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## What Won't Work

Reforming the international financial architecture is a game that any number can play. Predictably, there already exists an abundance of proposals. This chapter considers a number of alternative schemes that are deemed politically unrealistic, technically infeasible, or unlikely to yield significant improvements in the way crises are prevented, anticipated, and managed.<sup>1</sup>

Ruling out alternatives is a critical step in my strategy for crafting a practical agenda for reform; otherwise, one would remain bogged down in a morass of conflicting proposals. Because I argue partly by process of elimination, it is important to be clear about the criteria by which alternative schemes are eliminated. The first is that certain proposals will not, by themselves, significantly improve the way that crises are prevented, anticipated, and managed. Efforts to improve transparency and information provision and to construct leading indicators of crises fall under this heading. While they are useful, there are good economic reasons why they cannot be relied upon to predict or prevent crises.

A second ground for elimination is that certain proposals, however appealing in theory, are not technically feasible. A Tobin tax and George Soros's proposal for an international bond insurance agency, for example, can be eliminated on these grounds. A Tobin tax would be too easily evaded by market migration (booking foreign-exchange transactions in offshore tax havens) and asset substitution (relabeling the relevant transac-

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1. Proposals that concentrate on reforming the IMF are left for chapter 7, which is devoted to the role of that institution.

tions), while an attempt to establish an international bond insurance agency would have to confront a host of essentially insurmountable technical and administrative obstacles, as explained below.

A third basis on which to eliminate competing proposals is that of political feasibility. There may be sound analytical grounds for arguing that effective regulation of international markets requires an international government, but there is every reason to believe that national governments remain unwilling to cede significant additional prerogatives to international bodies. Europe is a limited counterexample where national governments have moved a significant distance toward ceding control over their national economic policies, notably their monetary policies, to a transnational entity, but it is *sui generis*; its case reflects a unique history and integrationist tradition not present in other parts of the world.<sup>2</sup> However compelling in the abstract the argument for a global financial regulator, a global bankruptcy court, or a global money to complement global financial markets, realism requires acknowledging that national governments have no appetite for initiatives that imply serious compromises of national political, legal, and economic autonomy. Such initiatives should be regarded as fodder for futurists, not for practical policymakers.

## **Disclosure and Discipline as Solutions to All Problems**

Market discipline cannot work without information. Official reports (that is, G-10 1996 and G-22 1998a) appropriately emphasize the need for borrowers to provide full information on their economic and financial condition so that lenders can identify problems, curtail their lending, and avoid problems for their own balance sheets. Bank supervisors should require prompt disclosure of financial information by intermediaries. Regulators should require issuers placing their securities publicly to follow internationally recognized auditing and accounting practices and report regularly on their financial condition. Governments should provide timely and accurate information on their own financial condition.

Without question, improving the information environment will strengthen market discipline, and promulgating international standards is the obvious way of advancing this agenda. But it is unrealistic to expect too much of these initiatives. At the deepest level, those who invoke them as a solution to financial crises underestimate the extent to which information asymmetries are intrinsic to financial markets. Even the most efficient financial markets are characterized by asymmetric information. It is unavoidable that borrowers should know more than lenders about

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2. As I elaborate later.

how they plan to use borrowed funds, not to mention about their own innate talents. This reality is a key reason why banks exist in market economies. Banks invest in the capacity to monitor borrowers, hiring loan officers and investment analysts experienced in the task and creating a specialized capacity that allows them to exploit economies of scale and scope in assembling information about potential borrowers. In a sense, without asymmetric information to create a need for delegated monitoring there would be no banks.<sup>3</sup> And the fact that banks are certain not to disappear soon is indicative of the extent to which asymmetric information is a fundamental fact of financial life.

These observations have profound implications for how one thinks about the operation of financial markets. They imply that the price mechanism cannot always be relied upon to restore equilibrium.<sup>4</sup> They imply that banks are intrinsically fragile. As banks are in the business of building a capacity to gather and analyze information about their customers, they will find it hard to raise liquidity by selling assets in times of crisis, given the difficulty this information asymmetry poses for third-party evaluation of loans.<sup>5</sup> Combine this with the fact that banks provide liquidity-transformation services (they borrow short from depositors with idiosyncratic needs for liquidity and demands for less liquid, more remunerative investments), and it is clear that banks are susceptible to self-fulfilling runs in which investors, uncertain of their access to deposits, scramble to get their money out. To be sure, this problem is most severe when, as in Asia, banks fail to use recognized accounting standards or to rely on reputable international accounting firms to audit their books, leaving their creditors unable to distinguish good banks from bad ones and permitting isolated runs to become systemic banking panics. This is why better information, secured by adherence to internationally recognized auditing and account-

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3. Banks provide other services, as acknowledged below, but the fact that bank intermediation is particularly important in emerging markets where the information environment is particularly impacted suggests that the delegated monitoring role of banks remains a major factor.

