a bankruptcy court. However, there is a key difference in that rulings by the court would have a legal bearing on creditors' claims, who would not be able to press for payment if the country is under bankruptcy protection. As in domestic bankruptcy, legal protection should have a major impact on the efficiency of the workout.

Like more flexible debt contracts, this initiative addresses the problem of inefficient workouts, in this case by imposing order along the lines of traditional bankruptcy law, and would automatically address liquidity crises. All cross-border contracts, no matter how rigid, in countries that are signatories of the international bankruptcy court would become implicitly more flexible. Importantly, this initiative goes a long way toward solving the two main difficulties we saw in the previous class of initiatives. First, the comprehensiveness across instruments that is required is naturally achieved by the court's jurisdiction over all cross-border obligations, rather than constructed transaction by transaction. Second, it also provides a natural solution for the

collective action of countries seeking to benefit from the initiative. Therefore, we support this initiative and favor it over the previous class of initiatives.

Official-Private Coordination

The initiatives reviewed above are not mutually exclusive and would in fact work better in combination. For example, it would be a good idea to implement official support through lending of last resort and an international contagion facility with an international bankruptcy court in place. Still, the question arises whether there should be more active coordination or interaction between the official and the private sectors, or in other words, how should the official sector promote private sector involvement (PSI). In this segment, we first review some constructive means of facilitating PSI through voluntary means and then discuss forced PSI, in which official support is made conditional on private burden sharing.

In the previous section we mentioned two instances in which voluntary PSI was useful in leveraging official support. First, we noted that official lending of last resort would be more effective if it were cofinanced by the private sector and that the failure to address PSI in the Fund's CCL was a weakness. Private involvement in official last resort lending would be important to ensure achieving critical mass to prevent crises and also to ensure accountability through pricing and private country eligibility. These arrangements with the private sector have to be conducted in normal times when there is a private interest to provide this kind of insurance to countries, and should be high on the agenda once market conditions return to normal.[9]

Second, PSI in an official international financial contagion facility would also be quite useful in arriving at the kind of sums needed to effectively support countries. It is clear that financial enhancements are needed for the private sector to be willing to lend to countries during the period of contagion. The idea is therefore to provide official enhancements sufficient to revive private interest in lending in such a way that leverage is maximized. For example, official enhancements may take the form of partial guarantees of private credits, so that the risk mix becomes acceptable for private lending.[10]

It is worth noting that the use of official enhancements to spark private lending is a way of relaxing the sovereign risk constraint that private creditors face. In fact, IFIs face a much lower sovereign risk and may be able to leverage their lending by transferring that lower risk to private parties. The reason for their risk advantage is that their policy requires them to suspend operations in countries that run into arrears. Since they are a cheap source of future credit and are committed to stop lending in case of arrears, sovereigns have always repaid, giving these multilateral institutions their preferred creditor status. In a world where such binding devices are scarce, questions

[9] Argentina and Mexico secured private credit lines of this kind before the crisis. The IFIs recently supported the extension of Argentina's program in the middle of financial contagion, another good example of official-private coordination.

[10] The World Bank recently extended a partial guarantee that allowed Argentina to obtain investment grade, three notches above its regular rating.

have been raised about whether these institutions are making adequate use of their commitment technology. In the context of countries lacking access to private financial markets, there is no question that the official sector can be very effective in alleviating this distortion.

Therefore, we strongly support voluntary PSI in the context of official support facilities, both arranged at normal times at market terms and arranged at emergency times with financial enhancements. However, we think that forced PSI, which appears to be the basis of a new doctrine on official sector policy, can very easily become counter-productive unless it is done in a manner more similar to either a bankruptcy process or a Brady plan. In the rest of the section we review this case.

For reasons that we argue below, forced PSI is likely to be very costly and should only be considered in the extreme cases in which domestic adjustment and official international support are deemed insufficient to reestablish confidence. If confidence is not reestablished, official money will be quite unproductive, as the private sector would exploit the opportunity to bail out of the country. But forced PSI should not be used as a way to teach a lesson to the private sector and thus reduce moral hazard because it is likely to have very large social costs. Moreover, the number of cases that would qualify is not independent of the supply of official funding. In general, the traditional approach of domestic adjustment and official support, with the private sector coming back on its own, is superior and should not limited by a stingier approach to official international involvement.

