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Consequences of Financial Globalization for Policy Making

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Die Heftigkeit der Finanzkrisen der neunziger Jahre bietet eine ausgezeichnete Gelegenheit, um einige wichtige wirtschaftspolitische Themen zu diskutieren, die mit der Globalisierung der Finanzmärkte und dadurch mit den Wahlmöglichkeiten der Politik in der nahen Zukunft zusammenhängen. Die jüngsten Krisen bestätigen die Auffassung, dass offenbar ein Zielkonflikt besteht zwischen den Vorteilen eines sich rasch entwickelnden und grösstenteils unregulierten Finanzsystems, das Portfolioinvestitionen in grossem Umfangs anzieht, und den Kosten der finanziellen Verwundbarkeit. An diesem Punkt gibt es kein Allheilmittel, das das «Fear of Floating»-Syndrom mildern könnte, ausser vielleicht einigen kurzfristigen Übergangslösungen wie beispielsweise marktbasierten Wechselkontrollen sowie verbesserter regionaler Koordination als mittelfristigem Ziel. Doch provisorische Massnahmen sind *per se* keine langfristigen Lösungen, da ihre Glaubwürdigkeit stark vom Kontext der Reformen abhängt, in dem sie veranlasst werden. Die Fallen der Globalisierung haben auch zu Versuchen geführt, die globale Finanzarchitektur zu stärken, um das Risiko abrupter Schwankungen der Marktstimmung zu reduzieren. Bis jetzt hat man sich dabei jedoch ausschliesslich auf die Themen Transparenz und Datenaustausch konzentriert. Andere tiefergreifende Veränderungen, darunter die Rahmenbedingungen für die Restrukturierung von Schulden, werden noch heftig diskutiert.

Keywords: financial liberalization, currency crisis
JEL-Codes: E44, F21, F42

1 Introduction

The virulence of financial crises in the 1990s has taken everyone by surprise, and has claimed many victims including countries which were not among the "usual suspects". After the Mexican Peso crisis of 1994–95, the East-Asian crisis in 1997, the Russian default in 1998, the first precipice-flirting Brazilian episode at the end of 1998, the spectacular Argentine meltdown in 2001 and its contagion effects on Uruguay and Paraguay in 2002 have all raised serious issues about the impact of financial integration on policy making and the possible deficiencies of the current world monetary system. Such episodes offer an excellent opportunity to re-ex-

* The author is writing in his own capacity. The views presented in this paper do not necessarily represent those either of the World Bank Group or of its shareholders.

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amine and discuss some important policy issues linked to the globalization of financial markets and therefore, to the policy choices available in the near future. The paper is organized a follows: the first section aims at clarifying terms and issues as "globalization" has rapidly become a definitional mayhem. The second section will review the consequences of financial globalization, and, in particular, the mechanics of currency and banking crises, and policy making implications. Lastly, the third section will address the main challenges ahead, i.e. the role of financial liberalization, the role of exchange rate policies, and the role of the international monetary system.

2 The Globalization of Financial Markets: What Are We Talking About?[1]

Motto of the 1990s, the term "globalization" reveals literally dozens of different uses, which is the source of great confusion. What economists and businessmen have often in mind while referring to globalization is the increasing internationalization of markets, that is, the move towards closer economic and financial integration. According to that economic definition, globalization refers mostly to the level of international integration. From that perspective, interdependence (in its economic understanding) must be seen rather as a *consequence* of this internationalization process and not as a proper definition. The driving forces behind the globalization of markets are complex, but two factors have either facilitated or accelerated deeper financial integration, namely technological progress and liberalization. Technological innovation in the field of telecommunication is by far the most dramatic change shaping new kinds of production networks, financial instruments and profit strategies. Cellular phones and computer networks such as the internet are the most well known examples of technological innovation. Of course, there have been significant interactions between technological progress and liberalization measures, with at times, two-way causalities. Such interactions have been particularly strong in finance and telecommunications. In various countries indeed, liberalization measures have been partly induced by technological advances that made existing regulations inappropriate. Information exchange and financial innovation have made *de facto* financial markets much more integrated. Then, financial deregulations have fostered investment operations. In the field of telecommunication also, national regulations had to

1 This section draws on BUCHS and SCHEHR (1999).

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adapt to technical progress, thereby offering new investment opportunities. In short, the causality link between liberalization/deregulation and globalization is not one-sided and the two phenomena feed on each other.

