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What Creditors Could Do

Bad lending decisions should be attributed just as much of a role in creating financial crises as rash borrowing decisions. Accordingly, an examination of what can be done to stabilize the boom-bust cycle needs to look at the possibilities of action on the part of creditors as well as debtors. Indeed, when this project was started, my idea was to see whether the problem could be cured entirely from the side of the lenders. In the end, I concluded that this was just not feasible, partly because there seems no way of escaping from remunerating asset managers on the basis of the short-run performance of the portfolios they manage, but that certainly does not mean that I would want to go to the other extreme and put all the onus of avoiding future crises on reforms by the borrowers, as discussions in the official sector have for the most part tended to do. This chapter is therefore devoted to examining the scope for reforms on the part of lenders; the next chapter turns to the borrowers.

What actions might encourage equity flows and might make them more stable? These prove to be distinctly limited: Desirable as equity flows may be, there is not a lot that governments can do to stimulate further the flows of this type to emerging markets. The chapter then turns to two generic ideas for reducing the crisis potential from flows involving the purchase of fixed-income assets. This is followed by looking separately at proposals for reforming the lending of the multilateral development banks (MDBs), of the commercial banks, and of the private bond markets.

Equity

It has already been argued in this study (chapter 4) and elsewhere (e.g., Rogoff 1999) that there are good reasons, especially in terms of risk sharing, for desiring a shift of capital flows from loans to equity. From the standpoint of vulnerability to capital flow reversal, however, most analysts would differentiate sharply between the two forms of equity capital—FDI and portfolio investment. Multinationals will surely try to profit from any one-way bets that may be presented to them by misguided exchange rate policies by shifting their working capital around, and having investments in a country may stimulate operations that appear to them hedging while similar operations in the absence of investment might have been precluded as obviously speculative. Nevertheless, multinationals will not shift their fixed investments in any significant way in response to short-run fears of crisis, and covering is likely to be modest in comparison with the volume of investment. Individual portfolio investors, in contrast, believe they have the possibility of liquidating their investments, and many of them make a conscious effort to enhance their returns by judicious market timing. As noted in chapter 4, the preponderance of the evidence points to the conclusion that portfolio investors are more fickle than domestic investors in similar assets, and, therefore, they tend to magnify booms and busts.

Nowadays no developed country maintains important restrictions on the ability of its firms to invest abroad; therefore, there is little of first-order importance that can be done to encourage FDI. However, countries have quite a few minor ways in which they can stimulate appropriate foreign investments by their companies. The scorecard used in the investment component of the 2005 Commitment to Development Index of the Center for Global Development provides an excellent guide. The index rewards countries that are members of multilateral investment insurance agencies, notably the Multilateral Investment Guarantee Agency. It also rewards countries for having a national insurance agency but penalizes them if that agency makes no attempt to monitor standards with regard to the environment, labor, or human rights; if investors in certain sectors are ineligible for cover; if that insurance agency uses national economic interest tests that are at the expense of the host country; if that agency covers inefficient import substitution projects; or if it restricts eligibility to firms majority-owned by its nationals. The index also rewards countries for preventing double taxation, for example, if they sign tax-sparing agreements, and the index penalizes them if they prevent their investors from benefiting from developing country tax incentives. It rewards them for subscribing to and implementing the OECD antibribery convention and for participating in the Extractive Industries Transparency Initiative workshop. It also rewards them if they provide official assistance in identifying investment opportunities or in developing local investment promotion agencies.

In other words, there are quite a few things, albeit not high-profile actions, that developed countries can do to encourage an enlightened form of FDI by their firms in developing countries.

Encouraging FDI but not foreign portfolio investment would create a bias toward foreign firms as suppliers to markets in emerging countries because it would deny any route for foreign equity investors to supply capital to domestic firms. Even if one is not quite so convinced that foreign portfolio investment is a boon for emerging markets as most people now agree FDI to be, it seems reasonable to think that portfolio investment should be encouraged rather than the converse.

Here the main battle has already been won. For a long time most of the big countries of continental Europe had regulations, based on the old-fashioned principle that the way to safeguard investors is to prevent investment in anything that is not super-safe, that precluded their pension funds investing in emerging markets. However, after much argument, the European Union's Financial Services Action Plan provided an agreed legal framework for cross-border investments that firmly embeds the prudent-man principle as the basis for the regulation of pension funds and strictly curbs the restrictions that member states may impose. Thus, all pension funds must be allowed to invest at least 70 percent of their portfolio in shares, and they must be allowed to hold at least 30 percent of their portfolio in non-euro assets. Once this reform has entered into force, it will be difficult to argue that there are any serious restraints on portfolio investment in emerging markets on the part of EU members. In fact, the main constraints on such investments will be those maintained in—not by—the United States, where a number of individual states impose old-fashioned regulations that preclude or limit foreign investment by pension funds or insurance companies based in those states (especially by the pension funds of state agencies).

