Strengthening the International Financial Architecture

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Abstract. *After reviewing the post-World War II evolution of the international financial architecture, this paper presents a critical appraisal of current proposals for reform: limiting capital account convertibility, introducing an international lender of last resort, and reforming debt market institutions and instruments. These proposals do not quite examine whether the potential of triggering a contagious crisis is confined to a few countries. Instead of looking for an institutional framework that in an abstract and universal sense minimizes the probability of a crisis, a more modest approach focusing on countries that could potentially trigger a crisis could have a much higher payoff.*

Introduction

The financial crisis that began in Thailand in mid-1997 spread to other countries in Asia as well as in other continents. The depth of the crisis, its spread to economies that had shown no clear evidence that anything was amiss, and the slow recovery came as a surprise to most analysts. The realization that while financial crises cannot be eliminated altogether, much could be done to predict them and manage them better has led to further examination of the architecture of the international financial system in an effort to strengthen it. Such an examination was first urged by the Halifax summit in 1995 of the G-7 leaders. A number of proposals from academics; governments (Canadian, French, German, and US); private groups; including speculators, as well as groups sponsored by international financial organizations have emerged in the last two years (Eichengreen 1999; Buiter and Siebert 1998; Calomiris 1998a, b; Dornbusch 1998; Fischer 1998; Litan 1998; and Soros 1999 among others; see the critical review of this literature by

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Rogoff 1999). Indeed, as Eichengreen (1999, 1) remarks, "there is no shortage of proposals for reforming international financial architecture." Moreover, there is a substantial overlap among the proposals. For example, a group consisting of finance ministers and central bank governors for 22 systemically significant economies met in April 1998 in Washington, D.C. and identified three key areas where they thought action was needed: enhancing transparency and accountability; strengthening national financial systems; and managing international financial crises. They appointed three working groups to study these areas and to make appropriate policy recommendations. The reports (Group of 22 1998a, b, c) of the three working groups were released in early October 1998 at the time of the annual meetings of the Board of Governors of the International Monetary Fund (IMF) and the World Bank. The proposals of others also deem these three areas as important and address them in different ways. It should cause no surprise, that given the active involvement of the IMF in managing the Mexican and East Asian financial crises, and the fact that it is the international financial institution that was explicitly designed to manage the global financial system, the IMF's future role figures prominently in most proposals.

This paper is focused on systemic, rather than domestic issues raised by the crisis. The next section traces the post-World War II evolution of the international financial architecture, within the framework of the theoretical and policy debate that accompanied the decisions to reform the international monetary and financial system over time. The third section presents a critical appraisal of the current proposals for reform: limiting capital account convertibility, an international lender of last resort, and proposals for reforming debt market institutions and debt market instruments.

The Post-Second World War Evolution of International Financial Architecture

Before critically examining various proposals, it is worthwhile to recapitulate briefly the evolution of the architecture since the end of World War II. As is well known, the emerging victorious allies of the war, including the Soviet Union, wished to create multilateral institutions for setting the rules of the game to govern international trade and financial flows. They hoped that well-designed institutions would prevent the recurrence of the events and policies that led to the collapse of trade and financial flows during the interwar period, a collapse that many view as having contributed to the great depression and led to World War II. At the celebrated conference in Bretton Woods, New Hampshire in 1944 in which the Soviet Union participated, two institutions for governing international finance and investment, namely, the IMF and the World Bank were created. At the not-so-celebrated conference sponsored by the Economic and Social Council of the United Nations in Havana, Cuba during November 1947-March 1948 (in which the Soviet Union did not participate with the

Cold War having broken out in the meantime), a charter was approved for an International Trade Organization (ITO) meant to be the analogue of IMF and the World Bank for international trade. But with the United States not ratifying the charter, the ITO was stillborn. Instead, the General Agreement on Tariffs and Trade (GATT), which had been concluded in October 1947 after negotiations initiated by the United States among 23 countries, and which was to have been subsumed in the ITO, was implemented on the basis of a provisional protocol. The hopes for establishing an organization for world trade did not materialize until the agreement incorporating the results of the Uruguay Round of multilateral trade negotiations was signed in April 1994. This agreement created the World Trade Organization (WTO) that formally came into being on 1 January 1995.

