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Repairing the Lender-Borrower Relationship in International Finance

by Ian Vásquez

Executive Summary

Since the end of the Bretton Woods system of fixed exchange rates in the 1970s, a dysfunctional relationship between lenders and borrowers in international finance has developed. The problem has become more acute in the 1990s as the severity and frequency of international financial crises have grown. Through official lending and mediation, usually led by the International Monetary Fund, authorities have reduced the possibility of sovereign default in an effort to avoid the spread of financial turmoil. That strategy has shielded investors and debtors from economic reality, has prompted calls for changes in the international financial architecture, and is leading to some reforms at the IMF.

IMF initiatives to provide preventive bailouts to countries before difficulties arise and to “bail in” the private sector are fraught with problems. Preventive lines of credit are likely to be misused and to increase moral hazard, while efforts to force losses on the private sector may precipitate the very crises they are intended to prevent. The historical

experience suggests that direct two-party bargaining between creditors and debtors is a better way of handling financial crises than is reliance on official third-party interventions. Private investors in the 19th and 20th centuries regularly solved collective action problems and supplied so-called public goods that official agencies intend to provide. Default, or the real possibility of default, led to renegotiations of debt conditioned on reforms in the debtor country.

Official intervention, on the other hand, has not been characterized by fundamental reforms based on credible conditionality, as evidenced by the recent experiences of Russia, Brazil, and East Asia. During the Third World debt crisis of the 1980s, moreover, IMF lending created among all parties a sort of stalemate that postponed recovery for years. In a world characterized by direct two-party negotiations, market institutions in insurance, credit, and surveillance would do much more to stabilize the international financial system than can be hoped for from continued interventions.

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Introduction

When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least hurtful to the creditor.

—Adam Smith
The Wealth of Nations

A dysfunctional relationship has developed between lenders and borrowers in international finance. But recent financial crises around the world are not necessarily evidence of that. Governments have gotten their countries into trouble with their creditors for hundreds of years, and periodic problems with paying back loans will surely continue to be a feature of global finance well into the future. Yet since the 1980s the resolution of financial problems has often treated insolvency as illiquidity and attempted to shield creditors and debtor governments from economic reality, creating disorderly debt workouts in the process.

It is not clear whether that approach, which has come about largely as a result of International Monetary Fund credit and mediation, has ultimately benefited either debtor states or their creditors. Clearly, the IMF bailed out private investors in Mexico in 1995 and has bailed them out in Asia and Brazil since 1997, leaving ordinary citizens to pay the bill. The fund is aware of this imbalance and has proposed to expand its practice of lending to countries that have accumulated arrears with their private-sector creditors in an effort to get those creditors to be held more accountable. The fund has simultaneously instituted a credit line that would provide emergency funds before a crisis erupts. But the rationales for this apparently schizophrenic behavior—that such actions are necessary to maintain stability, limit the severity of financial crises, and bail in the private sec-

tor—are dubious. Direct two-party negotiations between lenders and borrowers are superior to the three-party approach characterized by IMF-led interventions.

A Consensus for Change

Widespread dissatisfaction with the way the IMF has handled the Asian and subsequent financial crises has prompted calls for reform of the IMF and, more grandiosely, the global financial architecture. Even the fund agrees that important changes should be made in the way it operates. It has promised, for example, to become more transparent, allowing outside economists, policymakers, and market participants to better evaluate its performance and that of its client countries on the basis of publicly released letters of intent, country reviews, and other internal documents. It remains to be seen whether the lending bureaucracy will become transparent enough to introduce a greater degree of accountability.

Even before the current era of massive bailouts, the fund had come under criticism, especially after the 1970s collapse of the Bretton Woods system of fixed exchange rates that the agency managed. Financial turmoil in the 1990s has only increased that criticism and led many economists to recommend that the fund be shut down.¹ Though in principle the fund provides short-term credit on the condition that governments improve their macroeconomic policies and introduce structural reforms, in practice the fund has provided credit to dozens of governments for decades. At least 50 countries have received IMF credit for more than 20 years.² That record does not speak well either of the conditionality or of the temporary nature of IMF loans. Naturally, the fund denies that its conditionality lacks credibility and that it has made loan addicts of nations with some of the worst economic policies on record. Many nations have, after all, reformed their economies and moved to the market, especially since the late 1980s. A proper eval-

uation of the fund's performance in the reforming countries thus requires careful scrutiny of how the agency's money and advice were put to use in those cases.