If there is not much more to be done in terms of liberalizing portfolio equity investment by industrial countries, is there something that could be done to reduce its volatility? For example, when portfolio investment in emerging markets first started, much of it took place through the medium of closed-end investment funds.[1] Because these closed-end funds are typically unable to switch their funds out of a country even if the market has begun to suspect that the country may be heading for a crisis, why not revive them? This is in fact most unlikely: Most closed-end funds were

1. A closed-end fund is one where the money placed in the fund remains invested in the recipient country irrespective of the desire of the investors to liquidate their holdings. The effect of a net desire to liquidate holdings is therefore to depress the price of the fund's shares on the market of the capital-exporting country rather than to cause a sale of shares on the market of the capital-importing country. (The fund's managers retain the right to change the *composition* of the fund's assets, but the assets remain in the country that the fund advertised that it planned to invest in.)

created because that was the only way that a number of emerging markets were at first prepared to allow foreign portfolio equity investment. To reimpose the restrictions that have subsequently been lifted so as to recreate the incentive to run closed-end funds would risk jeopardizing the goodwill of the financial community, even if it were administratively practical. Now that emerging markets have opened up to other forms of foreign investment, investors have no incentive to hold closed-end funds, which usually trade at a significant discount to the value of the assets held by the fund. This is believed to be because once it has been set up, a closed-end fund has a monopoly on the management of those assets and can therefore charge higher management fees than the competitive rate. Because investors know they have no way of bringing competitive pressure to bear, they simply have to accept a lower return on the assets held by the fund, for which reason they pay a lower price to purchase those assets.[2]

Nowadays closed-end funds may almost have disappeared, but an analogous distinction still exists between dedicated and crossover investors. Dedicated investors are those funds that restrict their investments to one geographical region (usually broader than a country—typically Asia, Latin America, or even emerging markets) or possibly one sector; crossover investors switch their funds between emerging markets and any other markets. During the Asian crisis, it was mainly the crossover investors who sold out because they were anxious to avoid being found holding tainted assets; the dedicated investors held fast, relatively secure in the knowledge that their purchasers knew what they were buying and expected some volatility as the price of the good returns they anticipated in the longer run. Hence, investors in emerging markets mainly constituted dedicated investors by the end of the crisis.

The emerging-market recovery of 2003–04 was fueled by a return of the crossover investors as well as by a surge of new money into the dedicated funds, so that now the crossover investors are reputed to be again a major element in the picture. Differential taxation would seem about the only handle through which public policy might conceivably be able to operate and reward the dedicated investors as against the crossovers. The problem is that, because there is no legal distinction between dedicated and crossover investors, this would require a public body that distinguished the deserving dedicated investors from the undeserving crossover ones and that made sure that the former group did not violate the rules that had led to their classification as dedicated investors. Perhaps it is better to accept a degree of volatility in equity prices and rely on the existence of

2. Part of the academic literature (Lee, Shleifer, and Thaler 1990) questions this explanation, but that is academic indeed as long as this explanation is widely believed in the markets, which seems to be the case.

investors who understand that the logic of contrarian investing favors the dedicated funds rather than the crossovers.

All Fixed-Interest Lenders

Two proposals could potentially apply to all nonequity investments. One is intended to achieve a shift in the currency of denomination of loan contracts so that, instead of being written in the currencies of the lenders (notably in the dollar), they are denominated in the domestic currency of the borrower. The other proposal is intended to allow borrowers a bit of breathing space in the event of a crisis, in the hope that they would be able to regain confidence and resume normal business if given a little extra time.

The problem of currency mismatches arises when the currency of a borrowing country is devalued against the currency in which many loan contracts are written. A major part of the problem in East Asia in 1997 was that exchange rate crises provoked major devaluations, which then meant that the many domestic agents who had borrowed in dollars—either banks or their borrowers—were exposed to drastic increases in the value of their liabilities without any compensating increase in the value of their assets. These currency mismatches thus provoked, or at the very least worsened, financial crises. The same happened in Argentina in 2001, and the escalation of the value of much of the public debt that was indexed to the dollar was an important factor behind the market panic in Brazil in 2002.

Morris Goldstein and Philip Turner (2004) analyze the problem of currency mismatches in depth. Their proposed solutions focus largely on actions by emerging economies and will therefore be considered in chapter 7. However, they also suggest that "the IMF should publish regularly data on currency mismatches at the economywide and sectoral levels and should draw attention to those mismatches regarded as excessive." This would at least act as a stimulus to emerging-market governments in taking the sort of actions they suggest to discourage mismatching.

An altogether more drastic solution was proposed by Anne Krueger (2000), now (though not when she advanced the proposal) the first deputy managing director of the IMF. She suggested that developed countries should lend to emerging markets only in their own currencies. A whole literature (e.g., Eichengreen and Hausmann 2003) asserts, although it has never tried to prove, this to be impossible because the countries suffer from "original sin," which means that foreign investors would refuse to lend by buying assets denominated in the borrower's own currencies. Krueger suggested that investors nonetheless be deprived of the alternative of lending in their own currencies, which would end such lending if the original-sin people are right but would transform it to a more benign form if they are wrong (box 6.1).

