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The Architecture Exercise: What's Missing?

The architecture exercise is not over. Work continues at the IMF on the development of early warning indicators, ways of detecting risks residing in national balance sheets, and macroprudential indicators for the financial sector. The Fund has created a Capital Markets Consultative Group and an International Capital Markets Department, and it has begun to employ a more parsimonious approach to conditionality.[1] Furthermore, the Fund has continued to work on developing operational guidelines for private-sector involvement, something it was asked to do after the G-7 governments set out their own guidelines at the 2000 Okinawa Summit. At the 2001 Genoa Summit, moreover, the G-7 finance ministers discussed the roles of the multilateral development banks, and they are apt to receive close attention during the next phase of the architecture exercise.[2]

1. Henceforth, structural conditions will be included in Fund programs only when they are critical for achieving those programs' macroeconomic objectives. Those that are relevant though not critical *may* be included in Fund programs if they fall within the Fund's core areas of responsibility, but not as the subject of separate performance criteria or structural benchmarks; instead, they should be monitored as part of the overall assessment of a country's progress under its Fund program (IMF 2001c).

2. In his first public statements on the international financial institutions, Paul O'Neill, the US secretary of the treasury, urged the IMF to work harder at crisis prevention, but he paid more attention to the World Bank. Its scope, he declared, has been too diffuse. It should focus more sharply on the core objective of raising income per capita and on countries that lack capital-market access. He also endorsed a proposal made by the Meltzer Commission—substituting grants for loans that are unlikely to be repaid. ''If it is a grant,'' he said, ''we should call it a grant and not a loan'' (O'Neill 2001). The United States made that same proposal at the Genoa Summit in 2001, but it was not adopted.

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Old tasks, however, remain unfinished. There are now a great many standards and codes but very few carrots and sticks with which to foster compliance, and the official community is relying too heavily on market discipline. It is also unduly optimistic about the speed with which emerging-market countries can upgrade their financial systems. Hence, they should be strongly encouraged to adopt interim measures aimed at insulating their financial systems from the intrinsic volatility of international capital flows. There are principles, tools, and guidelines to foster private-sector involvement in crisis resolution, but they rely too heavily on the ability of crisis-stricken countries to elicit cooperation from the private sector—from domestic debtors as well as foreign creditors. Stronger and speedier methods are needed to cope with creditor panics, as well as debt-related problems such as those of Pakistan, Ukraine, and Ecuador, discussed in the previous chapter. There are, in short, some big pieces missing from the new international financial architecture.

This chapter starts with crisis prevention. What more can be done to encourage compliance with international standards and codes, so as to strengthen the financial systems of emerging-market countries? What might be done in the interim to reduce their vulnerability to fluctuations in capital flows? The chapter then turns to crisis resolution. What can be done to stem capital outflows from crisis-stricken countries and to manage debt problems more deftly without inviting the introduction of comprehensive capital controls or giving the IMF the quasi-judicial power to stay creditor litigation?

Promoting Compliance with Standards and Codes

Many carrots and sticks might be used to promote compliance with international standards and codes. In 1999, the Financial Stability Forum established a task force on the implementation of standards, which compiled a long list of strategies (FSF 2000a). A few examples follow.[3]

- Include specific financial-sector reforms in IMF conditionality with the aim of achieving compliance during the course of an IMF-supported program.
- Condition access to certain IMF facilities, such as the Supplemental Reserve Facility (SRF) and Contingent Credit Line (CCL), on a country's progress in complying with key standards, or impose more onerous terms, such as higher charges, on countries failing to make progress.

3. This list is my own; it draws on Kenen (2000b). The FSF task force made no mention of the first strategy, using conditionality, and it couched some of its other suggestions in more guarded terms. It also listed objections to each strategy.

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- Impose higher capital requirements on cross-border bank loans to countries that have not complied with the relevant standards, such as the Basel Core Principles.
- Refuse to grant entry to foreign banks that come from countries that have not complied with those standards, and supervise more intensively the existing affiliates of banks that come from those countries.

Some of these strategies could be adopted unilaterally by individual governments, although they would be more effective if they were adopted collectively. Others would require concerted action by the official community. Objections have been raised to all of them, however, and most have quietly been rejected or discarded.

The Retreat from Official Incentives

There are persuasive objections to the first strategy, using conditionality to foster financial-sector reform. The Fund adopted that approach during the Asian crisis, when Thailand, Indonesia, and Korea were made to include far-reaching financial-sector reforms in their Fund-supported programs. This strategy, however, has several serious defects discussed in chapter 4. It cannot be applied preemptively or uniformly; it does not work well for reforms that take much time to implement, such as the upgrading of bank supervision; and it was partly to blame for the overloading of conditionality in the 1990s.[4]

Other objections apply to the next strategy, using compliance with standards—or progress in achieving such compliance—to govern access to IMF credit or to set the terms of access to a particular IMF facility. It can be used rather easily to govern access to a single Fund facility, such as the CCL, but it would be hard to use comprehensively. It would be hard politically, because it could deprive a country of the financing vitally needed to cope with a serious crisis. And it would therefore be risky, because a country cut off completely from Fund credit might be tempted to adopt other, systemically harmful ways of combating a crisis. Hence, the threat to deny future financing might not be credible. It would be equally hard for the Fund to impose more onerous terms of access, such as higher charges, on countries that had not made adequate progress in

4. The Fund, however, should not forswear the use of conditionality if it adopts the contractual approach proposed in the next section of this chapter. A country that does not enter into a long-term contract with the Bank and Fund after being urged to do so should be warned to expect that it will be asked to undertake major financial-sector reforms whenever it seeks Fund financing—including financing under an ordinary standby arrangement.

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complying with key standards.[5] The Fund imposes different charges for drawings on different facilities, such as the Supplemental Reserve Facility (SRF), the Contingent Credit Line (CCL), and the Poverty Reduction and Growth Facility (PRGF), but has never, to my knowledge, imposed different charges on different countries that seek to draw on the same facility. Furthermore, the prospect of having to pay higher charges may not do much to foster compliance with the relevant standards: the immediate political cost of adopting reforms to stave off higher charges may be seen as exceeding the future financial cost of paying higher charges.

Introducing carrots and sticks into the Basel capital-adequacy framework looked to be a more promising strategy, and it was considered initially by the Basel Committee on Banking Supervision. Bank claims on a sovereign, it suggested, should not obtain a reduced risk weighting unless the borrowing country subscribes to the Special Data Dissemination Standard (SDDS); claims on a foreign bank should not obtain a reduced risk weighting unless the foreign bank's supervisor is implementing the Basel Committee's Core Principles (BCBS 1997); and claims on a foreign securities firm should not obtain a reduced risk weighting unless the foreign firm's supervisor is implementing IOSCO's Objectives and Principles of Securities Regulation (FSF 2000a). But in a subsequent paper, the Basel Committee abandoned this strategy. As judgments about compliance with standards will tend to be qualitative, it said, the committee did not wish to create a regime in which compliance would be assessed in a "mechanical fashion" (BCBS 2001). This concern is legitimate but not very persuasive. Supervisors of banks making cross-border loans will still have to make judgments about the risk characteristics of those loans, and their judgments may not be very different from those they would have made had they taken explicit account of the borrowing countries' compliance with the relevant standards. Furthermore, the IMF and other official bodies will still have to make judgments about compliance by individual countries. Excising compliance with standards from the capital-adequacy regime will deprive the official community of a powerful way to foster financial-sector reform.

The fourth strategy listed above is, therefore, the only survivor, a result confirmed when the Financial Stability Forum received a report from its follow-up group on the implementation of standards (FSF 2000b). The report stated clearly that official incentives are needed, because market discipline not may be sufficient. Many market participants do not currently take account of a country's adherence to standards when making risk assessments; weak domestic financial systems can impose negative externalities on the international financial system; and markets, focused on end results, may fail to recognize progress in the implementation of

5. This was the strategy recommended by the CFR Task Force (1999).

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standards. Furthermore, it would be inconsistent for the official sector to ask that the private sector take account of implementation without also doing so in its own decisions. But in its recommendations, the follow-up group confined itself to the fourth strategy:

> National authorities should be encouraged to give greater consideration to a foreign jurisdiction's observance of relevant standards as one of the factors in making market access decisions.
>
> National authorities should give greater consideration to a foreign jurisdiction's observance of relevant standards as one of the factors in supervision and regulation of (a) subsidiaries or branches of foreign institutions from that jurisdiction; or (b) domestic institutions dealing with counterparties in that jurisdiction. (FSF 2000b, 13-14)

It said nothing whatsoever about the use of carrots and sticks by the international financial institutions.

