Toward New International Financial Architecture: An Asian Perspective

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1. Introduction

We have observed a series of currency crises in emerging market countries in the last eight years: Mexico in 1994, Asian countries in 1997-98, Russia in 1998, Brazil and Turkey in 1999-2000, and, the latest, Argentina in 2001-2002. Ever since the Mexican crisis, countless official meetings were held and many books and articles were written on how to reform policies of the international financial institutions (IFIs), especially those of the International Monetary Fund (IMF). The discussions and efforts to reform the IFIs were commonly referred to as building a new international financial architecture. The architecture should have a blueprint for an international framework supported by the following four pillars: (1) Crisis Prediction and Prevention; (2) Crisis Management—Lender of Last Resort (LLR) type; (3) Crisis Management—Private Sector Involvement (PSI) type; and (4) Institutional and Organizational Changes among IFIs.[1]

The crisis prediction and prevention includes topics such as early warning signals, building a robust financial system, and choice of the exchange rate regime. Even if all the precautions are taken, a crisis does happen occasionally. That is the nature of the financial and capital markets. Once a crisis breaks out, it becomes a problem of minimizing damages to the economy and containing a crisis in one country. There are two ways to approach crisis management, namely LLR and PSI.

The LLR-type crisis management is important and appropriate when a country is suffering from a temporary shortage of foreign exchanges and lack of investors' confidence. The IMF support package provides enough liquidity to meet investors' withdrawal of investment—often short-term bonds issued by and lending to the government and private-sector institutions of an emerging market country. This buys time so that the country can turn around and build up foreign reserves.[2]

The PSI-type crisis management is important when the amount of official support is limited and when private-sector lenders should shoulder some burdens in

[1] Although not explicitly referred to, I benefit from various sources of work, in particular, two excellent works, Eichengreen (1999) and Kenen (2001).

[2] An appropriate analogy is a domestic banking crisis. When investors think that a bank is broken—assuming no deposit insurance—, depositors withdraw their funds. If all depositors try to withdraw funds, then a bank will be broken, because a bank will not be able to liquidate all the assets at fair value in a hurry. The central bank's role is to provide liquidity, that is massive loans without conditions, to banks so that banks can meet its deposit withdrawal in full. In fact, once the central bank backs banks, depositors are assured that their deposits are safe, so that a bank run stops even before all deposits are taken out.

resolving a crisis. After all, recent currency crises are caused by capital flows of commercial and investment banks and private-sector investors—massive inflows first and massive outflows afterwards. It is only fair that they share the consequences of their own actions, rather than being bailed out by the official sector, again and again. If investors can wait for orderly redemption rather than collecting loans and dumping assets, a country has a better chance to maintain and pay back full asset values.[3]

Institutional and organizational changes are also needed, as the IMF, the World Bank, and other international organizations are not functioning as they are supposed to. While some of the mandates of these organizations may overlap—for better or worse—, there may be a lacuna between the turf of these organizations. Emerging markets, that have graduated the developing country status, but not yet advanced countries, may fall through the cracks of these IFIs surveillance and monitoring. Broadening the mandate of some IFIs, while streamlining some others, may be necessary. Therefore, a quest for new international financial architecture has been very important for the stability of global financial markets. The issues are wide-ranged, but quite relevant for the stability of the global financial markets and economic developments in the future.

But, who will be an architect? And who will pay for building and maintaining the framework?

2. Common Factors and Differences

Let us briefly review similarities and differences among the currency crises in the last eight years, but I will not dwell on details of each crisis.[4] First, I point out three common factors. All crisis countries had formally or informally practiced a dollar peg, which contributed to developing macroeconomic imbalances—an asset price bubble, current account deficits, and others symptoms. Second, financial sectors of these countries developed vulnerabilities in the form of too much lending to particular sectors, or of currency and maturity mismatches on their balance sheets. Third, short-term capital inflows had become much larger than foreign reserves and other liquid foreign-

[3] There are two analogies to PSI. First, a bank moratorium (banking holidays) in the domestic banking crisis is a case for giving time to cool panicking depositors' head, and if assuring information is provided in the meantime, the panic will stop. Second, a bankruptcy court can order a temporary protection of assets from creditors and work out the best and fair deal for all creditors. Asset grabbing in chaos usually hurt both creditors and borrowers.

currency assets. A sudden reversal of large short-term capital flows was a source of acute currency crises. In fact, this distinguishes the 21st century type crisis from the traditional current account crisis.[5]

However, there are important differences among Mexico, Asia, Russia, Brazil, Turkey, and Argentina. The following five differences can be highlighted.