There are at least two distinct reasons why the traditional approach would not work. One is a remaining liquidity problem, and the other is solvency. The liquidity problem can arise because, even if the domestic adjustment and the official support are sufficient to reestablish solvency, the private sector may face a multiple equilibria situation in which the decision to stay or leave depends on what each investor thinks others might do. To ease this problem the IMF has recently used "moral suasion" or cajoling (e.g., veiled pressure on banks to refinance or maintain credit lines in Korea and Brazil) as a coordinating device.

Another case emerges when the concern over solvency is such that the traditional approach is perceived as inadequate because the country is unable to sustain its current debt level, and hence additional money per se is unlikely to reestablish confidence. Here, debt reduction may need to form part of the solution. Mechanisms to address these cases are now under experimentation. These include renegotiation with private bondholders as a prior condition for Paris Club rescheduling (e.g., "comparable treatment" requirement in Pakistan) or IMF support (e.g., default of Brady bonds in Ecuador).

Obviously, in a crisis any financial room for maneuver is very valuable. However, the disastrous experience of Ecuador should teach us some important lessons about the perils involved. First, the official international sector should not lose sight of its fundamental coordinating role during crises. To request private sector involvement as a prior action before the official sector commits itself puts the cart before the horse. It

demands the private sector to participate in a still non-existing program, thus reducing the informational content of the situation. Secondly, the delay involved in waiting for a private sector response may involve a dramatic deterioration of domestic economic conditions as economic activity collapses, aggravating fiscal and financial imbalances and further undermining confidence. Finally, the whole notion of comparative treatment may be the wrong paradigm. After all, during the last "orderly workout" that Latin America went through, i.e., the Brady plan, the roles of public and private sector were quite different. The public sector put additional resources toward generating the enhancements that allowed for private sector debt reduction.

If forced burden sharing becomes part of the "implicit contract," it will have an effect on the cost of capital. This need not be a bad trade-off if the conditions for burden sharing are clear and not subject to abuse; in that case, they would define a standard of "excusable default" that would ensure flexibility when needed. An international bankruptcy court would fit this characterization. In that case, under insolvency conditions PSI would kick in according to international law, coordinated and supplemented by official support.[11] The efficiency of this workout mechanism is likely to lead to lower financial costs, rather than higher.

However, the case-by-case, secretive approach with weak coordination that has been followed so far makes this proposition doubtful. In this case financial costs will increase. Perhaps more importantly, if forced PSI is used for anything other than extreme cases, it will end up being a destabilizing and worsening move. Up to now, if an economy got into trouble, the willingness of the government to call for an IMF agreement was seen as a way to signal its disposition to adjust and thus was a means to reestablish confidence. Under forced PSI, the private sector would take such an announcement as one reason to try to get out of the country before a stay or a debt reduction is forced upon it. This would aggravate the situation and provide less liquidity and opportunity to get the needed adjustments done in time. Under these conditions, governments will be less willing to call on the IMF for assistance.

In synthesis, forced private burden sharing should be a very exceptional situation. It should only be used for cases in which the level of debt is seen as unsustainable. But the current push, designed to use burden sharing as a way to teach the private sector a lesson, is quite unhelpful. After all, if Ecuador has become insolvent again, in spite of the analyses that led to its last debt reduction during its Brady plan of 1994, it is not because of moral hazard. Instead, it is because of a sequence of massive real shocks such as El Niño, the decline in oil and other commodity prices and the volatility in international capital flows. Under these conditions, it became impossible to reach domestic political consensus before substantial additional damage was done to the fundamentals.

Hence, to engage in forced private sector involvement as a way to limit moral hazard is the wrong approach. Instead, more forceful and faster official intervention and a clearer offically sponsored private debt reduction is critical. The world cannot afford

[11] At the same time, the country ought to adjust and reform. Ideally, the balance between private and official support would depend on how prudent the country's policies are.

another case of a country that is forced to default on the private sector as one more condition to reach an IMF agreement and then is left to linger on without any official support.

