INTRODUCTION

International Financial Crises: What Role for Government?

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> If investment flows are to continue to emerging economies, a new means must be found to bring predictability to the resolution of unsustainable sovereign debt. But will this be imposed by fiat or evolve though market forces? Will the IMF return to its original mandate or extend its command and control over developing nations and markets? . . . The outcome will determine the wealth and well-being of the globe's developing countries.
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> —Adam Lerrick and Allan H. Meltzer (2002: 1)

The Credibility Problem

The impoverishment caused by broken promises on the part of governments that fail to protect private property rights, enforce contracts, and limit taxing and spending to prudent levels is evident in the increased frequency of financial crises in emerging market economies. Argentina's stunning default in December 2001 and the Brazilian crisis in 2002 are only the latest examples of how bad government policies undermine confidence and destroy wealth.

After the Argentine government defaulted on its debt, reneged on its promise to convert pesos into dollars on demand, devalued its currency, denied free access to bank deposits, and, most recently, imposed capital controls, what investor could possibly have confidence in the future of that country—or in Brazil—without fundamental political and economic reform?

The International Monetary Fund's refusal to bail out Argentina

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was an admission that a new course was needed to deal with sovereign debt crises, which are closely linked with currency and banking crises. To contain and prevent such crises requires that governments pursue transparent pro-market policies that cannot easily be reversed. There must be a long-term commitment to free trade, the rule of law, and sound money; otherwise global investors will take their capital elsewhere. By failing to honor its debts and to maintain the value of its currency, the Argentine government destroyed the confidence it had established and increased the costs of attracting future investment funds.

Although the IMF has poured billions of dollars into emerging market countries since the 1994–95 Mexican peso crisis, the credibility problem remains—namely, how to create an institutional framework in which governments "do no harm," so that markets can increase economic growth and stability. That issue and the question of whether IMF intervention can improve on potential market solutions to sovereign debt crises were the focus of the Cato Institute's 20th Annual Monetary Conference—"International Financial Crises: What Role for Government?"—cosponsored with *The Economist*, October 17, 2002, in cooperation with the Donald and Paula Smith Family Foundation.

The articles in this issue of the *Cato Journal* were all first presented at the 2002 monetary conference. Those that relate directly to sovereign debt, especially the question of alternative approaches to restructuring unsustainable debt of emerging market countries, are summarized in this introduction.

Promoting Financial Resilience

To avoid the debt, currency, and banking crises that have plagued emerging markets, governments should work with, not against, market forces. That is the best way to promote financial resilience, according to *William McDonough*, former president of the New York Federal Reserve Bank. Strengthening market institutions is essential for averting financial crises and efficiently allocating capital around the world. Both the new Basel Capital Accord and any future changes to the framework for resolving sovereign debt crises must start from market principles.

The Basel Capital Accord

The 1988 Basel Accord, which established capital adequacy standards, became outmoded as global capital markets, innovation, and advanced information technology outpaced regulators. Existing regu-

lations are burdensome and need to be revamped. McDonough, as former chairman of the Basel Committee on Banking Supervision, favors improving the allocation of credit by increasing capital requirements for high-risk banks and lowering requirements for low-risk banks. He also would allow greater flexibility in measuring operational risk.

The more fundamental question, however, is whether a new accord, which would presumably continue to harmonize capital standards, is superior to competition among standards. That issue is central to the problem of promoting financial stability and resiliency. As *Jacobo Rodríguez*, a financial analyst at the Cato Institute, notes in his article, "Greater emphasis on market discipline, innovation, and competition among regulatory regimes . . . would help promote the safety and soundness of the international financial system in a superior way than either the old or the new Basel Accord."

A Market-Based Approach to Resolving Global Financial Crises

McDonough argues against "grand solutions" to international financial crises because of the complexity of the cases. More important, "History tells us that new developments in markets and practices quickly will render obsolete those measures that might seem well attuned to today's circumstances." The private sector of international capital markets has become far more important than the public sector. Consequently, private market participants, not official bodies or governments, should lead the way in reform. The approach to financial crises should be "market-based and adaptive," according to McDonough, as well as "strategic, creative, and principled." Thus, the private and public sectors should work together to improve the overall institutional framework, particularly in the case of sovereign debt crises.