However, even "with almost no 'basic constitution' designed to regulate its organizational activities and procedures" (Jackson 1989, 89), and despite having remained provisional in its application throughout its life, the GATT was instrumental in the successful completion of eight successive rounds of multilateral trade negotiations, the last being the Uruguay Round, for reducing tariff and nontariff barriers to trade. Above all, with the establishment of the WTO, a rule-based and transparent system governing world trade has been created (Srinivasan 1998).

The World Bank and the IMF, unlike the GATT, had been endowed at their creation with a basic constitution and mandate, although in a sense the World Bank was an afterthought to the idea of creating an IMF-type organization. Indeed the letter of invitation to the 44 governments to participate in the Bretton Woods Conference mentioned the prime purpose of the conference was to discuss the prospects for creating an IMF and possibly a bank for reconstruction and development. Be that as it may, in his opening remarks at the first meeting of the Bretton Woods Commission on the Bank, Lord Keynes said:

> It is likely in my judgment, that the field of reconstruction from the consequences of war will mainly occupy the proposed Bank in its early days. But as soon as possible, and with increasing emphasis as time goes on, there is a second primary duty laid upon it, namely to develop the resources and productive capacity of the world, with special reference to the less developed countries (Mason and Asher 1973, 2).

Mason and Asher (1973, 459) suggest that the Bank was to implement its development mandate:

> First and foremost, by helping to meet the large foreign exchange requirements for capital infrastructure through project loans and by providing, if necessary, technical assistance in the selection and preparation of projects; second, by emphasizing priorities in the selection of projects

> and assisting member countries to frame sensible public sector development programs with priority consideration in mind; third, by attempting to influence borrowing countries to adopt development policies to promote mobilization of foreign and domestic capital and its allocation through market forces to its most productive uses.

Over its more than five decades of existence, the World Bank has moved a long way from hard-headed project-based lending for infrastructure to considerably softer, if not soft-headed, policy-based lending and lending for social sectors and the like. A number of regional development banks, including the Asian Development Bank, were founded later. They follow policies similar to those of the World Bank, but their smaller size and regional focus enable them to be more innovative in some respects.

Turning to the IMF, de Vries (1987, 9) points out that,

> A major reason for the creation of the Fund was to help members avoid the excessive cyclical swings in their domestic economies caused by the need to correct balance of payments disequilibria inherent in the gold standard .... Financial officials therefore sought alternatives to domestic deflation as a way to correct balance of payments deficits .... The new objective of public officials was to simultaneously attain and maintain internal equilibrium (full employment) and external equilibrium (balance of payments equilibrium).

Stability of exchange rates was also a prime objective with any temporary disequilibrium in balance of payments being financed by a country's own reserves, supplemented by the temporary use of reserves provided by the Fund. Only a long-term fundamental disequilibrium was to be corrected by a change in the exchange rate with the approval of the Fund. The articles of the Fund never defined fundamental disequilibrium, but de Vries (1987, 11) suggests that most economists viewed it as one that "could not be corrected by aggregate demand policy in a reasonable time without an excessive degree of unemployment or inflation."

It is worth recalling that the IMF created at Bretton Woods was meant primarily to deal with balance of payments problems on the current account. While capital flows were recognized, Article VI of IMF specified that the Fund's resources should not be used to finance "a large or sustained outflow of capital." Indeed the Bretton Woods system allowed the use of capital controls. A recommendation that liberalization of capital movements should be made one of the purposes of the IMF was made by the IMF's Interim Committee only in 1997.

During the IMF's early years, reserve assets consisted of gold and convertible currencies, which then included only the US dollar. Given that gold supplies could increase only slowly, this meant that in order for the world to have an adequate supply of reserves (i.e., aggregate international liquidity) as world trade grew, the US would have to run growing current account deficits. The creation of a new reserve asset, namely the Special Drawing Right (SDR) by the Fund in 1969, did not solve the liquidity problem. Even leaving aside the issue that the US gained seignorage from the rest of the world's use of dollars as a reserve asset, the willingness of other countries to hold US dollars depended on their confidence in the dollar's convertibility to gold at a fixed price. In the mid-1960s as the US inflation rate rose, in part due to the US financing the Viet Nam War through fiscal deficits rather than increases in taxes, the confidence in the dollar's convertibility began to erode. The system collapsed when President Nixon abandoned the dollar's convertibility in 1971.