Box 6.1 Original sin

Ricardo Hausmann originally termed an inability to borrow abroad in domestic currency "original sin." The term suggested that countries borrow abroad by issuing liabilities denominated in foreign currencies because they have no choice; it is the only way that foreigners will lend to them. Hausmann has used this term in a series of papers he has written in association with Barry Eichengreen and in some cases with Ugo Panizza; more recently a number of other authors, including some like Goldstein and Turner (2004) who are sharply critical of the Eichengreen-Hausmann policy proposals, have used the term.

A frequent consequence of original sin, which means borrowing abroad in foreign currency, is the creation of a currency mismatch, a state in which assets and liabilities are denominated in different currencies. Thus, an Indonesian corporation that borrowed abroad in dollars but sold at home in rupiahs would acquire a currency mismatch as a consequence of original sin. But the two phenomena are conceptually distinct. If the Indonesian firm sold abroad in dollars, its debt obligations would be hedged by its foreign exchange earnings, and so original sin would not create a currency mismatch. Conversely, an Argentinean borrower who earned pesos and whose mortgage from a local bank was denominated in dollars (pre-2001) would have a currency mismatch without any foreign borrowing being involved.

Eichengreen and Hausmann have also used the term "domestic original sin" to refer to the supposed inability to issue long-term, fixed-rate debt in domestic currency. At one time Eichengreen and Hausmann even argued that an inability to borrow abroad in domestic currency and to borrow long-term at home in domestic currency on fixed-rate terms were two aspects of the same phenomenon, but their more recent work recognizes that these are two distinct problems.

Another related concept that has been introduced in recent work by Reinhart, Rogoff, and Savastano (2003) is "debt intolerance," meaning an inability to carry a high volume of debt without running into a debt crisis. The term is again quixotic inasmuch as it suggests that it is the debtor that refuses to countenance a high level of debt, whereas the analysis says that, because of suspicions in the capital market, countries with a history of reneging on their debt find that the terms become adverse when their debt is still relatively modest. Either original sin, currency mismatches, or domestic original sin may contribute to debt intolerance, but they are again distinct phenomena.

(box continues next page)

Krueger (2000) identified two alternative ways in which a legal requirement to denominate a loan in the borrower's own currency might be created. One would involve action on the part of the borrowing countries, and discussion of it is therefore deferred to chapter 7. Krueger's other way of forcing financial institutions to lend in the borrower's currency envisaged action on the part of the lending countries. They would "pass and enforce legislation requiring their financial institutions to accept liabilities [presumably she meant assets] abroad only in local currencies, and to hedge foreign-exchange risks in international markets." It is not clear whether this would completely eliminate the problem of currency mis-

Box 6.1 *(continued)*

Why is it a problem if a country borrows abroad in some other country's currency? Because it makes for instability when done by a debtor country. When a debtor country is forced to devalue, it finds that the value of its debts in terms of its own currency has suddenly increased, thus magnifying its problems. Note that this is still true even if the microeconomic agent that had borrowed abroad was covered because it was an exporter; had it borrowed in domestic currency instead, the devaluation would have reduced the foreign currency value of its debts, easing the national situation at what one assumes to be a difficult time. Conversely, when a currency appreciates, that is usually a time when a country is in a good situation to take on an additional burden; for a debtor country that has borrowed abroad in foreign currency, this is a time when the country suddenly finds its burden is eased. To them that hath shall be given.

Note that these effects work in reverse for creditor countries: A devaluation increases the (domestic currency) value of a creditor country's assets if these were invoiced in foreign currency, helping the creditor country's adjustment; and a revaluation reduces the domestic currency value of its foreign currency denominated assets, meaning it gets less help when it does not specially need help anyway.

Hence, both debtor and creditor countries can benefit if assets are denominated in the currency of the debtor. At least, that would be the case if debtors could be relied upon not to inflate away their debts. So long as creditors are not totally convinced that borrowers have grown out of such temptations, prudence will suggest that they should lend in the debtor's currency only if their asset is inflation indexed.

Eichengreen and Hausmann have provided abundant evidence that original sin is widespread, but there is no convincing evidence that it is inevitable. There are emerging market countries—most conspicuously South Africa—that borrow in their own currency. Growth is rapid in domestic bond markets in emerging markets that issue bonds that are denominated predominantly in domestic currency. Foreign investors buy some of these bonds, thus accepting exposure to currency risk in countries that are supposedly afflicted by original sin. Indeed, some investment banks run funds consisting exclusively of the local currency denominated bonds of emerging markets. Shortly before this study went to press there was a report that the Banco do Brasil had sold domestic currency denominated bonds in the international market, where they were readily sold. Although it should certainly be an objective of policy to largely rid the world of foreign currency denominated borrowing, to blame such borrowing on original sin is silly.

matches or simply transfer it within the country because someone has to take the other side of the foreign-exchange hedge, and it is only if that someone were a foreigner that the problem would be eliminated. But even if a national were to take the hedge, it would hopefully be someone in a better position to carry the risk (such as an exporter that earns income denominated in foreign currency).