4. If information were complete, the borrowers whose risk of defaulting is greatest would be asked to pay the highest interest rates. (A default premium would be built into their borrowing costs.) But if outside investors found it difficult to determine whether borrowers are of the high- or low-risk type, they would charge them all an interest rate that is an average of those that, in a full-information world, would apply to the high- and low-risk types. Low-risk borrowers would be overcharged for their loans, high-risk borrowers undercharged. The only debtors that would wish to borrow would be the low-quality, high-risk ones. And a further rise in interest rates, rather than discouraging them from borrowing, would only cause more relatively low-risk, high-quality borrowers to drop out of the market. (This adverse-selection problem is analyzed in the emerging-market context by Mishkin 1996.) Better information can attenuate this adverse-selection problem, but it is unrealistic to assume that it can be made to disappear.

5. This point was developed in chapter 5.

ing standards and strengthened prudential supervision, can help to ameliorate the panic problem. But if asymmetric information is why most economies continue to rely on banks for intermediation services, bank fragility is unavoidable. The advocates of information-related initiatives mislead when they assume the problem away.

Analogous problems exist in securities markets, where incompletely informed investors infer information from the actions of others. It is clear how market volatility can be amplified by investors' tendency to infer that a security is of lower or higher quality than previously thought from the decisions of other investors. Delegating asset management to a specialized money manager will not help to the extent that it is hard for investors to ascertain the quality of those managers. Poor-quality managers will then have an incentive to engage in lemming-like behavior, emulating the actions of other, possibly more adept money managers in an effort to disguise their true type. Again, it is clear how this can amplify market volatility (see Devenow and Welch 1996).

If theory does not convince, then history should, for it shows that markets do not smoothly adjust the price and quantity of credit in response to new circumstances. This was apparent in 1997, when there was little tendency for the spreads on syndicated bank loans and bond issues on primary and secondary markets to move in advance of the Asian crisis (as noted in appendix C). It was apparent in the lead-up to the 1992 crisis in Europe, when the forward premium on foreign exchange failed to rise significantly before the pressures spilled over in the currency market.<sup>6</sup> Clearly, sudden investor reactions, volatility, and, in extreme circumstances, crises are financial facts of life even in countries with relatively sophisticated securities markets and highly developed information systems.

Then there is the practical question of whether governments can reliably promise to gather the relevant data. Consider for example the current preoccupation with the offshore borrowings of banks and corporations. Assembling data on their borrowing was straightforward when all foreign financial transactions were government controlled, but now that corporations and others are free to borrow from offshore banks and nonbank financial institutions, it is far from clear how to gather this information short of an invasive survey of all private-sector entities. It is questionable whether the US government, for example, could accurately estimate the short-term foreign liabilities of US banks and corporations.

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6. The exception was Italy, which was in the same position in 1992 that Thailand found itself in 1997. There, investors perceived a serious problem of overvaluation, and forward rates moved outside the country's ERM band several months before the crisis (Eichengreen and Wyplosz 1993). But the same was not true of other countries whose currencies were then attacked.

More generally, the success of these initiatives will hinge on the cooperation of governments, banks, and corporations—which should not be assumed. Banks gambling for redemption have a strong incentive to disguise their true financial condition, understating nonperforming loans in an effort to delay the day of reckoning. Governments in financial straits but hoping that conditions will improve have an incentive to disguise their financial condition and to conspire with banks and corporations doing the same.<sup>7</sup> Central banks asked to provide data on currency forwards and futures may respond by moving into the use of more exotic derivative instruments. Data that once were useful for predicting crises may be rendered irrelevant by the international community's very commitment to provide them.

Peer pressure can help to limit such subterfuge. The IMF can blow the whistle on countries that delay or fabricate data, although the collegiality characteristic of the institution raises questions about the credibility of the threat.<sup>8</sup> Appointing a panel of independent experts to adjust national statistics to international standards would help. In addition, this is a place where regional surveillance has a useful role; the European Union, for example, has a committee of independent statisticians that scrutinizes EU governments' fiscal accounts and standardizes their reported deficits. This precedent might be emulated in other parts of the world.<sup>9</sup> Realistically, however, it has taken EU members four decades of progressively deeper political and economic integration to reach the point where they are prepared to accept such invasive and potentially embarrassing mutual surveillance. Similarly, the IMF's code for fiscal transparency and recent extensions of the SDDS to encompass the off-balance-sheet transactions of governments and central banks will make it more difficult for governments to disguise their true financial condition.<sup>10</sup> In practice, however, for each additional disclosure requirement adopted by the Fund, there are other steps available to governments and banks.<sup>11</sup>

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7. One need only recall how the Mexican government responded to increased scrutiny of its financial position in 1994 by hiding its deficits in the accounts of the development banks. The Thai central bank's forward commitments and the South Korean central bank's transfer of international assets to overseas branches of domestic banks in 1997 further illustrate the point.