Coupled to the speed of capital transfers and increased capital mobility, two major changes have transformed the way financial markets operate. The first is growing concentration of market power in the hands of institutions such as pension funds and insurance companies, which increasingly trade securities across borders; the second factor is financial innovation, with the development of securitization (allowing firms to borrow directly from markets rather than through banks) and the proliferation of derivative instruments.

As a result, gross capital flows have literally taken off since 1980, and especially in the past decade. For example, gross flows of portfolio investment and foreign direct investment (FDI) in industrial countries more than tripled between the first half of the 1980s and the first half of the 1990s, whereas worldwide flows of foreign direct investment outward industrial countries more than quadrupled between 1984 and 1990. This last trend reflected a genuine surge in capital flows to emerging markets: FDI to such countries, including Asia, Latin America and Eastern Europe, expanded during 1991–96 at an average annual rate of about 40%. Portfolio investments to emerging markets have been more volatile during the same period, except in Asia where a steady increase occurred until 1997.[2] It is important to note that this surge in capital flows not only reflected financial opening in emerging markets but also very low interest rates in the US and in Japan. The second half of the nineties showed more volatility, as financial markets became much more risk-averse after the East-Asian debacle and the Russian crisis, all the more because interest rates started to rise again in the US. But the one measure which singles out the sharp increase in the volume of international transactions, and which shows the increasing challenge faced by monetary authorities to influence exchange rates by official intervention, is the average daily turnover in the foreign exchange market: it has grown from US$ 190 billion in 1986 to US$ 1.5 trillion in 1998, that is, a figure approximately equivalent to 85% of all countries' foreign exchange reserves (see *table 1*). However, foreign exchange trading declined substantially between 1998 and 2001, reflecting a variety of factors including a reduction of risk tolerance since the East-

2 IMF (1998) pp. 12–13.

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Asian and Russian crises in 1997–1998, a reduction of exchange trading desks and the launching of the Euro.

Table 1 Foreign Exchange Trading

	1986	1989	1992	1995	1998	2001
Global estimated daily turnover (US$ billion)	188	590	820	1190	1500	1200
As a ratio of (in %): World exports of goods and services	7.4	15.8	17.4	19.1	22.5	15.0
Total reserves minus gold (all countries)	46.7	75.9	86.0	84.2	85.6	56.2

Source: IMF (1998); and author's calculations on the basis of *World Economic Outlook* (IMF) databases and BANK FOR INTERNATIONAL SETTLEMENT'S (BIS) annual reports (var. issues).

As impressive such numbers may be, one should not forget that the degree of capital market integration is much more limited. Indeed, large net flows of capital should in principle show in large current account imbalances: emerging markets, which are scarce of capital but with high investment needs should run impressive current account deficits, whereas industrial countries, the savings rate of which being larger than investment needs, would be expected to run current account surpluses. This is far from being the case empirically. This fact, among others such as the close correlation between domestic savings and investments, simply suggests that in spite of the increasing integration of financial markets, the latter do not form a single global market. Yet, there should be no misunderstanding: the current degree of financial integration is high enough to affect the conduct of domestic economic policies, which involves opportunities and risks. This is precisely what the next section will argue.

3 The Consequence of Financial Globalization: What Do We Really Know?

3.1 Financial Resource Allocation and Growth

The contribution of greater integration of financial markets to growth is subject to an interesting debate among economists. From a theoretical standpoint, financial markets foster efficient allocation of resources with

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the intermediation between savings and investments provided that capital is being channeled into productive investments. The opening of domestic capital markets offers more opportunities to diversify risks and seek other investment prospects, to the benefit of capital scarce countries. Yet, capital flows may also create problems if they only serve to finance consumption booms, following a typical "boom-bust" cycle. As always, the devil lies in the details, and the absorption capacities, the efficiency of the banking system, and the productivity of investments must always be borne in mind to assess the domestic effects of foreign capital flows. On more empirical grounds, however, there is mixed evidence that capital account liberalization promotes long-run economic growth. Some studies have found a stable and positive correlation between growth and indicators of financial development, but others identify considerable geographical variation.[3] Recent research finds that although international financial integration is *associated* with economic growth (high levels of GDP *per capita* and strong institutions), empirical evidence does not support the view that international integration stimulates economic growth.[4] Some studies actually suggest that the effect of financial opening on the relative volatility of consumption is *non-linear,* showing negative effects for most developing countries but positive effects for industrialized countries.[5] The evidence is therefore not convincing so far, as it is difficult to isolate financial integration from a whole set of institution building issues. In addition, the quantification of these long-run gains is an open question mark, as pointed out by BHAGWATI (2002, p.6).