More generally, making official involvement conditional on PSI implies that official support is not provided or, in the best case, that it is delayed. It is key to recognize that this implication entails a very substantial foregone benefit, and therefore a very substantial cost to these moral hazard-based initiatives. If applied to cases other than those of true insolvency the results would be disastrous. Given the prevalence of liquidity crises and financial contagion, the availability of official support is likely to be quite beneficial despite moral hazard. Moreover, the difficulty in stopping a crisis once it starts argues in favor of speed, not of convoluted and slow coordination with hundreds of anonymous bondholders. Even if support is finally provided, a delay in the provision of official support greatly complicates crisis prevention. Furthermore, delay is quite detrimental, even in the context of a non-preventive rescue strategy.

The conclusion is that the broad application of these initiatives as the basis for official intervention would have serious adverse side effects on financial integration and market volatility. Furthermore, in our view the importance of moral hazard is grossly exaggerated relative to other distortions in the international financial markets that emerging countries face. Most of the workout coordination can be obtained by other means without risking delays. Therefore, we do not favor the initiatives based on the doctrine of (forced) PSI to control moral hazard and consider it a last resort in exceptional cases.

Financial Institutional Framework

In this section we review initiatives that address the institutional framework in which capital flows take place. They include the financial standards and regulations in financial systems, both national and international. We also address the issue of monetary and currency arrangements in emerging countries, a key area within international financial architecture which has received surprisingly little attention so far.

Recent crises have uncovered widespread weaknesses in financial systems and have prompted the elaboration of financial standards and regulations to strengthen them. It is interesting to notice that the emphasis on the kind of fixing that needs to be done directly depends on which class of distortions is deemed to be more substantial.

Those who think that moral hazard is the main problem emphasize the strengthening of the solvency of financial institutions to make sure that they do not play with other people's money. The main initiative in this field has to do with capital adequacy requirements for banks in the domestic system and strong supervision to ensure that they are enforced. Basle risk weights for bank lending are also being reformed along the same lines, ensuring that lending to higher risk countries faces a higher regulatory cost.

This agenda has moved forward very quickly in Latin America, especially after the Tequila crisis, and is behind the resilience of the region's banking systems in withstanding recent financial turmoil and the deep 1998-99 recession. In fact, most Latin American countries have capital adequacy requirements that are above the Basle standards and supervisory systems have been thoroughly reformed. While this has made banks stronger, it has not translated into more stable flows of international capital. Hence, while these policies are quite uncontroversial in the region, it is unclear that they do much to limit international financial turmoil.

There is also the question of how to measure risk to determine Basle weights in industrial countries for cross-border lending. One idea that has been floated is to use the ratings of credit rating agencies for this purpose. As proposed at present, the new initiative would increase the cost of capital for all Latin American countries except Chile. This in itself would aggravate the dearth of capital flows to emerging markets and increase the distortions associated with sovereign risk. Moreover, to the extent that ratings follow market developments, it appears that this method will introduce further instability in the market and may, in the extreme, cause self-fulfilling panic crises. This idea appears ill-conceived.

The initiatives inspired in the Theories of Too Little focus on how to improve the commitment to repay. Those include issues such as the clear definition of property rights, the legal ability to attach collateral, the efficiency of the judicial system to enforce contracts, the efficiency of domestic bankruptcy law, and the existence of credible credit bureaus. We believe that these areas are not receiving all the attention they deserve. They all would lead to more finance and growth and impose no tradeoffs.

By contrast, new initiatives to reduce mismatches through regulatory schemes impose a more serious tradeoff between growth and stability. The crises in East Asian have made the magnitude of currency and maturity mismatches much more visible and raised new regulatory concerns. Some have argued in favor of stricter regulation of these mismatches. Others (Krueger, 1999) have proposed taxing foreign currency borrowing. Our main concern is that these mismatches are the consequence of original sin, i.e., the inability to borrow abroad in domestic currency and the inability to borrow long term, even domestically, in domestic currency. If mismatches are restricted without solving the original sin problem, it will lead to a drastic reduction of financial intermediation, both domestic and cross-border. We view this as justifying a different approach to currency arrangements.