We are thus left with market discipline, which is not very well suited to the purpose at hand. The reason was mentioned in both of the FSF reports (2000a, 2000b): insofar as market participants pay any attention to the quality of prudential supervision in a counterparty's country, they are concerned with the absolute quality of that supervision. They do not—and should not—care very much about a country's progress.[6] This difficulty is compounded by another. Most of the relevant standards aim at defining "best practice" rather than minimally acceptable practice,[7] and those who drafted the standards defined best practice by contemplating the sophisticated financial systems of the industrial countries. That is why developing countries insist that compliance must be voluntary and why they insist on being assessed in terms of their progress, not their absolute compliance. Some of them also worry about the goodness of fit between their own institutions and practices and those of the developed countries—and some are deeply suspicious of the entire exercise, seeing it as an insidious attempt to replace their indigenous institutions with those of the developed countries, thereby paving the way for foreign dominance of their financial systems.

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6. In the same vein, the IMF and World Bank (2001) noted that market participants would like to have simple quantified ratings rather than nuanced assessments.

7. The codes concerned with transparency constitute an exception. The requirements of the SDDS are defined operationally, not as goals that governments must strive everlastingly to reach, and the codes concerned with transparency in fiscal, monetary, and financial policies define "good" practices rather than best practice. Goldstein (2001) seems to regard all of the key standards as minimum requirements, but most others describe them explicitly as statements about best practice; see, e.g., Eichengreen (1999b), Evans (2000), Folkerts-Landau and Lindgren (1998), and White (1999). It should nonetheless be noted that the Basel Committee has issued a manual for use in assessing compliance with the Core Principles, in which it distinguishes between essential criteria and additional desirable criteria, and similar efforts are being made by other standard-setting bodies (Evans 2000).

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Even those countries that are not hostile to the whole exercise frequently express concerns about institutional incongruities—whether international standards can be applied to their indigenous institutions and whether those institutions can be reformed without disrupting practices that have served them rather well. Andrew Crockett (2000) acknowledges that international standards must be designed for adoption by countries with widely different histories and institutional structures (see also Köhler 2000). Barry Eichengreen (1999b, 27) makes the same point bluntly: ''Given how economic, social, and political circumstances differ across countries, there should be a strong presumption that the same arrangements are not suitable for all of them.'' Furthermore, he notes, the international financial institutions do not possess the expertise and personnel required to give each country detailed advice in all of the relevant areas, even if that were desirable.[8]

A Contractual Approach

These legitimate concerns must not be allowed stand in the way of reform. No emerging-market country should be expected to import the laws, regulations, and modes of corporate governance used in the industrial countries. There are, after all, significant differences among the industrial countries' regimes. Yet emerging-market countries must acknowledge the need for some international standardization. Governments, financial institutions, and corporations that seek to participate in international capital markets must adopt the rules, conventions, and practices commonly used by those markets. In the last few years, moreover, the international financial institutions have been acquiring the expertise required to make them useful partners in the design and implementation of financial-sector reform.

What form should that partnership take? There may be a need for a new regime to foster financial-sector reform—one that can meet three requirements. The regime must allow for the fact that financial-sector reform is a time-consuming process; it involves the recruitment and training of bankers, traders, accountants, lawyers, and regulators, not merely the making of laws and regulations. The regime must also allow for the fact that many reforms are bound to elicit strong political opposition and must therefore be homegrown. They should be designed not by the IMF or an ad hoc team of foreign advisers who arrive with their minds and baggage full of standard blueprints, but by those most familiar with the domestic environment—political, juridical, and institutional. They should

8. The IMF and World Bank (2001) cite these concerns in their report on the implementation of standards. Thus far, however, they have found that ROSCs ''appropriately allow for consideration of cross-country differences in stages of development and administrative capacity, as well as different cultural and legal traditions'' (2001, 13).

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be disseminated and debated before they take final form. Otherwise, they are bound to engender objections from those directly affected by them and could eventually fall victim to the law of unintended consequences. Finally, enforceable deadlines are needed, along with carrots and sticks, which is why the international financial institutions have an important role to play.

These requirements might be met by a new regime based on formal contracts between a government, on the one hand, and the IMF and World Bank, on the other. Each contract would describe in detail the financial-sector reforms that the government pledges to complete during the life of the contract (which might typically last five to seven years). The preparation of the contract would involve four steps: (1) A list of needs would be defined by the Financial Sector Assessment Program (FSAP). (2) The reforms themselves would be designed by a group of experts chosen by the government, who would include civil servants, private-sector participants, and advisers from other countries—emerging-market as well as developed. (3) After being approved by the country's government, the experts' proposals would be published, debated, and revised before being submitted formally to the Fund and Bank. (4) The proposals would be translated into contractual obligations, with a deadline for each step in the reform process—adopting the necessary legislation, introducing the relevant regulations, and, when appropriate, establishing and staffing the new institutions required for implementation. The Fund and Bank would then monitor the country's progress, year by year, over the life of the contract.

What might a government gain from entering into this sort of contract? First, the reforms could be designed and adapted carefully to the country's needs and institutional setting—something that cannot readily be done under crisis conditions. Having made such a contract, moreover, the country would be protected against an abrupt demand for financial-sector reform should a future crisis erupt. Suppose that a country having a financial-sector contract sought to draw on the Fund during the life of the contract. It might have to modify its macroeconomic policies but would not be told to undertake further financial-sector reform, except insofar as required to cope with its immediate problem. By slimming the scope of conditionality, moreover, the contract by its very existence would reduce the time required to reach agreement with the Fund and would thus grant faster access to IMF financing. Finally, a country with a financial-sector contract, or one that had been told that it did not need one, could be promised easier access to the IMF, with more funding or front-loading, if it was meeting its obligations.[9]

9. Knight, Schembri, and Powell (2000) make a similar suggestion.

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The provisions of a long-term contract would also give operational meaning to the notion of progress in the implementation of international standards. By publishing the terms of a country's contract and assessing its subsequent adherence to that contract, the Bank and Fund could convey to market participants information they could not easily extract from the snapshot provided by a Report on the Observance of Standards and Codes (ROSC) or from an Article IV report updating developments after a ROSC. A country's progress would be measured against its contractual obligations, not against the abstract goals set out in the various standards and codes. Once it had met its contractual obligations, moreover, the country itself and its private-sector borrowers would move automatically into a safer risk class.

Interim Measures

One financial-sector contract might suffice to put in place the set of reforms most urgently needed in a particular country. Other countries might have to make two or three such contracts in order to complete the many reforms required to strengthen their financial systems. In the meantime, however, countries having serious financial-sector problems should be strongly encouraged to adopt interim measures aimed at reducing their vulnerability to financial crises. In fact, a country's contract with the Bank and Fund might commit it to adopt one or more of the measures listed by the Working Group on Capital Flows set up by the Financial Stability Forum (FSF 2000c).

The working group introduced the subject with this general observation: "Especially when the supervisory regime is not adequate, or supervisory resources are scarce, national authorities might consider a set of more explicit recommendations dealing notably with liquidity and foreign exchange exposures" (FSF 2000c, 32). It then listed several measures: imposing limits on banks' open foreign currency positions, reducing reserve or liquidity requirements on long-term foreign currency debt relative to those on short-term debt, imposing special reserve requirements on foreign currency funding, and requiring banks to hedge their foreign currency exposures and to insist their borrowers also do so as a condition for obtaining loans.[10] The working group went on to note that

10. The need to ensure that borrowers cover their own foreign currency exposures was obviously meant to rule out the imprudent practice of many Asian banks in the 1990s. They hedged their foreign currency exposures by making foreign currency loans to domestic firms that had no foreign currency revenues or claims. It may indeed be wise to insist that banks hedge their foreign currency exposures by making forward contracts with foreign banks or domestic counterparties approved by the central bank, rather than trying to hedge them by making foreign currency loans. Similar restrictions could be imposed on the use of complex derivative instruments that can likewise be employed to offset or incur foreign currency exposure; see the discussion in Garber (1996) and Garber and Lall (1998).

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> such explicit regulations can be only a partial and transitory substitute for adequate banking supervision. Regulatory requirements generally are less effective when banks are utilizing sophisticated risk management systems for foreign currency exposure. . . . However, such measures may be effective when banks are using less sophisticated risk management systems. They have the advantage that they can be implemented quickly by bank supervisors with resource limitations. (FSF 2000c, 32)

Other official bodies have made similar statements, including the finance ministers of the G-7 countries in their report to the Köln Summit:

> The use of controls on capital inflows may be justified for a transitional period as countries strengthen the institutional and regulatory environment in their domestic financial systems. Where financial sectors and supervisory regimes are weak, safeguards may be appropriate to limit foreign currency exposure of the banking system. (Group of 7 1999b, para. 30e)

Many others recommend safeguards of this sort.[11] Even the IMF, which had wanted its members to move to capital account convertibility, has come around to endorsing their use as a way to ''moderate the pace of short-term inflows'' (Fischer 1999, F564).

