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The New International Financial Architecture: Reconstruction, Renovation, or Minor Repair?

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The Finance Ministers of the G-7 countries appear to believe that they have completed their work on the new architecture of the international financial system. However, key issues have not been resolved. The official community must still decide if and when debt restructuring should replace large-scale official financing. It must still decide how to offset the effects of the asymmetry between the large size of global capital markets and the small financial sectors of emerging-market countries. It must still devise strong incentives for emerging-market countries to adopt the codes, reforms, and policies endorsed by the architecture exercise. It has not given serious, critical attention to the quality of International Monetary Fund (IMF) conditionality and the basic dilemma posed by open capital markets: Must the restoration of investor confidence take priority over domestic stabilization and the mitigation of economic hardship in a crisis-stricken country? Copyright © 2000 John Wiley & Sons, Ltd.

KEY WORDS: capital flows; currency crises; debt restructuring; exchange rate regimes

SUMMARY

Shortly after the Mexican crisis of 1995, the G-7 countries launched an effort to strengthen the international financial system, to reduce the risk of future crises and cope more effectively with those that still occur. The effort took on new dimensions after the outbreak of the Asian crisis in 1997.

The effort to prevent future crises has focused mainly on the promulgation of new codes and standards. The International Monetary Fund, for example, has devised a data dissemination standard that requires emerging-market countries to publish large amounts of economic and financial information. The Basel Committee on Banking Supervision has adopted core principles for banking supervision, and analogous principles have been drafted for the regulation of securities markets. Other codes deal with accounting practices and corporate governance. Unfortunately, it has proved easier to draft codes than to find ways of inducing adherence to them. The IMF can require compliance of countries that need financing. At that point, however, compliance comes too late to serve as a preventive measure and becomes instead a remedial measure. Furthermore, compliance requires reform, which takes time, and the official community has been reluctant to recommend the use of interim measures, such as controls on capital inflows, to reduce the vulnerability of financial systems that still need to be reformed.

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It has been even harder to find better ways of dealing with crises when they occur. After the Mexican crisis, the official community warned emphatically that creditors and debtors should not expect to receive large-scale official financing in the event of future crises. The government concerned and its private foreign creditors might have to work out a solution on their own, and it might therefore be necessary for a crisis-stricken country to suspend its debt-service payments temporarily. To assist in the restructuring of sovereign debt, new debt contracts should contain collective-action clauses aimed at preventing dissident creditors from blocking an agreement, and the IMF should be willing to 'lend into arrears' whenever a government is making adequate adjustment efforts and trying in good faith to reach agreement with its creditors.

With the onset of the Asian crisis, however, a striking disjuncture developed between official rhetoric and official practice. One after another, the crisis-stricken countries sought and obtained large-scale financing. Thailand obtained $17 billion; Indonesia, $36 billion; and Korea, $58 billion. Korea's interbank debt was restructured, but only after the Korean government guaranteed the debt settlement, and the credibility of that guarantee was backed up implicitly by official financing. In short, debt restructuring did not replace massive financial assistance.

Nevertheless, there have been important innovations. In 1999, for example, the G-7 govermnents agreed that official financing should not be given to countries that intervene heavily to defend exchange rate pegs unless certain exceptional conditions are met. In four recent cases, moreover, the IMF has declined to provide enough financing for governments to meet their debt payments. It has yet to do that, however, in the case of a systemically important country. The governments of large emerging-market countries may therefore believe that their countries are 'too big to fail' and may still expect to receive massive assistance in the event of a crisis, despite their failure to reform their financial systems.

Clearly, more work must be done to strengthen the international financial system. What we have now are mere architect's sketches, not a blueprint for comprehensive renovation.

INTRODUCTION

Let me answer immediately the question posed in the subtitle of this lecture. The exercise that began after the Mexican crisis of 1994–1995, and is now ending, was never viewed by the participants as an effort to raze and reconstruct the international financial system. Notwithstanding the extravagant promises of some political leaders, it was not meant to be a New Bretton Woods. It was seen, however, as a broad effort to renovate the system, and not just make minor repairs, and that is the standard by which to assess it.

The exercise began immediately after the Mexican crisis and gathered momentum after the outbreak of the Asian crisis in 1997, but it would be wrong to assess it merely by asking whether the reforms adopted or proposed would have prevented those crises or mitigated their effects. We have instead to ask whether those reforms can be expected to deal with the wide range of issues posed by developments in international financial markets during the 1990s: the entry of emerging-market countries as major borrowers, the entry of institutional investors as major lenders, and the corresponding shift in the composition of capital flows to developing countries. Banks continue to play an important role, but *via* the interbank market, not by making medium-term syndicated loans to governments like those of the 1970s and early 1980s. Furthermore, the banks' relative importance as sources of funds for developing countries has been sharply reduced by the growth of direct-investment flows and of securitized lending.

You might, therefore, expect me to proceed straightforwardly by listing the principal problems posed by those recent changes and asking what has been done to resolve them. But I will begin differently, by tracing the evolution of official views between the Halifax Summit of 1995, which started the architecture exercise, and the Cologne Summit of 1999, which has, I fear, concluded it prematurely. I prefer this chronological approach for two reasons.