From today's standpoint, with the US dollar reigning supreme as the strongest and most desired currency to hold in the world, and with inflation in the US and almost everywhere else in the world having been brought down to single-digit levels, it might seem strange that the US dollar was viewed as recently as 25 years ago an overvalued weak currency that was risky to hold beyond a certain point! This suggests that one has to beware of creating new institutions or tampering with existing institutions in response to problems and crises, which, despite appearances to the contrary, could be transitory.

In the post-Bretton Woods era, unsurprisingly the experience of the IMF was not happy. The summary assessment as of 1987 by de Vries (1987, 281) of the experience of the Fund is very much to the point:

> Except for a relatively short period in the 1950s when highly unusual circumstances existed, adjustment of external payments imbalances by both industrial members and developing members has been difficult to achieve. Neither the system of fixed but adjustable exchange rates nor the floating rate system has made adjustment of payments imbalances easy .... Under the floating rate system, greater use of exchange rates was expected to give national authorities greater freedom to pursue the monetary policies of their choosing. However, that system, too, has not worked as expected. With controls on capital movements virtually nonexistent, the sensitivity of large unrestricted movements of capital to members' monetary policies, inter alia, has placed distinct limits on the independence of national monetary authorities …. In fact, since the early 1960s, the growing interdependence of the economies of most Fund members—the gradual coming into being of a truly global economy—has made balance of payments adjustment an increasingly complex process.

The *Journal of International Economics* (1972) published a symposium on the International Monetary System soon after the collapse of the Bretton Woods system. In his contribution to the symposium, Fleming (1972, 345) identified four basic objectives that any reformed international payments system should fulfill. To wit:

> (1) It should permit governments to maintain a level of demand for domestic output that represents their preferred compromise between full employment and price stability; (2) It should promote maximum freedom for international trade; (3) It should foster, over time, balances of payments on current account that correspond—with due allowances for reserve growth—to an optimal international movement of capital; and (4) It should promote reasonable stability in external economic relationships.

Fleming went on to add, in what must surely be an understatement, "There is a certain conflict between these objectives"! A quarter century after Fleming, Obstfeld (1998) describes the same conflict in similar terms.

Clearly in the absence of controls on capital movements, Obstfeld (1998, 8) points out what he calls the "open economy trilemma" or "inconsistent trinity", that is, a country cannot simultaneously maintain fixed exchange rates and an open capital market while pursuing a monetary policy that is oriented toward domestic goals. In his view, "Eventually, the very success of the Bretton Woods system in spurring international trade and the related capital movements brought about its own collapse by resurrecting the "inconsistent trinity" (Obstfeld 1998, 12). He finds that

> Numerous countries have tried to fix their exchange rates for various reasons, but few have been willing or able to do so for long. Sooner or later, exchange-rate stability tends to come into conflict with other policy objectives to which voters attach greater priority. Once the capital markets catch on to the government's predicament, a crisis can add enough economic pain to make the authorities give in (Obstfeld 1998, 13).

Available empirical evidence supports Obstfeld's conclusion. Edwards and Savastano (1998), in their survey of the empirical studies of the experience of alternative exchange rate regimes in developing countries, point out that in 1976, as many as 86 of 100 (or 86 percent) developing countries had their exchange rates pegged to the US dollar, French franc, or other currencies or a basket of currencies. Twenty years later only 55 out of 123 countries (or 45 percent) still had a pegged exchange rate regime. They raise a set of very relevant questions such as

> Should nominal exchange rate anchors be used in early phases of a stabilization program? Are floating exchange rates viable in emerging econo-

> mies? Does real exchange rate appreciation always precede currency crises?… Should Mexico abandon its floating exchange rate...? Could Russia have avoided the August 1998 devaluation of the rouble? Should the East Asian countries peg their exchange rates to restore price and output stability? Should Argentina exit its currency board toward a more flexible regime? (Edwards and Savastano 1998, 2)

