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Reforming the International Financial System

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Late in 2001 the new Deputy Managing Director of the International Monetary Fund (IMF), Anne Krueger, boldly suggested that under certain conditions international debt repayments by a sovereign borrower (= government) should be temporarily suspended while negotiations take place on restructuring its debt. Thus the IMF officially endorsed one of the more radical suggestions for improvements in the international financial architecture that have been made since the Mexican financial crisis of 1995 and the several Asian crises of 1997. This article provides analytical and historical background to evaluate this and other proposals for reform.

The problem addressed by the proposal is straight-forward. When any debtor develops economic difficulties, creditors worry about being repaid, and they move as quickly as they can to protect their positions, for example by declining to renew credits or roll over claims that have matured. They may even sell the claims before maturity, although for that of course they must find buyers. The difficulty several governments faced in rolling over maturing debt played an important role in several recent debt crises -- Mexico (1995), Russia (1998), Brazil (1998-99), and Argentina (2001-02). Even creditors that would be willing to roll over their claims at a satisfactory interest rate may hesitate to do so on grounds they will be alone, and thus caught in a payments crisis. When the ability of the borrower to continue to service the debt is doubtful, lenders become eager to exit quickly, to protect their principal.

This problem can arise for any debtor and its diverse creditors. We deal with it domestically through bankruptcy proceedings. A debtor in trouble can "file chapter 11" of the bankruptcy law, which legally suspends payments to all creditors (except the tax authorities). That suspension gives a breathing space for one of several things to happen. The debtor can re-organize its financial affairs to make resumption of debt service more likely. As part of re-organization it can borrow anew, e.g. for working

capital, with legal preference given to the new creditors. It can negotiate with its old creditors for an extension of maturity and even an easing of terms, interest or principal. All this is done within the United States under the protection and with the guidance of a court of law. Only if a business firm cannot restore value as a going concern are the debtor's assets liquidated with proceeds distributed to the creditors, again under the guidance of a court. Analogous processes exist in most countries, although Europe tends to be tougher on debtors than the United States.

One of the key features of domestic bankruptcy proceedings is that not every creditor needs to agree to the negotiated deal to be bound by it. If creditors carrying two-thirds of the claims agree to a settlement, all creditors are covered -- the so-called "cram down" provision. Concretely, a single small creditor cannot hold up a deal in an attempt to get better treatment.

No such procedure covers international claims on sovereign borrowers. So if a government runs into payments difficulty, each creditor may move to protect its interests, risking a rush to the door in times of difficulty, or even possible difficulty. The IMF proposal is designed to fill this gap, to provide the international analogue to national bankruptcy proceedings, as applied to governments. (International lending to corporations is of course covered by bankruptcy law in some country, usually the country where the securities were issued.)

Although this need has been recognized for some time, at least since the debt crises of the early 1980s, it was given a strong push by the case of Elliott Associates versus Peru. In early 1996 Elliott purchased, at a heavy market discount, loans to Peruvian banks guaranteed by the Peruvian government in 1983. The purchase was made while negotiation between Peru and its creditors was proceeding. In November 1996, by agreement with 180 creditors, Peru exchanged cash and Brady bonds (collateralized as to principal by US Treasury securities) for their claims. Elliott sued for full payment of principal and accrued interest. The claim was dismissed by a Federal court, but reinstated on appeal. To assure payment, Elliott in fall 2000 obtained restraining orders both in New York and in Brussels against coupon payments to Brady bond holders, i.e. to the creditors who had agreed to the debt

restructuring. To avoid a formal default, Peru settled with Elliott out of court by paying \$56 million, against Elliott's purchase price of \$11 million less than five years earlier.

This episode rewarded a hold-out at the expense of creditors who reached a negotiated settlement, and cast a legal fog around the whole issue of debt restructuring, at least with respect to private creditors. (Where only public creditors are involved, official debt restructuring is negotiated among governments in the "Paris Club." The same governments have needed to meet repeatedly over the past two decades, and each can expect an unduly tough stand in one negotiation to be reciprocated at subsequent negotiations in which it may have a greater stake in reaching a settlement.)