8. Note, for example, the language describing the procedures that will be used to delist a country from the SDDS: this will be done only in the event of "serious and persistent nonobservance."

9. Indeed, the need to strengthen regional surveillance in other parts of the world is the strongest argument for creating new bodies such as an Asia or Asia-Pacific Monetary Fund. This is the argument elaborated in Bergsten (1998b).

10. Before the Asian crisis, subscription to the SDDS did not entail a commitment to provide data on central banks' off-balance-sheet liabilities or the short-term foreign-currency liabilities of the corporate sector, two key indicators of problems in Thailand and Indonesia.

11. The severity of the problem—and the extent to which it pervades advanced industrial as well as emerging-market economies—is evident in the unexpected magnitude of the major money-center banks' losses on derivatives exposures in the second half of 1998.

None of these arguments vitiates the case for improving the information environment. But too much should not be expected of these initiatives. Unavoidably, information asymmetries will remain. And there will always be unexpected events. Crises will still occur, and it will still be necessary to create mechanisms for coping with them.

## Leading Indicators

If investors, with so much at stake, cannot reliably forecast crises, then it is hard to see why bureaucrats should do better. This has not prevented the official community and policy entrepreneurs scenting the existence of a market from attempting to develop leading indicators of currency and banking crises.<sup>12</sup> Their track record is not good. Models built to explain the 1992-93 ERM crisis did not predict the 1994-95 Mexican crisis. Models built to explain the Mexican crisis did not predict the Asian crisis. These failures reflect the fact that the underlying vulnerabilities were different in each case. ERM currencies were attacked because high European unemployment sapped governments' ability to uphold their financial commitments, while the Mexican government was rendered reluctant to raise interest rates by the weakness of the banking system. Whereas the immediate problem in Mexico was high levels of short-term public debt, in South Korea it was the level of short-term bank debt, and in Indonesia it was the level of corporate debt. In other words, the existence of 31 flavors of crisis greatly complicates prediction.

Nor do the variables on which leading-indicator exercises depend offer much guidance about when the attack will come. Whether speculators pounce will depend not just on the weakness of the banking system or the level of unemployment but on how much governments are perceived to care about aggravating these problems. The only thing more difficult to measure than a government's resolve is investors' assessment of it. And even if observers conclude that the currency peg is vulnerable, no one market participant is likely to be sufficiently large to build up the short position needed to exhaust the authorities' reserves.<sup>13</sup> For that to occur, different investors will have to coordinate their actions.<sup>14</sup> And what

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12. See, for example, IMF (1998c), Kaminsky and Reinhart (1998), Kaminsky, Lizondo, and Reinhart (1997), Hardy and Pazarbasioglu (1998), Sachs, Tornell and Velasco (1996), Tornell (1998), Radelet and Sachs (1998b), and Goldstein and Reinhart (1999). In addition, there are a number of academic studies that have sought to deepen understanding about past currency crises without making predictive claims: Eichengreen, Rose, and Wyplosz (1995, 1997), Eichengreen and Rose (1997), and Frankel and Rose (1996).

13. Or to liquidate a sufficient quantity of bank deposits to bring down an entire banking system.

14. A point given theoretical substance by Obstfeld (1996).

serves as the coordinating device will vary from case to case and generally elude prediction.<sup>15</sup>

Existing early-warning systems exemplify these problems.<sup>16</sup> The relationship between macroeconomic and financial indicators and the probability of large changes in exchange rates and reserves tends to be sensitive to the sample of countries and the period for which estimation is carried out, belying the notion that there exists a single set of variables and a stable set of relationships on which to base crisis forecasting.<sup>17</sup> The models that perform best rely on reversals in the direction of capital flows and sudden reserve losses, variables that are really concurrent rather than leading indicators. Once this information is available, in other words, the horse has left the barn (see Minton-Beddoes 1998).

The same criticisms apply to models that rely for their predictive power on crises in other countries in the current or preceding periods. Insofar as crises elsewhere are simply picking up common unobservables responsible for financial turbulence in all the affected countries, it will be too late for policymakers to eliminate the problem by the time evidence of those unobservables is detected. Even if measures of crises in neighboring countries are picking up not just common omitted factors but pure contagion—that is, the tendency for instability in one country to infect another, independent of macroeconomic and financial conditions in the latter—this is of little practical value for policy. The only thing that is known with certainty about contagion is that its spread is uncertain. While some crises have powerful repercussions abroad, others do not. The contagion associated with the Thai devaluation was a surprise, for example, and its spread to Indonesia was particularly unexpected. Far more work will be needed on contagion before we will possess reliable early-warning indicators of whether it is loose upon the land.