3.2 Currency and Banking Crises

Long term benefits and short term problems are not mutually exclusive. New opportunities arising from the greater integration of financial markets are not free of risk, simply because macroeconomic interdependence is a fact. For long, when capital was not so mobile, the transmission of macroeconomic shocks or policies occurred through the current account (trade flows). Interest differentials were not automatically offset by large flows of capital due to restricted mobility. However, with higher capital mobility, transmission effects take place both through the current account

3 See EDISON, KLEIN ET AL. (2002) for a survey of the empirical literature to date.

4 See EDISON, LEVINE ET AL. (2002).

5 See KOSE ET AL. (2003). The results of the study show that although the volatility of output growth has, on average, declined in the 1990s relative to the three earlier decades, the volatility of consumption growth relative to output income growth has increased for more financially integrated developing countries in the 1990s.

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but also through the capital account. That may explain why some currencies are more vulnerable to a crisis, especially in a fixed exchange rate system, and why some banking crises happen, but in such cases, globalization is rather the instrument than the source of the problem. Indeed, financial crises are quite common in modern economic history, but increased capital mobility has simply made it harder for governments to lean against the wind: "fine-tuning" policies relying on inflationary or debt-accumulating policies are thus more difficult to conduct because market responses and sanctions come earlier. In other words, governments do not benefit from any grace period, and have to face the consequences of their policies earlier than before, which is not necessarily bad news. Of course, the speed of capital inflows and outflows can also induce contagion problems, and accelerate the path of a given crisis as in Mexican crisis in 1994/95, the East-Asian crisis in 1997 and the Russian crisis in 1998. This is the other side of the coin.

In fact, the main causes of currency crises traditionally include monetized fiscal deficits (which creates a capital outflow and depletes reserves) and the bailing-out of banks with expansionary monetary policy (which has the same effect), but also include speculative attacks. By the same token, the main "causes" or vulnerability factors in a banking crisis include the difference of maturity of the banks' assets and liabilities, currency mismatching, risky lending policies, and general over-borrowing. The connection between the two types of crises is simple: financial liberalization and deposit guarantees tend to generate over-borrowing (due to excess confidence) and current account deficits, which make the domestic economy more vulnerable to both internal and external shocks. A banking crisis, for instance, may force the authorities to bail out the banking system, which invariably provokes a currency crisis, even if the authorities sterilize the operation.[6] In this respect, the Russian crisis in 1998 was a "classic" case of *unstable fiscal dynamics,* with a combination of sizable primary deficits, high real interest rates and negative growth[7], whereas Argentina's meltdown in 2001–2002 reflects *unstable foreign debt dynamics* and a *huge balance-sheet problem* because of the currency structure of accounts in the face of real exchange rate overvaluation.[8]

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6 A monetized bail-out drives domestic interest rates down, fostering capital outflows, a depletion of reserves and a currency crisis. A sterilized bail-out drives interest rates up, putting pressure on an already fragile banking system, which feeds up devaluation expectations and paves the way for a massive speculative attack against the domestic currency.

7 See BUCHS (1999), MALLERET ET AL. (1999) and SAPIR (1999).

8 See PERRY and SERVEN (2003), BAER ET AL. (2002), and BUCHS (2003).

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Yet, the 1997 crisis in East-Asia surprised the academic and business communities, precisely because the main features of previous financial crises were by and large absent: with only moderate overvaluation of their respective currencies, balanced budgets, sustainable debts over time and no immediate risk of default, some East Asian countries were subject to a spectacular loss of market confidence, which triggered a series of currency crises. It has been pointed out *ex-post* that the impressive build-up of short-run debt by the East Asian economies during the 1990s made them increasingly vulnerable to a reversal, and therefore, to a *liquidity* crisis.[9] If it is true that short-term debt ratios were quite high in the three East Asian countries which were severely hit by the crisis (Indonesia, Korea and Thailand), short-term capital flows can hardly be depicted as exogenous factors in the confidence crisis: if anything, short-term debt is clearly *endogenous,* as it signals the increasing reluctance of markets to offer long-term finance. In this respect, pin-pointing hot money flows as the trigger of the crisis almost certainly misses the point and offers no policy lesson. A more convincing explanation is that after the Peso crisis in Mexico, international financial markets became more nervous, and yet continued to gamble on the East-Asian financial "bubble". As most imbalances originated in the private sector and not in the public sector, it is plausible to imagine that most foreign creditors present on the market had sufficient information to assess the situation and make juicy profits, provided that they would leave the train *on-time,* i.e. just before the bubble bursts. In such a situation, the real trigger of the crisis is difficult to determine, which encourages herd behavior, as creditors suddenly react on the basis of the other creditors' actions, and no longer on the basis of the debtor's fundamentals. This type of panic phenomenon is nothing really new in economic history, as described in the seminal work of KINDLEBERGER (1979). To a large extent, the same happened during the Russian crisis and in Argentina, when debt-rollover was not longer feasible.