They list a series of conceptual measurement and econometric problems that plague the available studies that could have answered their questions. They conclude that "The evidence available does not shed much light either on whether floating exchange rates represent feasible or desirable options for developing countries" (Edwards and Savastano 1998, 18). In their view the situation with respect to the long-run behavior of real exchange rates (RER) and the relevance of the Purchasing Power Parity (PPP) doctrine to emerging economies is no better:

> Our knowledge of the basic time series properties of RER in developing countries, and in particular of the relevance of PPP as a long-run benchmark for equilibrium RER in these economies is rudimentary ... the over-representation of Latin America in the sample of developing countries examined in the studies, the lack of clarity with regard to the variant of the PPP theory that is supposedly being tested, and the dearth of empirical work aimed at testing a well-defined PP hypothesis using cointegration techniques ... contribute to the above feeling …. (Edwards and Savastano 1998, 29-30).

It is sobering that sound empirical studies on a vital issue as the choice of exchange rate arrangements are scarce. Of course, as Edwards and Savastano note, it is true but trite that the choice would not matter as long as fiscal, monetary, trade, and other policies that are consistent with the chosen exchange rate regime are in place!

Eichengreen (1999, 7, 8) argues that

> in a world of high capital mobility there are only two feasible approaches to exchange rate policy. One is not just to peg the exchange rate but to lock it in …. Doing so requires abolishing the central bank and its discretionary powers in favour of a currency board and making that change irreversible. Closing off all avenues for discretionary monetary policy not just for a time but for the foreseeable future is something few countries are prepared to do...[they] have to follow the other alternative of allowing the exchange rate to fluctuate.

Echoing Edwards and Sevastano, Eichengreen (1998, 11) also notes that

> only countries in which investors have exceptional distrust of discretionary monetary policy, where the domestic economy is sufficiently flexible and resilient to adopt to whatever monetary and fiscal conditions are implied by a fixed exchange rate, and where there exists deep-seated public support for the policy, however painful its consequences, can sustain the currency board alternative.

Currently Argentina and Hong Kong, China are the only significant economies with a currency board.

Proposals for Strengthening the International Financial Architecture

Limiting Capital Account Convertibility

Fleming's desiderata for what he calls modestly as the new international payments system applies just as well for what is currently and pompously being called international financial architecture. However, there is an important distinction between the pre-1971 situation and the present one. As noted earlier, the IMF created at Bretton Woods was primarily an institution for helping members with balance of payments difficulties on the current account and until 1997 it did not include capital account liberalization as one of its purposes. On the other hand, current problems arise, not so much as they did earlier on the current account, but on the capital account. The current debate on controls on capital movements or capital account convertibility is particularly relevant in this context. Even some ardent free traders including Bhagwati (1998) have advocated a go-slow approach on liberalization of capital accounts, let alone quasi-dirigistes like Rodrik (1998). Others such as the Nobel Laureate Tobin (1978) have long advocated taxing short-term capital movements.

The case for free capital movements is the same as that for free flow of goods and services across borders: free flow of goods, services, and capital are optimal for a small open economy as long as there are no informational asymmetries; a complete set of competitive international markets for goods, factors, and assets exist; and lump sum redistribution is feasible within each economy for achieving distributional objectives, if any. By the same token, the general theory of distortions due to Bhagwati (1971) also shows that in the absence of such markets and with various domestic distortions, current free trade need not necessarily be optimal even for a small open economy. The same applies to free capital movements as well. Bhagwati (1998) has drawn a distinction between markets for goods and financial markets and argues that the case for free trade in goods does not necessarily carry over to free financial flows. It is true that informational asymmetries leading to moral hazard, adverse selection, and other forms of opportunistic behavior are severe in financial transaction. But they are not completely absent in goods trade as Akerloff (1970) showed long ago.