(1) Sovereign debt vs. Private-sector debt. In the case of Mexico, large outstanding short-term debts were those of the Mexican government. They were called *Tesobonos*. Similarly, the government debts were quite large in Russia and Argentina. On the other hand, Asian debts were predominantly in the private sector. In Thailand, commercial banks borrowed massively from foreign commercial banks. In Indonesia, corporations borrowed directly from foreign commercial banks. In Korea, commercial banks guaranteed manufacturing corporations borrowings abroad in addition to their own borrowings from foreign banks. In Asia, fiscal authorities were running surpluses before the crisis, while in Latin American countries and Russia, fiscal deficits eroded investors' confidence. Clearly, a lack of fiscal discipline, that is an act of the government, has been the source of problem in Latin America and Russia. Considering that the Asian economies fell into a crisis, despite prudent macroeconomic policies, that is, fiscal surpluses, many Asians felt that international investors and speculators are to blame for their misfortune.

(2) Bonds vs. Bank lending. In Mexico, Russia, and Argentina, debt instruments were government bonds and short-term treasury bills, namely sovereign bonds. This distinguishes the 1990s crises in Latin America from its 1980s debt crisis, and the Asian crisis. In the 1980s, syndicated loans by foreign banks were at the center of the problem. In Asia, borrowings from foreign banks (but not syndicated loans) were a major part of countries' external liability. This difference is also important in thinking how to manage a crisis. It is difficult to restructure bonds, while bank loan restructuring is regularly done. In order to restructure bonds—that is lengthening maturities if not outright debt reduction—a unanimous consent has to be obtained. But it would be almost impossible to call a bond holders meeting if bonds have been

[4] See Ito (1999, 2000a, 2000b) for the details of the arguments.

[5] Michel Camdessus coined this word after the Mexican crisis. The 21st century crisis is different from the traditional type.

sold to a large number of retail customers, because there may be hundreds, if not thousands of them. International bank lending, on the other hand, is typically done by a fewer number of banks, typically thirty to fifty banks. Namely, crises resulting from bank lending are easier to manage than those from bonds.[6]

(3) LLR, successful and unsuccessful. In the case of Mexico, the $50 billion package was put together by the IMF in January 1995. The $50 billion package consisted of the United States contribution of $21 billion and the IMF contribution of $17.8 billion.[7] This was much bigger than the outstanding amount of *Tesobonos*, the short-term Mexican government bonds.[8] The IMF package to Mexico can be viewed as a successful LLR-type operation. In Thailand, on July 2, 1997, the baht was floated, and quickly depreciated by 15 percent.[9] The Thai baht had not depreciated more

[6] Indeed, Russia and Argentina defaulted on their bonds, while a very few international banks lost money on their loans to Thai banks or Korean banks, although international banks were asked at some point to roll over their loans to a crisis country. However, those who lent to nonbanks, including finance companies in Thailand and corporations in Indonesia, lost when borrowers went bankrupt.

[7] On December 20, 1994, the Mexican peso was devalued by 15 percent, and two days later, it was floated under pressure. Within a week, the peso was trading in the range that was 50 percent lower than the pre-crisis level. A fear of potential default of the sovereign bonds prompted the U.S. government and the International Monetary Fund (IMF) to move quickly in an attempt to put together a large IMF support package. When the support package of $50 billion was promised to Mexico at the end of January 1995, the market pressure on Mexico started to subside. The spillover of financial instability, namely contagion, was also feared. Latin American countries, especially Argentina, felt pressures on their currencies. This was nicknamed a tequila effect. But when an IMF program was put together for Argentina in March, the contagion was over.

[8] It is important to consider why the crisis management in Mexico and the crisis management in Thailand resulted in different outcomes. An attempt to contain the damage from the Mexican crisis with an unusually large support package was justified by the three factors. First, default of the sovereign bond would create a messy situation. Many lawsuits against the government might prevent a speedy resolution of a crisis. Second, the Mexican crisis was viewed as a liquidity crisis, as opposed to a solvency crisis. Few questioned the long-run solvency of the Mexican government. Third, contagion effects might destabilize the Latin American countries. That would have created another problem among countries that had been performing rather successful. Of course, a bilateral commitment from the United States was at least partly motivated by its desire for political stability in a country that shares a long common border and more broadly in the region of the Americas. As a result, the Mexican government did not default on *Tesobonos*, and contagion to other Latin American countries was effectively stopped. In that sense, the IMF package of January 1995 was a successful LLR-type operation. However, deep depreciation put heavy losses on Mexican banks, which had dollar denominated liabilities, and the government suffered from higher payout costs for *Tesobonos*, that were effectively dollar linked. Most of the damages were done even before the IMF package was put together.