What do we know about the effectiveness of these interim measures? Several countries have used taxes or tax-equivalent measures to limit capital inflows, including Brazil, Chile, Colombia, and Malaysia, and the Chilean experience has been widely studied.[12]

In 1991, Chile imposed a reserve requirement on foreign borrowing. A sum equal to 20 percent of the amount borrowed had to be deposited with the central bank, where it would earn no interest, and it had to be held there for a minimum of 90 days and a maximum of one year. In 1992, the reserve requirement was raised to 30 percent and extended to one year regardless of the initial maturity of the external credit; and the regime was later broadened to outflank circumvention. It was made to cover all forms of foreign financial investment in Chile, including foreign purchases of Chilean equities.[13] Five questions have been asked about the Chilean regime: Did it confer more autonomy on Chilean monetary policy?

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11. See, e.g., Blinder (1999), Caprio and Honohan (1999), Feldstein (1999), Goldstein and Calvo (1996), Lamfalussy (2000), CFR Task Force (1999), and IIF (2001). But see Eichengreen et al. (1998a), who warn that interim measures targeted at banks cannot adequately substitute for prudential supervision, even temporarily. Such measures cannot prevent other forms of imprudent behavior by banks or protect the banks from imprudent behavior by others. Their point is well taken, although they carry it too far.

12. On the Colombian and Brazilian cases, see Agosin and Ffrench-Davis (1995); on the Malaysian case, see Rodrik and Velasco (1999).

13. Agosin and Ffrench-Davis (1997) describe the evolution and principal features of the Chilean regime. The 30 percent reserve requirement was suspended in 1998, but the regime was not dismantled until 2001.

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Did it insulate Chile from other countries' crises? Did it reduce the volume of capital inflows? Did it reduce the volume of short-term inflows relative to long-term inflows? And could it be readily emulated by other countries?

Sebastian Edwards (2000) concludes that the Chilean regime did confer more autonomy on domestic monetary policy, but that the effect was small and transitory. He also finds, however, that it did not protect Chile from other countries' crises. The tequila effect of 1995 did not hit Chile nearly as hard as it hit Argentina, but Chile was strongly affected by the Asian crisis (Edwards 1998, 1999a). Few studies find that the regime had any significant impact on the overall volume of capital inflows,[14] but most find that it shifted the composition of inflows in the desired direction: short-term inflows fell relative to long-term inflows.[15]

The Chilean regime was leaky, as everyone agrees.[16] And other, larger countries would find it harder to monitor capital inflows and minimize evasion. But it is not especially hard to monitor bank borrowing and thus use tax-equivalent measures to hold down the banks' foreign debts pending the further development of prudential supervision. Eichengreen (1999b) and Guillermo Calvo and Carmen Reinhart (2000c) warn that attempts to reduce bank-related inflows would probably lead to larger amounts of short-term corporate borrowing. That would not matter much, however, if the attempt to reduce bank-related inflows was meant to diminish the vulnerability of the banking system, not to reduce short-term borrowing per se.[17]

Martin Wolf ("Caging the Bankers," *Financial Times*, 20 January 1998) sums it up succinctly. There is, he says, an overwhelming case for the regulation of foreign currency borrowing by commercial banks:

> Prudential control over short-term foreign currency borrowing by institutions underpinned by the state is inescapable. The [Asian] crisis shows, once again, that banks fall into this category—that they are part of the public sector. Unregu-

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14. But see Reinhart and Smith (1998), who find that it did reduce total inflows.

15. See Edwards (2000) and the studies cited there. Edwards notes that the effect on short-term inflows shows up most clearly when inflows are classified by original maturity rather than remaining maturity. But that is what one would expect; long-term inflows are reclassified automatically as short-term inflows when they approach maturity, and this reclassification necessarily raises the share of short-term inflows among the total. Edwards argues that remaining maturities are more relevant than original maturities for assessing vulnerability. Original maturities are more relevant, however, for assessing the effectiveness of the regime.

16. Garber (1998) notes, however, that the Chilean regime withstood efforts to evade it via financial engineering.

17. Eichengreen (1999b) also warns that corporations might be induced to engage in arbitrage by taking on external debt and depositing the foreign currency proceeds with domestic banks. That would not be problematic, however, if a reserve requirement or outright tax were levied on the banks' short-term foreign currency debt, including foreign currency deposits owed to domestic entities.

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> lated flows of short-term international capital are a license to rack up losses at the expense of taxpayers. If banks are not to be reformed, they must be more securely caged.

Banks, of course, must be reformed. That is the principal aim of the effort to strengthen prudential supervision in emerging-market countries by fostering compliance with the Basel Core Principles. Until that is achieved, however, the banks *should* be caged. Asian banks have reduced their dependence on foreign currency funding, but other countries' banks have not, and a contraction of interbank lending played a prominent role in the recent Turkish crisis.

Short Notes on Other Shortcuts

Before we turn from crisis prevention to crisis resolution, two more questions need attention. Can emerging-market countries strengthen their financial systems by admitting foreign banks? And what can we learn from Malaysia's attempt to cope with the Asian crisis by restricting capital outflows rather than trying preemptively to regulate capital inflows?

Those who answer ''yes'' to the first question adduce several arguments. Foreign banks, they say, will diversify the asset base of a country's banking system, reducing its vulnerability to domestic shocks. They will provide and impart scarce managerial skills, which will enhance the quality of bank lending, as well as loan-loss provisioning and overall risk management. Finally, foreign banks can count on financial support from their parent banks, including foreign currency credit that is not available locally when it is urgently needed.[18] Others warn, however, that competition from strong foreign banks may threaten the survival of domestic banks and may therefore induce them to ''gamble for redemption.''[19]

Unfortunately, participants in this debate rarely distinguish between two strategies—letting foreign banks set up local affiliates, and letting foreign banks buy into domestic banks.[20] The two strategies have different consequences for a country's banking system and for its domestic banks.

The entry of foreign banks as separate entities, competing with domestic banks, can strengthen a country's banking system, taken as a whole, but it may not do much to strengthen the domestic banks themselves. Foreign banks will impart much-needed skills to their local employees, who will, in turn, transfer them to domestic banks whenever they change jobs.

18. For these and other arguments favoring foreign bank entry, see Calomiris (1998a), Caprio and Honohan (1999, 2001), Eichengreen (1999b), Fischer (1999), and Meltzer (1999).

19. See Chang and Velasco (1999) and Williamson (2000a); Eichengreen (1999b) also mentions this possibility.

20. See, however, Calomiris (1998a), who focuses explicitly on the second strategy.

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Foreign banks will diversify the asset base of a country's banking system but may not have any first-order effect on the asset base of the domestic banks. Foreign banks may be able to borrow from their parent banks, but that will not be helpful to domestic banks. Finally, foreign banks may tend to concentrate on wholesale banking, which will not raise the quality of the banking services available to firms and households. There are thus reasons to question the efficacy of this first strategy.

The case for the second strategy is stronger. When a foreign bank acquires a domestic bank, totally or partially, it strengthens that bank directly. It may not diversify the asset base of the domestic bank, but it will indirectly add that asset base into its own asset base, by pooling its global gains and losses. It will also want to upgrade the staff and internal controls of the domestic bank. If foreign banks acquire the strongest domestic banks, other domestic banks may be more strongly tempted to gamble for redemption. Therefore, this strategy is not a substitute for tight prudential supervision; the two must go together. But it may be a powerful way to strengthen a country's banking system.

What about capital-outflow controls? Economists never tire of saying that controls on capital outflows are more costly and less effective than controls on capital inflows. They are more costly, it is said, because they discourage capital inflows as well as capital outflows, and because they are harder to enforce. A foreign investor is free to choose among many destinations and can readily bypass a country that uses capital-import controls rather than trying to evade them. Residents and foreigners confined to a single country by capital-outflow controls will try very hard to evade them whenever they come to distrust the country's prospects or policies. For that same reason, moreover, capital-outflow controls tend to spawn corruption. Finally, capital-outflow controls have often been used to delay the making of policy changes that are inevitable and become more painful when they are deferred. Imbalances build up until they are rectified. They rarely go away.[21]

When, therefore, Malaysia imposed controls on capital outflows in September 1998, it was roundly criticized. It was told that it should take the same unpleasant medicine that Thailand, Korea, and others were taking and that it would be unable to borrow on international capital markets and thus would suffer grave damage.[22] But Malaysia fared rather well after imposing controls: interest rates fell, output rose, and Malaysia built up its reserves while pegging the ringgit firmly to the dollar. In fact, the Malaysian economy recovered in much the same way as the Thai

21. For a concise survey of supporting evidence, see, e.g., Edwards (1999a).

22. See the comments collected in Kaplan and Rodrik (2001).

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economy, though more slowly than the Korean economy.[23] And Malaysia was able to borrow again in 1999, when it floated a $1 billion bond issue at a 330 basis-point premium (Kaplan and Rodrik 2001).