Krueger relied on developed-country bank supervisors to enforce the provision that foreign assets be denominated only in local currencies. This would constrain financial institutions that are dependent on their supervisors, like banks, but might not apply to bonds or certificates of deposit sold

by emerging-market issuers to foreign mutual funds, pension funds, insurance companies, or other financial intermediaries. It might thus be difficult to legislate a complete abandonment of foreign currency borrowing (even if the original-sin people are wrong), but even a switch to domestic currency lending by banks might make the system much less crisis prone.

The other proposal that is intended to cover all loans (including bonds) addresses the problem of a run. This proposal is due to Buiter and Sibert (1999, 231–32), who suggested including what they called a universal debt rollover option with a penalty (UDROP) in all foreign currency obligations (including bonds, loans, and options).

> All foreign-currency IOUs must have a rollover option attached to them. This includes private and sovereign, long-term and short-term, marketable and non-marketable, negotiable and non-negotiable debt, including overdrafts, credit lines, and contingent claims. . . . All borrowers, public and private, must be given the option. . . .
>
> The option would entitle the borrower, at his sole discretion, to extend maturing debt for a specified period (say three or six months) at a penalty rate. The borrower would be entitled to the rollover only if the debt in question had been serviced in full, barring the final repayment. . . .
>
> We expect the penalty spread and other features of the rollover contract to be negotiated between debtors and creditors, rather than decreed by a government or international body.

The purpose of the proposal is to relieve the liquidity pressures that build up in crisis situations. Buiter and Sibert emphasize that their scheme is intended only to help an otherwise solvent borrower that is unable to roll over its foreign currency debt because of a liquidity crisis. And it would surely be attractive if one could feel confident that liquidity crises would be resolved within three or six months.[3]

Unfortunately that would seem likely only when liquidity crises are pure panics that are resolved merely by the passage of time. But liquidity crises normally develop when creditors begin to harbor doubts about the ability of debtors to service their debt on the contractually agreed terms, and they end only when those doubts are resolved. The crucial question is why a three-month (or a six-month) delay without any restructuring of debt obligations beyond that point should allay such doubts: The presumption has to be that the debtor's condition will be essentially the same at that time as it was when the UDROP was exercised, which implies that all a UDROP would accomplish would be to delay the crisis.

3. There are at least two ways, however, in which the intent of the proposal could be negated. One would be by denominating international loans in the currency of the borrower, which would at least have the merit of eliminating original sin. The other would be by the borrower and lender contracting for the rollover to be exercised at a prohibitive interest rate, to which the borrower might agree if it wished to demonstrate to the lender that it had no intention of exercising the option—but which would then leave the borrower high and dry if in the end it encountered a crisis.

Perhaps an amended version of the UDROP proposal could play a more strategic role if it were accepted that an extension of loan maturities was a normal part of the solution to a liquidity crisis. In general, an extension of much more than six months seems likely to be needed in order to resolve a crisis; recall that Korea and its bank creditors negotiated a three-year extension of maturities at the end of 1997. Of course, no one would suggest writing an automatic UDROP of three years; this is a dimension that ought not to be prespecified but instead negotiated between the debtor and a creditor committee ad hoc as and when the rollover option is invoked. Creditors will presumably seek the shortest rollover period that gives assurance of allowing the debtor to restore its liquidity and exit from crisis. But if the creditors are recalcitrant in agreeing to a realistic time frame, it would seem desirable to relieve the debtor of the obligation of paying amortization pro tem. This would need to be approved by some appropriate arbiter, such as the IMF or a specially created ad hoc body. The incentive for the debtor to agree to the shortest realistic period for the rollover is to preserve its standing in the capital markets.

Creditors have reacted adversely to the UDROP idea. If it turns out they are so strongly averse to it as to bring lending to a halt, one might exempt long-term loans above a certain maturity. Trade credits might be allowed to satisfy the requirement by a provision that a given volume of credits revolve over time, on the model of the banks' 1998 agreement with Brazil. But the loans that should not be exempted, no matter how severe the impact on volume, are short-term loans without any trade contract as collateral. It is true that UDROP would add to the risk of short-term lending to a debtor whose medium-term position looks doubtful, but that is the point. Short-termist lenders would find it more difficult to persuade themselves that they can buy short-term assets and then win the race to the exits if things go wrong. The game in which investment bankers advise their clients that it is safe to buy short-term assets from country *X* because it looks safe enough for the next few months would be undercut. Only investors willing to make a relatively long-term commitment would invest in emerging-market loans, and those are the only investors worth having.

Multilateral Development Banks

A solution to the problem of the currency mismatches that arise from the lending of the MDBs has been advanced by Eichengreen and Hausmann (2003). Although I agree with Goldstein and Turner (2004) that the habit of borrowing in a foreign currency is not so deeply embedded that it makes sense to label it original sin, I also believe that the proposal Eichengreen and Hausmann made to overcome the problem with regard to MDB lending deserves more than the summary dismissal it has received from such influential writers as Goldstein and Turner and Rajan (2004).