Finally, those who focus on the Theories of Too Volatile emphasize initiatives that protect the financial systems against sudden changes in market sentiment. One class of initiatives is aimed at strengthening the liquidity of the banking system by setting high liquidity requirements. It is interesting to note that the most prudent Latin American governments have found it useful to have a liquidity policy, while the OECD has explicitly eliminated liquidity requirements from its regulatory scheme. Hence, high liquidity requirements must be seen as a second best, given the presence of some other distortion that is much more prevalent in emerging markets. We believe that two

problems are involved here. The first is original sin, which makes currency and maturity mismatches take on a more important role while limiting the central bank's ability to use fiat money to backstop the system (given the presence of net dollar liabilities). The second is the general illiquidity in asset markets which severely limits the universe of assets which can be used as sources of secondary liquidity.

In our view, the imposition of high liquidity requirements on the banking system is a useful initiative, but it is important to allow these liquidity reserves to be remunerated in order to minimize the increase in the cost of capital and the reduction in financial intermediation.

The other side of the coin of high liquidity requirements on banks is an emphasis on large international reserves, especially in relation to short-term obligations. To the extent that liquidity concerns are prevalent in recent experience, policies aimed at delivering high reserves and discouraging short-term debt make sense. At the same time, these policies have the drawback of imposing higher costs of capital and reducing the domestic absorption of foreign savings. We must recognize that at present reserve levels relative to M2 are about ten times larger in Latin America than in the typical industrial country. This radical difference must also reflect the presence of a fundamental difference in economic structure. Holding reserves makes sense if there are states of the world in which a country cannot access the international capital markets. For example, by being sufficiently liquid a country can avoid falling into the kind of self-fulfilling liquidity crisis that is associated with rolling over the foreign debt. This is the consequence of distortions other than moral hazard and is unlikely to be addressed by any of the initiatives to curb moral hazard that are on the table.

It is important to recognize that these kinds of prudential policies are second best. For example, while in Australia international reserves are about 5% of M2, they average over 35% of M2 in Latin America. Also, while the short-term debt of Australia represents 50% of the total foreign debt and about five times the level of international reserves, in Latin America reserves cover 107% of short-term debt. Clearly, Latin American countries are concerned about avoiding situations that do not seem to arise in Australia. One explanation is that Australia does not suffer from original sin and hence can borrow abroad in its own currency. This means that the Central Bank can act as lender of last resort because it can provide liquidity through fiat money to a critical mass of the foreign debt, and it does not need international reserves to do this. Hence, liquidity problems may be very much related to currencies that suffer from original sin. Interestingly, the country in Latin America with by far the lowest level of international reserves is Panama, the only dollarized country. Here it is interesting to note that the banking system does not fear periods of illiquidity in spite of the absence of a Central Bank. Its integration to the international system and the absence of original sin does away with the liquidity problem, even in a country that has a relatively low credit rating.

In this sense, the mechanisms of international last resort lending or a contagion facility can be viewed as another and superior way of addressing issues of liquidity since they involve not self-insurance, but actual insurance.

The question of how to implement financial standards and regulations in emerging countries is open to debate. Specifically, if recommended standards and regulations are not adopted by countries once advised to do so, how far should international organizations go in encouraging their implementation and enforcement? For example, it has been proposed that IMF and other IFIs include compliance with standards in their conditionality, in the pricing of their loans or as a factor relevant for eligibility in selective facilities (e.g., CCL). In the same vein, compliance could also be a factor in Basle weights or other international regulations. Given our degree of ignorance about the merits of different models of financial organization for development, e.g., the five Asian tigers suddenly became five basket cases and are now recovering strongly in the course of a few quarters, it pays to be cautious in the implementation of global guidelines. As argued by Rodrik (1999), there are too many development puzzles and too many different and unique roads to success to warrant the imposition of a globally standardized approach

Finally, there is the important issue of how to reform financial regulations in developed countries in order to prevent problems that may affect emerging markets. A case in point is international financial contagion, whose main transmission mechanism, if not root cause, resides in how financial intermediation to emerging markets operates. Two main problems have been identified in recent experience. The first is the likelihood that financial intermediaries become over-leveraged as a result of market losses and are forced to sell off their positions. The second is the dependency of emerging markets on a select group of specialist financial institutions, which makes the market for paper quite illiquid. These problems lead to fire-sale prices in times of trouble and the collapse of the market.