There are two interpretations of this seemingly odd result. Edwards (1999a) concludes that Malaysia's controls did not do much harm—but did not do much good, either. Others say that the controls were redundant because the pressure on the ringgit had subsided before they were imposed (see, e.g., Dornbusch 2001; Mussa et al. 2000). But Ethan Kaplan and Dani Rodrik disagree:

> Far from being out of the woods, the Malaysian economy in late August 1998 was still mired in a financial quagmire. Whether this was partly its own doing is irrelevant from our current perspective. The crucial point is that Malaysia's policy framework in September 1998 looked as fragile as Thailand's had been in July 1997 or Korea's in November 1997. (Kaplan and Rodrik 2001, 21)

The ringgit, they say, was under great pressure, and the foreign financial press was predicting that Malaysia would have to seek help from the IMF.

Therefore, Kaplan and Rodrik conduct a "time-shifted" comparison in which they contrast Malaysia's performance in 1998-99, after it imposed capital controls, pegged its exchange rate, and reduced its interest rates, with the performance of the Thai and Korean economies in 1997-98, when they were swallowing the medicine prescribed by the IMF. This is their main conclusion:

> Previous comparisons have asked how Malaysia did relative to Korea or Thailand after September 1998. We have asked instead how Malaysia did compared to Korea or Thailand when the latter were undergoing their IMF programs (while making allowance for changes in the external environment). We have shown that the first approach yields answers that on balance make the capital controls look bad. The second approach yields answers that make the controls look very good. (Kaplan and Rodrik 2001, 32)

Which approach is right? Kaplan and Rodrik invite the reader to decide—and that is not easy. One paper on one episode is rarely decisive. Kaplan and Rodrik rightly note that Malaysia's situation was more precarious in September 1998 than others have inferred from the behavior of the ringgit during the previous months—and it would become more precarious in the ensuing months, after Prime Minister Mahathir dismissed his deputy, Anwar Ibrahim. But one must also point out that Malaysia's banking system was somewhat less fragile than those of Thailand and Korea, which helps explain why Malaysia was not hit as hard at the beginning of the Asian crisis.

23. See Edison and Reinhart (2000), who also find that Malaysia's capital controls were more effective than those used by Thailand in early 1997 before the acute phase of its currency crisis.

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Finally, consider another time-shifted comparison. What would have happened to Malaysia in 1997-98 if, at the start of the Asian crisis, foreign investors had expected that Malaysia would impose capital-outflow controls? The anticipation might have done great damage. That indeed is the strongest reason for taking the conventional view. Whatever one's judgment about the outcome of the Malaysian episode, it would be wrong to conclude that capital-outflow controls are a first-best remedy for a currency crisis.

Rethinking Private-Sector Involvement

We come now to the biggest bit of unfinished architecture—finding viable ways to involve the private sector in the resolution of debt-related crises. In his recent paper on the architecture exercise, Morris Goldstein (2001) quotes statements by G-7 and IMF officials in which they praise the progress made in fostering private-sector involvement.[24] But others are less comfortable. Mervyn King (1999) says that "much remains obscure," and an IMF report concedes that "the international community does not have at its disposal the full range of tools that would be needed to ensure a reasonably orderly—and timely—involvement of the private sector" (IMF 2000d, 12). The critics, however, are too polite. The current approach is deeply flawed, because it relies much too heavily on voluntary cooperation by the private sector.

The Limits to Voluntary Cooperation

The premium placed on voluntary cooperation leads to undue delay, forcing crisis-stricken countries to adopt excessively harsh policies in order to restore investor confidence and, in too many cases, forcing the official community to provide large-scale financing. It also forces debtor countries to offer exceedingly generous settlements that sow the seeds of future crises. Such settlements threaten the debtor countries with unstable debt dynamics, and they reward imprudent lenders, who should be made to understand that a country unable to service its debt on the original terms cannot be expected to service its debt on more onerous terms.

The private sector has warned repeatedly that any departure from the voluntary approach will undermine the discipline that sustains international lending—the so-called bonding role of debt. If the official commu-

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24. See also Köhler (2000), Geithner (2000), and the survey by Roubini (2000), who describes the Köln framework as a set of "clear principles and tools" for striking the right balance between the private sector's need for guidelines and the official sector's need for flexibility in addressing specific cases. But Roubini admits that there is still a need to clarify the terms of the trade-off between official financing and reliance on voluntary private-sector involvement.

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nity adopts a coercive approach, debtors will find it too easy to default. Thus, Gerald Corrigan (2000) warns that the use of involuntary standstills, especially officially sanctioned, would pose a clear and present danger to the ''culture of credit'' in international capital markets, and an IIF working group has similarly cautioned against any form of official pressure or coercion:

> Some of the public discussion of crisis resolution has stressed the need to ''bind'' creditors into support programs. Any shift toward involuntary mechanisms for private sector participation, however, would tend to defeat a key purpose of the 1990s approach, namely the emphasis on prompt restoration of market access. The most tangible binding mechanism is IMF ''lending into arrears.'' . . . The September 1998 decision by the IMF Executive Board to widen the 1989 policy permitting such lending, to encompass bonds and other nonbank credits, seems counterproductive, especially at a time of retrenchment in capital flows to emerging markets. (IIF 1999)

The IIF has also objected obliquely to the imposition of a reserve floor to keep a debtor country from using reserves or IMF credit to repay private creditors (one of the ''tools'' listed in the Köln framework), because ''meeting financial obligations is a legitimate and essential use of reserves and balance-of-payments financing.'' (IIF 2001, 6)[25]

Yet these objections elide two issues: the effects of coercion on the balance of bargaining power between debtor countries and their private creditors and thus on the terms of debt restructurings, and the effects of coercion on the ability of debtor countries to shirk their contractual obligations without being punished. The two overlap to some extent. The terms of a restructuring enter into the cost paid by the debtor when it refuses to honor its contractual obligations. But the analytical literature on the bonding role of debt looks in a different direction by stressing two other forms of punishment.

The first form of punishment is emphasized by Michael Dooley (2000a). It is the immediate adverse effect of a protracted negotiation between a debtor country and its foreign creditors. By disrupting financial intermediation in the debtor country, a protracted negotiation impairs the productivity of the capital stock and leads to a larger output loss, and it is the size of the output loss that deters a debtor from defaulting. On this view, which goes back to Jeremy Bulow and Kenneth Rogoff (1989), an effort to coordinate creditor behavior can be counterproductive. By shortening the time it takes to reach agreement on a debt restructuring, it reduces the amount of domestic disruption, diminishes the output loss, and thus makes it less costly for a debtor to default.

25. William Rhodes (''Don't Press-Gang the Private Sector,'' *Financial Times,* 13 October 1999) expresses concern about two other ''troublesome'' proposals: the mandatory inclusion of collective action clauses in debt contracts, and the amendment of Article VIII.2(b) of the Fund's Articles of Agreement to make the enforcement of loan contracts subject to the foreign exchange regulations of the debtor country—a matter to which we will return later.

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The second form of punishment is emphasized by William Cline (2000b). It is the effect of a default on the debtor's reputation and its ability to borrow again. If it can no longer borrow, it cannot engage in consumption smoothing on behalf of its citizens.[26] On this view, which goes back to Jonathan Eaton and Mark Gersovitz (1981), the welfare loss resulting from more volatile consumption is the main deterrent to default.[27] This reputational argument is more plausible than the one advanced by Dooley, and it may help explain why emerging-market countries have agreed to expensive debt exchanges. A government that defaults today on its maturing debt is apt to have trouble tomorrow rolling over the rest of its debt, may have to default again, and will then suffer additional damage to its reputation. But access to new borrowing for consumption smoothing is not the only reason for wanting to preserve a reputation for repaying debt on time—access to new borrowing for investment may be a more important motive.