The analogical application of bankruptcy proceedings to governments is attractive. Like all analogies, it can be carried only so far. In bankruptcy, two business judgments must be made: what would be the value of the firm's physical assets on liquidation must be compared with the firm's prospects of ultimately paying more than that if, relieved of some debt, it is allowed to continue to operate.

Governments do not service debt out of operating earnings, but out of tax revenues, which face competing social claims. Thus political and ultimately ethical judgments must be made about the desirability of continuing to service the outstanding debt, not just the technical feasibility of doing so. That is a much more complicated and controversial judgment than those that must be made in normal bankruptcy proceedings.

The IMF probably has the best capacity to judge the near future fiscal and balance-of-payments prospects of a debtor country; and even, although it does not advertize the fact, to judge the technical competence and integrity of the sitting government to carry out its promises. But it is not especially well suited to make the ethical trade-offs between violating a contractual promise to pay creditors versus the social costs in terms of education, health care, or security of carrying out that promise. That judgment needs to be made by politically responsible officials. Here, the IMF could provide a forum for such discussion, although ministries of finance should receive inputs from other parts of government, as it

does in the United States.

So there is a rationale in principle for a legally sanctioned pause in debt servicing in the case of sovereign debt held by private parties, discouraging holdouts, and providing preferred new credits where appropriate. Several questions need to be asked about putting it into effect and making it really work: 1) What should be its coverage, in terms of a country's indebtedness? 2) To which countries should it apply? 3) Would the possibility of an enforced pause in servicing reduce international flows of capital, particularly to developing countries? 4) What steps need to be taken to put such an arrangement into place?

The obvious candidates for coverage are overseas holdings of a government's bonds and overseas bank credit to the government. These are the claims on which sovereign immunity from legal action is typically waived in the debt contract. But if a pause were limited to overseas creditors, foreign holders could arrange to sell maturing debt to residents and be repaid through correspondents. This is of course more difficult to control when the bonds in question are of domestic issue, rather than an international issue, but where foreign holdings of domestic bonds are extensive -- as was the case in Mexico, Russia, Brazil, and most recently Argentina. Foreign creditors moreover will not appreciate being held up while domestic creditors are repaid. Thus for both practical reasons and for reasons of parity in treatment domestic holdings of government bonds must also be subject to the pause. And if domestic banks rely heavily on government bonds as a source of their liquidity, suspending repayments of government securities may also require introducing restrictions on bank deposit withdrawals, unless suitable arrangements are made with the central bank to liquify them when necessary.

What about other domestic claims on the government, or a situation where foreign holdings of domestic issues are negligible but international credits are covered? Again, foreign creditors are not likely to agree to overt discrimination, except possibly in cases where the crisis is clearly external rather than budgetary in origin -- and even then only if residents are subject to effective controls on their ability to convert domestic into foreign currency. It would not be acceptable, in terms either of efficacy or of

equity, to halt payments to foreigners in the name of providing temporary relief and a pause for debt re-negotiation while allowing residents to be repaid and freely export the proceeds.

The point seems obvious, yet implementing it in today's world is highly problematic. Many countries have dismantled their controls on foreign exchange, or greatly reduced them to cover only financial institutions. And those that remain are highly pervious to a public determined to export capital - including purchases of foreign currency (e.g., greenbacks). Again, in recent crises none of the countries had really effective exchange controls, and Malaysia was widely criticized for tightening them in 1998.

What about country coverage? Everyone has in mind "emerging markets," which have acquired access to the international capital market through various channels. But this is a constantly changing category. Moreover, should it include the low-income members of the OECD, such as Mexico, or even of the EMU, such as Portugal? Should it include Italy, whose future fiscal outlook is by no means rosy? Or Germany, which recently threatened to break through the EMU's dreaded three percent budget deficit barrier? Or the United States, whose outstanding debt and foreign holdings of domestic debt exceed that of any other country? What would be the grounds for extending the provision to some members of the IMF but not to others?

The question naturally arises whether inclusion of an automatic roll-over provision in all or most government debt would deter the flow of capital to developing countries. It is worth noting that corporate debt has long been subject to bankruptcy proceedings in the United States and many other countries, and the corporate bond market both within the United States and the international market are robust; there may be some deterrence, but whatever its magnitude, it has not kept the corporate bond market from thriving.