In addition to quick reversals and increased volatility of capital flows, it has also been suggested that the recent wave of financial crisis and financial distress was heavily affected by a more general form of capital re-

9 The underlying story here is the distinction between *insolvency* and *illiquidity*. Insolvency applies to a borrower lacking the net worth to repay outstanding debts out of future earnings, whereas illiquidity applies to a borrower lacking immediate cash to repay its current debts although he might be perfectly able to honor its debts service in the long run. In other words, a solvent borrower may face a severe liquidity crisis if he is not longer able to borrow from the capital markets in order to meet its current debt service obligations.

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trenchment from emerging markets, i.e. *"sudden stop"*[10]. As the argument goes, the massive capital inflows that set sail to emerging markets (Latin Americas in particular) in the early 1990s all of a sudden came to a standstill following Russia's financial crisis, triggered by an emerging market aversion factor among foreign investors and a more restrictive monetary policy in the US. The argument seems to be tailor-made for Latin America, which indeed witnessed drastic current account adjustments as well as serious real exchange rate realignments in countries such as Brazil and Chile. Yet, does the "sudden stop" story fit into the Argentine debacle? From a purely factual point of view, not quite. First of all, Argentina's spreads over US Treasury bills remained below that of Brazil, Venezuela and Ecuador until the end of 2000, and Brazil's spreads were even significantly higher in 1998–1999; second, and this reflects the first factor just mentioned, Argentina continued to attract more capital flows as a share of GDP than other countries, even with the "sudden stop" effect, until late 2000; third, the current account adjustment which followed the 1998 capital crunch was actually very small in Argentina in 1999, compared to that of Brazil, Chile, Colombia or Ecuador. Yet, during the same period, Argentina's economy performed worse than all the other countries of the region, which suggests that the "sudden stop" story is not at the root of Argentina's economic meltdown, although it certainly acted as an amplifier of domestic problems.

4 Challenges Ahead for Policy Making

4.1 Financial Liberalization and Economic Vulnerability

What the recent crises confirms is that there seems to exist a *trade-off between the benefits of a rapidly evolving and largely unregulated financial system attracting large portfolio investments and the costs of financial vulnerability.* To use even bolder terms, the combination of a weak banking system and an open capital account is "an accident waiting to happen"[11]. There is a consensus in the literature that internal liberalization (elimination of domestic credit controls, of credit rationing, interest rate ceilings)

10 The term "sudden stop", which depicts large and unexpected reductions in capital flows, was coined by DORNBUSCH ET AL. (1995), inspired by a banker's adage *"it is not speed that kills, it is the sudden stop"*. The idea is that a large and unexpected reduction in capital flows may well trigger huge shocks on investment, credit and consumption, ultimately putting at risk private and public solvency. See CALVO (1998) and (2002) for the full demonstration of the argument.

11 IMF (1998) p.75.

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should precede external liberalization[12], but all financial crises that occurred in emerging countries in the 1980s and 1990s evidenced that liberalization is not enough and that the build-up of a competitive and efficient banking system takes time. The standard recipe to overcome such problems is usually better prudential regulation and supervision, but this is easier said than done. Indeed, capital adequacy ratios may not have the same information content in industrialized, emerging or transition economies. In many countries, capital adequacy ratios are much higher than the required 8% of risk-adjusted assets, and so is the level of excess reserves of banks. Yet, accounting practices are so "creative" in some countries that such figures are virtually meaningless. The same applies to loan classification which makes non-performing loans a vastly underestimated problem. Supervision is the other key element, but it is perhaps even more problematic than "regulation". It is fashionable to refer constantly to the *"25 Core Principles for Effective Banking Supervision"* of the Basle Committee, but these are more a general framework of reference than an operational blueprint. What seems to be increasingly needed is better institutions in order to design appropriate regulations and supervision instruments. It is a matter of *institution building,* an area which is not well covered in economic theory.[13]