If reputational considerations are paramount, however, then the concerns of the private sector are overblown. Coercive behavior by the official sector may lead to debt restructurings that are less attractive from the creditors' standpoint, and they cannot be blamed for objecting to that prospect. But coercion today in respect of debt restructuring cannot be deemed to imply coercion tomorrow in respect of new private-sector lending. Lenders can still refuse to lend if they see fit to punish a debtor for a ''strategic'' default or for mismanaging its economic policies in ways that impair its ability to repay its debts.[28]

The undue emphasis on voluntary cooperation is compounded by another, more serious defect of the official approach to private-sector involvement. It emerged most clearly in a statement by the G-7 finance ministers and central bank governors issued in September 1999, between the Köln and Okinawa Summits:

> When a country's underlying capacity to pay is strong and prospects for the spontaneous restoration of market access on viable terms are good, the combination of official financing and policy adjustment should allow the country to regain full market access with voluntary approaches. In other cases, the early restoration of full market access on terms consistent with medium term external sustainability

26. Eichengreen (1999b) also emphasizes the ''collateral damage'' to a debtor's reputation but does not explicitly invoke the consumption-smoothing argument.

27. Dooley (2000a) takes note of this argument but says (rather elliptically) that it seems very weak relative to the amount of debt actually observed.

28. The IIF working group quoted above makes this same point obliquely: ''The central issue is the borrowing government's assessment of the relative value of early return to private capital markets. The greater the weight placed on this objective, the more the government tends to understand the need for temporary high prices. The less the weight, the more borrowing governments tend to allow outcomes to slide toward reschedulings and restructurings'' (IIF 1999, 51).

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> may not be realistic, and the use of a broader spectrum of tools may be warranted to provide for an adequately financed program and a sustainable medium term payments profile. In these cases, responsibility lies with debtors and creditors to work cooperatively to find a solution to the country's debt problems within the context of an IMF program that addresses the country's immediate financing gap, provides an appropriate balance between official and private financing, . . . and is sustainable over the medium term. (Group of 7 1999a, Annex, para. 5)

In effect, voluntary approaches should always be used *except* in the case of a country with an unsustainable debt burden, where the ''broader spectrum of tools'' may be needed, including those that the G-7 countries are fond of describing euphemistically as ''concerted'' approaches. Horst Köhler used the same dichotomous formulation:

> There is broad agreement that the operational framework for private sector involvement should rely as much as possible on market-oriented solutions and on voluntary approaches. It is also undisputed that there may be exceptionally difficult cases that call for more concerted approaches to involve the private sector, *including the possibility of standstills as a truly last resort.* (Köhler 2000; emphasis added)

In a recent Fund document, however, we find an anomaly. It cites Korea, Pakistan, and Ukraine as examples of the concerted approach (IMF 2000d). Yet those are the very same cases that officials and others commonly cite as successful examples of the voluntary approach.

There was, of course, coercion in the case of Pakistan, which was told by the Paris Club that it had to seek comparable treatment from its private creditors, and there was likewise coercion in the case of Ukraine, which was prevented from using its reserves to redeem maturing debt. In both instances, however, coercion was applied to the debtor, not its private creditors. In the Korean case, by contrast, the country's commercial-bank creditors were subjected to strong pressure. They were told, in effect, to roll over their claims on Korean banks; otherwise, they would doom the whole effort to stave off a default—from which the banks themselves would suffer. Many terms have been used to describe this episode. Michael Mussa et al. (2000) say that the foreign banks undertook a ''voluntary'' rescheduling; Barry Eichengreen (2000b) speaks of ''moral suasion'' applied by the banks' regulators; Steven Radelet and Jeffrey Sachs (1998) assert that the rollover was ''enforced'' by the IMF as a condition for further disbursements of official funds. Those who classify it differently, however, tend nevertheless to agree that it was unique and cannot be readily replicated. They give four reasons.

First, the number of foreign banks was relatively small, and they dealt directly with the Korean government, not the Korean banks, because the government had guaranteed the debts of the Korean banks.[29] Second, the

29. For that same reason, moreover, the subsequent conversion of the foreign banks' claims into bonds had the effect of substituting sovereign debt for private debt, and this had the

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asymmetric liberalization of Korea's capital account regime had restricted corporate borrowing from foreign banks, so there was little risk that foreign banks would run down their claims on Korean firms when asked to roll over their claims on Korean banks. Third, Korea was deemed to be a systemically important country, and the official community had invested its reputation, as well as its money, in the attempt to resolve the Korean crisis; had that not been the case, the major industrial countries might have been more reluctant to put pressure on their banks. Finally, and most important for what lies ahead, the provision of large-scale official financing had allowed foreign banks to run down their claims on Korean banks. Those least willing to roll over their claims were able to exit totally; others were able to reduce their exposure to acceptable levels.[30]

There was a stabilization of interbank claims and trade credits during the Brazilian crisis. The Brazilian authorities were reluctant to request it. They were said to be concerned about causing other investors, foreign and domestic, to run down their holdings of Brazilian government debt (see Cline 2000b; IMF 2000c). But they were also worried about another possibility. Banks reluctant to agree to a freeze might run down their claims very fast, before the freeze could take effect (see IMF 1999e). In the end, however, Brazilian officials convened meetings with the banks, persuaded them to stabilize their interbank claims and trade credits, and helped them devise a reporting system to monitor compliance. In the Korean case, arm-twisting by the official sector had been used to achieve a stabilization of interbank credits; in the Brazilian case, peer pressure was used instead.

Clearly, the best way to prevent a huge and disruptive contraction of a country's short-term debt is to keep the debt from growing to levels as high as it did before the Asian crisis. That is why so much attention has been paid to strengthening prudential supervision and why other measures should be used in the interim to limit interbank borrowing. When creditor panics occur, however, it is manifestly imprudent to rely on voluntary or quasi-voluntary measures to contain them unless the official community is willing and able to throw much money at the problem. Stronger measures are required to halt the liquidation of short-term

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further effect of reducing to zero the risk weighting of the foreign banks' claims; under the existing version of the Basel capital-adequacy accord, banks did not hold any capital against claims on an OECD government (IMF 2000c). On the other unique features listed in the text, see Eichengreen (1999b, 2000a, 2000b) and IMF (1999e).

30. Eichengreen (2000a), Giannini (1999), and the IMF (2000d) all stress this point. Boorman and Allen (2000) wonder whether the Fund should have tried to achieve a concerted rollover at an earlier stage, not only in Korea but also in Thailand, and Roubini (2000) asks the same question. The IIF working group (IIF 1999) says that there should have been an earlier signal of the official community's interest in involving Korea's private creditors. But if a large run-down of claims had to occur before the foreign banks would agree to a rollover, stronger pressure might have been needed to obtain an earlier rollover.

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foreign currency claims and to halt it promptly. This brings us to the case for standstills.

Suspensions, Stays, and Standstills

Three sorts of debt-related problems can be addressed by a mandatory standstill—a brief suspension of debt payments combined with a stay of litigation. The first is the one just considered, in which a creditor panic threatens to cause a sharp depreciation of a country's currency—whether the currency was pegged or floating before the onset of the panic. The second is the case of a country that is temporarily unable to make all of its debt service payments—because a large lump of debt is about to mature and cannot be refinanced on sustainable terms, or because the country has suffered a temporary fall in its export earnings or rise in its import payments. The third is the case of a country that faces an unsustainable debt burden over the long run because of its own past errors or because of an adverse shock, such as a seemingly permanent worsening of its terms of trade.

In the first case, the country needs immediate cash-flow relief, as well as time to quell the panic by making the policy changes required to reassure panicky creditors or to let the panic subside by itself as creditors come to their senses. In the second case, official financing can resolve the problem and may be the best remedy, but if it is unavailable or inadequate, the country will have to reschedule its debt. In the third case, of course, the country must reduce its debt; there is no other way to deal with an unsustainable debt burden. In the first case, then, a standstill should suffice. In the second and third cases, it cannot suffice but can be helpful; it can buy time for the debtor country to convince its creditors that longer-lasting relief is required—debt rescheduling in the second case and debt reduction in the third.