Moreover, some deterrence to the flow of private capital to emerging markets would not necessarily be a bad thing. Research on the domestic benefits of foreign capital is surprisingly ambiguous, and in a world ridden with import protection and with taxes and hence incentives for tax

evasion the benefits are not even unambiguous on theoretical grounds. On balance, the evidence suggests a net contribution to per capita income in debtor countries, although the evidence is much stronger for foreign direct investment (involving importation of management skills, marketing know-how, and technology as well as funds) than it is for portfolio equity or interest-bearing debt. Indeed, if the economic losses associated with financial crises in the 1990s are attributed in large part to heavy foreign indebtedness, and to the withdrawal of foreign funds, the net effect of interest-bearing debt during the 1990s has probably been negative rather than positive. At least after the fact, it is clear that too much international borrowing and lending took place, and any device that introduced greater caution into such lending would be beneficial. But for reasons to be discussed below, it is a major error to attribute these financial crises primarily or even substantially to foreign capital, although the actual or feared withdrawal of foreign funds certainly deepened the crises after they had begun.

Assuming then that a roll-over provision would represent a net improvement in current institutional arrangements, how could it be brought about? One suggestion, which seems to be favored by the US Treasury, is that such temporary stand-still or roll-over clauses should be adopted voluntarily in debt contracts involving cross-border transactions, or at least those involving currencies other than those of the borrower. Debt contracts, whether bonds or loans, contain many conditions today, including, when the borrower is a national government, the waiver of sovereign immunity; it would be simple in principle to add a clause permitting temporary extension of the maturity of the debt, either at the initiative of the debtor or by the debtor with approval of some third party, such as the IMF. Any potential debtor eager to get access the capital market, however, would be reluctant to start the process, particularly since it could be done only for new debt, and would in this respect sub-ordinate new creditors to outstanding creditors. It would take many years before all outstanding debt contained such clauses, even if adoption on new debt were universal. But sufficient publicity on the advantages of such provisions, plus pressure by international financial institutions, might gradually bring it about; and the process could be accelerated if the major rich countries adopted the practice in their external debt,

or even in all their public debt.

A second possible route would be through legislation in the major creditor countries, plus in those countries where debtors had significant assets, such as aircraft or ships, that might be legally seized by a creditor -- a list that would of course vary from debtor to debtor. Such legislation would be designed to immunize debtors in distress from successful lawsuits, provided the agreed conditions were satisfied. Sales of claims on debtors in distress to residents of countries without such legislation would undoubtedly occur, but the courts in such countries would be rendered impotent to do anything effective.

A third possible route would be through by treaty, which to be effective would have to cover at least the countries in the preceding paragraph. One form of such treaty would be formal amendment of the Articles of Agreement of the International Monetary Fund, which would be an especially desirable route if the IMF were asked to play a key role in the process, for example by certifying the need for a standstill and that the debtor country had met the conditions for a settlement. This third route is the cleanest and most coherent, although the ratification process would necessarily take substantial time.

A government can run into serious debt problems because of exceptionally bad luck -- for example, an unforeseen sharp and durable drop in world demand for its principal export product, which may also be a major source of government revenue; or because of exceptionally short-sighted behavior in undertaking the borrowing. And of course the lenders are also taking a gamble, especially when the country is being short-sighted -- and they are usually paid for taking this gamble in the higher interest rates they receive. The possibility of default should in such cases not be a surprise, nor should they pretend that it is a surprise. The losers will be the people of the debtor country if the economy needs to be severely squeezed to enlarge the trade surplus to service the outstanding debt. Yet squeezing the economy often worsens the government's budget deficit, so it is caught in a double bind.

Other Financing Problems

A country may need some relief from debt servicing -- or at least the possibility of relief -- even when the debt burden is not unbearable in the long run. If a lot of debt is coming due in the near future, creditors may worry about the ability of the country to re-finance in the short run, and in the process make the refinancing impossible -- an example of a self-fulfilling prophesy, which is a common problem in the world of finance. Of course, borrowers would be well-advised not to get themselves into this situation in the first place, for example by borrowing at longer term. But sometimes bunched borrowing may be unavoidable, due to external events beyond the country's control. To avoid the often harsh consequences of a creditor panic, requiring a reduction in economic activity, the international community should be able, just as a central bank is within a national economy, to liquify the economy with foreign exchange in the short-run in order to persuade foreign creditors and potential creditors that they individually will not be left holding an unserviceable claim.