[9] In Thailand, initially the impact of floating the exchange rate of July 2, 1997 was not substantial. The exchange rate depreciated by 15 percent but not in the order of 50 percent in the case of Mexico. Some thought that a successful exit from the *de facto* dollar peg was achieved. However, when the IMF program was announced, accompanied by the disclosure of the amount that the central bank owe to the

than 20% before the IMF with Japan and Asian countries put together a package in late August. The package was also meant to be an LLR-type operation, but the size fell short of a truly impressive amount. Of the $17.2 billion package, the IMF contributed $ 4 billion, Japan contributed $ 4 billion, other Asian countries—China, Australia, Hong Kong, Malaysia, Singapore, Korea, Indonesia, and Brunei—contributed US$1 billion or US$ 500 million (for the latter three countries) each, together with the World Bank and the Asian Development Bank. The United States was conspicuously absent from the Thai package. However, on the same day of IMF package announcement, the Bank of Thailand was forced to reveal the amount of forward contract, amounting to $23.4 billion, that would result in foreign reserve losses in the near future. Therefore, the package for Thailand was viewed in the market as too small. As a LLR-type package, it was a failure. Similarly, the initial Indonesian package (November 1997) and the initial Korean package (December 1998) were too small. Although their packages were large in the announced dollar terms ($40 billion for Indonesia and $57 billion for Korea), the bilateral supports, including those from Japan and the United States, were labeled as the "second-line of defense". Without clear guidelines on how to trigger the second line of defense, the market discounted the effectiveness of the package. The actual disbursement from the IMF and bilateral partners for Indonesia and Korea was not large enough to calm down the market. The exchange rate did not rebound on the day of the IMF program announcement for either country. For an LLR-type operation, IMF packages for the Asian countries were too small, thus failed to stabilize the market quickly.

(4) Contagion. What distinguishes the Asian crisis most was its wide-spread contagion effect. The Asian crisis that started from Thailand spread to the rest of Asia in several months. Two other countries, Indonesia and Korea, required IMF support packages, and other countries also were severely affected by currency depreciation. In the case of Mexican crisis, the crisis was more or less contained, and the tequila

market by forward contracts, confidence was not restored. This delayed the recovery, and in the meantime, the economy went into a recession, thanks partly to an austerity plan as the IMF conditionality. Many find IMF erred in prescribing an incorrect prescription to the Asian type crisis, in particular fiscal austerity in the midst of weakening economy. Even IMF (see Lane (1999)) admitted later that fiscal austerity was a mistake. The fiscal deficits were not the core problem, unlike the Latin American crisis.

effect was short-lived. The Russian crisis, especially after the default of its bonds, sent a shock wave to international investors. Spread on risky assets became wider and several investors made losses from holding Russian bonds. The demise of the Long-term Capital Management (LTCM) is commonly attributed to a sudden change in various spreads. The Brazilian crisis and the Argentinean crisis did not produce measurable contagion effects either, probably because the crises were protracted and the market fully discounted the effect of going off the pegged exchange rate.

(5) Default and the PSI. Although discussions of private sector involvement started right after the Mexican crisis and continued through the Asian crisis, no concrete steps were taken, except the famous standstill on bank loans to Korea, that was introduced on December 24, 1997. (International banks with loans to Korean banks were strongly advised by the regulators that their outstanding amounts should be rolled over.) When Russia defaulted on its government debt payments in August 1998, it was a surprise to the market. The IMF had decided that there was no improvement in fiscal situations, and did not support further lending into Russia. This led to voluntary workout between the Russian government and creditors, but heavy losses were incurred on the part of creditors. Argentina also decided to default on its government bonds in December 2001, after it failed to implement necessary fiscal austerity plan. The Russian and Argentinean defaults were unilateral, and deemed to be more chaotic.

These differences are important in thinking about preventing a crisis or managing one.

3. Prevention

What kind of progress was made in quest for the new international financial architecture, in the wake of the Mexican and Asian crises?