Even if all these problems were solved, there would still be reason to doubt that crises could be predicted with high reliability, because of the market's reaction to the provision of leading indicators. If certain variables and thresholds were identified as reliable predictors of past crises, market

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15. Theorists modeling these coordination problems acknowledge this in the language they use, referring to outcomes as “sunspot equilibria.” Furman and Stiglitz (1998) rightly note that insofar as countries are vulnerable to these sorts of self-fulfilling attacks only when they enter a danger zone of economic and financial fragility, it should still be possible to predict crises *on average* (in the stochastic sense). But, as they conclude, the fact that the top quartile of countries can be eliminated as plausible candidates for self-fulfilling attacks is not very helpful for policy.

16. Other reviews of this literature, which make similar points, are Berg and Pattillo (1998) and Furman and Stiglitz (1998).

17. Corsetti, Pesenti, and Roubini (1998), Berg and Pattillo (1998), and Furman and Stiglitz (1998) all demonstrate this point by updating the sample analyzed by Sachs, Tornell, and Velasco (1996a) and showing that few of the results continue to hold.

participants cognizant of them and aware of the tendency for macroeconomic variables to be slow-moving and persistent would sell their claims before those thresholds were breached. Thus, the crisis would occur before the flashing yellow light was observed.<sup>18</sup>

None of this is to deny the value of studies seeking to deepen our understanding of past crises. But the success of current papers in explaining past crises does not mean that they will succeed in predicting future crises.

## **An International Debt Insurance Agency**

George Soros has recommended creating a public corporation to insure investors against debt default (Soros 1997, 1998). In the same way that deposit insurance averts the danger of depositor runs, the credit insurance issued by this corporation would avert the danger of a loss of creditor confidence in which investors refuse to roll over their maturing loans and precipitate self-fulfilling debt and currency crises. The herd behavior that roils capital markets would be reduced; like insured bank depositors, insured foreign creditors would have less incentive to scramble for the exits. Moreover, pension funds, mutual funds, and insurance companies precluded from holding low-rated bonds would not be forced to sell into a declining market if the country issuing them suddenly experienced financial difficulties.

Countries would underwrite the cost of Soros's insurance by paying a fee when floating loans. To ensure that the scheme was actuarially sound, each country's access would be limited to a ceiling set by the IMF on the basis of its assessment of the country's macroeconomic and financial condition. Loans in excess of the ceiling would not be insured. The IMF would make clear that it was not prepared to aid countries having difficulty servicing uninsured loans. Lenders would consequently charge countries borrowing in excess of that ceiling higher interest rates to compensate for the risk of default. And because the Fund would determine the amount of insured borrowing and reject pleas for aid from countries experiencing difficulty in servicing uninsured loans, there would be no prospect of a bailout to encourage excessive borrowing and lending.

But to assert that the international community will be able to stand aside in the event of default on uninsured loans, in disregard of the systemic consequences, is to assume a solution to the problem.<sup>19</sup> In prac-

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18. Not that this would be entirely bad: if early-warning exercises led investors to sell before those critical thresholds were breached, market discipline would be strengthened and welfare would be enhanced (assuming, of course, that early-warning exercises focused on the right variables in the first place!).

19. The dilemma is analogous to that which arises in connection with narrow banking (as described in chapter 4).

tice, those worried that debt problems in one country might spread contagiously to others, endangering the stability of the international system, are sure to be worried most about uninsured bonds. Information about uninsured issues will be least, accentuating the tendency for their prices to move together. Uninsured issues will be perceived as especially risky, causing their prices to suffer most in periods of generalized financial turbulence. Institutional investors that specialize in holding uninsured issues will have the greatest need to meet margin calls in a crisis, forcing them to liquidate their holdings in other countries.

Nor is it clear how the IMF would determine the cutoff for the loans that qualified for insurance. In theory, the Fund would determine the safe, economically sound level of debt for each of its members and insure only that amount. But not only do bureaucrats lack a convincing model of the optimal level of debt, it is far from clear that the decision would be taken on the basis of economic rather than political considerations. The Fund would presumably insure more borrowing by countries with sound economic and financial policies and use that fact as leverage to encourage policy reform. But what would happen when a less reform-minded government took office or policy otherwise took an unexpected turn? Would the Fund then lower the ceiling for insured loans? Would insurance for previously insured loans be revoked? Would insurance be available only for foreign-currency loans, or would loans denominated in the home currency also qualify? If the demand for foreign funds exceeded the ceiling, what would determine which loans were insured? Would insurance be allocated on a first-come-first-served basis? Who would decide which of several competing loans was insured and which was not?