Crockett (1997) provides a thorough analysis of the theory and practice of financial stability. In the presence of a very distorted domestic financial system, liberalization of capital movements could be welfare-worsening and could hurt many. In fact in such an environment a domestic banking crisis often becomes a currency crisis. The recent financial crises have amply illustrated this well-known result. But the policy conclusion to draw is not that capital account liberalization should be abandoned, but that distortions in the domestic financial system should be eliminated first, and second, to institute the needed changes in the international financial architecture for reducing the scale and frequency of financial crises. In fact the Working Group on Strengthening the Financial System (Group of 22 1998b) has enumerated some major domestic distortions in financial sectors and has suggested ways to eliminate them. However, the Group appears to endorse a uniform set of international standards for sound financial practices. Uniformity or harmonization of standards across heterogeneous systems, with possibly differing but nonetheless legitimate objectives and in various stages of development is not necessarily desirable. In particular since the risk characteristics, diffusion of information, and thinness or otherwise of asset markets surely differ, a common set of capital adequacy and loan loss provisioning norms would be inappropriate. Nonetheless there is no doubt, that given that banks are likely to be dominant in financial markets in countries without deep and liquid securities markets, the Working Group's proposals have merit and should be implemented even in the absence of financial crises.

The IMF as an International Lender of Last Resort

Dornbusch (1998) suggests that, "In the aftermath of every crises, whether war or currency collapses, there is a soul-searching effort to build a better world .... This is a great occasion for bad ideas, or just impractical ones, to draw attention and gain respectability." The proposals for reforming the IMF seem to fit Dornbusch's description. As Obstfeld points out, "In reality, the IMF has been seeking a new permanent role ever since the demise of the Bretton Woods system it was designed to oversee" (Obstfeld 1998, 27). A number of authors (e.g., Calomiris 1998a,b; Eichengreen 1999; Fischer 1998; Meltzer 1998; Soros 1999) argue that an "international lender of last resort" is needed to prevent contagion in international financial markets, though their proposals for creating one differ. Some would have the IMF assume that role and recommend that its resources should be augmented for this purpose. However, the eagerness of the IMF for playing such a role and the strong support from the US, its dominant shareholder, for a contingency finance mechanism anchored in it, does not necessarily mean that the proposals have merit.

The need for an international lender of last resort is based on an analogy of the corresponding role played by central banks in national economies. The classic analysis of the latter is by Bagheot (1866). Fischer (1998) provides incisive discussion of Bagheot's work. Whether the analogy is indeed appropriate is arguable. Fischer (1998) strongly argues that it is, while Litan (1998) raises some serious doubts about its appropriateness.

Fischer (1998, 11) rightly points out that "if the lender of last resort were able to distinguish perfectly and intervene only to stop unwarranted panics, leaving institutions that would be insolvent in normal times to fail, managers of these institutions and their investors would have the right incentives." As he recognizes, ability to distinguish perfectly is virtually impossible and deposit insurance and "too big to fail" doctrine compound the problem. National central banks attempt to mitigate moral hazard by putting in place prudential regulations on domestic financial institutions. Moreover, they monitor and supervise the performance of such institutions and have not only the power, but also the information needed, to enforce their regulations. It is extremely unlikely that the IMF will have similar power over and information on its member countries. Further, the central bank as a lender of last resort, by providing needed liquidity, attempts to shield sound financial institutions from a panic-induced run while closing weaker ones or merging them with stronger ones. It is by no means obvious that the recent spread of financial crisis is the analogue of a bank run from which fundamentally sound countries should be protected. Besides, distinguishing fundamentally sound from unsound is even more difficult when it comes to countries. And closing or merging unsound ones is not an option! Clearly lending to shore-up an unsound financial situation merely postpones a crisis and makes it worse when it does occur as it must. The IMF as a lender of last resort could make sense, if not, lending would lead to a collapse of the global financial system. But to lend to shore up what many analysts see as an unsustainable exchange rate, as the IMF-led $41.5 billion package for Brazil prior to the January 1999 devaluation seems to have done, does not appear as a sound policy.