First, the issues are hard to disentangle. Consider an example. The governments of emerging-market countries are often told that they should limit and make more explicit the guarantees they give to banks and other private sector entities, in order to reduce moral hazard and thus prevent

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imprudent borrowing. This recommendation is commonly made in the context of crisis prevention. It is also important, however, from the standpoint of crisis resolution. It may be entirely appropriate for the International Monetary Fund (IMF) to furnish large-scale financial assistance to a member government—to serve as the 'lender of last resort' in a liquidity crisis—but it was not designed to serve as a lender of last resort to the private sector. Yet it is apt to play that role indirectly and involuntarily whenever it comes to the aid of a government that gives open-ended guarantees to domestic banks or other private sector entities. The role of the IMF in crisis resolution cannot be well defined and defended if its members' obligations are not equally well defined.

Second, a chronological approach will help me show how the official agenda has evolved in response to the actual crises of the 1990s and, more importantly, will support my chief assertion. At the start of the architecture exercise, private sector participation in crisis resolution was viewed as a substitute for large-scale official financing. With the onset of the Asian crisis, however, a disjuncture developed between official rhetoric and official practice. There was very heavy reliance on large-scale official financing and very little private sector participation. The gap between rhetoric and practice may be narrowing, because of recent changes in both rhetoric and practice, but it is too early to tell whether the current stance of the official community is definitive and sustainable.

Before beginning my chronological account, I should perhaps explain my earlier statement that the Cologne Summit appears to have ended the architecture exercise. In previous years, the annual report of the G-7 Finance Ministers to the summit promised to report to the next year's summit on the further progress of the architecture exercise. In their report to the Cologne Summit, however, they promised merely to report 'as necessary' (G-7 Ministers, 1999, para 9). Furthermore, the statement of the G-7 Finance Ministers and Central Bank Governors issued at the Bank-Fund meetings, 3 months later, spoke of the 'plan' set forth at the Cologne Summit and the need for 'full implementation' of the reforms endorsed at the summit (G-7 Ministers and Governors, 1999, para 17). Michel Camdessus, Managing Director of the IMF, has said much the same thing—that the work on architecture has 'entered a new phase' with 'fewer announcements of new initiatives, but greater focus on the specification and implementation of existing ones' (Camdessus, 1999a). In short, the architects appear to believe that they have completed a blueprint ready for use by the masons and carpenters. I will endeavor to show, however, that what we have now are mere architect's sketches, not a complete plan.

Neither governments nor private sector participants have been given strong incentives to behave more prudently. In fact, the architecture exercise has failed to confront a phenomenon I will describe as *strategic denial*. It is assumed implicitly that governments will do the right thing, although they have powerful reasons to do as little as possible for as long as possible. Furthermore, the exercise has failed to convince private lenders that 'they should get two scoops for assuming risk—one in the form of a higher risk premium when the debt is purchased, and the second in the form of an official bailout if things work out badly' (Task Force Report, 1999, p.63). Finally, the exercise has not dealt decisively with a fundamental asymmetry in the international financial system—the small size of the financial sector of the typical emerging-market country, compared with the sizes of the global markets in which the country operates.

MEXICO AND HALIFAX

Let us go back to the origin of the architecture exercise—the Halifax Summit of 1995, at which the G-7 governments made five recommendations reflecting their misgivings about the way the Mexican crisis had been handled and, more generally, their concern about coping with future crises.

1. They urged the IMF to intensify its surveillance of its members' policies and send 'franker messages' to governments that seem to be avoiding necessary policy changes. The Fund did that soon thereafter in the case of Thailand, but its franker messages were ignored.
2. They asked the IMF to set standards for the publication of economic and financial data by member governments and to identify publicly those that comply with the standards. In response, the Fund devised a general standard

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for all member governments and a Special Data Dissemination Standard (SDDS) for those that participate in international capital markets and those that aspire to do so.

3. They asked the IMF to devise ways of accelerating access to IMF credit in crisis situations and to make larger up-front disbursements in those situations. In response, the Fund adopted an Emergency Financing Mechanism (EMF) to facilitate close consultation between the Fund's management and its Executive Board during discussions with governments seeking financial support—consultations that had not occurred in the Mexican case.
4. They asked the G-10 governments and other governments not previously involved to double the size of the credit lines available to the IMF under the General Arrangements to Borrow (GAB). The result, after long negotiations, was the creation of the New Arrangements to Borrow (NAB), involving several additional governments. The NAB is now the Fund's primary source of short-term credit when its own resources are too small to meet the demands on them.
5. They asked the G-10 countries to review other procedures that might help to resolve future crises. In response, the G-10 countries formed a working party chaired by Jean-Jacques Rey of Belgium. Its report (G-10 Working Party, 1996) was issued a full year before the Asian crisis, and it was endorsed by the G-10 governments.

THE REY REPORT

As the Rey Report influenced subsequent work on the international financial architecture, let me review its main findings.

The G-10 working party considered an idea advanced initially by Jeffrey Sachs in his Graham Lecture at Princeton (*Do we need an international lender of last resort?*, 1995). Sachs had proposed the design of a full-fledged bankruptcy regime for sovereign debtors. But the working party rejected this approach, not only because of the enormous legal and practical problems involved, but also because it found fault with the analogy between sovereign and private debtors. Nevertheless, it acknowledged that existing arrangements for resolving debt problems are no longer adequate, because of the growth of securitized lending. (Recall that the massive financial package assembled for Mexico in 1995 was meant to avoid an imminent default on the *tesobonos*—the short-term dollar-indexed securities issued in huge quantities by the Mexican government in 1994 and held by a great many institutional investors.)