The main initiative on the table to address these concerns is the tightening of regulation to discourage high leverage, which would therefore make over-leverage less likely. We are concerned that, as in the case of other initiatives on the table, this one seeks financial stability by simply reducing capital flows to emerging markets, thus aggravating one of the important distortions to be fixed. In our view, it would be preferable to focus reforms in other directions. For example, regulatory forbearance to be activated in the case of a systemic shock like international financial contagion would help to diffuse the sudden jolt that over-leverage causes. In this sense, marking to market makes illiquid markets even more unstable when the asset price collapse is not based on fundamentals. Regulatory flexibility under these contingencies, in order to impede the cascading collapse, would be an effective circuit breaker under "peak" times, preferable to reducing flow levels on a permanent basis.

Much more promising would be a relaxation of the regulations that prohibit important institutional investor from buying non-investment grade paper. This may represent a radical change in the structure of emerging markets, which have become overly dependent on a small set of specialized investors. Allowing institutional investors to hold a very small fraction of their portfolio in non-investment grade emerging country paper (say 1 percent) instead of the current prohibition would have a negligible impact on

portfolio risk but would be very helpful in providing stability and liquidity to the market. It would also permit higher flows and reduce the collapse during contagion episodes.

Conclusion

Most current initiatives for reforming the international financial architecture are guided by two principles: a) constrain official financial support in order to avoid bailing out the private sector and creating moral hazard; and b) increase stability in financial markets by limiting capital flows to emerging markets. We find these principles unsatisfactory as a basis for a solution to the problems of international finance for development and propose alternative solutions. Even more, we fear that current initiatives may be developmentally counterproductive once their negative effects on the level of capital flows and growth are factored in.

Ours is a Latin American assessment of the initiatives, and therefore not a neutral viewpoint. In order to clarify the debate it is important to recognize that reforms to the international financial architecture have asymmetric effects for the parties involved. In particular, reforms that support deeper financial integration and faster growth in the region may also be more costly to industrial countries in terms of financial risks when disruptions occur. The above principles minimize the financial costs of international cooperation, which may reflect the fact that the efficient integration of emerging markets may be too costly for industrial countries.

We have argued in favor of new institutions to address liquidity and contagion problems. We have expressed support for the idea of an international bankruptcy court. We find value in improving financial regulation and supervision but think that the greater additional pay-off in Latin America is related to the improvement of institutions that solve commitment problems and manage liquidity risks.

We also find that many of the origins of liquidity crises and problems of financial fragility are caused by original sin, i.e., the fact that the national currency cannot be used to borrow abroad or even domestically to borrow long term. This creates the mismatches that can easily come home to roost at the first sign of trouble. It also limits the ability of central banks to backstop the market unless they hold enormous amounts of international reserves. This calls into question the monetary architecture of the world. Can a world of over 100 currencies achieve financial integration? This question is left for a companion paper (Hausmann, 1999).

Debate about the new financial architecture is spurred by dissatisfaction with the world as we find it. Financial turmoil is exacting enormous social costs in all emerging market countries. Contagion has made the problem more difficult and costly to address through the exercise of national virtue. It has transformed localized infections into an international disease that needs an international cure.

How much of current social suffering is attributable to an inadequate financial architecture is an open question. But it is clear that the costs of this inadequacy are borne

mostly by emerging countries, while any decisions on how to change international institutions and their financial backing inevitably involve the industrial countries. One is reminded of Ortega y Gasset's remark that the pain of others is so much easier to bear than one's own.

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