Above all, there is the question of why the world needs a *public* insurance corporation. If the idea is so attractive, why can't investment banks and other underwriters set it up as a self-financing operation?<sup>20</sup> The answer presumably has something to do with the tendency for private insurance markets operating in an impacted information environment to break down. Perhaps adverse selection and moral hazard would undermine the viability of private insurance. These problems would not arise if all countries were required to participate in an IMF-run program, if the Fund had better information than the private sector on the creditworthiness of potential borrowers, and if its conditionality could guarantee that insured borrowers would not embark on riskier policies. Unfortunately, these assumptions are either economically implausible or politically unrealistic.

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20. Mann (1998) attacks this question head-on, arguing the need for private market-based insurance instruments.

## A Tobin Tax

Each episode of turbulence in international financial markets prompts calls for taxing foreign-exchange transactions.<sup>21</sup> Some proponents of this tax question the rationality and efficiency of the market. They suggest that currency traders buy and sell in disregard of fundamentals, which introduces unnecessary volatility into foreign-exchange markets and capital flows (see, e.g., Felix 1995). Others acknowledge the rationality of currency traders but characterize their activities as socially counterproductive, invoking second-generation models of currency crises and arguing that unregulated financial markets make it too easy for speculators to shift the economy from the good to the bad equilibrium.<sup>22</sup> It follows that a tax on foreign-exchange transactions that makes it more difficult for investors to speculate against currencies could in principle reduce the incidence of crises and enhance the social welfare.

Some critics of the Tobin tax deny the existence of these and, for that matter, all problems in financial markets. They warn that a transactions tax would disrupt the market's ability to carry out its financial functions. Recent experience makes it hard to take seriously the strong efficient-markets view. As for the objection that a Tobin tax would seriously worsen resource allocation, it is hard to see how the modest tax most proponents have in mind, on the order of 5 or 10 basis points, could be so disruptive.

The more compelling objection is on grounds of feasibility. In times of crisis, currency traders would simply disregard the tax. Under these conditions, a tax of 5 or 10 basis points is a negligible deterrent. And a larger tax—throwing boulders instead of sand in the gears—would seriously disrupt the operation of financial markets.

Moreover, the tax could be evaded by booking foreign-exchange transactions in tax-free jurisdictions.<sup>23</sup> This ability to move transactions offshore means that the tax would have to be implemented simultaneously by all the leading centers of foreign-exchange trading. This may be only a handful of locations, but the fact that it includes countries as diverse as the United States and Hong Kong suggests that easy agreement, not to mention vigilant enforcement, cannot be assumed.

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21. The original argument is Tobin (1978). It has been revived recently by a number of commentators (see, e.g., Kuttner 1998).

22. See, for example, Eichengreen, Tobin, and Wyplosz (1995) and, more recently, Wyplosz (1998a, b). The idea is that introducing a cost of international capital mobility can moderate the interest rate increases needed to defend the currency and thereby tip the balance for a government deciding whether or not to raise interest rates in a concerted defense at the cost of aggravating various internal economic problems.

23. This possibility is analyzed by Kenen (1996), Garber and Taylor (1995), and Garber (1996b).

In addition there is the problem that new foreign-exchange trading centers would then spring up in remaining tax havens—the Cayman Islands, for example.<sup>24</sup> This tendency would be limited by the additional costs incurred by traders when the transaction was undertaken and booked in an offshore center. Currency traders would be hesitant to move their transactions to a locale of uncertain reputation where counterparty risk is significant—where they are uncertain that their transactions will in fact be booked at the contracted price and their funds will be collected promptly. If banks attempt to solve this problem by moving their own operations offshore, they will first have to invest in trading rooms and personnel at the new dealing site. It may not be attractive for any of them to do so unless other banks do so simultaneously.<sup>25</sup> That said, the danger of offshore centers developing will surely increase over time. Universal adoption, through an amendment to the IMF's Articles of Agreement, and effective enforcement, no mean task, would be essential for a Tobin tax to be more than a temporary expedient.

Even if market migration were slowed, there would remain the danger that the tax could be evaded by the simple relabeling of transactions. Traders betting on changes in the exchange rate don't merely trade national currencies; they trade any one of a number of assets denominated in different currencies. If currency transactions were defined for tax purposes as the exchange of bank deposits in different currencies, traders could substitute the exchange of treasury bills denominated in those currencies and then sell those treasury bills for deposits.<sup>26</sup> Tax avoidance is a problem with all taxes, of course, not just with taxes on foreign

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24. The French government's proposal for reforming the international financial architecture alludes to the need to deal with the problem of offshore centers, and this has long been a favorite theme of IMF Managing Director Michel Camdessus. The problem was highlighted by the Long Term Capital Management debacle, when those who advocated stronger regulation of hedge funds by national authorities were quickly reminded that many hedge funds were already legally domiciled offshore and that many others would simply move offshore in response to tighter regulation. None of these observations, however, prompted realistic proposals for dealing with the problem of offshore financial centers, which would seem intractable; some free rider will always have an irresistible incentive to free ride, and there is little that can be done about this problem.