The working party praised existing arrangements for restructuring debts to governments (the Paris Club) and debts to commercial banks (the London Club). It noted, however, that their success has been due in part to the fairly small numbers of creditors involved, making the free-rider problem relatively easy to manage, and this is no longer true. It is now necessary to contemplate debt workouts involving large numbers of institutional and individual investors. Such workouts are bound to be complicated, not only because of the numbers of investors involved, but also because those investors, unlike creditor governments and commercial banks, do not have enduring links with the debtor countries.

Nevertheless, the working party rejected emphatically the substitution of large-scale official financing for debt restructuring, despite the difficulties involved in restructuring securitized debt:

> ... it is essential to maintain the basic principle that the terms and conditions of all debt contracts are to be met in full and that market discipline must be preserved. However, in exceptional cases, a temporary suspension of debt payments by the debtor may be unavoidable as a part of the process of crisis resolution and as a way of gaining time to put in place a credible adjustment program
> ... neither debtor countries nor their creditors should expect to be insulated from adverse financial consequences by the provision of large scale official financing in the event of a crisis. Markets are equipped, or should be equipped, to assess the risks involved in lending to sovereign borrowers and to set the prices and other terms of the instruments accordingly. There should be no presumption that any type of debt will be exempt from payments suspensions or restructurings in the event of a future sovereign liquidity crisis (G-10 Working Party, 1996, p. i, emphasis added).

Crude translation: We may have been right to bail out Mexico, but don't expect us to do that again.

The working party made two specific recommendations to facilitate the restructuring of securitized debt. First, new sovereign debt contracts should contain so-called collective-action causes to

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provide for the representation of creditors, to permit qualified majority voting on proposals to alter the terms of debt contracts, and to require that every creditor share with the rest all payments obtained from a debtor. Second, the IMF should be prepared to provide financing before a debtor government has reached agreement with its private creditors and cleared its arrears. Such lending, said the Rey Report, 'can both signal confidence in the debtor country's policies and longer-term prospects and indicate to unpaid creditors that their interests would be best served by quickly reaching an agreement with the debtor' (G-10 Working Party, 1996, p. iv).

The working party conceded that no individual issuer might want to be the first to include collective-action clauses in its new debt contracts, for fear that this would raise the cost of borrowing. But it concluded rather lamely that 'it would be both natural and appropriate for the private sector to take the lead in the development of new clauses and that such efforts should receive official support as appropriate' (G-10 Working Party, 1996, p. 16). Unfortunately, the working party was quite right about the reluctance of individual borrowers to adopt the clauses, and it was too optimistic about the willingness of the private sector to 'take the lead' in this matter. And nothing much has happened since. It has often been suggested that the major industrial countries set an example by including such clauses into their own bond contracts, but the Finance Ministers' report to the Cologne Summit was content to recommend that further consideration be given to 'the possible inclusion of such provisions in our own debt instruments, and otherwise encouraging the use of such provisions in the debt instruments issued by other sovereigns in our markets' (G-7 Ministers, 1999, para 42).

As for the other recommendation, that the IMF should 'lend into arrears' to governments that are making strong policy adjustments and good-faith efforts to negotiate with their creditors, the Fund has done this before and has agreed somewhat reluctantly to do it again. (It has indeed done it recently, by approving new funding for Russia before the Russian government had reached agreement with its London Club creditors on the restructuring of Soviet-era debt, and it may do it in the case of Ecuador before this lecture is published.)

It is worth noting, however, that the Rey Report dealt mainly with sovereign debt and that private sector debt poses harder problems. A government can readily suspend its own debt payments. It may not be able to suspend private sector debt payments without imposing capital controls. Individual private sector debtors may be loath to jeopardize their access to new credit by suspending their debt payments voluntarily. Furthermore, it would be difficult for the IMF to determine whether a country's private sector debtors are making a good-faith effort to reach a debt settlement with their foreign creditors, if and when the Fund must decide whether to 'lend into arrears' to the country's government.

THE EVOLUTION OF OFFICIAL RHETORIC

The problems posed by private sector debt loomed large in the Asian crisis and attracted close attention from another working group. This one was established by the G-22, an *ad hoc* gathering of industrial and emerging-market countries convened by the US Treasury in 1998. The report of the working group took the same stance as the Rey Report, but it laid greater stress on the desirability of voluntary agreements between debtors and creditors, rather than formal suspensions of debt service payments. Its report was drafted soon after Russia suspended its debt payments abruptly in August 1998, and it was obviously influenced by the disruptive effects of that unilateral action:

> When a country faces the imminent prospect of being unable, even with agreed policy adjustments, to meet its debt service obligations in large measure, and initial consultations with the IMF and other international financial institutions indicate that it cannot expect to obtain sufficient official financing to meet those obligations, it is in the interests of the crisis country, as well as of the international financial system as a whole, that the government avoid disruptive unilateral action and seek to achieve a cooperative solution to its payments difficulties through voluntary negotiations with its creditors . . .
> . . . When the financial sector may be unable to meet its obligations, the government may still have a role to play. To forestall a disruptive attempt by creditors to reduce their claims on the financial sector and to facilitate orderly negotiations between domestic financial institutions and their foreign creditors, the government may need to approach these foreign

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> creditors and ask that they voluntarily agree to roll over or extend the maturities of their claims (G-22 Working Group, 1998, p. 29).