This taxonomy is quite different from the one imbedded implicitly in the current official approach to private-sector involvement. It reverses the usual pairing of problems and solutions. A mandatory standstill may well be a first-best remedy for a creditor panic, but that is the case in which the current official approach recommends a combination of policy changes to restore investor confidence, modest amounts of official financing, and voluntary private-sector involvement. A standstill would be helpful in the second case as well, but it will not be necessary if official financing is forthcoming promptly. A standstill would be helpful in the third case, too, but it is not a substitute for outright debt reduction. The current official approach, however, pays little attention to the second case and recommends a concerted approach only in the third case.[31]

31. The G-22 working group on international financial crises touched obliquely on the second case when it discussed the coverage of a debt suspension. A suspension, it said,

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The weakness of the current official approach can be highlighted differently. In chapter 2, the Fund's Asian strategy was described as being precariously balanced, because its success in combating a creditor panic depended on the amount of financing supplied and the amount of adjustment required. Yet the converse was also true. The amounts of financing supplied and adjustment required depended on how successful the strategy was in combating creditor panic. In other words, the size of the ''financing gap'' was thoroughly endogenous. That is always true in crises of this sort, and there is a temptation to do what the Fund did. It put up large amounts of money in the hope of restoring confidence but doled out too little money to fill the whole financing gap, with the result that the gap grew larger.[32] In the other two cases considered above, the size of the financing gap is more easily measured, along with the size of the contribution that should come from the private sector via debt rescheduling or debt reduction. In those cases, however, the Fund should do more than measure the financing gap. It should also assess how any proposed agreement between a debtor country and its foreign creditors will affect the sustainability of the debtor's situation. It should not hesitate to warn that it will not provide further financing if the agreement is defective from that crucial standpoint.[33]

The Problems Posed by Standstills

If mandatory standstills are to be used more frequently, however, four difficult issues must be addressed. (1) Would they have the counterproductive effect of making investors flee faster? (2) Are comprehensive exchange controls required to enforce a standstill? (3) Who should impose a standstill—and how? (4) Can debtors be protected from litigation when they suspend debt payments?

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should cover only those types of debt that are contributing ''substantially'' to a country's payments problem (Group of 22 1998a).

32. Boorman and Allen (2000) also stress the endogeneity of the financing gap in the case of a creditor panic, while Miller and Zhang (2000) argue that standstills can relieve the IMF of the need to furnish large-scale financing to cope with a creditor panic. See also Williamson (2000b), who frames the issue starkly. A creditor who fears that debt restructuring is a possibility will want to exit immediately. Hence, limited official financing is an unsatisfactory remedy, as some will be able to exit but others will not. The official community must therefore choose between unlimited financing and a standstill, and the former is apt to create moral hazard if it is used routinely. When faced with a country beset by a creditor panic, Williamson says, the Fund should require the country to impose a standstill while it negotiates with the Fund for limited bridge financing. (Williamson's point echoes one made abstractly by Roubini 2000, that a full ''bailout'' is formally equivalent to a full ''bail-in''; see n. 36 of chapter 4, above.)

33. If the Fund is to take this strong stand, however, it should also convey to the private sector as early as possible its views about the nature of a country's problems and the role that the private sector should play in resolving those problems.

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The risk that standstills will serve merely to accelerate a rush for the exit and, perhaps, produce contagion is the most common objection to them.[34] Mervyn King (1999) suggests, by contrast, that once standstills are part of the furniture, they will cease to be viewed as ad hoc responses and may no longer have those effects; and others have argued that the threat—or promise—of a standstill can actually quell a creditor panic by convincing creditors that they don't have to beat the rest to the exit. But these arguments are not very persuasive. They assume implicitly that creditors know what will happen after a standstill expires and can therefore be absolutely sure that they will not have to provide longer-term relief in the form of debt rescheduling or outright debt reduction. Yet the objection itself is not really germane to the choice at issue. The choice is not between a standstill and prompt, large-scale official financing, but between a mandatory standstill and an attempt to organize a voluntary rollover. Experience to date suggests that a rollover cannot be achieved until reluctant creditors have already left or run down their claims to levels at which they are willing to roll them over. Hence, there is no way to know a priori which will provoke the larger reduction in the creditors' claims—the threat of a mandatory standstill or the rundown of claims that has to occur before creditors will agree to a voluntary rollover.[35]

Critics often argue that standstills cannot be enforced without exchange controls and that many countries can no longer use them because they have dismantled the apparatus required to enforce them (see, e.g., Geithner 2000; IMF 2000d; Roubini 2000). That is not necessarily so. The G-22 working group on international financial crises provides a response:

> A selective suspension, even if mandatory, may not require the use of comprehensive capital and exchange controls. A government can suspend its own debt payments, and it may be possible to suspend payments on some types of private sector debt, such as the foreign currency debts of banks, without imposing comprehensive capital controls. An announcement by the government without any binding enforcement mechanism may suffice to induce substantial compliance by most of the main private sector debtors. (Group of 22 1998a, 31)

The working group noted, however, that a selective suspension could give rise to fears that it will be widened or that comprehensive controls may be coming. Furthermore, one must concede that a suspension of

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34. See, e.g., Fischer (1999), Geithner (2000), and Lipton (2000). An IMF paper on private-sector involvement goes so far as to call this the test by which all such proposals must be judged (IMF 1999e). Roubini (2000) asserts that the run-down of interbank claims on Brazil in the second half of 1998 was triggered in part by the Korean episode and the fear that a similar ''coercive'' solution might be adopted in the Brazilian case. See also IMF (2000d), which lists several reasons for fearing that a standstill is apt to exacerbate contagion.

35. One Fund study raises another possibility: the credible threat of a suspension may lead private creditors to agree to a voluntary rollover sooner than they would in the absence of that threat (IMF 2000d).

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debt payments not backed by exchange controls cannot prevent domestic debtors with large foreign currency obligations from purchasing foreign exchange as a precaution against the resumption of creditor flight when the suspension expires. Without controls, then, there may not be a one-to-one correspondence between the coverage of a suspension and the balance of payments relief it provides.

There are two answers to the third question: Who should impose a standstill? Some proponents of standstills want the IMF to do that. Curzio Giannini (1999) and John Williamson (2000b) suggest, for example, that a country seeking support from the Fund and having a debt-related problem should be required by the Fund to impose a temporary standstill. But Morris Goldstein (2001), David Lipton (2000), and others believe that the decision should reside with the country itself, as it must bear the reputational cost of imposing a standstill.[36] Others acknowledge the force of that argument, but they believe that governments may be inclined to act precipitously. Therefore, they say that a government should not impose a standstill without the consent of the Fund or some similar entity (see, e.g., Martin 1998, 1999).[37] But they should not be worried about the risk of precipitous action. Most governments are keenly aware of the reputational cost that they will incur if they resort to standstills and the cost they will impose on their private-sector debtors. Furthermore, Fund approval would not confer immunity from disruptive litigation—the fourth and final problem that must be addressed.

In an influential paper written right after the Mexican crisis, Jeffrey Sachs (1995) sought to design the equivalent of a bankruptcy regime for sovereign debtors. To provide protection against litigation, he looked to Article VIII.2(b) of the Fund's Articles of Agreement. That provision says in part,

> Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member.

There are, however, two huge obstacles to using this provision in the manner proposed by Sachs. First, it cannot be used to shield a sovereign debtor; no government can claim to have its hands tied by its own exchange controls. Second, Article VIII.2(b) has been construed quite narrowly by US and UK courts; they have interpreted ''exchange contracts''

36. Eichengreen (2000a) points out, moreover, that the IMF may be seen to be unduly disposed to endorse suspensions because of its need to protect its own preferred-creditor status.

37. Eichengreen (2000a) makes a similar suggestion but for a different reason: a country may opt for a standstill in order to defer painful policy changes.

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to be contracts involving an exchange of currencies rather than debt contracts.[38] It would, of course, be possible for the Fund's Executive Board to issue its own interpretation of Article VIII.2(b) in an attempt to protect private-sector debtors from the risk of litigation when they are barred from making debt payments by a mandatory standstill; but national courts might choose not to be bound by the board's interpretation. Debtors cannot be protected from the risk of litigation without changing the actual language of Article VIII.2(b), and any amendment to the Fund's Articles of Agreement has to be ratified by three-fifths of the Fund's membership having at least 85 percent of the total voting power. This means, in turn, that an amendment to Article VIII.2(b) would require the approval of the US Congress, which is unlikely to grant it.[39]

To bypass this obstacle, others suggest that the Fund ''endorse'' a standstill (see, e.g., Miller and Zhang 2000; Radelet and Sachs 1998). But this suggestion is weaker than the one mentioned before—that standstills should not be imposed without the consent of the Fund—and does not resolve the problem. No endorsement by the Fund, whether strong or weak, can protect a debtor country against litigation.