In short, the risks involved in external financial liberalization reinforce the argument for serious financial reforms. This is actually what happened in the aftermath of most banking crises in the past, especially in Latin America, as illustrated by a recent empirical study which finds that *financial liberalization fuels institutional reforms, typically in the aftermath of crises*[14]. Quite disturbingly, this suggests that there is a learning-by-doing trend in financial development, which makes crises almost unavoidable. Yet, the experience of the 1990s calls for caution regarding this "Schumpeterian view" of financial crises, as the destruction of institutions and the credibility damages associated therewith can prove difficult to overcome from a political economy perspective.[15] The link between "short-term pain" and "long-term gain" may not be linear, and as put by BHAGWATI (2002) in an essay exploring the "capital myth" (pp.6–7), "any nation contemplating the embrace of free capital mobility [...] must reckon with these costs and weight them by the not negligible probability of running into a crisis". In crude terms, the cost-benefit analysis of international fi-

12 See BLEJER and SAGARI (1988).
13 See WORLD BANK (2002).
14 KAMINSKY and SCHMUKLER (2003).
15 The typical example coming to mind is Argentina in 2002.

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nancial integration looks like a puzzle with missing pieces: on the one hand, short-term costs are pretty clear and unfortunately well documented, but on the other hand, the long-term benefits are intuitively plausible yet not empirically robust.

At this juncture, the logical policy implication of this puzzle is to look for alternatives: either regarding the *timing* and *speed* of external financial liberalization (e.g. sequencing of reforms), or regarding means to mitigate the short-term risks associated with financial liberalization (e.g. architecture of the world financial system), or regarding various forms of capital mobility.

4.2 Exchange Rate Policies

The debate about appropriate exchange rate regimes has raged over the last decade, and issues have been discussed *ad nauseam.* It not only focused on the merits of alternative regimes in disinflation programs, but also on the costs of failure, and on credibility and reputational issues. In most countries, the fixed versus flexible exchange rate debate stems from the fact that exchange rates are often assigned two very different roles, which can prove difficult to manage. On the one hand, exchange rates can be used jointly with other policies to foster macroeconomic stabilization and low inflation in providing a nominal anchor to the economy and thus imposing financial discipline. On the other hand, exchange rates, again together with other policies, do also play a key role in maintaining international competitiveness, hence the importance of some degree of flexibility. The extent to which these objectives can be compatible heavily depends on the specific context of the countries involved in the debate, and this has generated a whole literature on the optimal degree of exchange rate flexibility.[16]

So much for the theory. But in practice, the series of recent currency crises both in industrial countries (the EMS crisis in 1992/93) and emerging countries has revealed the inherent fragility of fixed or semi-fixed rates, which is much more serious than previously thought with the integration of world capital markets. The implication is straightforward: *for most countries, the choice between fixed and flexible exchange rate is becoming increasingly irrelevant.* As documented in OBSTFELD and ROGOFF (1995)

16 For an overview, see AGÉNOR and MONTIEL (1996, chapter VI).

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and confirmed by the Argentine tragedy, aside from a few minor tourist economies, oil sheikdom and heavily dependent principalities, few fixed exchange rates have survived the past several years intact.[17] One is therefore left with various degrees of exchange rate floating, but it is well known that flexible rates tend to be extremely volatile in emerging economies, as can be wages and prices, with large balance sheet effects on liabilities expressed in foreign currency. Between floating and the "fear of floating", are there alternatives available? Two have received considerable attention lately, i.e. *dollarization* and *capital and/or exchange controls.*

Let us start with dollarization. Although the terms "currency substitution" and "dollarization" are often used in the literature to describe the extent to which foreign money (currency and deposits) substitutes for domestic money in its three traditional functions (unit of account, medium of exchange, and store-of-value), what is referred to in this discussion is the adoption of the US Dollar (or any major currency) as the sole legal tender for all transactions, i.e. *full dollarization.* This peculiar currency regime was successfully used until recently only in Panama, but at the turn of the century, Ecuador and El Salvador joined the club in repudiating their respective currencies and adopted the US Dollar. The logic of dollarization is pretty simple: no currency, no exchange rate risk, no crisis. Yet, as it is well known from the optimal currency area literature, the sustainability of this type of arrangements depends on various factors including trade openness, economic structure and types of economic shocks. In this respect, unless an economy is sufficiently integrated with the US economy, permanent dollarization may not be sustainable in terms of competitiveness. In addition, with dollarization, economic adjustment in the face of economic shocks relies exclusively on fiscal policy, which is not only slow but also politically delicate. All this means that the straightjacket imposed by dollarization may prove unbearable unless domestic markets are extremely flexible so as to allow quick relative price adjustments. Although the jury is still out in the case of both Ecuador and El Salvador, the overvaluation of their real exchange rates is already threatening their international and regional competitiveness and creates a friction between their tradable and non-tradable sectors. Therefore, as an extreme form of exchange fixing, dollarization looks like a doubtful viable alternative to the exchange rate puzzle discussed before. If exchange rate stability is to

17 If one excludes the two CFA Franc zones in Western and Central Africa, tied to the EURO through a French Treasury guarantee, as well as oil sheikdoms, small islands and highly dependent principalities, the list is limited to approximately 15 countries according to the IMF classification of exchange rate arrangements as of September 2002.