The specific proposal of Eichengreen and Hausmann is to have the MDBs borrow in a synthetic unit whose value is determined by a basket of inflation-indexed emerging-market currencies.[4] The World Bank, for example, would sell bonds denominated in this unit to international investors. Eichengreen and Hausmann reason that such a basket would be potentially attractive to investors (of which the proverbial Belgian dentist is the archetypal example) for several reasons. Being indexed, its value could not be inflated away. Being a basket, its value would tend to be more stable than that of individual emerging-market currencies.[5] The basket would be expected to exhibit mild secular appreciation against (for example) the dollar, for two reasons: because it is fully indexed while the dollar is not and because most of the constituent currencies would be of countries that can expect to benefit from the Balassa-Samuelson effect in coming decades.

To cover itself against exchange risk, all that the World Bank would need to do would be to on-lend the borrowed money on an indexed basis in the currencies that constitute the index in the proportions that make up the basket.[6] Because the Bank's lending would be indexed, the borrowing countries would be unable to inflate away their debts. On the other hand, a real depreciation of a country's currency necessitated by a crisis or a need for adjustment would maintain its debt constant in terms of its real (inflation-adjusted) domestic currency but reduce its debt in terms of foreign currencies. Thus, no problems of currency mismatches would arise through borrowing from the MDBs. This is in sharp contrast with the past, when the reluctance of the MDBs to engage in imaginative financial engineering in the lending they offer to their borrowers at times resulted in major financial burdens on the borrowers (see Kapur, Lewis, and Webb 1997, chapter 16). The Bank's real lending rate could, of course, be the same for all borrowers, just as its dollar lending rate is the same for all.

Note that this proposal deals with a part of emerging-market borrowing that would not be reformed by any of the other proposals dealt with in this study. In particular, it is a complement to, rather than a substitute

4. Every proposal for financial innovation stimulates skeptics to ask why the market has not already developed the asset that is being advocated. An answer to that rhetorical question, which is based on Borensztein and Mauro (2004), is summarized in the concluding chapter of this study.

5. Eichengreen and Hausmann simulate the behavior of two hypothetical 20-country baskets and show that their volatility against the dollar would have been comparable with that of major international currencies.

6. Presumably the Bank would not be able to secure an exact hedge in this way unless it were constantly changing the composition of the basket in which it borrowed, which would undermine the ability to create a vibrant market in the synthetic unit; however, marginal remaining exposures could be hedged through the financial markets.

for, the reforms in emerging-market borrowing that were advocated by Goldstein and Turner and that are endorsed in chapter 7.

Commercial Banks

After the oil price increase in the 1970s, banks played a major role in intermediating funds to emerging markets in the form of trade credits or, even more important at that time, syndicated loans. As a result, banks were at the heart of the debt crisis of the 1980s. They never regained their role as the dominant lenders during the new boom in capital flows in the 1990s. They nonetheless again became a significant source of funds, though with a much diminished role for medium-term syndicated credits to the public sector and a correspondingly larger role (especially in East Asia) for short-term loans to the private sector, particularly interbank loans. And, as before, it was their flow of funds that turned decisively negative soon after the crisis started and that therefore contributed most acutely to worsening the East Asian crisis.

One reason that bank lending is so volatile is that banks lend in the form of loans that can be liquidated simply by not rolling them over when times turn difficult. Although many of these loans in the 1970s had a medium-term maturity, one of the conclusions that banks drew from the debt crisis was that they would be safer lending only with the traditional short-term tenors, so that they would find it easier to liquidate their positions if events looked threatening. This relies on a fallacy of composition, for although it may be easier for any one bank to liquidate its loans, an attempt by bankers collectively to get out is prone to provoke the very crisis that they are individually seeking to avoid.

The main responsibility for not borrowing in such a dangerous form has to rest with borrowers and will therefore be discussed in chapter 7. Nevertheless, this does not imply that there is nothing the lenders can do. Various authors have in fact suggested several different approaches that the authorities of the lending countries can take in order to make the lending by their banks less problematic.

Perhaps the most familiar idea is that the authorities should withdraw the encouragement they have in the past provided for banks to lend short term by revising the first Basel agreement, which required them to hold less capital against short-term loans of less than a year's maturity. The final version of the new Basel agreement, known as Basel II, will indeed change this requirement, but in the wrong direction! Small banks subject to the standardized approach will still be allowed lower risk weights for short-term interbank loans—defined as those with a maturity of less than three months (Basel I specified one year). At least there is an improvement so far as large (highly rated) banks are concerned: Such banks will be subject to a 20 percent risk weight for all interbank lending regardless of maturity.

The Basel negotiators have worked on the premise that supervisors ought to concern themselves only with the interests of bank depositors. My colleagues Wendy Dobson and Gary Hufbauer (2001) argued that the supervisors of the banks of the main industrial countries should be required to take a broader view of their social obligations. They accordingly looked to a number of changes in the process of bank supervision to ameliorate the problem of volatility in lending to emerging markets. They argued that bank supervisors have the ability and, hence, a responsibility to change the incentive systems that banks face in a way that will dampen the volatility of their lending, which they attribute to the fact that the banks enjoy a publicly provided safety net. This gives banks an incentive to engage in unduly risky behavior, pushing loans—even to risky borrowers—when times are good, in the expectation that the safety net will prevent the worst if they should have difficulty liquidating their loans when times turn bad.