In its Report on Managing International Financial Crises (Group of 22 1998a, viii-ix), the Working Group concluded that

> The IMF must have sufficient resources to remain capable of catalysing policy reform and restoration of market confidence. Therefore, it is essential to implement rapidly the agreed IMF quota increase and to put into place the New Arrangements to Borrow (NAB). Countries that anticipate possible difficulties should seek early assistance from the IMF in order to reduce the risk that they will be placed in a position where they lack suffi-

> cient resources to meet their debt obligations in full. The combination of adjustment and financing typically associated with IMF assistance should be sufficient to resolve most payments difficulties and should continue to constitute the normal framework for managing and resolving international financial crises.

After all, the IMF was established to provide resources to countries facing temporary balance of payments difficulties so that they are able to adjust without having to change their exchange rates or impose restrictions on trade, and also to help them with the process of adjustment to any long-term disequilibrium through changes in exchange rates. IMF assistance and its resources (if the quantum exceeded the amount that countries were entitled to draw on almost automatically) were made available conditional on needed fiscal and monetary policy changes. Decades of experience with the various facilities of the IMF do not encourage one to believe that the IMF has been very successful in catalyzing policy reform and restoring market confidence. IMF's recent dealings with Russia are also not particularly encouraging. Whatever be the other rationales for the agreed IMF quota increase and the NAB, the argument that they are needed to support an enhanced IMF role in managing financial crises is not entirely convincing.

The conclusion that countries anticipating crises should seek IMF assistance early seems unexceptional prima facie, but at a deeper level appears somewhat problematic. First of all, models and indicators of the probability that a country would face a crisis, such as those that some researchers at the IMF and others have been able to put together, are not infallible. As such their predictions are subject to two types of error viz. predicting a crisis that would not occur and failing to predict one that would. Even if the data and the model underlying such indicators are publicly available—so that market participants are not only aware of the possibility of prediction errors but also could build their own models—and a country seeks IMF assistance based on such indicators, and this fact is common knowledge, market participants might conclude that the policymakers in the country know more than what has been incorporated in the indicators themselves. This might increase their perceived probability of a crisis and could precipitate the crisis. Thus a crisis, which was only probable but not certain would become certain.

> Second, if the IMF had played its surveillance role effectively, and had provided correct advice to a country, and the country had acted on the IMF's advice, the circumstances for seeking early IMF assistance to prevent an anticipated crisis should not arise. Put another way, if the country and the IMF were to perform their normal roles in the surveillance process (i.e., the IMF provides correct advice and the country acts on it), there should be no anticipated crisis but only an unforeseen one. And, of

> course, seeking early assistance to prevent an unforeseen event is by definition impossible. In practice neither the IMF is omniscient to give always correct advice nor is it omnipotent to ensure that countries always act on its advice. Under the circumstances, whether or not the report of IMF staff following Article IV consultations (i.e., surveillance) should be published, rather than just the facts and data underlying the report, is an open question (Goldstein 1998, 60-1).

Leaving aside the issue whether IMF's advice to a country following regular Article IV consultations is always appropriate, IMF-led bailouts in East Asia have been criticized, particularly by Jeffrey Sachs (Sachs and Radelet 1998) and others. They assert that the IMF prescribes the same medicine, namely tight fiscal and monetary policies, whether or not the crisis had its origin in fiscal profligacy or monetary looseness; that the IMF is too intrusive (Feldstein 1998) in imposing structural and institutional reforms that had no direct relation to the crisis; and that the IMF is not intrusive enough in using rescue packages to impose trade or investment concessions that are of interest to contributors to the financing of the package. Goldstein (1998, 32-3) makes a spirited defense of the IMF against these critics. Sachs notwithstanding, there is ample evidence that the true precrisis fiscal situation (taking into account the contingent liabilities from implicit and explicit government guarantees) in some East Asian countries was in fact worse than it appeared. To be fair to the IMF, one has to recognize that any attempt to contain a rapidly deteriorating situation and allay panic will in some sense have to overshoot to be credible. That the IMF relaxed some of its tight fiscal policy demands in Indonesia and Thailand as the situation warranted is an indication of its flexibility.