Rather than attempt "to impose solutions from outside," McDonough recommends working with market participants to improve the debt restructuring process. He opposes the IMF's proposal for a sovereign debt restructuring mechanism (SDRM) that would use a statutory approach to resolve sovereign debt crises. He thinks that private investors do have an incentive to resolve international payment problems quickly and that we should explore "creative market-based ways to lever in private participation and stretch the impact of public sector funds."

Lessons from the Argentine Debt Crisis

In December 2001, the Argentine government defaulted on $95 billion of its debt, the largest sovereign debt crisis in history. Subse-

quently, the peso's foreign exchange value fell by 70 percent against the dollar, bank deposits were frozen, and the economy shrank to its 1993 level, as more than 50 percent of the population fell below the poverty line (Casey 2003: A2; Lerrick and Meltzer 2002: 1). The causes of that crisis and the lessons we can learn are the subject of articles by Ricardo López Murphy et al., Allan Meltzer, Charles Calomiris, and Steve Hanke.

Former Argentinean finance minister *Ricardo López Murphy* and his colleagues *Daniel Artana* and *Fernando Navajas* at the Latin American Economic Research Foundation in Buenos Aires give a detailed account of the 2001–02 Argentine economic crisis. They see excessive government spending (financed in large part by dollar-denominated foreign debt), the lack of trade liberalization, and political instability as the basic causes of the debt crisis. Moreover, wage-price rigidities made adjustments to external shocks sluggish and increased unemployment. Although the federal government had taken important steps to revitalize the economy in the 1990s, those steps were insufficient. Argentina still lacks a *credible* commitment to limited government and open markets. The authors point to the wholesale attenuation of property rights that occurred as the government forced banks to extend credit to cover the growing fiscal deficit, ended the dollar peg under the currency board system, issued quasi-monies to keep state operations running, blocked bank accounts, defaulted on its international debt, and finally devalued the peso. Until Argentina engages in serious political reform, there can be no certainty about future growth and stability. In particular, the authors argue that there must be "a harsh, permanent halt to the Argentine mania of running fiscal deficits, concealing them, and later enduring the consequences of a government that disavows its commitments."

Allan Meltzer, chairman of the Gailliot Center for Public Policy at Carnegie Mellon University and past chairman of the International Financial Institution Advisory Commission (IFIAC) emphasizes that the Argentine debt crisis was a case of government, rather than market, failure: "The government did not make any of the reforms needed for recovery." Like López Murphy et al., Meltzer argues that "without political reform, there is little prospect that new promises will be kept." And like McDonough, Meltzer favors a market-based approach to sovereign debt crises, including the use of collective action clauses (CACs) in debt instruments (see Lerrick and Meltzer 2002).

If the IMF is to be involved, it should play "a market-supporting role"—namely, help to create a liquid market for sovereign debt. The Argentine government would exchange old debt for new bonds con-

taining CACs, and the IMF would stand ready to buy existing bonds at a minimum price presumably set below what the market would offer, given the expectation of future reform.[1] Once the debt crisis is resolved, private capital will flow into Argentina only if investors are convinced that reform is real. To Meltzer that means instituting "the rule of law, prudent fiscal policy, sound banking systems, and viable exchange rate regimes."

Charles Calomiris, professor of economics at Columbia University and a past member of the IFIAC, presents five policy lessons from the Argentine and Brazilian debt crises:

1. Fiscal policy ultimately shapes monetary policy in emerging market countries without a credible central bank. Debt monetization is always a danger.
2. Without political stability, there is no guarantee of banking stability even in a well-regulated banking system. In time of crisis, the net value created by safe and sound banking practices can be confiscated by government officials to serve their own interests, as economic czar Domingo Cavallo did in Argentina when he forced banks to fund government debt.
3. The IMF should not try to prevent sovereign debt defaults when justified. Bailouts provide the wrong incentives and prevent market solutions.
4. The extent of economic freedom is a more meaningful measure of an emerging market country's debt capacity than the ratio of sovereign debt to GDP. Fiscal rules to limit government spending and to keep taxes from destroying productive activity, as well as a liberal trade policy, are key determinants of an emerging market's ability to repay debt.
5. Contagion is "selective," in the sense that bad policies in one emerging market country can adversely affect another emerging market only if similar polices are followed in both countries.