Solving the Problems Posed by Standstills

There is another, more promising approach—adding a standstill provision to every debt contract or to the subset of contracts involving foreign currency debt. This approach was suggested by Paul Martin (1998) and by Willem Buiter and Anne Sibert (1999), and it was also mentioned by the G-22 working group on international financial crises:

> It is also worth considering the addition of options to sovereign bonds and interbank credit lines that would allow a debtor government or debtor banks to extend the maturity of a bond or credit line for a specified period of time at a predetermined spread. Such options could be exercised to ease pressure on the government and the banking system in the event of a liquidity crisis. Such provisions could have an effect opposite to the effect of the put options that have been exercised in certain recent crises. These put options have reduced the maturity of various credits and thus exacerbated market pressures. (Group of 22 1998a, 12)

Under the scheme devised by Buiter and Sibert (1999), each government, on its own, would require the inclusion of a rollover option in *all* foreign

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38. See IMF (2000d) and the more extensive treatment by Tarullo (2001), who also deals with the next point covered in the text.

39. Eichengreen (1998) is undoubtedly right in saying that any such amendment would be widely regarded as taking one step too many toward an international bankruptcy regime and tipping the balance too strongly in favor of debtors. In fact, the US Treasury appears to take that view—or believes that the Congress would take it; see Geithner (2000).

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currency debt contracts, including the government's own obligations.[40] They call it the Universal Debt Rollover Option with a Penalty (UDROP). The rollover option would allow the individual borrower, at his or her sole discretion, to extend the maturing debt for a fixed period, say 90 days, by paying a penalty. The option could be exercised only if the debt had been serviced in full, apart from the pending final payment, and it would not be renewable. Buiter and Sibert suggest that the penalty be defined as a ''hefty'' addition to the spread over LIBOR that the debtor would normally pay (and that the normal spread might be defined by a long-run moving average of the actual market spread).

The size of the penalty and other features of the rollover option applicable to a particular debt contract would be set by the parties concerned, not by the government or by any international body. There would, of course, be no need to provide any explicit protection against litigation. A creditor cannot object to a fixed-term debt suspension when it is built into the debt contract to which the creditor has assented. This, indeed, is the most attractive feature of the scheme, compared to other ways of imposing a standstill.[41]

As debtors would have to pay heavily to exercise the option, the rollover option would not be exercised under orderly market conditions. Buiter and Sibert believe, however, that it would be exercised widely under crisis conditions, with the result that all foreign currency creditors—public and private, foreign and domestic—would be bailed in automatically. Korea and Brazil, they say, would have benefited from their scheme. Buiter and Sibert acknowledge that individual debtors might be tempted to exercise the rollover option under normal market conditions if they cannot pay their own debts. They would therefore entertain a variant of their scheme in which a country's central bank would have to declare that a ''crunch'' had arrived before individual debtors could exercise their options. But they decline to entertain another variant in which that task would be assigned to the IMF.[42] More important, they do not even deign

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40. They would therefore include rollover options in foreign currency contracts between domestic residents, as well as contracts involving contingent claims (where the amount to be rolled over would be the value of the liability if and when the contingency materialized). But they would *not* include them in debt contracts like the Mexican *tesobonos*, with foreign currency indexing. Yet indexed contracts should in fact contain such options; they create what amounts to a foreign currency claim when, as in the Mexican case, foreigners run down their holdings and swap the domestic currency proceeds for foreign currency, depleting the country's currency reserves or causing the domestic currency to depreciate hugely.

41. It is mainly for this reason that rollover clauses should be written into the government's own obligations even under the modified version of the Buiter-Sibert scheme proposed below. They would serve in effect to nullify the usual waiver of sovereign immunity by protecting the government against litigation.

42. Their reason, however, is not the one given by others, that it is the responsibility of a country's own government to bear the onus and cost of suspending the country's debt

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to mention a more radical departure from their basic scheme—an arrangement under which a central bank declaring a crunch would automatically activate all of the rollover options, including those of private debtors.[43]

In its present form, the Buiter-Sibert scheme can lead to a ragged response instead of a prompt, comprehensive standstill. Consider a country with two groups of banks that have large foreign currency debts. One group has weak balance sheets; the other has strong balance sheets. The central bank can distinguish between them and will not lend heavily to the weak banks, but foreigners cannot distinguish between them. Suppose that the banks' foreign creditors begin to run down their claims. All of the banks will buy foreign currency to repay their debts. The weak banks, however, will soon find it impossible to borrow enough domestic currency to buy the foreign currency they need, because the central bank will not supply it, and they will therefore exercise their rollover options. But the strong banks can continue to repay their debts for as long as they can buy foreign currency at a price that does not impair their solvency.

If the country's exchange rate is fixed, its reserves will continue to fall (albeit at a slower pace) after the weak banks exercise their UDROPs, and it could exhaust its reserves if the strong banks do not exercise their UDROPs because of the interest penalty they would incur. And when the country runs out of reserves, it must let its currency depreciate. If the country's exchange rate was floating initially, it will begin to depreciate immediately, before the weak banks exercise their UDROPs, and it will continue to depreciate (albeit at a slower pace) after they have done so. But the depreciation of the country's currency will not force the strong banks to exercise their UDROPs until they can no longer afford to buy the foreign currency needed to pay off their debts. Hence, the banks' response to the crisis will not halt the depreciation of the domestic currency until it has done very serious damage to all of the banks' balance sheets.

This story resembles the actual outcome in the Korean case, where foreign currency creditors were not bailed in until the creditor panic turned into a currency crisis. If the penalty rate is high enough to discourage some debtors from exercising their rollover options quickly, it may be too high to produce a rapid, coordinated response by a country's debtors. It would therefore be better to employ a modified version of the Buiter-Sibert scheme—one that would *require* all debtors to exercise their rollover options simultaneously.

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payments. They are instead concerned that the IMF would be influenced by extraneous considerations, including a country's compliance with IMF standards of good conduct, and they believe that the IMF does not have the expertise or political independence to be an effective arbiter.

43. Although he does not say so explicitly, Martin (1998) appears to favor this sort of arrangement.

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This change would require two modifications in the Buiter-Sibert scheme. If the government or central bank were given the right to activate all of the rollover options, the necessary legislation would have to define the conditions under which it could do so.[44] If private-sector debtors could be forced to exercise their rollover options, they should be compensated for part of the penalty they will then have to pay. The fiscal cost of doing that, however, may be much smaller than the fiscal cost of an interest rate defense, which is what a country might have to adopt if it had no way to impose a standstill.

To be sure, it would take a great deal of time to write rollover clauses into the whole stock of foreign currency debt. They could not be inserted into existing debt contracts. The problem is much like the one involved in writing collective action clauses into the whole stock of debt. But there is also an important difference between them. In the case of collective action clauses, borrowers fear that their inclusion will raise the cost of issuing new debt, although that fear may be unfounded.[45] In the present case, by contrast, the interest penalty compensates the creditor, and the size of the penalty could still be set by the parties directly involved, as proposed by Buiter and Sibert, even if the central bank were given the power to activate all of the rollover clauses.

Like other measures discussed above, the inclusion of rollover clauses in debt contracts could raise the risk of triggering anticipatory flight. For reasons already given, however, that risk is often exaggerated. The number of creditors rushing for the exits to avoid a temporary standstill may be no larger than the number who must exit or reduce their claims before an agreement can be reached to roll over foreigners' claims voluntarily. The inclusion of rollover clauses could contribute to contagion but could perhaps have the opposite effect by preventing a creditor panic from causing a full-fledged currency crisis, with its inevitable spillover effects on other countries. But a standstill may be the most sensible way to avoid the need for large-scale official financing; and because rollover clauses preclude litigation, their inclusion in sovereign and private debt contracts may be the best way to impose a standstill.

Summing Up

The architecture exercise has been reform on the run. The swift succession of crises in the 1990s forced the official community to move quickly, but

44. The same thing would have to be done, however, under the variant of the Buiter-Sibert scheme in which the central bank would have to declare when a crunch had arrived before individual debtors could exercise their UDROPs.

45. See the findings of Eichengreen and Mody (2000a, 2000b). Note also that bondholders may have less reason to be wary of rollover clauses. Unlike collective action clauses, which may affect their bargaining power in a future negotiation involving a reduction in the value of their claims, the activation of a rollover clause would only delay for, say, 90 days the contractual payments they are supposed to receive. (But it would be wise to make sure that

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each crisis differed from the one before, and the official community was required repeatedly to integrate new tactics into its overall strategy—a sort of galloping incrementalism. It was at the same time constrained by an imperfect political consensus across the G-7 governments themselves as well as across the much larger membership of the International Monetary Fund. There have been disagreements about the causes of crises, ways to prevent them, and ways to resolve them.

This book has devoted much attention to those disagreements and their implications for the form and functioning of the international financial system. Along the way, it has drawn some broad conclusions and made some specific recommendations. Taken together, they provide the context and agenda for the next phase of the architecture exercise.

