Making the World a Safer Financial Place

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This is the time of year when the Boards of the IMF and World Bank meet to congratulate themselves on their progress in making the world a safer financial place. Officially, the Bank-Fund annual meetings only convene at the end of September, but informally they have already begun. Thus, some days ago Horst Koehler, the IMF's chief in command, gave a speech at the Council on Foreign Relations in Washington, D.C., in which he asserted that the IMF had accomplished much in its efforts to "promote financial stability and growth... [and] safeguard the integrity of the international financial system."

Statements like Koehler's are familiar. We hear them annually. But it would be understandable if listeners regarded them even more skeptically than usual this year. After all, this has been the year of the Argentine and Brazilian crises. It has been the year of Enron and Worldcom. It has been a year of much debate, but no real progress, in implementing the IMF's so-called "two-track approach" to more efficiently resolving financial crises.

Do Argentina and Brazil, together with Enron and Worldcom, suggest that the efforts of the IMF and the World Bank to better prevent financial crises are a failure? At a minimum, they raise questions about the efficacy of official approach. That approach has been predicated on the idea that greater financial transparency will allow markets to anticipate and head off financial problems before they occur. Investors will draw back more gradually and begin rationing credit to emerging markets before lending reaches excessive levels and financial sustainability is threatened.

Enron and Worldcom remind us that transparency is easier to advocate than to practice. Inevitably, clever chief financial officers can always stay one step ahead of the markets and the regulators. John Heimann of the Financial Stability Institute, the organization in Basel that trains bank regulators from emerging markets, calls this the problem of "bloodhounds versus greyhounds."

None of this is to deny that transparency is helpful. But recent revelations in the United States serve the useful purpose of reminding us that there are limits to how much can be achieved through this approach. Borrowers always know more about their own motives, and therefore about how they will use their borrowed funds, than their lenders. Information in financial markets will always be imperfect, in other words. Hence, there will always be unexpected developments, and violent market reactions to them. This is another way of saying that there will always be crises.

From this point of view, the Enron and Worldcom scandals are no surprise. What is surprising is that these revelations did not lead to a financial meltdown in the United States.

There has been a flight to quality, but this has not resulted in the failure of a major bank or nonbank financial institution. The scandals have contributed to the decline of the stock market and the weakness of the U.S. recovery, but they have not led to a full-blown crisis like that of the 1930s. What was different in the 'thirties was that the collapse of the stock market was followed by the collapse of the banks and then by the complete and utter collapse of the economy. Today the banking system, to all appearances, is more robust, rendering the economy more resilient to shocks.

Thus, a key lesson of Enron and Worldcom is the importance of rigorous supervision and regulation of the banking system. Strengthened prudential supervision, it so happens, is another focus of the international policy community's crisis prevention efforts. But stronger bank regulation by itself is not enough. We once thought that Argentina had the best regulated banking system in Latin America, and look what happened there.

What happened, to be precise, was that problems of debt sustainability forced Argentina to abandon its pegged exchange rate, and the collapse of the currency then led to the collapse of the banking system because both banks and their borrowers had dollar-denominated liabilities. Argentina's banks collapsed despite the fact that they were well managed and strictly regulated. The conclusion I draw is that strict bank regulation is not enough. Limiting the currency mismatches on bank balance sheets is not enough, for example, if those mismatches are simply passed on to the corporate sector, placing the banks in jeopardy when corporations stop paying.

This is not a new observation: careful analysts already drew it from the Thai crisis five years ago. (Thai regulators had required the banks to match the currency composition of their assets and liabilities but allowed those exposures to be passed on to the corporate sector.) Unfortunately, we have been too slow to act on the recognition.

The most important action would be to ensue that bank regulation is consistent with the broader macroeconomic framework. Specifically, this means that emerging markets should float their exchange rates. Floating exchange rates are no panacea, but they make it less likely that a previously stable exchange rate will collapse. Gradual adjustments are easier for the financial system to handle. Moreover, continuous exchange rate movements encourage nonfinancial as well as financial corporations to hedge their exposures. Consequently, the private sector is less likely to experience a crisis when the exchange rate moves by a large amount. This is at least one reassuring aspect of events in Brazil, where the currency is weak and financial markets are turbulent but the banking system has so far stood the test.

The IMF has moved some way toward encouraging its emerging market members to embrace greater exchange rate flexibility. But it continues to view the choice of exchange rate regime as a matter to be decided on by individual countries as they please. By now we should have learned that the choice of exchange rate regime has important implications for international financial stability. The IMF should therefore be less ambiguous and more forceful in pushing emerging markets to float. For example, it should have pushed Argentina to abandon its currency board back in 1998.

Of course, a floating exchange rate and a well-regulated banking system have not sufficed to insulate Brazil from financial problems. Everyone says that Brazil's problem is electoral uncertainty. I disagree. There is no question that the new president, be he Lula or Serra, will stick by his commitment to the IMF to maintain a primary budget surplus of 3.7 per cent of GDP. No Brazilian president wants to be seen as responsible for Brazil going the way of Argentina. Even Lula will put other social and political priorities on hold in order to preserve financial stability.