The Finance Ministers' report to the Cologne Summit struck a better balance between voluntary and mandatory measures:

> There is a variety of circumstances where countries might face external financing pressures. There are circumstances where we believe emphasis might best be placed on market-based voluntary solutions to resolve the country's financial difficulties. There are also cases where more comprehensive approaches may be appropriate to provide a more sustainable future payments path. In practice, there will be a spectrum of cases between these two extremes. Where a country falls on this spectrum will help to determine the policy approach best suited to its particular circumstances. Relevant considerations include the country's underlying capacity to pay and its access to the markets.
>
> In addition, the feasibility of different policy approaches will depend on the nature of outstanding debt instruments. These will influence assessments of which claims need to be addressed to resolve the country's financing difficulties, the magnitude of possible concerns about equitable treatment among various categories of creditors, and the scope for voluntary versus more coercive solutions (G-7 Ministers, 1999, paras 47 and 48).

Soon thereafter, however, the G-7 governments switched to a simpler formulation, focused on the 'two extremes' rather than the 'spectrum of cases' between them, and they altered their characterization of the polar cases:

> 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 may not be realistic, and the use of a broader spectrum of tools may be warranted to provide for an adequately financed program and sustainable medium term payments profile (G-7 Ministers and Governors, 1999, Annex, para 5).

This passage implicitly evokes the familiar but flawed distinction between liquidity crises and solvency crises. The former, it says, should be amenable to resolution by voluntary measures, which should aim at restoring full market access; the latter may require other measures, including, presumably, the 'more coercive' measures mentioned in the Ministers' report to the Cologne Summit. Furthermore, this new formulation marks another significant change in official thinking. Whereas the Rey Report regarded debt restructuring as a substitute for massive official financing, the G-7 governments seem now to be saying that voluntary arrangements between creditors and debtors should go hand in hand with official financing—although the passage quoted above is studiously silent on the amount of official financing.

It would thus appear that the official community has softened the hard line it took when it endorsed the Rey Report. Its actual behavior, however, never conformed to the rhetoric of the Rey Report. Although it warned repeatedly against the expectation of large-scale official financing and called for more extensive private sector involvement in crisis resolution, it relied on large-scale financing throughout the Asian crisis and did not achieve very much in the way of private sector involvement. There was, as I said at the start, a growing disjuncture between official rhetoric and official behavior.

It should, of course, be said that the official community never ruled out resort to large-scale financing. It merely warned against the *expectation* of large-scale financing. The distinction was drawn early and clearly. Right after the publication of the Rey Report, I organized a symposium, published as a Princeton *Essay in International Finance*, on the fate of the recommendations made by the Halifax Summit. The introduction, by Lawrence Summers, contained this paragraph:

> Some will say that the recommendations made at the Halifax Summit and in the [Rey Report] are inconsistent The Halifax Summit Communiqué called . . . for enlargement of the credit facilities available under the GAB. But the working party warned that creditors and debtors should not count on large-scale official assistance. These recommendations are not inconsistent, however. On the contrary, they speak to the ambiguities and uncertainties that reside in the problem they seek to address. Creditors and debtors must not count on large-scale official assistance, but the need for such assistance cannot be ruled out categorically, and the IMF must therefore have access to adequate financial resources and the ability to provide them rapidly in the rare cases in which they will be required (Summers, 1996, p. 5).

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But those cases were not rare in the late 1990s, when official assistance was the rule and debt restructuring the exception.

FINANCIAL FRAGILITY AND CRISIS PREVENTION

Before reviewing official behavior in the late 1990s, let me mention another important development—the broadening of the architecture exercise after the Halifax Summit.

Much has been written about the role of financial sector problems in the Asian crisis—how they helped to cause the run on the baht that triggered the crisis and how they worked thereafter to cause enormous output losses in the crisis-stricken countries. Hence, it is often assumed that financial sector reform was tacked onto the architecture exercise after the Asian crisis. That is not true. I will not burden you with a summit-by-summit account of the exercise. Let me merely draw your attention to the Lyons Summit of 1996, which shifted the focus of the architecture exercise and vastly extended its scope. The Halifax Summit and Rey Report were chiefly concerned with crisis management. The Lyons Summit initiated what has since become a many-faceted attack on crisis prevention, by calling for efforts to strengthen financial systems and prudential supervision in emerging-market countries.

This effort has since spawned the *Core Principles for Effective Banking Supervision*, drafted by the Basel Committee on Banking Supervision, and analogous standards and codes for securities market supervision and for the insurance sector. It has also led to work on accounting standards, corporate governance, and ways to enhance the transparency of fiscal and monetary policies. (On the status of this work, see Camdessus, 1999b.) The effort also produced a new organization, the Financial Stability Forum, which is currently working on three issues—supervising hedge funds and other highly leveraged institutions, strengthening bank supervision in offshore centers, and reducing the volatility of short-term capital flows. I will say no more about these activities but will return later to an unresolved problem—the need to give the governments of emerging-market countries much stronger incentives to implement the new codes and standards.

THE EVOLUTION OF OFFICIAL BEHAVIOR

To trace the development of the disjuncture between official rhetoric and behavior, we must return to the start of the Asian crisis. There is an ongoing debate about the causes of the crisis. Some blame deep-seated flaws in the strategies and policies of the Asian countries. Others blame a combination of hubris and bad luck, along with herd behavior by foreign investors. Two comments are in order.