Dobson and Hufbauer welcomed the general thrust of the reforms to bank supervision that are proposed in Basel II, but they suggested a number of modifications designed to make industrial-country bank supervisors contribute to the stability of the system. They argued that risk weights should be higher for loans to particularly risky borrowers, and they identified two groups they would place in that category. One is emerging-market borrowers with weak financial systems. The other is highly leveraged hedge funds. One might add that one of the strengths of Basel II is that an attempt has been made to vary the risk weights applied to corporate borrowers to reflect their differential riskiness.

Echoing a proposal first advanced by staff of the Federal Reserve Board in a different context (Kupiec and O'Brien 1997), Dobson and Hufbauer (2001) also proposed that banks in the nonstandard category, those using internal ratings rather than the standard approach to determine risk weights, should be fined if the risks prove ex post to have been underrated. They urged supervisors to be alert to evidence of herding in the form of a run into emerging-market assets, and they argued that supervisors should tighten capital requirements in an internationally coordinated fashion if they see that happening. They proposed that banks should be allowed—but not compelled—to use subordinated debt to meet a part of their capital requirements, an arrangement that would co-opt the capital markets into helping the supervisors police the banks. Inevitably, they also urged better disclosure and greater transparency. In addition, banks should be encouraged to provide more adequately for future loan losses by requiring the tax authorities to automatically accept loan-loss provisions that have been endorsed by bank regulators rather than allow such provisioning only when the evidence is irrefutable that loans have actually turned bad. Although I have doubts as to whether these changes alone would suffice to curb the past volatility of bank lending, their series of ideas is highly sensible.

An even more radical proposal regarding provisioning for future loan losses has been advanced by Jean-Claude Trichet, now the governor of the European Central Bank and previously governor of the Banque de France, and, more recently, by José Antonio Ocampo (2003). They have proposed that all the industrial-country banks should be expected to adopt the policy of forward-looking provisioning that is required of Spanish banks by their supervisors.[7] Forward-looking provisioning means setting aside provisions not just for loans that are already recognized as being problematic but also for the statistically expected level of future loan losses. The idea is that when an economy enters into recession the banks would already have made significant provisions for the loan losses that would then materialize; therefore they would be unlikely to be forced into lending cutbacks that would further accentuate the recession. Indeed, it is conceivable that it would turn out that their provisions were greater than needed, in which case the banks would actually be in a position to step up lending in a cyclical downturn instead of retrenching, as has been the normal historical experience. Even if banks maintain their traditional policy of cutting and running when times turn tough, the innovation would at least serve to restrain the extent to which they could overlend in the good times.

Another proposal is addressed specifically to the tendency of the banks to cut and run when a crisis materializes, especially by not rolling over loans in the interbank market. Henri Bernard and Joseph Bisagnano (1999, 41) suggest "an ex post charge for liability insurance . . . triggered . . . when official assistance is required to resolve a country's financial crisis. . . . Interbank lenders could then be assessed an ex post insurance premium, related to their withdrawals, in other words, a 'haircut'." The expectation of being assessed such a premium (or subjected to an exit tax, to use an alternative terminology) could be helpful insofar as it deterred banks from making short-term loans in the first place or from liquidating their loans in the midst of a crisis. It seems clear, however, that the size of the insurance premium (exit tax) that would be required to resolve a crisis if the banks were not in fact deterred would be uncomfortably large if this were the sole mechanism for reducing contractual payments to what the country could afford to pay.

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7. José Antonio Ocampo (2003, 236) explains:

> The best-known [case of forward-looking provisioning over the cycle] is Spain, which in December 1999 issued a regulation requiring countercyclical provisions calculated by statistical methods. The main feature of this approach is the estimation of "latent risk" based on past experience over a period long enough to cover at least one business cycle. This generates a dynamic in which provisions build up during economic expansions and are drawn upon during downturns. . . . The major innovation of this system is its explicit recognition that risks are incurred when credits are approved and disbursed, not when they fall due.

In most cases, what will be needed to achieve rapid recovery from a crisis will be a debt reconstruction that stretches maturities rather than the reconstitution of some part of the liquidity that has been lost. This approach may thus be helpful in undermining the confidence of bank lenders that they will win the race to the exits if trouble develops, but it will not necessarily be of much help in resolving a crisis that has already developed.

Bonds

Before the Second World War, long-term bonds provided the principal mechanism for lending to the emerging markets of the day. Today bonds tend to be of shorter maturity and often also contain put options that reduce their effective maturity to the borrower. Several proposals have been discussed for making bonds more friendly to emerging-market borrowers.