25. If, as Kenen (1996) suggests, the tax were levied at twice the normal rate when the counterparty was in a tax-free jurisdiction, more than one bank would have to move simultaneously to that jurisdiction for relocation to pay.

26. This point is made by Garber (1998). Substitution is not without costs, of course. Most obviously there is the increase in the number of transactions, as traders first sell bank deposits for securities, then trade the securities, and finally repurchase bank deposits. And holding stocks or bonds even for an instant entails an element of price risk not shared by bank deposits. This will be especially true of currencies issued by countries whose stock and bond markets lack liquidity. But the ability of financial engineers to develop synthetic assets to hedge these risks and more generally to evade foreign-exchange taxation should not be underestimated.

exchange transactions. The tax authorities should have the power to reclassify transactions if they suspect them to be motivated mainly by tax avoidance. But there is good reason to think that the markets will always remain one step ahead of the authorities.

Seen in this light, a tax on all capital inflows, similar to Chile's deposit requirement, has two signal advantages over a Tobin tax. First, it would apply to all financial transactions between residents and nonresidents and therefore be less subject to asset substitution.<sup>27</sup> Second, it would limit countries' vulnerability to the destabilizing effects of sudden capital outflows not by attempting to staunch those outflows, which is unlikely to be effective, but by taxing capital at the inflow stage, when the incentive for evasion is less. To be sure, a Chilean-style inflow tax will make no difference when it is residents who are fleeing the currency. But where excessive capital inflows, such as those prompted by government guarantees that permit domestic banks to lever up their bets, create the problems that lead ultimately to that outflow risk, there is a sound rationale for the policy.

## **An International Court for Sovereign Debts**

A recurrent strand of academic thought invokes the idea of an international bankruptcy court.<sup>28</sup> Motivation stems from the observation that there exists no international analog to domestic bankruptcy procedures, in particular no international court for the orderly restructuring of sovereign debts.

The notion of an international bankruptcy court raises complex issues, because insolvency provisions differ across countries and specialists do not agree on the particulars of an efficient bankruptcy code. That said, it is possible to discern something of a consensus on basic principles. First, bankruptcy procedures should empower the courts to impose a stay on payments. This will prevent a grab race in which creditors scramble after the remaining assets of the troubled enterprise, forcing it to be dismantled even when it would be profitable if restructured and, more generally, heightening the costs of adjustment.

With this standstill in place, fundamentally insolvent enterprises can be liquidated and viable ones reorganized. Debtors and creditors should

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27. There will still be other possible channels of evasion, such as over-invoicing imports, as described in chapter 5. But as explained there, these too may have nonnegligible costs.

28. See, *inter alia*, Kampffmeyer (1987), Raffer (1990) Sachs (1994), Miller and Zhang (1997, 1998), and Radelet and Sachs (1998b) for variants of this idea.

be encouraged to negotiate a mutually acceptable reorganization plan.<sup>29</sup> If the parties are unable to reach an agreement within a reasonable period, the courts should then have the power to impose it. To discourage debtors from resorting to bankruptcy as a way of shedding their financial obligations and managers from stripping the enterprise of assets while negotiations are underway, the courts may also have the power to seize control of the firm's financial affairs and replace its management, if necessary.<sup>30</sup>

Finally, some national bankruptcy procedures allow distressed debtors to tap the markets for interim financing—to obtain what is referred to in the United States as debtor-in-possession financing. Even a firm whose assets are worth more in place than when dismantled may be unable to continue operating unless it obtains working capital. The courts can facilitate this by giving postpetition creditors priority over existing claimants. Those existing claimants will benefit as well if the enterprise is worth more as a continuing concern than if wound up.<sup>31</sup>

In contrast to these national arrangements, there is no international bankruptcy court to which countries can appeal. Even if the creditors' claims are collectively maximized when they renew their maturing loans and give governments, banks, and corporations time to reorganize their financial affairs, each individual creditor still has an incentive to scramble for the exit if he can attach the available collateral.<sup>32</sup> The absence of an international authority with the power to impose a standstill leaves unre-

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29. This agreement may have to satisfy certain legal constraints, such as the priority of claims. In other words, creditors who receive preferential treatment outside of bankruptcy also receive preferential treatment in it.

30. Similarly, some national bankruptcy procedures give the courts or the administrator the power to nullify transfers made by management to related parties in the period immediately preceding the bankruptcy filing.