The first has to do with semantics, but it is still important. Defects in the structure and functioning of the Asian economies and the strong trade links between them helped to produce and propagate the crisis. Lax regulation of the financial sector, combined with directed and connected lending, *alias* crony capitalism, led to an accumulation of bad loans and of short-term foreign currency debt in the banking system. Therefore, some economists say that the Asian crisis was due to bad fundamentals; see, e.g. Corsetti *et al*. (1998). Without necessarily rejecting their analysis, let me object strongly to their terminology. The term 'bad fundamentals' was used in the literature on first-generation currency crisis models of the sort descended from Krugman (1979); it denoted a basic inconsistency between a country's macroeconomic policies and its commitment to a fixed exchange rate. Those who now use it generically are really trying to differentiate their interpretation of the Asian crisis from that of other economists, including Krugman (*Balance Sheets, The Transfer Problem, and Financial Crises*, 1999) himself, who interpret the crisis as the result of a self-validating shift in expectations—the phenomenon featured in second-generation crisis models of the sort descended from Obstfeld (1986). Their terminology, however, does a disservice to their analysis, which stresses defective characteristics of the Asian countries and of their growth strategies, rather than their macroeconomic policies.

The second comment is not semantic, and it is very important. It is concerned with fundamentals in the conventional macroeconomic sense. For the most part, the Asian countries had sound fundamentals in the years before the crisis, and this has led Sachs (1997) to attack the IMF for telling the crisis-stricken countries to tighten their fiscal and monetary policies. They do not deserve to be

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punished, he says, because they did not sin. He would, of course, be right if the Fund aimed at punishing governments for failing to follow virtuous policies. But that is not the purpose of conditionality. It is instead a forward-looking effort to bring a country's policies into line with current and future conditions. When conditions change, policies must likewise change—and the Asian countries faced dramatically different conditions in 1997 and 1998 than in 1995 and 1996. Capital inflows had given way to capital outflows, calling for sharp cuts in current-account deficits. Such cuts are usually made by the expenditure-switching effects of currency depreciation backed up by the expenditure-reducing effects of tighter fiscal and monetary policies.

In the Asian case, of course, currency depreciation had its own expenditure-reducing effects. Banks with huge foreign currency debts could not go on lending; firms with huge foreign currency debts could not go on borrowing; and essential credit flows dried up abruptly. Output fell sharply in the crisis-stricken countries, taking down tax revenues and reducing imports. The IMF should not be chastized for failing to anticipate these events. It took economists a couple of years to prove that what actually happened in Asia can also happen in theory; see, e.g. Krugman (*Balance Sheets, The Transfer Problem, and Financial Crises*, 1999). Furthermore, it took the Fund less time to tell the Asian countries that they should run bigger budget deficits. (The Fund *can* be criticized for taking too little account of the interdependence of the Asian economies and of the similarity in their manufactured exports. The income and price effects of a crisis in one Asian country and the depreciation of that country's currency served not only to propagate the crisis but also to lessen the need for expenditure-reducing policies in the countries importing the crisis *via* reduced exports.)

The Fund's advice on interest rates poses more difficult issues. I share the concerns expressed by Krugman (1998) and, more recently, by Blinder (1999). When, as in the Asian case, output is falling fast because the financial sector has imploded, it is very expensive, economically and socially, to defend a country's currency by raising short-term interest rates to very high levels—by solving the confidence problem at the cost of a deep domestic recession. It is absurdly expensive, moreover, to persist in an interest rate defense when the confidence problem and recession have both been exacerbated by political turmoil, as in the Indonesian case. At interest rate defense may be most cost effective when combined with exchange rate flexibility. The large loss of reserves resulting from the defense of a rigidly pegged rate is apt to generate expectations of a sudden drop in the value of the currency—expectations that cannot be countered without a very large interest rate increase. But Krugman goes further, and he may be right. Whenever investors begin to behave in ways that imply a severe loss of confidence, because of a country's policies, politics, or both, the temporary use of capital controls may be less expensive than an interest rate defense, even after allowing for the principal cost of imposing controls on capital outflows—a long-lasting loss of access to international capital markets. I venture to suggest that capital controls would be more widely contemplated if they were not closely identified with the foolish rhetoric and nasty habits of Mahathir Mohamad.

Turning again to chronology, let us consider the sequence of events that led to the use of large-scale financing in the Asian crisis—to a $ 17.2 billion package for Thailand in August 1997, followed by even larger amounts for Indonesia and Korea (see Table 1).

The crisis began in the spring of 1997, several months before it attracted much attention. Thailand had enjoyed several years of rapid growth, which led to increasingly irrational exuberance, a real estate and building boom, and imprudent lending by banks and finance companies. From 1992 to 1996, their loans to the private sector grew by 140%. The banks funded much of their lending by foreign currency borrowing from foreign banks. The finance companies funded some of their lending by local currency borrowing from Thai banks. In 1996, however, export and output growth decelerated, undermining expectations of further rapid real growth. The stock market and property prices fell, and financial institutions began to experience defaults by domestic debtors.

In May 1997, an incipient banking crisis turned into a currency crisis, when foreign banks became reluctant to roll over their loans to Thai banks. Thereafter, the banking and currency crises fed on each other. The banks' balance sheets were hit

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hard by the failure of several finance companies. The banks, in turn, sought belatedly to hedge their foreign currency debts by buying dollars forward, and the Bank of Thailand subsidized their purchases by intervening massively on the forward market.

In mid-June and again at the end of that month, the Prime Minister declared that the baht would not be devalued—a classic example of strategic denial. Two days later, however, the central bank announced a managed float for the baht and asked for 'technical assistance' from the IMF. But the bank was unable to manage the float, having mortgaged its reserves by its forward sales. The dollar value of the baht fell by nearly 25% during the next 4 weeks.