The proposal that first attracted attention was the inclusion of collective action clauses in bond contracts.[8] This was proposed by Eichengreen and Portes (1995) and was then taken up by the Rey Report (Group of Ten 1996). When this proposal was first mooted, we heard dire predictions from some of the New York–based lenders, echoed by some of their clients, that any attempt to include such clauses would bring lending to a halt or, at the least, lead to drastic increases in interest rates. Then someone realized that approximately one-third of such bonds, namely most of those signed in London, already included such clauses. Barry Eichengreen and Ashoka Mody (2000a, 2000b) therefore examined whether the inclusion of such clauses had resulted in higher interest rates to the borrowers, as per the prediction. It turned out that the impact was modest and also, interestingly, that the direction of impact depended on the borrower's creditworthiness. Countries with poor credit ratings did indeed have to pay somewhat more to borrow with the added security of collective action clauses, presumably reflecting lender concern that a lack of willingness to pay might lead borrowers to abuse the clauses even when they would have been able to pay. Countries with good credit ratings actually paid marginally less, presumably reflecting lender recognition that the clauses would reduce the cost of restructuring debt (and the possible interruption in debt service payments while this happened) in the remote contingency that the countries should encounter an inability to pay so that restructuring proved necessary.

Eventually the lawyers found a way of reconstructing bonds issued under New York law, even without collective action clauses (Buchheit and Gulati 2000). The key was to accompany the offer to swap old bonds for

8. This is the term given collectively to clauses allowing a bondholders' meeting to be convened to consider a debt reconstruction, rules allowing interest and amortization terms to be modified by a qualified majority of bondholders, sharing clauses, etc.

the new bonds that contain the revised payment terms with proposals to amend the nonpayment clauses of the old bonds in ways that make these much less attractive and impede any holdout bondholders from successfully litigating to demand continued or accelerated payment. Examples of amendments might include old bonds being delisted, the waiver of sovereign immunity being withdrawn, and negative pledge protection being removed. None of these requires the unanimity that prevents revision of the payments clauses. Because these disfiguring amendments to the terms of the old bonds are adopted simultaneously with bondholders exchanging their old bonds for the new debt instruments, they are known as exit consents. Exit consents were used in restructuring junk bonds in the 1980s, but the first time the technique was used to restructure sovereign bonds was in Ecuador in 1999. Exit consents have one great advantage over collective action clauses: They can be used to deal with the stock of old bonds rather than simply allow today's new issues to be restructured in the future. They also have one great disadvantage: They do not give total protection against the threat of litigation by holdouts.

For a while it looked as though countries that needed to restructure their debt were going to have to rely indefinitely on exit consents. But then Anne Krueger (in a speech at the National Economists Club, Washington, November 26, 2001) proposed the creation of a sovereign debt restructuring mechanism (SDRM) in the IMF, and, presto, the far-sighted lenders who had been vigorously opposing collective action clauses decided that they were a lesser evil and would be worth endorsing in order to fend off the threat of the SDRM. All of a sudden the lenders began encouraging issuers to insert collective action clauses in the contracts of new bonds, and the borrowers were only too happy to oblige. In this respect, reform has already happened.

Bond borrowing is more useful to emerging markets if the bonds are long term because that means there is less scope for the lender to cut and run in difficult times. One way that nowadays many bonds give scope for cutting and running is by the inclusion of put options. Korea found in late 1997 that many of its creditors chose to exercise their put options, which gave them the right to demand the early return of their money. This meant that Korea faced an additional call on its reserves at the very worst time. A five-year bond with a put option exercisable in six months' time is not really a five-year bond at all; from an economic standpoint it is a short-term, six-month bond with a rollover provision if the lender consents. It should be counted as such in the statistics. Accurately reporting it as such would force both the borrowers and their national authorities to recognize the risks that are being taken. One would expect that this would diminish the attractiveness of agreeing to the inclusion of put options in bond contracts and, hence, lengthen the effective maturity of bonds.

Regulations require that insurance companies registered in a number of states in the United States may hold only investment-grade bonds. This is

a legacy from the days when fiduciary requirements were enforced by limiting what the fiduciary was entitled to hold instead of holding fiduciaries to the prudent-man standard. It is not clear that it any longer makes sense: One can surely argue that insurance companies should be allowed to decide for themselves what is in the interest of their clients, subject to supervision by the insurance regulators who make sure that the overall investment policies of the insurance companies do indeed safeguard the interests of their principals.

What makes even less sense is that the fiduciary requirement is specified in terms of what they may hold, not what they may acquire. The difference can be crucial. In late 1997, insurance companies holding Korean bonds were forced by this requirement to sell them in the midst of the market implosion, when credit-rating agencies panicked and suddenly cut Korea's rating to below investment grade. The holders were not allowed to exercise their judgment as to whether Korean bonds remained a good investment (which they certainly were after their price had collapsed). They were forced instead to sell and add to the pressures on Korea, at the cost of their clients. If a requirement such as this is to be retained at all, it needs to be redrafted to limit what insurance companies can buy rather than what they can hold. That would prevent their being forced to sell in response to a credit downgrading, as happened in Korea in late 1997. And that would make bond borrowing more stable.

A Program

Which of these proposals would it make sense to include in an action program designed to make borrowing more stable and thus curb the boom-bust cycle?