This issue arose in Mexico in January 1995, and in South Korea in January 1998. Large currency depreciations had occurred in the preceding month in both cases, making exports much more competitive and prospectively reducing the substantial trade deficits. But a large amount of short-term debt matured in the coming months -- government tesobonos in the case of Mexico, interbank loans in the case of Korea -- and creditors were individually reluctant to extend their credits, even though by that time the economic fundamentals of each country seemed to be satisfactory, or on the way to becoming satisfactory. The international community assembled a large official support package in each case, centered on an IMF program and loan but augmented by funds from other institutions and governments; and in the case of Korea pressed creditor banks into extending their maturing credits. In the end the efforts succeeded, but the economic costs were excessively high and in each case the effort was ad hoc and full of suspense over whether the requisite support could be assembled and whether it would work. And in both cases, large amounts of the assembled official funds had to be used to cover the privately held maturing debt, so creditor panic was partially neutralized rather than averted.

[It is noteworthy in both these cases that resident funds began to leave in volume before the

currency devaluations; withdrawals of foreign funds occurred mainly afterward, when there was still doubt whether the government or banks would be able to repay their obligations.]

As a result of these and other experiences, the IMF has taken two important steps to improve its ability to deal with such crises in future: it has streamlined its procedure, so that when necessary it can act much more quickly than was true heretofore, although its processes still take more time than may be available in an emerging financial crisis; and it has augmented the resources available to it for emergency lending through the New Arrangements to Borrow, which with the earlier General Arrangements enables the IMF to call on 25 countries for up to \$46 billion under appropriate conditions. The IMF was originally set up to lend into temporary imbalances in current account transactions. In the mid-1990s the IMF extended its purview to cover international capital transactions as well. Some recent problems, however, have been primarily or wholly budgetary rather than external in origin. This was especially true of Russia in 1998, but also of Brazil (1998) and Argentina (2001), although all three developed an international dimension. The governments could finance their deficits only on increasingly onerous terms. Rolling over the debt at ever higher interest rates aggravated the budgetary problem, and of course also enlarged the imbalance in external payments insofar as foreigners held government debt and declined to renew it.

The IMF lends to governments, so IMF loans provide temporary budgetary as well as balance of payments relief. But it is doubtful that the IMF should provide budgetary relief when there is no strong external dimension to the problem. To create the presumption that it will is likely to invite strategic behavior by governments to get relatively cheap sources of funds at medium-run maturity -- longer than they can usually get on their public debt under stressful conditions.

Thus there are three quite different circumstances calling for IMF support:

1) to help finance a temporary deficit in international payments arising, for example, from a cyclical fall in foreign demand for a country's exports, or to cover the period before a currency devaluation can improve the trade balance. This was the traditional purpose of the IMF.

2) to help avert a creditor panic, when much external debt matures in a short period of time, even when there is no long-term payments problem, to assure creditors that the country has enough liquidity to repay the debts -- in which case the ready availability of IMF support may make it unnecessary to use it, as bankers are always willing to lend to those whose credit is high.

3) to participate in the consolidation and perhaps reduction of external debt that has become too heavy for the government or country to carry indefinitely. Here the IMF provides funds to help persuade private creditors to accept some debt reduction in exchange for some cash up front, under conditions when the alternative of default is even less attractive.

The Krueger proposal, while not addressing IMF financing, concerns only the third of these circumstances. Normal IMF action and resources have been able to deal with the first, except when extensive capital flight by foreigners and residents alike impose requirements beyond the current account deficit. The IMF may or may not have enough resources, quickly enough, to deal with the second case; it has not yet been fairly tested.

Of course, the world of affairs rarely falls cleanly into each of these three categories. Elements of each may be present at the outset; and of course the first case may easily provoke the second, or even the prospect of the third.