The Thai crisis was due largely to an unsustainable domestic boom financed in an unsustainable way, but it was greatly exacerbated by exchange rate policy. Although the baht was not formally pegged to the dollar in the years before the crisis, it was very firmly pegged to the dollar, and the dollar had appreciated *vis-à-vis* the yen, dragging the baht with it. And that was not the only or most costly consequence of *de facto* dollar pegging. There were three more.

1. In the run-up to the crisis, Thai banks and businesses took on enormous amounts of foreign currency debt without feeling the need to hedge their foreign currency exposure.
2. At the start of the crisis, the government's commitment to *de facto* pegging delayed the devaluation of the baht until Thailand had run out of reserves (or, more precisely, had mortgaged its reserve by selling dollars forward).
3. As the crisis deepened during 1997, the baht went into free fall, and the authorities could not keep this from happening. The dramatic depreciation of the baht undermined the solvency of the banking system and thus led to the credit crunch that was a main cause of the sharp fall in output. Real GDP did not grow in 1997, and it fell by 10% in 1998.

The second effect—the stubborn defense of the *de facto* peg—speaks to the power and pernicious effects of strategic denial. An interest rate defense is costly in economic terms, especially for a country with a weak banking system, and a devaluation is costly in political terms, especially for a country that has used exchange rate pegging to 'import credibility' from the outside world. Hence, a government facing a currency crisis is understandably prone to insist—even to persuade itself—that its problems are not serious and that the attack on its currency is unjustified. The Thai story illustrates the temptation and the cost. So does the Mexican story. Mexico experienced three political shocks in 1994—the uprising in Chiapas and two assassinations—and each shock was followed immediately by a dramatic drop in capital inflows. The Mexican authorities blamed bad luck for the weakness of the peso and the resulting loss of reserves, and they issued large amounts of dollar-indexed *tesobonos* to buy time for their luck to change. They did let short-term interest rates rise in line with US rates but did not raise rates aggressively to defend the peso, fearing the effect on Mexican banks. Instead, they promised repeatedly not to devalue the peso. And they were extremely persuasive—so persuasive indeed that they were accused of acting in bad faith when they had to devalue the peso in December 1994.

There were important differences, however, between the Thai and Mexican cases. In the Thai

Table 1. Official financing for Thailand, Indonesia, and Korea (in US$ billions)

Country and source	Original package	Disbursed as of March 1999
Thailand:		
IMF	4.0	3.1
World Bank and ADB	2.7	2.0
Other	10.5	8.0
Total	17.2	13.1
Indonesia:		
IMF	10.1	9.2
World Bank and ADB	8.0	2.5
Other	18.0	2.6[a]
Total	36.1	14.3
Korea:		
IMF	21.1	18.8[b]
World Bank and ADB	14.2	9.6
Other	23.1	—
Total	58.4	28.4

Source: International Monetary Fund.
[a] Includes $ 1.0 billion under Miyazawa Initiative.
[b] Before deducting $ 4.8 billion repaid by Korea.

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case, the currency crisis was the direct and inevitable consequence of a banking crisis—inevitable because the banking system had huge unhedged foreign currency debts. In the Mexican case, the condition of the banking system did not produce the currency crisis, although it prevented the raising of interest rates to defend the peso. But the Mexican crisis threatened to become a full-fledged debt crisis. Mexico could not roll over maturing *tesobonos* or redeem them on its own. The case for large-scale assistance was strong, moreover, because the Mexican crisis was seen to have ominous implications. The debt crisis of the 1980s had begun 12 years before when Mexico could no longer refinance its dollar debt to foreign banks. Although the Thai crisis had serious systemic effects, they were not fully foreseen when the crisis erupted and cannot be invoked, as they were in the Mexican case, to justify large-scale official financing.

Furthermore, official financing proved to be more effective in the Mexican case than in the Thai, Indonesian, and Korean cases. The peso depreciated sharply when it was allowed to float, but it ceased to depreciate in March 1995, as soon as Mexico announced a package of policy changes and could draw on the credit lines previously approved by the IMF and the US Treasury. In the three Asian cases, by contrast, the announcement effects were weak, partly because there was reason in each case to question the ability and willingness of the country's government to implement the policies to which it was committed, but also because it was widely known that much of the funding provided would not be available immediately to defend the country's currency. In the case of Korea, for example, most of the $ 23.1 billion in 'other' (i.e. bilateral) funding shown in Table 1 was meant as a 'second line of defense' and was never released, although the Korean government asked for access to it. It is, of course, difficult to strike the right balance between the need to 'front load' financing in order to shore up confidence in a country's currency and the need to 'tranche' financing in order to ensure implementation of the policy changes required by the Fund. The task is made even harder when, as is now common, the Fund requires a government to undertake institutional reforms that take a long time to implement.

Finally, the Mexican crisis came before the Rey Report, while the Thai crisis followed it—which brings us back to the question posed earlier: Why was it deemed necessary to assemble large-scale financing for Thailand instead of adopting the strategy suggested by the Rey Report—restructuring Thailand's short-term foreign currency debt? I have heard three answers to this question:

1. A suspension of debt payments would have provoked widespread contagion, whereas it had been confined initially to neighboring countries in Southeast Asia and was not yet virulent, even there.
2. The Rey Report had dealt chiefly with sovereign debt and had only limited relevance to the Thai crisis, which involved large amounts of private sector debt.
3. The reluctance of the Thai government to come to grips with the crisis—it was in total denial, not merely strategic denial—raised doubts about its willingness to impose and enforce a suspension of debt payments.