The United States and other developed countries can help emerging market countries by following sound fiscal and monetary policies, and by opening our markets more fully to the developing world. Calomiris argues that such a policy agenda would be the best form of "aid." He also supports the Meltzer Commission's (the name commonly given to the IFIAC) recommendations for overhauling the

[1]This scheme was first proposed by Lerrick and Meltzer (2001). Anna Schwartz, in her article in this volume, questions the wisdom of setting an official floor under the price of illiquid debt. In her view, the IMF should not intrude "into a matter that the market is fully competent to solve."

IMF and other international financial institutions (IFIs) to make them more market friendly.

In particular, the IMF should not amend its Articles of Agreement and "become a bankruptcy process facilitator." A voluntary, contractual approach to sovereign debt restructuring would be preferable to a statutory approach, argues Calomiris. Indeed, "a rush to adopt the SDRM might forestall beneficial private adaptations within the contractual approach that would otherwise occur." Thus, like McDonough, he favors gradualism and markets rather than a grand solution and centralization by government fiat.

Steve Hanke, a professor of applied economics at the Johns Hopkins University, takes aim at critics of the currency board system. He distinguishes a pure or orthodox currency board with a hard peg to the dollar from the Argentine system, in which the central bank still exercised discretion. It was that discretion, plus a number of decisions taken by Cavallo (including forced debt swaps, use of multiple exchange rates, and broadening of the dollar peg to include a basket of currencies), that eventually led to the end of convertibility, default, and devaluation. Critics of the Argentine monetary regime are attacking a straw man, in Hanke's view. What Argentina needs now, says Hanke, is complete dollarization so there is no room for discretion or sterilization—that is, no ability to use domestic monetary policy to offset capital flows.

Alternative Approaches to Sovereign Debt Restructuring

The articles by Jack Boorman, Randall Kroszner, Anna Schwartz, and Jeffrey Sachs all deal with the question of whether there should be a sovereign bankruptcy law under the auspices of the IMF or whether it would be better to take a contractual approach to resolving debt crises in emerging markets. The authors summarize the chief differences between the statutory, or SDRM, approach and the contractual or, market-based, approach. They also evaluate the political feasibility of the two approaches.

The Sovereign Debt Restructuring Mechanism

The SDRM was first proposed by Anne Krueger, first deputy managing director of the IMF, in November 2001 and subsequently modified. *Jack Boorman,* special advisor to the managing director of the IMF, presents a detailed discussion of the SDRM and argues that it would provide a solid framework for settling sovereign debt crises.

He welcomes the use of CACs but thinks they could be part of the SDRM. A supermajority of creditors would decide the terms for all creditors, thus avoiding the holdout problem, and the IMF would assist in the dispute resolution process and possibly provide financial assistance. Boorman sees the statutory approach as less costly and more certain to bring about satisfactory results than a pure market-based approach. However, he admits that there is much work to be done and that political support for the SDRM is currently lacking.

Jeffrey Sachs, director of The Earth Institute at Columbia University, is a long-time supporter of establishing a universal bankruptcy law that would address sovereign debt crises. The long-run gains from having a sovereign bankruptcy law and an international court to facilitate the debt restructuring process far outweigh the costs, according to Sachs. Nevertheless, little progress has been made because the short-run costs to specific creditors at the start of any restructuring process create a major roadblock to changing the legal framework. Sachs is not optimistic that that barrier will soon be broken, but he believes we should continue to search for a better institutional framework to help meet the needs of developing countries.