Around the prevention pillar, data transparency, constant monitoring, and financial sector surveillance were emphasized right after the Mexican crisis. Since the Mexican government did not disclose foreign reserves data for several months prior to the December 20 devaluation, IMF and the financial market participants were kept dark on the true macroeconomic conditions of the Mexico economy. Prevention would have been possible, if an early intervention by the IMF and the market pressures in the name

Therefore, planning fiscal surpluses did not enhance confidence of investors.

of market discipline had forced the Mexican government to adjust its policies earlier. Similarly, the Thai central bank forward contract position had not been disclosed, hiding the level of net foreign reserves. In the case of Korea, the central bank was believed to be depositing foreign reserves in Korean commercial banks (which is legitimate operations), but commercial banks used up dollars to repay borrowings from foreign banks.

IMF introduced the Special Data Dissemination Standard (SDDS), in that participating countries follow the IMF standard of disclosing macroeconomic and financial data regularly. The exercise started as a modest attempt to disclose the publication schedule and contact information even before the Asian crisis, but grew later to be the link to the data bank of the participating countries.

Another attempt on the prevention front was the studies on the exchange rate regime. The Mexican peso was viewed as overvalued due to its pegging to the US dollar, while the inflation rate was higher in Mexico. An exit strategy for a country that succeeds in an exchange-rate-based stabilization became an important topic.[10] Of course, if vulnerabilities are spotted early enough, then policy can be shifted to avert a crisis. Another research direction has been how to predict a potential crisis. This is called a literature on early warning signals.

On the exchange rate regime issue, the so-called two-corner solution (or the bi-polar view) became popular after the Asian crisis.[11] According to the view, only stable exchange rate regimes are the two extremes: the free-floating exchange rate regime and the hard peg (a currency board and the dollarlization). According to this view, any intermediate regime, from a managed exchange rate regime to the fixed exchange rate regime without a currency board (the so-called soft peg), was unstable and prone to a currency crisis. At the time, the two-corner-solution view seemed to be supported by the fact: many countries have shifted from the soft peg to a floating exchange rate regime; currency boarder—Argentina and Hong Kong—survived spillovers from the Mexican and Asian currency crises. At one point in 1999, the United States was suggesting an idea that any IMF program makes it a necessary condition for a financial support that

[10] See Berg (2000) for the IMF stance on the exit policy.
[11] See Fischer (2001) for a support to such a view.

the country adopts a floating exchange rate regime.[12] However, this was never seriously discussed at the IMF. In fact, in the subsequent crises in Turkey, Brazil, and Argentina, the IMF did form an initial program in support of fixed exchange rate, rather than force one to adopt floating. The IMF must have feared that the banking system in the country will be seriously damaged, if floating was adopted immediately.

On the exchange rate regime issue, Asian countries felt that they should have been commended on their crisis prevention efforts. Thailand did float before they sought for an IMF support; all other currencies have floated shortly after Thailand, but well before a serious problem broke out in Indonesia. Why could the IMF not helped Asian countries with larger amounts of support package, when Asian countries have adopted a correct strategy to prevention a crisis? Would it have better if the Asian countries had united with a support of IMF in an attempt to hang on to the fixed exchange rate regime?[13]

Asian countries and economies, except Hong Kong, have been rather skeptical about the two-corner solution view. Free floating sometimes result in too much volatility—especially for a small open economy that encounters massive capital flows not justifiable by fundamentals. A managed exchange rate regime, with a currency basket central rate with a wide band has been promoted by Japan for its Asian neighbors.[14] After Argentina was forced to devalue and float in December 2001-January 2002, two-corner solution advocates have lost one of its key evidence of invincibility for their views.

Thoughts were given to and actions were taken on a pre-qualification to a special IMF support facility. Namely, if a country has sound economic policy and so approved by the IMF, the country is entitled to a quick disbursement of IMF lending in case a currency crisis. The crisis may develop, despite sound macro policy if, it is of contagion type. This is the idea behind creating a new IMF facility called Contingent Credit Line (CCL) after the Asian crisis. This was designed to work like a commercial

[12] "Rubin urges end to IMF aid for pegged currencies," Financial Times, April 22, 1999.
[13] Critics would say that most of the vulnerability was developed during the fixed exchange rate era, that is before July 1997, and floating came too late as crisis prevention measure. However, it still leaves a question in crisis management. This will be discussed below.
[14] See a discussion paper circulated by France and Japan to the ASEM Finance Minister Meeting in Kobe, January 2001 (available at www.mof.go.jp). See also Williamson (2000) for a similar proposal.