It would be wrong to dismiss these explanations. Although large-scale financing did not prevent the Thai crisis and its regional ramifications from affecting a large number of emerging-market countries, an attempt to impose a temporary standstill on the repayment of interbank debt might have led international banks to cut back their lending to many other countries. As for the relevance of the Rey Report, it had actually cautioned against any interference with interbank lines, which were the most volatile part of Thailand's foreign currency debt. Finally, there is the operational problem to which I referred earlier. It is not difficult administratively for a government to suspend its own debt payments, but it may be unable to suspend private sector payments without imposing capital controls—and may be unable to do that without lengthy preparations. At the first sign of those preparations, moreover, foreign investors and lenders will rush headlong for the exits.

Underlying all of these arguments, however, was the apparent belief that the Thai crisis could be contained by official financing without ratifying the precedent set in the Mexican case or damaging the credibility of the general message sent by the Rey Report—not to count on large-scale financing

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in the event of a crisis. Unfortunately, this belief was unfounded. The Thai crisis was not contained, and the official community was obliged to provide much larger amounts of financing to Indonesia and Korea—and to Brazil later on. An attempt was made belatedly to discourage Japanese banks from reducing their claims on Thai banks, and a more strenuous effort was made in December 1997 to reschedule Korea's interbank debt. That effort succeeded, but only after the Korean government undertook to guarantee repayment of the restructured debt—a pledge that was backed up implicitly by official financing. In none of the four major cases, moreover, not Thailand, Indonesia, Korea, nor Brazil, did restructuring serve as a substitute for large-scale financing.

Furthermore, the official community has begun to rationalize and institutionalize large-scale official financing:

The IMF has established two new facilities, the Supplementary Reserve Facility (SRF) and the Contingent Credit Line (CCL), aimed at providing large-scale assistance to crisis-stricken countries—or, in the case of the CCL, to countries threatened by contagion.

In January 1999, addressing the Allied Social Science Associations, Stanley Fischer, the First Deputy Managing Director of the IMF, argued forcefully that the Fund could and should be regarded as a lender of last resort to its members, even though it falls short of being a global central bank; see Fischer (1999).

In April 1999, speaking at the School of Advanced International Studies, Robert Rubin, the US Secretary of the Treasury, made a remarkable statement:

> ... the international community should not provide exceptional large-scale official finance to countries intervening heavily to defend an exchange rate peg, except where the peg is judged sustainable and certain exceptional conditions have been met, such as when the necessary disciplines have been institutionalized or when an immediate shift away from a fixed exchange rate is judged to pose systemic risk (Rubin, 1999).

This statement was remarkable for two reasons. First, it represented an effort to broaden the debate about the international financial architecture into a debate about the monetary system. Second, it appeared to imply that a crisis-stricken country might expect to receive large-scale financing *unless* it made mistakes. In other words, such financing might henceforth be normal, rather than exceptional. Similar language appeared thereafter in the report to the Cologne Summit (G-7 Ministers, 1999, para 33).

Finally, the G-7 governments seem now to be saying that future 'liquidity' crises can best be resolved by official financing, policy adjustments, and unspecified 'voluntary approaches' aimed at restoring market access (G-7 Ministers and Governors, 1999, Annex, para 5, quoted above).

In four recent cases, involving Pakistan, Ukraine, Romania, and Ecuador, the IMF has refused to provide enough official financing for the government to meet its current debt payments. In none of those cases, however, was the Fund seeking to substitute debt restructuring for large-scale financing in the context of a crisis resulting from a sudden loss of confidence. It was seeking to force the debtor country and its private sector creditors to deal realistically with an unsustainable situation. The first three countries have not defaulted formally on their obligations, but Ecuador was unable to pay the interest due on some of its foreign bonds and is now deemed to have defaulted.

In some of these cases and others as well, the Fund has found itself facing a tacit alliance between the debtor government and its foreign creditors. Both have resisted restructuring. The creditors have been loath to take losses and have also objected strongly to the guidelines for debt restructuring proposed by the major industrial countries, most notably the Paris Club principle of 'comparability' (which requires a country's private sector creditors to make debt-reducing concessions no smaller than those made by official creditors). The debtors have resisted restructuring because they fear losing access to international capital markets. They prefer to refinance their maturing obligations even though the interest rates they must pay to do so could saddle them with huge debt burdens over the next several years.

PROGRESS ON OTHER FRONTS

I have devoted most of this lecture to a single issue—the problem of involving private sector

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creditors in the resolution of financial crises. I have done that because I believe that the strategy followed thus far will not be viable over the long run. First, it perpetuates moral-hazard problems—which means that it may cause larger and more frequent crises in the future. Second, it will lead eventually to the need for a further increase in IMF quotas, and I cannot believe that the US Congress will agree to any further increase in the foreseeable future. When it approved the last quota increase, Congress created a special commission to review the activities of the international financial institutions, and its members include some of the Fund's most vociferous critics. As a matter of principle, moreover, the scope and scale of IMF lending cannot be made to depend *ex post* on the ability of member countries to get deeply into debt.