IMF's policy decision "to consider providing financial support for policy adjustment, despite the presence of actual and/or impending arrears on the country's obligations to private creditors, including arrears on marketable debt instruments" could have serious moral hazard implications. It is true that the Working Group (Group of 22 1998a, xi), while supporting IMF's decision, is cautious that

> such a signal should be provided only if: the government of the crisis country is not interrupting debt payments as an alternative to reform and adjustment; it is implementing a strong programme of policy reform; it is making a good faith effort to work with creditors in finding a cooperative solution to the country's financial difficulties; and international support is critical to the success of a strong adjustment programme.

The very fact that the IMF will provide such support could be enough to induce behavior that will produce such arrears. It has been suggested that such behavior is unlikely because no responsible leader would wish to put his or her country through a crisis only to avail of IMF lending to arrears. This is not a convincing argument: after all, policy failures such as directed and connected lending to favored groups contributed to the East Asian crisis.

In order to promote an orderly workout of debt following a financial crisis, the Working Group wishes to encourage creditor coordination through the inclusion of the so-called "collective action" clauses, such as collective representation of creditors, binding majority decisions and formulas for sharing costs of workouts in all domestic sovereign bond offerings, and quasi-sovereign bonds issued in foreign offerings. While it is obvious that an orderly workout is superior to a disorderly one, it is arguable that an attempt to force such a workout ex ante would simply reduce the size of the market and raise the cost of such bond offerings. Of course, if the increased cost just compensates for the risk of having to share the cost of workouts were they to occur, and reduces the probability of occurrence of workouts, it would be appropriate.

Some of the recommendations of the Working Group on Transparency and Accountability (Group of 22 1998c, vi) are either platitudinous, such as "the Working Group recommends that private firms adhere to national accounting standards and that national authorities remedy any deficiencies in their enforcement," or wishful thinking that compiling and publishing data on the international exposures of investment banks, hedge funds, and other institutional investors are feasible. It is also possible to argue, based on third generation models of financial crises, that in some contexts common knowledge of precise data could be worse than noisy information among market participants (Morris and Shin 1998).

It has been suggested by some (Soros 1999, Calomiris and Meltzer 1998) that an international lender of last resort should lend only to countries "that meet a stiff set of requirements, most importantly on the banking system ... loans would be made to qualifying countries on the basis collateral, and without policy conditionality" (Fischer 1998, 22). First of all, if a country meets requirements that are stiff enough, it is unlikely to experience a crisis itself or be affected by contagion to any significant extent, as the experience of Hong Kong, China; Singapore; and Taipei,China in the recent crisis suggest. Second, as Fischer (1998, 23) himself points out, "For such a scheme to work, lender-of-last resort loans would have to be denied to countries that do not qualify. Too big to fail makes this a very difficult task—and contagion makes too big to fail a rational strategy."[1]

[1]Giannini (1999) points out that the function of lender of last resort does not necessarily imply a large endowment of resources. This is because some institution may act as "crisis manager", promoting a concerted action by lenders to rescue countries or institutions facing a liquidity crisis. To some extent, "crisis management" is what the IMF and the G7 do now (see the discussion in Rogoff 1999).

Proposals for Reforming Debt Market Institutions and Instruments

Another set of proposals for reforming the international financial architecture focus on debt market issues. Buiter and Sibert (1998, 3) propose a universal (i.e., mandatory) debt roll-over option with a penalty under which

> All foreign-currency lending, be it private or sovereign, long or short, marketable or non-marketable, including overdrafts and credit lines, must have a roll-over option. This would entitle the borrower to extend or roll over the debt at maturity for a specified period (say 3 or 6 months) at a penalty rate. The penalty would have to be big enough to ensure that the borrower would never want to exercise the roll-over option under orderly market conditions. If crisis conditions still prevailed when the roll-over period expires, the option could be exercised again, at a higher penalty.