bank's credit line that a country can draw. The IMF requires a voluntary CCL applicant to pay a commitment fee to the IMF. In an effort of a developing country to qualify for CCL will make macro policies prudent, so that it contributes to prevention of a crisis. However, there has been no taker of CCL. Developing countries felt that it would be costly to pay commitment fee, while if the crisis comes, the IMF would help them anyway. An analogy is as follows: If a house is caught by fire, the fire engine will be sent a house whether or not the owner has paid local taxes. Moreover, some countries felt that just applying for CCL might be regarded by the market as a sign of vulnerability rather than a seal of good health. Theoretically, CCL has a beautiful architecutural look, but it seems too costly for a customer.

Another achievement by IMF is an introduction of Financial Sector Assessment Program (FSAP). The vulnerability of banking sector has been pointed out as a source of currency crisis or an aggravator of a currency crisis. A weak banking sector invites an attack on the currency, while a sharp depreciation often causes bank failures. After the Mexican crisis, international financial institutions debated how to strengthen financial surveillance of emerging market economies. *The Core Principles for Effective Banking Supervision*, was developed by the Basel Committee on Banking Supervision (BCBS) in 1997. The "principle" was not made more detailed implementable surveillance conditions in time. Initially, there was a confusion of who would write conditions and who conducts surveillance. Only after the Asian crisis, the FSAP was introduced as an IMF weapon. Whether FSAP will help emerging markets develop a more robust banking system remains to be seen.

One of more controversial options in preventing a crisis is capital controls. Until ten months prior to the breakout of the crisis, the Mexican economy looked like a model economy. Although the current account deficits were running at 8% of GDP and fiscal deficits were reasonably large, capital inflows were strong enough so that foreign reserves were actually increasing (peaked in February 1994). The macroeconomic picture was very similar before Thailand developed a problem in 1997. Large capital inflows mask financial vulnerability and suppress a question on the sustainability of the peg. This was a new phenomenon in the age of liberalized capital flows. When macroeconomic distortions—an asset price bubble or inflation building up—become obvious, capital flows suddenly reverse its direction, prompting a currency crisis. Thus, many argued for prudential regulation on short-term capital inflows, including withholding taxes on short-term (less than one year) investment in the country—the so-called Chilean-type capital control. The desirability of such market-based capital controls was debated in the wake of the Mexican and Asian crises.

Asians have been more cautious in liberalizing capital flows. China after all maintains strict capital controls. Singapore has banned offshore trading of its currency, while it has an offshore market for others' currencies. Thailand, Malaysia, and Indonesia reversed their liberal policies in the offshore trading of nondeliverable forward, only after the Asian crisis. Malaysia had temporary taxes on capital outflows from September 1998 for a year. These countries are more skeptical about the virtue of complete liberalization of capital flows before deepening the domestic financial and capital markets.

So, to recap, many changes were made in an attempt to prevent future crises. The SDDS, FSAP, and CCL were a concrete step taken by IMF to strengthen the prevention pillar in the new international financial architecture. In addition, the IMF became more careful in reviewing countries with large capital inflows, and any alarming signs in the financial and capital markets. Financial and capital markets surveillance was strengthened. Questions on the exit policy, early warning signal, exchange rate regime, and capital controls have been debated inside and outside of the IMF, but the debates have not yet produced a concrete policy changes in the IMF surveillance.

4. LLR-type Crisis Management

The LLR pillar needed a major repair. Since a necessary amount in support of Mexico—that is the amount of outstanding *Tesobonos* and potential outflows from its banking system—far exceeded the amount of the IMF was designed to lend—that is the access limit—, an additional support had to come from somewhere else. The United States agreed to co-finance the IMF support to Mexico. This, however, was not by a careful design, but through crafting the IMF package for Mexico in a hurry. The access limit means how much a member country can borrow from the IMF. In a Stand-by Agreement (SBA), a country could borrow up to three times of its quota—similar to equities subscription in a company—in the IMF. This access limit was raised in the case of Mexico to five times. But, this was not enough. In the package of $ 50 billion, the IMF was contributing only $ 17.8 billion—even with higher than usual access limit—, while the bilateral help from the United States amounted to $ 21 billion.