31. Taken together, these provisions are designed to maintain a balance between creditor and debtor rights—to balance the benefits of strict enforcement of debt contracts (strengthening the bonding role of debt) against the gains from maximizing the ex post value of the enterprise (clearing away unviable debts and removing debt overhangs that distort investment incentives). They are intended to encourage and if necessary impose the kind of agreement that creditors and debtors would reach in a world free of information and transactions costs. Hence, there is the well-known proposition that there would be no need for a court-enforced bankruptcy procedure in a world where borrowers and lenders could write provision for all the relevant contingencies into the original loan contract and where enforcement was costless. Existing procedures may be criticized for failing to get the balance between the interests of debtors and creditors quite right, but the fact that no one is inclined to abolish prevailing arrangements suggests that they are still preferable to a world in which the courts have no power to expedite negotiations.

32. Forbearance that is in the collective interest may not also be in the individual interest if there is no mechanism to enforce collective action. With luck, individual creditors might be brought to recognize their collective interest. But when information on compliance is incomplete and the creditors do have a long-standing relationship with one another, the incentive (and ability) to chisel on an agreement may be stronger still.

strained this destructive incentive to scramble for the exits. Similarly, the fact that there is no international court or arbitrator charged with coordinating negotiations and cramming down settlement terms means that talks can drag on, aggravating the macroeconomic and financial losses caused by default.

These observations motivate calls for a mechanism for imposing an internationally recognized standstill and creating an international court with the power to oversee negotiations and, if necessary, impose settlement terms. The analogy is drawn with Chapter 9 of US insolvency law, under which the debts of insolvent municipal governments are restructured. Kunibert Raffer's proposal for an international court of arbitration in a "neutral" country (one that is neither an active lender nor a borrower), empowered to impose a standstill and cram down settlement terms, is representative of the genre (Raffer 1990).

The objections to this idea are overwhelming. Most obviously there is the question of whether there really is the need to create a new entity with the ability to impose a standstill, because governments can already declare a unilateral moratorium. Dissident creditors have pressed lawsuits and sought to attach sovereigns' assets, but governments have generally had few attachable assets in the relevant jurisdiction.<sup>33</sup> Then there is the moral hazard that would flow from the fact that the international tribunal would not possess the other powers of a national bankruptcy court, which can seize control of the bankrupt firm's financial affairs and, in some cases, replace its management. Above all there is the political question of whether the creditor countries would be prepared to vest such formidable powers in the hands of an international tribunal of officials. For all these reasons, even the kind of limited scheme floated by the Canadian government, that the IMF Executive Board would give a Good Housekeeping Seal of Approval to countries that declared a 90-day standstill or moratorium on all cross-border or cross-currency debt contracts, is patently unrealistic (Canada, Department of Finance 1998).<sup>34</sup>

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33. Thus, even Peru, which was a particularly confrontational debtor under socialist President Alan Garcia, did not see any of its exports seized or its foreign assets attached (Cohen 1989). Note that Lehman Brothers' successful action in London courts freezing \$113 million in assets of two Russian banks in September 1998 related not to Russia's domestic debt default but to the failure of Russian counterparties to settle their forward foreign-exchange contracts.

34. It is not clear what the advantage would be of having the IMF Executive Board "officially approve" that moratorium, as suggested in Radelet and Sachs (1998b), unless there was some assurance that its approval would be recognized by national courts, which would use it as a basis for overriding other considerations. If the IMF lent into sovereign arrears, creditors might be tempted to press lawsuits in an effort to attach the Fund's resources. But this is a separate problem and it admits of a more limited solution (amending the IMF's Articles to give immunity from legal action to its own financial transactions and encouraging countries to amend their own sovereign immunities laws, as explained in chapter 5).

And if it is unrealistic to think that the IMF or another international entity could be empowered to impose a standstill on payments, it is pure fantasy to suggest that the Fund could be given the power to impose settlement terms on debtors and creditors. Insofar as the main function of any new body will boil down to facilitating communication between debtors and creditors, this can be provided by a standing committee of creditors with no enforcement powers, as described in chapter 5. If there is a need for further measures to ease restructuring negotiations, this is best done by adding sharing, majority-voting, minimum-legal-threshold, and nonacceleration clauses to bond contracts, again as explained in chapter 5. And if there is a need to provide debtor-in-possession financing, this is best done by IMF lending into arrears, as also explained there.

## **Global Moneys and Global Monetary Institutions**

Schemes for an international bankruptcy court may be unrealistic, but they are realism exemplified compared with recent proposals for a world financial regulator, a world central bank, and a single world currency. The impulse for these castles in the air is understandable. Financial institutions do business globally. Hedge funds invest globally. Financial markets are integrated globally. For all these reasons, crises originating in one country or region can quickly infect other parts of the globe. But the institutions of monetary and financial policymaking are segmented nationally; policies are framed with national rather than global conditions in mind, and the international coordination needed to cope with global problems remains difficult to arrange. Hence, Henry Kaufman (1998a, b) proposes a single superregulator of financial institutions and financial markets to set and enforce prudential regulations. Jeffrey Garten (1998) proposes a world central bank with responsibility for maintaining global financial stability that would act as a true international lender of last resort to stabilize currencies and financial systems. Despair over the undesirable properties of both fixed and flexible exchange rates has led a number of recent commentators to resuscitate Richard Cooper's idea of a single world currency (1984).