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be achieved, working out some regional arrangements concomitant with existing trade frameworks (e.g. Mercosur) would seem to make more sense than adopting the US dollar, a policy decision coined by WYPLOSZ (2002) as reflecting a "gringo complex".

The next alternative to be discussed is capital and exchange controls. The latter is a "classic" in the menu of options available to countries facing severe balance of payment difficulties, and is back in fashion not least because of the decision of Malaysia to embrace some exchange controls in 1998. Note first of all that both measures are different as well as their likely consequences, which sometimes creates considerable confusion. Basically, capital "controls" can take the form of diverse restrictions on capital flows (traditionally, inflows) or taxes on certain capital transactions[18], and limit the degree of capital account convertibility. Exchange controls can take equally different forms, but essentially limit the availability or use of foreign exchange as such. These measures mostly affect current account transactions (for residents or non-residents) but the distinction is sometimes much more complicated. Obvious examples of exchange controls include limited internal convertibility[19], or foreign exchange surrender requirements for exporters which is a particular case. The effectiveness of all these measures -capital controls and exchange restrictions- is subject to a large debate, but experience suggests that they tend to be exceedingly difficult as well as costly to enforce over time. The case for a tax on capital transactions, aimed at limiting speculative inflows and outflows, is certainly the most sensible proposal since it is market-based, whereas the others are more distortionary and may foster the development of black foreign exchange markets. Yet, they might offer some breathing space as stopgap measures, but they can only have some credibility if they are associated with serious structural reforms to strengthen the domestic financial system. In other words, it should be clear that capital and exchange controls are not a substitute for reform. Likewise, if they are used in the context of an overvalued exchange rate, they may well evolve from a temporary defense against speculation into a permanent system of trade protection.[20]

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18 A widely publicized example is Chile, which imposed until the year 2000 a one-year minimum holding period on capital inflows larger than US$10'000 as well as a 10% unremunerated reserve requirement (also with a one-year minimum holding period) for all external liabilities that do not result in an increase in the stock of capital.

19 The issue of convertibility hides a minefield of technical ambiguities. Here, internal convertibility is defined as the ability of residents to acquire and maintain domestic holdings of assets denominated in foreign currencies without any restriction. See GREENE and ISARD (1991).

20 EDWARDS (1995).

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To sum up, at this juncture, there is no magic bullet which can alleviate the *"fear of floating"* syndrome, except perhaps some stopgap measures such as market-based exchange controls in the short-run, and some better regional coordination as a medium-run objective. Yet, stopgap measures offer no lasting solution *per se,* as their credibility heavily depends on the reform context in which they are put in place.

4.3 Reforming the International Monetary System

Throughout the previous decade, the Bretton Woods institutions and the International Monetary Fund (IMF) in particular faced harsh criticism from various NGOs and academics, although for different and sometimes vastly contradictory reasons. Various ideas have been voiced to strengthen the global financial architecture, but the consensus so far has been to focus exclusively on the issues of *transparency* and *data dissemination.* The central idea is twofold: to reduce the risk of abrupt changes in market sentiment through greater transparency and to enhance the resilience of financial systems when market sentiment does change, for example, as a result of external shocks. Through increased coordination among existing institutions, a range of voluntary international standards of good practices for economic policies and for the financial infrastructure has been developed and promoted. Few would argue that disseminating more coherent information is bad news for the international financial system, but the continuation of financial crisis and distress in the early 2000s shows that these cosmetic changes are not up to the task. In addition, the ineffectiveness of IMF packages to stop the currency crises in East-Asia, Russia and Argentina, has caused a *malaise* about the genuine role of the IMF in general.