The real problem in Brazil is growth. If Brazil grows by 3 per cent next year, then there is no reason why the government can't service its debts. A primary surplus of 3.7 per cent will do just fine. But if growth slows to, say 1.5 per cent, then that primary surplus will have to be raised to 4 per cent. If real interest rates go up to, say, 12 per cent, reflecting uncertainty about how the government will respond, then the primary surplus will have to be increased further, to 4.2 per cent. While the winner of the election, whomever he is, will stick with the present fiscal targets, it will be hard for him to demand yet additional austerity – that is, still higher taxes and still larger spending cuts. Thus, growth is key to the sustainability of the debt.

But here the danger of a double-dip recession in the United States raises questions about whether there will be a growing world economy for Brazil to export to. The looming war against Iraq further clouds the outlook for the world economy. If the world doesn't grow, Brazil won't grow. Capital inflows will then dry up. The country will have to shift 4 per cent of GDP into exporting and import-competing sectors, that being the size of the current account deficit that will have to be eliminated.

This kind of adjustment is easier for Brazil than Argentina, since Brazil is more open. But redeploying resources on this scale is still difficult. A large depreciation of the *real* will be required to send the requisite price signals. And therein lies the rub. A weaker exchange rate will worsen Brazil's prospects for debt sustainability even further because so much of the country's debt is short-term and foreign-currency indexed.

The implication is that countries should be more cautious about borrowing abroad until they can do so at long maturities, in their own currency, and without indexing their bonds to the exchange rate. They need to develop domestic markets in those instruments. Unfortunately, building markets in long-term domestic currency bonds is a long-term investment. It has taken countries like Chile and South Africa the better part of two decades. It has involved privatizing the pension system to create a market for domestic-currency bonds, and moving toward a more flexible exchange rate to limit the temptation to rely excessively on foreign-currency markets. It has involved building macroeconomic policy credibility and upgrading financial supervision, all of which takes time.

But doesn't borrowing less abroad in the meantime mean that emerging markets will grow more slowly? Doesn't clamping down on international financial transactions mean that their financial markets will develop more slowly? Yes it does. In this sense, the efforts of the international policy community to strengthen the international financial system will only make life more difficult for developing countries.

The implication I draw is not that this crisis prevention agenda is misguided, but that it needs to be married to a significant increase in development assistance, targeted at countries that make real efforts to move in the directions recommended by the IMF to reduce the risk of global financial crises.

What about crisis resolution? There will always be uncertainty about the success of IMF packages, a point exemplified by Brazil. If there is a short campaign against Iraq -- a two week war that results in lower oil prices and a stronger world economy – then Brazil should be able to grow its way out of its problems and repay its loans. But that war could be more protracted. Thus, there is no guarantee that the IMF's package for Brazil will succeed. My own view is that the package for Brazil is a gamble worth taking, but it is still a gamble.
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These kind of gambles require putting lots of money on the table to back up the presumption that the country's debt is sustainable. This is an unavoidable consequence of the growth of global financial markets, which are larger and more liquid today than ever before. The IMF hasn't had a quota increase since 1998, and it has much of its liquidity tied up in Argentina, Brazil and Turkey. Both Mr. Koehler, in his speech to the Council on Foreign Relations, and with Guillermo Ortiz, Governor of the Bank of Mexico, in an article published last week, have rightly concluded that it is time to think about more resources for the IMF.

But what about alternatives to bailouts? Specifically, what about the IMF's two-track approach to changing the way we respond to crises? The first track is to add restructuring-friendly provisions – so-called "collective action clauses" – to bond contracts. These would specify who speaks for the bondholders. They would require a critical mass of the bondholders, say 25 per cent, to agree before a lawsuit could be filed against the debtor. They would allow a qualified majority of the bondholders, say 75 per cent, to vote to change the financial terms of a bond contract.

With these provisions in place, the IMF could more easily refuse financial assistance to a country with serious problems of debt sustainability and instead let the borrower resolve those problems in direct negotiations with its creditors. Having specified procedures for restructuring problem debts at the time when the loan was made, the lenders and the borrower could more easily agree on how to write down and stretch out the debt. These clauses will not solve all problems, but they will at least reduce the pressure for the Fund to do what it did for Argentina in August 2001: to provide a loan to a country whose debt was already unsustainable in the vain hope that good news would somehow turn up.

Back then, the IMF and the U.S. Treasury were motivated by the fear that an uncontrolled default would have devastating repercussions for both the crisis country and the international financial system. Having collective action clauses in place would reduce these fears. They would make it easier for the IMF to say no.

Had the IMF said no to Argentina a year ago, the country would have avoided four additional months of agony in which the government depleted its international reserves, firms and households liquidated their bank deposits, and the government ran down its political capital. Argentina's default would still have been painful, but the complete and utter social disaster that followed might have been avoided had adjustment begun earlier.