The IMF's ability to deal with financial crises, and to forestall creditor panic, would be immeasurably increased if it had the capacity to provide sufficient resources to cover even the worst contingency; if it had such resources, the probability of the worst contingency would be greatly reduced. Such capacity could be provided by empowering the IMF to issue its own "currency," Special Drawing Rights (SDRs) in such emergencies. At present, the IMF can issue SDRs (by 85 percent vote of its Board) for the purpose of meeting the long-run needs of the world economy for additional international liquidity. SDRs have been issued only twice, in 1970-72 and 1979-81, in amounts worth about \$27 billion today, making up a paltry 1.4 percent of the world's international reserves. (A third, special allocation doubling the total was agreed in 1997, and awaits US ratification.)

The proposal here would add a different purpose, more pressing these days, for issuance of SDRs. The conditions for temporary issuance would have to be tightly drawn, and any SDRs actually issued would subsequently be withdrawn when the emergency had passed, just as the Federal Reserve first injected and then withdrew extensive credit following the collapse of LTCM in 1998. The classical conditions for action by a lender-of-last-resort to banks, laid down by Walter Bagehot in 1873, is that in emergency it should stand ready to lend without limit, at a penalty interest rate, against good collateral (as priced in normal times), and make this readiness known ahead of time. These actions are to assure adequate liquidity in a financial system, not to bail out insolvent banks, which requires a different course. But dealing with insolvent institutions is much easier in a favorable financial environment than in one seized up for lack of liquidity.

With the ability to use SDRs, the IMF could play a surrogate role of lender of last resort for international financial crises, something it cannot assure today because of potential shortage of funds. It could then concentrate on the conditions instead of having to worry also about creating a coalition of willing new lenders in each case. IMF conditionality provides a functional substitute for collateral, although the pledging of collateral by states, as was done by Mexico against the US Treasury loan of early 1995, should not be excluded.

Moral hazard can be reduced not only by stringent conditions, but also by a number of other measures, such as conditioning the terms of IMF lending on prior acceptance of internationally-agreed standards, the presence of stand-still clauses in international loan covenants, and a rate of interest that is above normal rates.

Empowering the IMF in this way would require an amendment to the IMF's Articles, but that would be a natural addition if the Articles are to be amended to provide for a stand-still in debt repayment with IMF involvement, as under the Krueger proposal.

On the Inevitability of Financial Crises

Financial crises seem to be an inevitable concomitant of economic development, a kind of adolescent growing pain. As countries evolve from low-income, agricultural economies to modern high-income economies a severe tension develops sooner or later between the real economy and the financial superstructure that is necessary to sustain it. A key feature of development is to socialize private savings, drawing them away from jewelry and other private stores of value into financial institutions so that the saving can be mobilized for productive investment. This is the social role of banks. A key problem with this desirable process is that bankers (or their backers) now have more money at their disposal than they ever dreamed of. All kinds of attractive projects become financially possible. Some bankers do not seem troubled by the fact that they are dealing with other people's money. They start to invest on a large scale, which may create a real boom, and an associated euphoria. Production, profits, employment, and capital gains all rise. Things are going so well that any initial caution is soon forgotten.

But unless productivity is rising synchronously, such booms have an element of a Ponzi scheme, unsustainable in the long run. Former Federal Reserve Chairman William McChesney Martin once famously said that the role of the central bank is to take away the punch bowl just as the party really gets going. But that requires a prudent, independent, non-partisan central bank with its eye on the long run -- something most developing countries quite deliberately do not have, at least until they have been through a few serious financial crises.

Every country experiencing a financial crisis in the 1990s had an unsustainable domestic situation, a mis-match between financial claims and the performance of the real economy. The details differed significantly. Sometimes private banks were involved, sometimes governments, often both. Several governments discovered the wonders of the financial market, domestic as well as international, wherein bonds can be floated to finance government expenditures without the need, in the short run, to impose unpopular taxes. Thus did Russia, Brazil, and Argentina all avoid difficult choices, for awhile.