Those who take such proposals seriously might pay just a little bit more heed to the fact that politics are local. Nations remain jealous of their prerogatives. Even in Europe, where there is a strong integrationist tradition with intellectual roots stretching back centuries, nation-states continue to jealously guard their responsibility for the regulation of domestic financial markets and hesitate to turn this over to an international entity. Better coordination of national regulatory policies is possible and desirable, but it is hard to imagine 182 IMF member countries ceding responsi-

bility for the operation of their domestic financial markets and institutions to an international superregulator.

Europe's experience also discredits the notion that exchange rate and financial problems could be solved by creating a world central bank and a world currency. A world central bank to loan foreign exchange to national central banks but without a world currency, as Garten seems to suggest, would be pointless. An international central bank that "would not be able to override the decisions of the national central bank," as he acknowledges would inevitably be the case when discussing any new global monetary institution's relationship to the US Federal Reserve, would in practice extend only limited loans. Just as no commercial bank is willing to extend unlimited credit to a customer whose behavior it cannot control, no central bank is willing to extend unlimited support to other central banks whose actions it cannot control for fear of creating a runaway engine of inflation and aggravating problems of moral hazard.<sup>35</sup> This is a clear lesson of the European Monetary System (EMS): the provision in the EMS Articles of Agreement requiring countries with strong currencies to provide "unlimited support" to their weak-currency counterparts was not credible because the inflation-averse Bundesbank predictably obtained the German government's agreement that it could opt out when it saw fit. The notion that intra-European exchange rates could be pegged by unlimited interventions proved to be an illusion. Europe was forced to conclude that the only way to make the extension of unlimited interventions credible was by creating a true European Central Bank, and that so long as it was doing that it might as well create a single currency.

Thus, the logic for a world currency is impeccable; the only way to eliminate exchange rate problems once and for all, as Europe has learned, is by eliminating the exchange rate. But this is not the same as eliminating crises. Indeed, some critics warn that European Monetary Union (EMU) may end up increasing rather than reducing the incidence of financial crises. Insofar as the inflationary costs of a monetary bailout of a national government experiencing a debt run or of a national banking system experiencing a depositor panic will now be borne by the residents of all EMU countries, not just by those of the country experiencing the crisis, there arises a free-rider problem that tends to encourage lax regulation. The specific illustration may be exaggerated, but the general principle is valid: the elimination of exchange rates does not necessarily mean the elimination of crises; it may simply shift the pressure from the exchange rate to other variables.

Moreover, Europe has cultivated the political consensus to take the momentous step of ceding responsibility for its monetary policy to the

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35. This is also the critique of proposals to turn the IMF into a true international lender of last resort, as discussed in chapter 7.

European Central Bank only after 50 years of economic and political institution building that have no counterpart in other parts of the world. European monetary unification is a political as well as an economic bargain, as its critics are especially quick to observe. Only because the members of the European Union have taken very significant steps down the road toward political unification are they prepared to accept the authority of a transnational monetary institution. And they are prepared to take those political steps only because the recent impulse to do so (the "lesson of World War II," that Europe must integrate to avoid a recurrence of war) was superimposed on a venerable integrationist tradition. William Penn proposed a European parliament, Jeremy Bentham a European assembly, Jean-Jacques Rousseau a European federation, Henri Saint-Simon a European monarch. The Pan-European Union, founded in 1923 to lobby for a European federation, counted among its members Konrad Adenauer and Georges Pompidou. One could go on. The point is that there exist no comparable tradition and support for political integration in other parts of the world.

To be sure, dissatisfaction with existing exchange rate arrangements and the desire to insulate customs unions from the disruptive effects of intraunion currency swings will encourage expansion of Europe's monetary union to incorporate additional members. The Mercosur countries will surely contemplate a single currency to insulate their customs union from exchange rate instability.<sup>36</sup> One can imagine a phased transition starting with a series of regional monetary unions and ending with the creation of a world central bank and a world currency. But even the first step in this process assumes a degree of political consensus and a commitment to political integration that, at present, simply does not exist. Ideas such as these are useful for focusing thought on the shortcomings of existing monetary and financial arrangements and for helping to identify the global functions that coordination among national policy institutions must try to simulate. But to take them more seriously than this would be a diversion from the work at hand.

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36. Argentine President Carlos Menem raised the idea at the beginning of 1998 and again at a regional summit in the summer. The idea has also been mooted in Asia, for example, in the Association of Southeast Asian Nations (ASEAN).