The other approach to creating an alternative to bailouts would entail amending the IMF's Articles of Agreement to establish a Sovereign Debt Restructuring Mechanism, or SDRM. When that mechanism was activated, there would be a standstill on payments and a ban on litigation. The IMF or an independent tribunal would calculate the total amount of the country's external debt and convene a grand meeting of all the creditors, presumably in cyberspace, who would then take one great big majority vote accepting or rejecting the country's restructuring offer.

But why bother with an SDRM – wouldn't adding collective action clauses to each individual bond issue be enough? Wouldn't it be enough to clarify representation, impose thresholds for litigation, and permit majority voting, bond issue by bond issue? Or would the holders of Argentina's 88 bonds find it too difficult to cooperate with one another? Would it be too easy for vulture funds to buy 25 per cent of one of these 88 issues, enabling them launch a lawsuit seeking to attach Argentine assets and thereby causing the entire restructuring process to unravel? Would the need for 88 separate majority votes create an insurmountable obstacle to orderly restructuring negotiations?

History can shed light on this question, because there has existed an international bond market before, in the 19th century and the 1920s. That experience suggests that creditors, if left to their own devices, can solve these problems on their own. In response to earlier Argentine defaults, they did so by forming a bondholders committee made up of the representatives of investors in different Argentine bonds. Sitting together on such a committee, they effectively resolved their differences. Revealingly, there is now once again an Argentine Bondholders Committee, through which the holders of Argentina's 88 individual bond issues are coordinating their actions. Thus, there is no evidence that the need for cooperation in negotiations cannot be achieved by the markets.

Moreover, while there is considerable uncertainty about how an SDRM would work, we already have considerable experience with the operation of collective action clauses. More than a quarter of the international bonds issued by emerging markets – that quarter issued in London – already include the relevant provisions. The market is familiar with these clauses. It knows how to price them. In contrast, it will be much harder for it to anticipate the implications of an experimental statutory process. And greater uncertainty means higher costs for emerging market borrowers.

Recall that the IMF's proposal would involve a total ban on litigation. Investors would view this as a significant dilution of their rights. CACs, in contrast, would still permit litigation but require that a critical mass of the creditors would have to agree before taking legal action. It is the perception that the SDRM would weaken their rights that causes creditor bodies like the Institute of International Finance to oppose the initiative, and that causes emerging markets such like Mexico and Chile concern about the impact on their borrowing costs.

The sensible approach is therefore to start by encouraging the more widespread use of CACs. If this doesn't solve the problem, then we can contemplate the next step, namely, a Sovereign Debt Restructuring Mechanism. The right way to proceed, in other words, is incrementally.

This leaves me skeptical about the advisability of proceeding on two tracks simultaneously, as the IMF is attempting to do. Pushing ahead with the SDRM raises fears that CACs are not an end in themselves, that they are merely a stalking horse for a more ambitious statutory initiative that would put the IMF at the center of the restructuring process and significantly weaken creditor rights. The fear, as Charles Dallara of the Institute of International Finance put it last week, is that CACs would really be the first step down the slippery slope to the SDRM.

The U.S. Treasury also supports the more widespread use of collective action clauses. However, it has so far limited its efforts to further their adoption to uttering a few encouraging words. And encouraging words by themselves are not enough. The markets reward countries with high credit ratings that employ collective action clauses, but they penalize sub-investment grade countries that do so by charging an additional risk premium. They fear that clauses which make renegotiation easier will also make renegotiation more tempting and therefore more frequent. Sub-investment grade countries will therefore have to pay higher borrowing costs. There was an article last week in the *Gazeta Mercantil,* a Brazilian newspaper, reporting how European officials had urged Pedro Malan, the Brazilian finance minister, and Arminio Fraga, the Governor of the Bank of Brazil, to include CACs in their bond issues. You will not be surprised that the Brazilians resisted, saying that now is not the time.

If it is correct that the more widespread use of collective action clauses would make for a more stable international financial system, then there is an argument for subsidizing their use. Countries that exchange old bond issues without CACs for new bond issues with them should receive subsidies for this purpose from the World Bank. In addition, national regulations should be revised to give more favorable regulatory treatment to banks and other investment companies that hold these bonds.

This approach is more likely to produce the desired result than simply relying on encouraging words. It is more likely to work than making the use of CACs in new bond issues a condition of IMF assistance. Obviously, it would not have helped to stabilize Brazil had the IMF made this a condition of providing additional assistance last month, given the questions that already existed about Brazil's credit worthiness. And financial incentives for countries in a strong position are more likely to work than simply requiring Argentina to include CACs in its restructured bonds, which the IMF will surely do when Argentina finally gets around to renegotiating its defaulted debt. Because tThe write-down of the old Argentine bonds will be very substantial, Argentina's restructured debt will not be big enough to create a liquid market in these instruments.

What, then, does the international financial system need? First, more clarity on which track of the two-track approach has precedence. And, second, meaningful financial incentives for including collective action clauses in new bond issues, without which we are unlikely to ever make real progress in resolving financial crises.

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