Americans have no reason to be smug. The United States had almost one serious financial crisis a decade during its formative developmental period from the 1810s, culminating in the catastrophic

Great Depression of the 1930s. Even the lessons learned then and reflected in a host of regulatory legislation did not save the United States from the savings and loan crisis of the 1980s, brought on through legislation aimed to help important constituents of key congressmen. It was sometimes fashionable to blame these crisis on foreigners, and indeed there were occasionally international aspects; but they were overwhelmingly domestic in origin. Britain, France, and other European countries had similar experiences during the 19th century.

Could these crises, US or foreign, have been avoided? In logic, probably. But it would have required Platonic monetary guardians, detached, disinterested, far-sighted -- the antithesis of the modern politician -- to achieve it. In practice the capitalist system works by harnessing greed, not charitable inclination, to achieve economic progress. It has been smashingly successful during the past 200 years, especially the past 50 years, and its success is now spreading from Europe and America around the world. But the progress was not smooth, being punctuated by financial and economic crises which provoked improvements in institutional structure and legal incentives to channel the greed in socially constructive directions. It has been a process of trial and error, one that is on-going, for each new generation of financial wizards will try to find lucrative loopholes in the rules and structures put in place by the previous generation -- usually in response not to their foresight but to their own acknowledged mistakes and omissions.

The bottom line is that financial crises seem, empirically, to be an inevitable companion to the economic development of any country. Specifically, they are not the fault of the international economic system, nor does their presence signify serious defects in the international system, contrary to what has often been claimed in recent years. To be sure, the internationalization of financial markets enlarges the possible availability of funds, and increases the number of people who can be taken in by the current euphoria, to which supposedly hard-nosed western bankers and money managers are not immune. Thus foreign capital can affect the magnitude and detailed dynamic of financial crises. But history suggests the prime mover is domestic in origin, and in all recent crises resident funds were implicated in

precipitating the crisis.

As country after country has discovered, usually the hard way, a high level of disclosure of information is required for well-regulated and well-functioning financial markets. Yet full disclosure is anathema to commercial and financial practice in many societies. There must also be a clear hierarchy of financial responsibility and risk, ranging (in the United States) from shareholders with the most, through bond holders and other creditors, to depositors with the least. If something goes badly wrong, it must be clear who bears the costs. Yet governments in developing countries are often complicit in apparently private economic decisions, and politically-influential shareholders are reluctant to accept their losses -- indeed will struggle vigorously to avoid them. A financial system cannot function well so long as this is the case. Such struggles will not be eliminated simply by changing laws and regulations.

Deposit banks play a vital role in development. They are trusted institutions where financially unsophisticated citizens are willing to place their savings. This is a big social improvement over private savings held in the form of commodities such as gold bracelets, for they permit savings to be mobilized for development. To work, people must be confident that they can retrieve their savings when needed. That in turn requires either that the banks invest the savings carefully, on average, or that the state directly or indirectly guarantee the savings.

Banks in many developing countries have engaged in a massive violation of the trust that has been placed in them, by directing the savings into operating expenses of loss-making corporations, dubious "national champion" investments (some of which succeed, many of which do not), and real estate speculation or loans to politically well-connected individuals. Bank share-holders resist the implication that they should lose their stakes, and the struggle continues over who shall bear the losses that have already been incurred in financial crises. Until a clear and generally accepted hierarchy of responsibility is established, national financial systems will remain unreformed and will fail to achieve their social potential.

While the international system may not be responsible for financial crises, the foreign dimension,

having contributed to the preceding euphoria, may aggravate the crisis and increase its economic costs. Moreover, crises can spread from one country to another through a variety of channels, trade as well as financial. So maybe the international community can help to mitigate the damage. Every proposal for reform needs to be assessed with this possibility in mind, but also taking into account the possible harm it can do, either by significantly retarding the international flow of beneficial capital, or on the contrary by encouraging incautious lending on the assumption that any trouble will be covered by official international action.

The proposal for an internationally sanctioned stand-still on sovereign debt, if it could be cleanly and comprehensively implemented, would represent a modest improvement on existing arrangements. The proposal to empower the IMF to issue SDRs in a financial emergency, under stringent conditions, would represent a complementary modest improvement. Both would require amending the IMF Articles, no easy task. Neither proposal will banish financial crises.