4.3.1 The Role of the IMF: To Bail Out or Not?

The question has been debated over and over again since the East-Asian crisis. Essentially, it asks what the IMF should and actually can do in countries subject to a balance of payment crisis in order to restore confidence and prevent a full-fledged financial crisis? At first sight, an ironic answer could be "not much", especially given the speed and self-fulfilling nature of some recent financial crises. To begin with, the IMF appears ill-equipped to fulfill a genuine role of lender of last resort: the IMF cannot print money, it cannot lend freely – its loans being sliced into tranches

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subject to policy conditionalities, it does not lend at penal interest rates against collateral, and lastly, the IMF resources are limited. In fact, its record of intervention shows that it has never been the main lender of last resort.[21] In the Peso crisis in 1995, for instance, the United States provided most of the rescue funds, and in East-Asia, the IMF "bail-outs" were modest compared to capital outflows. In the case of Russia, the "package" of international lenders was even smaller, with $22.6 billion in new credits spread over 1998 and 1999, including a $11.2 billion new IMF loan. In the case of Brazil in the Summer of 2002, when debt sustainability was suddenly questioned in the light of the increasingly likely victory of "LULA" in the upcoming presidential elections, the IMF package came up with a $30 billion loan, i.e. the size of the cumulated exposure of the four major US investment banks on Brazil. Thus, to be a credible lender of last resort would require much larger amounts to be made available in the short run, and this has justified debates about a "bigger IMF". Yet, two major objections have been raised about the *desirability* of a "lender of last resort": first, it is not automatically obvious that a credible lender of last resort would do much in case of self-fulfilling panic;[22] second, there is a chance that IMF interventions increase "moral hazard" problems in bailing out losers and distorting market rules. The "METZLER Report", in particular, argued that international bailouts were a contributing factor to financial crises because of the moral hazard they tend to create, at the expense of the global taxpayers.[23] Although one can easily dismiss the cost implication of bailouts given the small size of funds disbursed so far and the good repayment record of crisis countries[24], the moral hazard argument is sometimes overplayed. To date, the only "classic" example of moral hazard is the Russian crisis in 1998, where foreign investors took breathtaking risks on the Russian Treasury Bill market until the very last minute, not only because it was highly profitable, but also on the *expectation* that Russia was too big to fail.[25] When it comes to other recent financial crises including Argentina's in 2001, it is difficult to make a strong case for moral hazard problems, however.[26] But even if one accepts the rele-

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21 See RADELET and SACHS (1998a, p.34), and THE ECONOMIST, *Toward a New Financial System,* 11 April 1998, pp. 64–66.

22 The reason might be that the use of a lender of last resort mechanism could well give all the confidence of seeing an ambulance outside one's door.

23 INTERNATIONAL FINANCIAL INSTITUTIONS ADVISORY COMMISSION (2000).

24 See JEANNE and ZETTLEMEYER (2001).

25 See BLUSTEIN (2001).

26 The general enthusiasm of Wall Street firms vis-à-vis Argentina until the very last minute is more a reflection of conflict of interest involving research and underwriting activities by US financial firms in the area of emerging markets sovereign debt than straight moral hazard. On this issue, see BLUSTEIN (2003).

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vance of moral hazard in some cases, how to address the issue is a totally different story. As the BUSH administration painfully discovered in 2002, having a "hands-off' approach in a given country can easily fuel investors panic in neighboring markets and indirectly contribute to propagating the crisis at the regional level: although the BUSH administration initially endorsed the "METZLER Report" critique *vis-à-vis* bailouts and did not want to use taxpayers' money to rescue Argentina, things got out of hand when Brazilian spreads started to ratchet up steadily in the Spring of 2002 and when financial panic hit Uruguayan banks. At the end of the day, despite rhetoric and contradictory statements of the US Treasury, the international financial community did intervene in both countries in August 2002 to prevent regional contagion.[27] So ironically, on the one hand, international bailouts may be a contributing factor to financial crises through moral hazard effects, but on the other hand, the absence of bailouts may have the same effect because of financial contagion problems. Against this background, the real question is not whether or not to bail out crisis countries, but what else could be done at the international level? Obviously, financial crisis management is a complex issue and it is difficult to come up with simple quick-fixes. It would seem, however, that when a country faces a pretty serious debt *stock* problem, the room for debt flow adjustments may be very limited and only postpone the problem. The only solution in such an extreme case is to finally tackle the stock problem. This is where debt restructuring comes into the picture.