In the first place, the system should certainly have a bias in favor of equity rather than fixed-interest lending. No very dramatic actions are available to promote what is essentially an already liberalized policy regime on equity investment; perhaps the main challenge will be to ensure that it remains liberal in the face of the antiglobalization people who think that the way to provide Americans with jobs is to prevent Indians getting hired. A number of secondary actions can help stimulate the flow of FDI, as reviewed above. In addition, a number of US states can liberalize regulations that still prevent pension funds and insurance companies based in those states from investing in emerging markets.

I certainly sympathize with the objective of shifting emerging-market borrowing into their own currencies so as to end currency mismatches, and it is now clear that Eichengreen and Hausmann (2003) were wrong in claiming that this would put an end to capital flows from developed to emerging economies. The Goldstein and Turner (2004) suggestion of having the IMF publicize currency mismatches is a minimal step in support

of this objective. The more substantive issues are whether the emerging markets should take the actions discussed in the next chapter and whether developed-country law (enforced by their supervisors) should compel the banks and other financial institutions in their jurisdictions to lend in local currencies. Sympathetic as I am to her objective, it seems to me that the Krueger proposal designed to compel local-currency lending goes too far. There are after all some countries where no responsible bank would be prepared to lend in the local currency and where a forward market for hedging such lending does not exist (or could seize up exactly when most needed). Yet the banks probably ought not to be discouraged from all lending (notably providing trade credit) in such countries. Telling banks they must lend in local currency in some countries but not in others would require the authorities to make judgments that (to put it diplomatically) could prove internationally contentious. It would therefore be better if supervisors were told to encourage rather than compel local currency lending and to encourage banks to cover their lending forward; if that is impossible, supervisors should urge banks to be cautious in how much they lend.

One very concrete proposal for tackling the problem of currency mismatches on a significant part of emerging-market borrowing is that advanced by Eichengreen and Hausmann (2003): MDBs would borrow in an indexed basket of emerging-market currencies and on-lend to emerging markets in their own currencies (indexed to their own consumer price indices). This would eliminate the problem of currency mismatching from MDB lending. This is all gain and no loss. It is ridiculous to dismiss it because one disagrees with parts of the Eichengreen-Hausmann analysis.

This chapter reviewed two proposals designed to limit the ability of investors to cut and run when a crisis materializes. The more ambitious is the Buiter-Sibert (1999) UDROP proposal for including a rollover option at a prespecified penalty interest rate. This seems unlikely as it stands to accomplish much, but an amended version of the proposal that provides for flexibility in the length of the rollover would make sense as one element of a new approach to liquidity crises. The principal difficulty is that one would need some way of deciding whether to extend the rollover while negotiations proceed. A borrower that is not negotiating in good faith could see its rollover terminated and thus become subject to such sanctions as default brings. However, to fashion this proposal into something workable would take a study in itself, and so I do not include it in the action program being assembled here.

The less ambitious proposal along these lines is the Bernard-Bisagnano (1999) proposal: Charge banks that have been lending to any country that needs an official bailout an ex post insurance premium—a premium related to the magnitude of their withdrawals in some preceding period. This seems unlikely to contribute much to resolving a crisis, but it might

have some value in deterring short-term lending to countries in a questionable medium-term situation. Once again, however, the value of the contribution is too uncertain to justify inclusion in the action agenda.

A range of ideas would seem able to diminish the volatility of lending by the commercial banks. I disregard what seem to me sensible proposals that do not bear directly on the issue at hand, such as the idea of obliging banks to float subordinated debt to meet a part of their capital requirements. Far more directly relevant would be an amplified risk-weighting system for loans to countries with weak financial systems, as proposed by Dobson and Hufbauer (2001), although it does pose a need to authorize some body to pronounce on which countries have weak systems and which do not. Their proposal to penalize (through fines) banks that use the nonstandard approach to assessing risk weights but turn out ex post to have underestimated the risks also seems eminently reasonable.

Perhaps more important are the ideas for encouraging banks to provide more adequately for future loan losses. The minimum that should be done here is adopt the Dobson-Hufbauer proposal to require the tax authorities to accept automatically loan-loss provisions that have been endorsed by bank regulators. Better still would be to plump for forward-looking provisioning on the Spanish model, as proposed by Jean-Claude Trichet and José Antonio Ocampo (2003).

So far as bonds are concerned, it was suggested that their maturity should be calculated by the term until the next put option falls due or the bond matures, whichever is shorter. The purpose is to discourage the put options that reduce the effective maturity of many bonds below their official terms; the reasoning is that other lenders, and supervisors, would not take false assurance from figures that essentially describe a fiction. Another change that is highly desirable is to eliminate the old-fashioned regulations that prevent many insurance companies from holding high-risk, high-yield bonds. The prudent-man principle should be allowed to apply unfettered, with the managers of the insurance company taking full responsibility for purchasing an appropriate portfolio. If that proves too radical for the authorities to contemplate, the least they should do is amend the requirement that insurance companies hold only investment-grade bonds to one that says they may acquire only investment-grade bonds, so as to eliminate the artificial pressure on them to sell existing bond holdings when the rating agencies panic in the middle of a crisis.

Would this agenda suffice to eliminate the boom-bust cycle? Probably not. That is why this study does not end here but has another chapter dealing with the actions that would also be needed on the part of the borrowers.