It may not be prudent to set arbitrary limits on the amount of official financing. Therefore, one must welcome the recent decision of the Executive Board to commission an independent review of the formula used to set IMF quotas, which has not been altered in more than 50 years and takes no account whatsoever of the extent to which individual countries have liberalized capital account transactions and are thus exposed to volatile capital flows. It may be useful, however, for the Fund to encourage or even require the use of strict prudential limits on short-term foreign borrowing by banks and corporations in emerging-market countries.

Fortunately, the architecture exercise has taken some tentative but promising steps in this and related directions. In their report to the Cologne Summit, the G-7 Finance Ministers acknowledged implicitly the need to confront the problems arising from the asymmetrical relationship between emerging-market countries and international capital markets. Because the latter are so large, small shifts in investors' behavior or the monetary policies of major industrial countries can cause huge fluctuations in capital flows to emerging-market countries.

The G-7 Ministers asked the Fund to study the benefits and costs of market-based measures aimed at curbing capital inflows, measures like those used by Chile, but gave those measures more support than they had before and went somewhat further:

> 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 (G-7 Ministers, 1999, para 30).

They also endorsed proposals made by the Basel Committee on Banking Supervision that would raise the capital cost of short-term bank lending to most emerging-market countries. Risk weights would be adjusted to reflect more fully the creditworthiness of the borrowing country, as well as the creditworthiness of the individual borrower.

Too often, however, the G-7 Ministers seem content to rely on the threat to deny official financing as the main way of promoting reform in emerging-market countries and reducing their vulnerability to financial crises. Alternatively, they say, adherence to various codes and standards should be used in designing Fund conditionality. This strategy is flawed.

First, it lacks credibility, thanks to the normalization of large-scale financing, the recent tendency of the official community to distinguish implicitly between liquidity and solvency problems, and the fact that small, systemically unimportant countries are seen to have solvency problems, whereas large, systemically important countries are typically deemed to have liquidity problems. Many governments may now believe that their countries are 'too big to fail' and that they will obtain large-scale financing in the event of a crisis despite their failure to reform their financial systems.

Second, strategic denial, along with the usual reluctance of politicians to take hard decisions, has led many governments to discount the likelihood of having to go to the Fund. Hence, they cannot be expected to undertake reforms merely to protect their access to official financing. Some Asian countries are already backing away from reforms they agreed to undertake when they needed the Fund's help. They have even begun to engage in *de facto* exchange rate pegging in response to the revival of capital inflows, so as to build up reserves and prevent their currencies from appreciating strongly.

It would be more sensible to rely on carrots and sticks that can have their full effect in ordinary

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times, not on those that take effect only when countries need help from the Fund. Let me give three examples:

1. If a government does not take steps to comply with the *Core Principles for Effective Banking Supervision*, the capital cost of lending to its banks should be raised sharply, and they should not be granted entry to other countries' markets.
2. If a government does not include collective-action clauses in its own bond contracts, it should be barred from issuing bonds in other countries' markets.
3. The Fund should be encouraged to issue a blunt warning when, in its view, a government is courting the risk of a currency crisis. If its warning is ignored, the Fund should tell the government that it will 'go public', even at the risk of provoking the crisis it wants to prevent.

These suggestions are not new. In fact, the G-7 Ministers alluded to the first and second, albeit rather cautiously (G-7 Ministers, 1999, paras 21 and 42). The third is more controversial because of the obvious risks. On the one hand, the Fund will not foresee every incipient crisis and may be blamed for missing some. On the other hand, it may be accused of causing crises that would not have occurred if the Fund had not gone public. Both risks, however, are usually exaggerated. The first risk, that the Fund will miss some crises, can be met by making it clear from the start that the Fund is not in the business of forecasting crises. Its task is to identify serious policy errors and unsustainable situations that are likely to cause crises if they are not rectified. The second risk, that the Fund will be blamed for causing crises, would be worrisome if it did not induce the Fund to be cautious and did not deter governments from ignoring the Fund's initial, confidential warnings. The Fund would not go public unless its warnings were ignored, and they would not be ignored if the Fund could then go public. Most governments would heed the Fund's confidential warnings, even if they were not sure that the Fund was right. Hence, the Fund would not need to go public often, and by the time it did, the precariousness of the country's situation would be apparent to all—not just to the Fund.

UNFINISHED BUSINESS

It should now be clear why I believe that the architecture exercise may be ending prematurely. Four major issues have not been resolved.

Firstly, the official community has still to decide whether it really intends to replace large-scale official financing with debt restructuring or whether it wants the IMF to evolve into a lender of last resort. If it means to rely heavily on debt restructuring, it must find more effective ways of involving the private sector in the resolution of currency crises, including those afflicting large, systemically important countries. If it expects to continue providing massive official financing, it must find ways to discourage emerging-market countries from going deeply into debt.

Secondly, the official community must decide what more can be done to mitigate the effects of the asymmetry between the large size of financial markets and the small size of the typical emerging-market country. More flexible exchange rates will help, along with capital inflow controls and strong prudential supervision of financial institutions, but they may not suffice.

Thirdly, the official community must induce emerging-market countries adopt the codes, implement the reforms, and pursue the policies strongly and rightly endorsed by the architecture exercise. The task cannot be left entirely to the IMF, which has too few carrots and sticks to wave at the problem and, as a practical matter, too few countries at which to wave them. Its influence is limited until countries need its help.

Finally, the official community—and academic economists—must answer the hard question posed by Krugman, Blinder, and others: Should investor confidence always take priority over domestic stabilization and the mitigation of economic hardship in a crisis-stricken country?

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