The Contractual Approach

In contrast to the SDRM, the contractual approach relies on market participants to restructure debt instruments without a sovereign debt law or an international bankruptcy court. Old debt would be exchanged for new debt that would contain CACs, including a representation clause permitting a supermajority of creditors to select a trustee to represent all creditors and an exit consent clause to prevent lawsuits after a supermajority of the creditors agreed on the new package. Since existing bonds are registered and traditional CACs and bondholders' committees already have been used, there is reason to believe that expanding CACs and allowing market participants to innovate would be a viable alternative to the centralized SDRM approach.

Randall Kroszner, professor of economics at the University of Chicago's Graduate School of Business and a former member of the Council of Economic Advisers, argues that the primary goal of sovereign debt restructuring should be to increase the creditworthiness of emerging market countries so that the private sector can resume growth. He compares the two approaches to sovereign debt restructuring and advocates (1) improving debt contracts through the use of CACs, (2) creating a dispute resolution forum *voluntarily* rather than by statute, and (3) making IMF and other international financial institution assistance transparent.

Anna Schwartz, a research associate at the National Bureau of Economic Research, finds no justification for creating a sovereign bankruptcy law. She contests the arguments given in support of an SDRM and argues that the IMF should not get involved in the restructuring process: "IMF intervention is a solution to a problem that does not exist." Private creditors are capable of resolving international debt crises through exchange agreements and expanding the traditional CAC approach, as recommend by Lerrick and Meltzer (2002).

Schwartz sees market discipline as the best way to penalize governments of developing countries for poor policy decisions. If such governments expect a significant increase in the cost of capital as a result of reneging on sovereign debt contracts, then they are likely to be more prudent.

Decades of aid from IFIs have dulled incentives to improve policy choices in emerging markets. With that record in mind, Schwartz concludes, "Perhaps the time has arrived to abandon debt-based development; to encourage the conversion of debt to equity; to set countries on a different path than one that leads to unsustainable debt, crises, and debt restructuring; and to rely on equity investment for development."

Indeed, as *Alan Reynolds*, a senior fellow at the Cato Institute, shows in his article, "The moral hazard of IMF lending has increased the risk that crises will occur, and the policy conditions tied to IMF loans invariably make those crises more severe than otherwise." Both he and Schwartz would agree that the key to economic development is to avoid excessive debt in the first place and to establish credible monetary, fiscal, and trade policies that foster economic freedom and responsibility.

Creating a Liberal International Economic Order

Global financial stability is impossible without economic liberalism—that is, the free flow of commerce and capital, sound money, and limited government under the rule of law. That is the message of Under Secretary of the Treasury for International Affairs *John B. Taylor* in his article "Increasing Economic Growth and Stability in Emerging Markets." If official assistance is given, says Taylor, it should be limited to developing countries that are pursuing market-friendly policies; "there should be no lending into unsustainable debt situations."

Taylor does not accept the conventional argument that contagion is inevitable and necessitates sizeable IMF financing to prevent a financial crisis in one emerging market country from spreading to others.

As he notes, the Argentine default did not have any significant impact on economic growth or interest rates in emerging market countries outside Latin America. Moreover, those countries within Latin America that have established a credible, market-oriented policy regime, such as Chile and Mexico, are performing well.

The Bush administration's emerging market strategy is to prevent crises by promoting sound policy decisions, which would reduce contagion, and to develop clear criteria for, and limit access to, official financing. Taylor supports those goals and has long recommended a market-based approach to settling sovereign debt crises. The lack of support for the SDRM among private investors, many emerging market countries, and the Bush administration suggests that we could see increased use of CACs in the near future.

Conclusion

"Good public policy entails considering all options and choosing the one that works better than the alternatives," writes Taylor. In the case of sovereign debt restructuring, he means "works better" in "encouraging country ownership [i.e., having countries develop their own policies, as Russia did with its flat tax initiative], reducing the frequency of crises, increasing private capital flows to emerging markets, and raising investment ratings of countries." The articles in this volume will help policymakers evaluate the alternative approaches to resolving sovereign debt crises, as well as international financial crises in general. Let us hope that future growth, stability, and freedom will increase as a result.

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