In addition, IMF disbursement became front-loaded. In the typical three year SBA, disbursement of support package is divided into several installments. An amount that the country can draw in the first installment was increased, to help combat an acute shortage in foreign reserves.

One might think that the IMF should increase the access limit in the age of liberalized international capital flows. Then another problem would arise. The resources of the IMF would not be enough to help simultaneous crises in several countries. This led to a thinking of increasing both permanent resources and a short-term credit line of the IMF. The former was a proposal to raise the quota. The latter was an increase in the amount of General Agreement of Borrow (GAB), namely a short-term credit line that IMF can tap into when the IMF needs short-term funds, from G10 countries.

The quota increase had been proposed, but a major progress did not happen until after the Asian crisis. The quota was increased in 1999. The discussion took place on increasing an amount of GAB. But, it resulted in creating an additional facility, rather than an expansion of GAB. The New Agreement to Borrow (NAB) was created with an expanded membership (25 countries) and an increased amount.

In addition, a *de facto* increase in access limit was actually materialized. At the time of Korean crisis, a new facility called Supplemental Reserve Facility (SRF) was introduced. Korea received almost 20 times of quota, instead of 5 times that was the case for Mexico and Thailand. SRF significant strengthened the LLR pillar.

So far, the progress after Mexico and before Asia has been described. An approach taken in the first stage of Thailand was the same. The IMF tried to supplement its resource by contributions from Japan and Asian countries. Japan was lending to Thailand, *pari passu*, with IMF, so disbursement of IMF was automatically doubled.

After Thailand but before Indonesia and Korea, there was a proposal on the Asian Monetary Fund (AMF). The proposal was put forward by Japan and the ASEAN countries. It was supposed that the participating countries of the AMF would contribute some of their foreign reserves to a central fund, and the fund would be used to help liquidity shortage in a currency crisis of the member county. This was a response to a frustrating realization that IMF resources were not enough to cope with a 21st century type currency crisis, and putting together a package with bilateral help would take time and efforts, as was the case for Thailand. The AMF proposal was opposed by the United States and the IMF (plus China) on two grounds: Soft conditionality and duplication. To provide financial help without stringent conditionality leads to easy money. Not only soft conditionality would not reform a crisis country out of crisis, but money would be at risk. In order to carry out strict surveillance, one needs a large number of high-quality staff. However, creating such an organization is a duplication of an already existing organization such as IMF. The idea of AMF died in the meeting on the margin of the Fund-Bank Annual Meeting in Hong Kong, September 1997. In order to enhance regional surveillance, the Manila Framework Group meeting was created in November 1997. However, the bilateral or regional financial help was nonexistent (beyond the second line of defense) in the Indonesian and Korean crises.

In May 2000, the Chiang Mai Initiative (CMI) was launched. It is envisioned that a network of bilateral swap agreement (local currency to US dollar or Japanese yen) will be developed among the northeastern Asian countries (Japan, China, Korea), and between one of the northeastern Asian countries and one of 10 ASEAN countries, as well as strengthening an intra-ASEAN swap agreements. Several swap agreements, including Japan-Korea, Japan-Thailand, Japan-Malaysia and Japan-Philippines, were successfully concluded. The ASEAN swap agreement was also enhanced to cover all 10 countries, and the size was increased to 1 billion dollars. It remains to be seen whether the ASEAN-plus-3 framework will be developed into more regional cooperative scheme in the future.

To recap the LLR front, the Mexican package was unusual in the sense that the access limit was raised and the package was heavily front-loaded. The Mexican crisis prompted discussions on quota increases and creation of NAB. The de facto increase in access limit was achieved by creating SRF. The regional efforts to come up with a supplementary help are underway in Asia by pushing the CMI.

5. PSI-type Crisis Management

On the PSI pillar, little was done in the wake of the Mexican and Asian crises.