4.3.2 Debt Restructuring: Market-based or Statutory Approach, or Both?

The idea of a fully-fledged international bankruptcy framework modeled on Chapter 11 of the American bankruptcy law had been floating around over the last ten years, but gained momentum when the IMF circulated a draft paper on debt restructuring in November 2001.[28] The idea is intuitively appealing: *a financially distressed sovereign nation should be allowed to declare a standstill on debt payments and to put itself under the protection of an international bankruptcy forum.* The comparison between corporate and sovereign debt restructuring is not perfect, and working out an international bankruptcy framework may require major adaptations of a Chapter 11-type procedure. Municipal bankruptcy may provide a closer analogy than corporate bankruptcy to the issues facing an international

27 It was pretty clear over the Summer of 2002 that the spreads of all Latin American countries started to be correlated with those of Brazil, with the exception of Mexico and Chile.

28 See KRUEGER (2001).

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bankruptcy framework. However, the debate has not focused so much on the legal details and structure of this potential procedure so far, but on its very desirability. Critics of the statutory approach raise two types of arguments: on the side of the financial community, it is argued that more market-friendly solutions such as contractual procedures could essentially deliver the same results.[29] Two contractual procedures are frequently cited, exchange offers and collection action clauses, and practical examples include Ecuador, Pakistan and the Ukraine. On the side of debtor countries, the major concern is the possible rise in future borrowing costs, which a bankruptcy procedure would entail. Interestingly, most of the debtor countries are currently afraid of publicly lending support for an international bankruptcy framework, as it may signal their intention to default in the future. Although the debate is still raging, the statutory and contractual approaches may actually be complementary rather than mutually exclusive, as pointed out by BOLTON (2002). Contractual approaches do not guarantee a comprehensive restructuring agreement of all bond issues and other debt claims and fail to address properly the crucial issues of creditor payments according to "absolute priority" and debtor-in-possession financing, which may reinforce the argument for an orderly statutory framework defining the rules of the game, striking a fine balance between debtors and creditors rights.

Even with this caveat in mind and assuming that a consensus emerges to work out the details, this is certainly easier said than done. The crux of the matter will be to identify the proper forum which would be credible and acceptable to all, especially if one wants to avoid "jurisdiction shopping", which is common practice in corporate bankruptcies. Would the IMF be the obvious candidate? Not really, both because the structure of voting at the IMF board gives a veto power to some important creditors (the US in particular), and, second, because the IMF would be in the awkward position of being both judge and interested party with a preferred creditor's status! But even if an "International Treaty" approach is followed, or if an independent forum is created, the role of the IMF during crises episodes is bound to change. One could imagine that the filing for bankruptcy protection may be made conditional to IMF certification, or the IMF could be asked to help enforce restructuring agreements under the form of future lending conditionalities.[30] These questions are wide open on the table, and illustrate the complexity of the matter. Other complications include

29 It must also be noted that Chapter 11 in the US is known to be favorable to debtor's interests whereas contractual approaches are generally favorable to creditors' interests.

30 See BOLTON (2002), pp.36–37.

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the treatment of domestic debt in such a scheme, which is not a trivial issue in countries such as Brazil or Turkey, where the bulk of the debt problem is domestic and not foreign. Even within its limitations and putting aside the legal nightmare associated with its implementation, one may argue that designing an operational international bankruptcy framework represents the ultimate acid test of the commitment of the international community to reform the global architecture.

5 Conclusions

Many lessons can be drawn from the recent financial crises, but perhaps the most powerful one is that policy making is more needed as ever to cope with the globalization of financial markets in a sustainable way. The trade-off between the benefits of a largely unregulated financial system and the costs of financial vulnerability makes it clear that more is to be done in the field of domestic as well as international regulations, before taking a huge leap forward. The existing regulatory framework in many countries is insufficient, and this calls for reforms and institution building. There are unfortunately not many alternatives in the toolbox: extreme measures such as capital controls can provide some temporary relief in emergency situations, but these can prove useful only if they are associated with serious structural reforms to strengthen domestic financial systems.

Additionally, the increasing integration of financial markets provides one additional confirmation that the conduct of autonomous macroeconomic policies is just an illusion. Greater interdependence requires greater interaction and cooperation among the different players. This sounds like an old story, but the challenges of financial globalization make it an urgent task. The existing *fora* provide plenty of opportunities to deal with policy coordination. In this regard, the best opportunity to seriously reform the global financial architecture is the sovereign debt restructuring proposal. This will be a crucial test of cooperation, and no doubt that the decisive factor will be the US positioning on the matter, especially *vis-à-vis* Wall Street. In this regard, the proof will be in the pudding, and procrastination in the kitchen door will not improve the recipe. Although the game will be tough, there is perhaps one good reason to believe in the future: financial crises have worldwide consequences which already affect the interests of the major industrialized countries.

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