The Framework

Let us return to the starting point of the architecture exercise—the decision to provide massive official financing when Mexico's currency crisis became a debt crisis as *tesobono* holders declined to roll over their holdings. Whatever one's views about the causes of the currency crisis—whether it was due to bad luck, bad policy, or the two together—one cannot deny that the *tesobono* crisis represented a creditor panic. The decision to resolve it by providing massive official financing may have been the right response, given the risk that a standstill or default could have had very grave consequences for Mexico and for other countries. Creditor panic played a role in the Asian crisis, too, and the official community would have been wrong to adhere rigidly to the conventional quota-based limits on the supply of IMF credit.

IMF quotas have been revised periodically, but they have not been adjusted systemically to meet the needs of countries with open capital markets. Under the Bretton Woods system, access to Fund credit was meant to provide short-term financing for countries that lacked sufficient reserves to cope with transitory shocks adversely affecting their current account balances or that needed to buy time to adjust to longer-lasting shocks. It was not meant to cope with reductions in capital inflows or with debt-related problems. During the debt crisis of the 1980s, Fund credit was used extensively to help countries deal with debt problems and, in the process, catalyze private-sector involvement in the resolution of those problems. During the 1990s, however, capital account liberalization greatly heightened the need for official financing to deal with sudden shifts in capital flows.

Routine recourse to large-scale financing is apt to encourage imprudent behavior by private-sector lenders and by governments as well. Lenders will make risky bets, expecting to be bailed out. Governments will pursue unsustainable policies, incurring excessive external debt and clinging tenaciously to unsustainable exchange rates despite stern warnings from

the terms of the rollover clauses posed no obstacle to secondary trading in the affected instruments during the 90-day period of a debt suspension.)

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the official community that it will not provide large-scale financing to countries that persist in defending those exchange rates. It has therefore been suggested that the IMF refuse to provide large-scale financing—that it should adhere hereafter to its conventional quota-based limits. But this recommendation is unrealistic. The quota-based limits are too small and cannot readily be revised to reflect the needs of countries exposed to huge shifts in capital flows. Quotas determine voting power in the IMF, as well as access to Fund credit, and governments strongly resist any redistribution of quotas that will reduce their influence over the Fund's policies.

There is thus need for flexibility, but it must be rule-based flexibility. Governments must know what to expect when they seek help from the Fund, and the Fund itself must be able to justify any and all departures from its adherence to its usual quota-based limits on access to Fund credit. It cannot allow its members' appetite for debt to govern its own policies.

The Fund sought to obtain this sort of flexibility when it established the SRF and CCL. But the criteria for access to the SRF are not very well defined, and the CCL has not attracted applicants despite the Fund's recent attempt to make it more attractive. For reasons described earlier, governments seeking assurance of access to Fund credit seem to prefer to make precautionary drawings of the conventional sort rather than expose themselves to the risks adhering to a CCL—the risk that they may have to make major policy changes when they seek to activate a CCL, and the risk that they may be told by the Fund that they no longer qualify for a CCL. The attempt to straddle prequalification and conditionality has had little success.

Four more observations deserve repetition. They pertain to the problem of contagion, the role and scope of conditionality, the case for mandatory standstills, and the grain of truth residing in the two-corner approach to choosing exchange rate arrangements.

The premise that led to the creation of the CCL, that countries with open capital markets risk being the innocent victims of contagion and need special protection, is contradicted by the nature of contagion. There have been innocent victims, but not very many. Countries that suffer contagion are, for the most part, those that are seen to display worrisome similarities to a crisis-stricken country. Furthermore, truly innocent victims may have to make policy changes when they succumb to contagion. No country can avoid the need to alter its policies when capital inflows fall abruptly or give way to outflows. Even in the rare case of an irrational creditor panic—one that is driven by fear, not fact—the restoration of rationality does not guarantee a speedy return to the status quo ante. Although capital outflows will cease, capital inflows may not revive quickly, and the affected country has then to adjust to smaller inflows. Financing is not a substitute for adjustment, and prequalifaction is not a substitute for conditionality.

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Nevertheless, conditionality must be aimed narrowly at adjustment, not at far-reaching reform of a country's infrastructure. Some reforms may be required to rehabilitate a country's banking system when, as is often the case, a currency crisis is caused or compounded by a banking crisis. But reforms that can be postponed should be deferred or, better yet, made in advance of the crisis. That is the rationale for the contractual scheme outlined earlier in this chapter.

The use of mandatory standstills, also recommended here, will not obviate the need for official financing—not even large-scale financing. Critics of standstills are right to warn that they can have damaging side effects. The threat of a standstill can cause foreign creditors to exit while they can, although the resulting rundown of claims may be no larger than the reduction that is likely to occur before foreign creditors are ready to roll over their claims voluntarily. A standstill cannot prevent a country's residents from rushing for the exit, nor can it prevent them from purchasing foreign currency while it is in place, so as to resume their debt payments after it expires. Therefore, a country confronting a creditor panic or one faced with the need to restructure its external debt may need official financing to prevent a precipitous depreciation of the country's currency and avoid dysfunctional adjustment of the sort that occurred during the Asian crisis.

Finally, the Fund must wean countries away from pegged exchange rates and should not hesitate to caution them against the use of a currency board regime to stave off future crises. In fact, the Fund should be rather skeptical of a request for Fund credit to resolve the banking problems that occur endogenously when countries with currency boards suffer big capital outflows. A currency board is supposed to induce a sharp contraction of bank credit whenever it pays out reserves to buy up its own country's currency. And a currency board by itself does not necessarily afford relief from debt-related problems. It can prevent the monetization of debt but cannot prevent the creation of debt. Few countries, moreover, can afford to fix their exchange rates forever, and those that can risk doing so may be better served by opting for formal dollarization. All others should move toward the opposite corner—managed flexibility.

The Agenda

How can the official community plot and follow a sensible course, without relying on rigid rules or pursuing a case-by-case approach that has no readily defensible rationale? It should rely on what can be called *presumptive* prequalification.

Countries that follow prudent policies and meet certain other tests should be entitled to expect that they will obtain large-scale financing when they truly need it. No other country should obtain large-scale finan-

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cing unless the Fund's Executive Board decides, by a large supermajority, that the country's problems are apt to do serious damage to other countries, whether because of the country's size relative to others tightly linked to it or because its problems threaten to impair the functioning of international financial markets.

How should the Fund decide that a country is following prudent policies? How should it communicate its findings?

The Fund's regular Article IV consultations offer a natural starting point. Suppose that the Fund's staff concludes that a country is accumulating too much short-term foreign debt relative to its reserves, that its debt burden will be unsustainable over the long run given the country's fiscal stance, or that the country may soon face the need to refinance a large dollop of debt under difficult market conditions. The managing director should advise the country *confidentially* that he or she will refuse to recommend that the country receive large-scale financing if it seeks to draw on the Fund during the next year. And the managing director should convey the same sort of warning if, in the judgment of the staff, the country's exchange rate is unsustainable and it is defending its exchange rate stubbornly by drawing down its reserves or incurring large reserve-related liabilities. Such a warning would not bar the country from making an ordinary quota-based drawing. Furthermore, it could be overridden by the Executive Board and would, of course, be rescinded as soon as the country had taken steps to rectify the situation.

What preconditions should govern a country's eligibility for unusually large amounts of Fund credit? They should be chosen with the aim of encouraging countries to adopt the measures proposed elsewhere in this book:

- The country should have subscribed to the SDDS and be meeting its main requirements, particularly those pertaining to the reporting of reserves, reserve-related liabilities, and the external position of the country's private sector, especially its banking sector.

- It should have invited the Fund and Bank to conduct a financial-sector assessment and, if advised to do so, should have entered into a financial-sector contract of the type proposed in this chapter and be meeting the deadlines set out in that contract.

- It should have introduced collective action clauses into its government's foreign currency bonds.

- It should have adopted legislation requiring the inclusion of 90-day rollover options in all of its foreign currency obligations, public and private, and should have put in place the procedures required to trigger the exercise of those options.

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A country failing to meet these preconditions might nevertheless receive large-scale financing if the Fund's Executive Board concludes that refusing its request would put other countries at serious risk or impair the functioning of international financial markets. A suitable supermajority could waive one or more of the preconditions.

This is an ambitious agenda and one that may not appeal to the G-7 governments or the larger membership of the IMF. A less ambitious agenda, however, will not afford sufficient protection in the event of future crises. It is utterly unrealistic to count entirely on crisis prevention. Mistakes will be made. Accidents will happen. Better, then, to be safer than sorry.

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