Many observers and officials, in particular European ones, were very unhappy about bailing out *Tesobonos* holders in the Mexican crisis. Critics argued that the private sector should share the burden. The logic is as follows: the yield of *Tesobonos* was much higher than that of comparable U.S. government securities. The existence of a large positive spread—the *Tesobonos* yield minus the US Treasury bill yields—must mean that devaluation (and default) risk was recognized by the market. The spread was a devaluation premium. If *Tesobonos* were to be repaid in full, after devaluation occurs, the premium would become free lunch. Shouldn't those who take high risk lose at the time of risk being materialized, while they should earn high returns otherwise? Although this logic was reasonable and compelling, it was overwhelmed by the concern of the consequences of a sovereign bond default and concern about contagion to other countries. The former concern can be said as follows: what would happen if a bond-holder sue in the U.S. court trying to attach the Mexican government asset in the U.S.? The resolution of a crisis would become really prolonged and messy. The latter as follows: It would be less costly to save bond holders rather than trying to contain a series of crises in other countries when the Mexican bonds were defaulted and contagion to occur. Even after the dust has been settled in Mexico, discussion on PSI did not proceed much among the official circle. Several academics put forward an argument that orderly workout, with automatic temporary standstill, would be desirable in the future crisis.

In the wake of the Mexican and Asian crises, progress on PSI and institutional changes were little and slow. It was the Russian crisis that forced the private-sector involvement, which was unilateral (by Russia), and involuntary (on the part of investors), and perhaps unintended (by IMF). However, this might have been a blessing in disguise. Risk consciousness among investors increased and risk premium soared after the Russian crisis. Investors would be careful in future investment to high-yielding bonds. After Russia, sovereign bond defaults have occurred in Ukraine and Ecuador. In December 2001, Argentina failed to fix fiscal deficits and to secure an IMF disbursement of a financial support, and declared that it would not be able to service the sovereign debts. How the negotiation for Argentinean bond restructuring would turn out remains to be seen.

6. Institutional Changes

After the Mexican and Asian crises, discussions on how to reform IFIs became intense. Some scholars proposed that the IMF should be transformed into an institution like a bankruptcy court to manage a debt crisis through a PSI approach. Others proposed to streamline IMF functions. After the Asian crisis, the Meltzer report (testimony for the joint the Joint Economic Committee, US Congress) called for a change in the IMF lending framework—pre-screening for a qualification and unlimited support for prequalified countries—and reorganization of roles among the IMF, the World Bank, and regional development banks.

Streamlining of the IMF roles and lending facilities were discussed, but the discussion resulted in very minor changes. The IMF and its Governors introduced several internal changes. The Interim Committee was transformed into the International Monetary and Financial Committee (IMFC), with a creation of its deputies' meetings. The IMF also created a new department that is dedicated to capital markets surveillance.

Other international meetings and forums, such as FSF and G20, were created to involve emerging market economies into international discussions. All in all, some progress has been made in terms of creating new forums, but not in a serious reorganization of any of the existing IFIs.

7. The Krueger Proposal

In November 2001, First Deputy Managing Director, Anne Krueger, proposed a new approach to sovereign debt restructuring. Her proposal contains several elements, but can be summarized as a new way to make sovereign debt restructuring more orderly. The country can apply for standstill to the IMF. If the IMF agrees, standstill will be announced, and all creditors have to participate in the restructuring discussion. During the standstill, no one can bring suit to attach assets to the sovereign bonds. Restructuring should be done by a majority (and not necessarily on an unanimous decision) of bond holders—collective actions clauses (CACs). This scheme requires amendment to the Articles of Agreement. Such a revision in the Articles of Agreement requires 85% of approval among the shareholders of IMF. The US with voting share of 17% alone could bloc the proposal. It is presumed that by changing Articles of Agreement, that is an international treaty, that supercedes domestic law.

Although I praise Dr. Krueger for her initiative to present a proposal on the table, I have three major questions/problems with her proposal. In a sense the proposal is too ambitious, and in a sense it is too narrow. First, the proposal is confined to sovereign debts. Therefore it does not solve a problem of the Asian currency crisis type, that was the crisis caused by private-sector borrowers. Second, although the proposal is clear on its intention up to standstill, it does not say much about the need or a method for a debt reduction after the standstill. Third, although the proposal is ambitious enough to call for global adoption of collective action clauses, it is unlikely to be adopted in the United States. CACs are commonly attached in bonds issued in London, but not in New York.

Let us discuss briefly on these points.