As the authors themselves point out, their proposal "will only be useful when otherwise solvent borrowers are unable to repay their foreign-currency debt because of a liquidity crisis or credit crunch" and "it only helps *when a country is solvent, willing to pay, but prevented from doing so because international financial and credit markets have a temporary seizure*" (Buiter and Sibert 1998, 3; emphasis added). Given that it is not an easy matter to determine whether or not a country is solvent since it involves, in part, expectations about policies of future governments, and further, that unwillingness to pay is even harder to distinguish from inability to pay, it is unclear whether a market for such options would indeed emerge. Even if one emerged, it is likely that at the equilibrium market price, the implicit cross subsidization by those countries whose likelihood of exercising it is overestimated by the market of others whose likelihood is underestimated, would be large. The authors, however, suggest it would be small.[2]

Dornbusch (1998) stresses that in designing an international system that is less cross prone, one has to address the basic factor underlying capital market crises, namely, unsound finance. Starting from the "domestic financial system of the UK or US where the supervisory authorities set and enforce capital standards as well as sophisticated risk measurement", at the international level, he proposes a "modest" scheme that will "create a new culture that focuses on dissemination of the right thinking, learning from the present crisis to put in place more responsible balance

[2]The Buiter-Sibert proposal reflects the basic idea that full repayment of debt contracts in every state of nature is not necessarily efficient. While this is a strong argument in favor of a larger share of equity financing, Rogoff (1999) lists important sources of bias toward debt finance: deposit insurance in both creditor and debtor countries, stronger legal and political protection for debt holders as opposed to provider of equity finance, and underdevelopment of equity markets in developing countries. Rogoff also observes that "G-7 funds aimed at helping distressed country debtors often end up recycling to G-7 debt holders (both banks and bondholders) in the form of higher payments, providing a further subsidy to debt finance" (Rogoff 1999, 29).

sheets." His more "ambitious" scheme will make "support in case of "honest" accidents conditional on compliance with a tightly written and audited scheme." He suggests that with an appropriate transition period, the IMF consultation process could be used for implementing the ambitious scheme. Thus

> Countries who would want to have IMF support when in trouble would only qualify if they have, in fact, in the recent past been in compliance with an agreed risk control strategy. This procedure has three advantages. First and foremost, it institutionalizes risk analysis as part of the local supervisory process and as such creates the right culture. Second, it directly lowers risk levels worldwide because countries will be eager to qualify for IMF support in case of honest accidents which are still possible though less likely. Third, anyone who opts out and wants to run a national gambling house can do so. But it is clear to financial markets that value at risk exceeds internationally acceptable thresholds and, as a result, financing will be hard to get and will be expensive. Hence the incentive for rogue countries to join the club (Dornbusch 1998, 5).

But he doubts whether this will happen since, in his view,

> The IMF is owned and operated by its board, i.e., representatives of countries like Japan who have no concept of sound finance and no willingness to get there soon. The IMF and its board actively enjoys crisis situations, since they give bureaucrats the opportunity to wield power, and expand the scope and mandate of their institution. The notion that anything preemptive is impractical is just far too easily accepted (Dornbusch 1998, 5).

If this indeed is the case, as I am afraid it might be, all proposals, Dornbusch's and others, which envisage the IMF as a crisis prevention agency would be nonstarters!

We will not comment on proposals such as the creation of an International Bankruptcy court for an orderly settling of debt at less than face value because they are extremely unlikely to be adopted. The criticism that in IMF-led bailouts imprudent lenders did not suffer significant losses has led to the inclusion in some of the proposals of what is called a "hair-cut" feature, namely a mechanism by which lenders are made to share the cost of bailouts after a crisis. The Buiter-Siebert and the G-22 Working Group proposals include hair-cuts implicitly or explicitly. While including hair-cuts seem desirable prima facie, on reflection one wonders whether the haircuts would end up raising the costs of borrowing excessively as well as reducing the flow of funds. In any case, it seems unlikely that proposals that include haircuts up front would be accepted.

The various proposals for reform of the international financial system do not quite examine whether the potential of triggering a financial crisis and contagion is confined to a few countries. After all, an overwhelming majority of the membership of the IMF are very small economies for whom letting foreign financial intermediaries in, if not altogether adopting dollarization or its equivalent, would be the appropriate action. If this is correct, then designing a system that is based on the specifics of countries that are likely to trigger a crisis would be more appropriate. In other words, instead of looking for an institutional framework that in an abstract and universal sense minimizes the probability of a crisis and better manages one if it occurs, a more modest approach focusing on countries that could potentially trigger a crisis will have a higher payoff.

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