(1) First, the Krueger proposal does not cover an Asian-type private-sector debt crisis. The liabilities in Thailand, Indonesia, and Korea, that brought down their currencies were private-sector debts. Of course, those debts and losses among the financial institutions became public obligations, but that was after financial sector restructuring was done—some months after the crisis broke out. In order to apply the Krueger proposal to private-sector debts, several significant adjustments, or legal jumps, have to be made. Legal aspects of international bond issues by private sectors may be akin to sovereign debt issues. CACs can be legally included if the financial centers, most notably New York, adopt such clauses. However, the reason why the Krueger proposal calls for a change in the IMF Articles of Agreement shows that even Dr. Krueger knows that it is difficult to expect that the key financial centers—i.e. New York—voluntarily changes the rule. Could the revised IMF Articles of Agreement cover the private-sector debt? If so, the Krueger proposal should be revised to say so. Otherwise, there is no progress on private-sector international bonds. Even if international bonds are covered, other problems remain. How could all other types of private obligations—international bank loans (bank-bank and bank-corporations), swaps, derivatives, bonds of private-placement type—be a part of standstill? Recall that a bulk of Thai external debt problem came from Central Banks' forward position exposures and commercial bank loans from international banks; a bulk of Indonesian problem was Indonesian corporations

borrowing from foreign and domestic banks; and Korean acute foreign reserve shortage came from Korean banks repaying their own borrowing plus their affiliated corporations' borrowing (exercising Korean banks' guarantees) from foreign banks. It is very difficult to imagine that a simple rule could be applied globally to cover these financial instruments.

(2) In the Krueger's proposal, it is clearly laid out how to get to standstill. However, standstill is to earn time to workout the debt resolution. The IMF is supposed to be there to approve a sustainable plan for debt workout, but not an executor. What if the country is on the verge of insolvency? Who would judge the fine distinction between "willingness to pay" and "ability to pay"? In theory, the government should always be able to pay for loans by raising taxes, cutting subsidies, and selling state assets. Some prominent bankers in the 1970s thought that syndicated loans to Latin American government was absolutely risk-free because a country never default. However, Latin America in the 1980s and Argentina in December 2001, again, are a stark reminder that the government may fall if the public does not accept the austerity. If the debt reduction is a step after standstill, making

(3) It is essential that the United States will sign on to the proposal. However, this may be a most difficult part of her proposal.

8. Case for PSI

PSI has two roles: a role to help filling a financing gap of a crisis country and a role to prevent moral hazard of investors prior to a crisis. The former could be a substitute to LLR, while the latter is complement to LLR.

In the world of free capital mobility, a crisis country—public and private sectors—typically has a large amount of external debts owed to private sectors. Several exceptionally-large amounts of official financing (IMF and bilateral) were arranged during the Mexican and Asian crises. Although IMF financing is not supposed to be used to pay for the external liabilities, money is fungible, and official assistance was helping the country continue honoring the debts and liabilities. This pattern, again and again observed in the recent emerging market crises, posed several important questions. In the recent discussion of PSI, its role of filling a financing gap has been emphasized, while its role of preventing moral hazard has received minor attention. PSI is important in preventing moral hazard, and this forward-looking aspect needs renewed attention.

While capital flows that help emerging market economies to invest and grow should not be discouraged, too much capital flows with especially high-risk-high-return strategies should be discouraged. Private-sector involvement is an important element to stop a free-rider problem caused by the high-risk-high-return players, and a chaos caused by asset-grabbing problem at the time of near default.

Ideally, if we can differentiate between a liquidity crisis (sustainable debts if time to work out is allowed) and a solvency crisis (unsustainable debts), we can find a better solution to help countries without helping high-risk players. Suppose for the moment, that we can differentiate two types of crises, and two types of investors.

For the liquidity crisis of the country, it is often enough to apply a LLR solution. A massive financing to help the government to pay for its debt, and bailing out also investors, is probably a best solution, as the alternative is a financial sector crisis that is caused by the exchange rate possibly "overshoot."

However, there is equally attractive option, temporary standstill and voluntary workout. If it is made clear that it is a liquidity problem and not a solvency problem, for example by announcing that IMF is ready to do an LLR-type lending, there is a greater chance that PSI can be done on a voluntary basis. Then there is no need for an elaborate legal changes.

8. Concluding Remarks

So, after all the work toward a new international financial architecture, how complete is a new architecture. Are we close to designing a new house that is robust against a major financial earthquake? Probably not. The current situation is more like a renovation is done rather than a new house is designed. We still do not know an appropriate exchange rate regime and degree of capital controls in preventing a crisis. Can CCL be modified to interest developing countries? We still do not know an appropriate distinction or a mix of LLR and PSI. Finally, we have not seriously debated institutional and organizational changes among the IMF, the World Bank, and regional development banks. More currency crises will certainly occur in the future. But, hopefully, they will help us finish designing a better international financial architecture.

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