By its own admission, the fund has not yet, however, resolved two problems with the lender-borrower relationship that have become acute in the 1990s: how to become a credible surveillance agency that prevents crises from occurring and how to avoid creating moral hazard.³ The IMF's role as a surveillance agency has been seriously tarnished by the Asian crisis. The fund provided no warning about the impending collapse of currencies and domestic banking systems and instead lauded the East Asian economies in public documents shortly before the outbreak of the crises. The financial community has not been comforted by the fund's claims that the agency did in fact provide warnings to officials in Thailand but kept that information confidential. That episode only highlights an inherent conflict in the fund's role as both a credit-rating agency for countries and an agency that attempts to prevent the eruption of financial turmoil. If the IMF did detect alarming economic conditions in an emerging economy, the public release of that information would precipitate a crisis; not sounding the alarm, however, would further undermine the IMF's credibility as a surveillance agency. As long as the IMF pretends to play both roles, that conflict will continue to exist.⁴

A prominent feature of recent IMF rescues has been their sheer size; the fund has arranged more than \$180 billion in bailout packages since 1997. While past international rescues involved small amounts of money to defend fixed exchange rates in return for improved policies, economists Michael Bordo and Anna Schwartz observe that "recent bailouts involve handing over relatively large amounts to both foreign lenders and domestic investors *after* devaluation of a pegged exchange rate to avoid their incurring wealth losses."⁵ Despite the resulting moral hazard, the IMF has downplayed the existence of the problem even as it has proposed

initiatives to make the private sector take on greater losses in times of crisis. Because of the "rampant moral hazard" that the IMF creates, the Federal Reserve Bank of Minneapolis, for instance, concludes that "the IMF should cease its lending activities altogether."⁶

A Lender of First Resort?

The IMF, however, has chosen to move in the opposite direction by establishing a mechanism to provide bailout funds in an effort to prevent financial difficulties *before* countries experience them. The new Contingent Credit Lines program, approved in April 1999, is intended to serve as "a precautionary line of defense"⁷ to stave off creditor panics in countries with fundamentally sound economies. But the fund has not shown good judgment in determining what countries would benefit from preventive bailouts. The two times the fund has provided such aid—to Russia (July 1998) and to Brazil (November 1998)—the bailouts failed to prevent currency devaluations and financial crises. Such funds merely became gifts to speculators and financial institutions, leaving both countries in greater debt.

Even though the CCL establishes specific criteria for access to its resources, major problems arise that will only exacerbate creditor-borrower relationships. The most obvious one is that use of this IMF instrument will provide a signal to the markets that authorities believe a country's economy is under stress, thus creating a self-fulfilling prophecy. Although proponents of the CCL believe its very existence will provide markets with sufficient reassurance to keep it from ever having to be used—much in the way emergency liquidity funds from central banks provide confidence in domestic financial systems—the fund lacks the ability to instill such confidence since it cannot create unlimited amounts of money as can a traditional lender of last resort. (The case against turning the IMF into an international lender of last

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resort has been convincingly made elsewhere.)⁸ That dynamic appears to have contributed to the failure of preventive funding in Russia and Brazil. Furthermore, not only will moral hazard be aggravated by the CCL's signaling function; the increased bailout function will lessen investor caution even more. Indeed, in creating the CCL the IMF did not renounce its bailout role in cases in which financial turmoil has already begun.

The need for the CCL is also undermined by two dubious assumptions on which its use is based: that countries with sound economic fundamentals are subject to contagion and that the criteria for use of CCL funds ensure that the instrument will not be misused. According to Jack Boorman of the IMF, the new facility will protect countries from contagion, "which hits them not because of actions or policies of their own doing, but because of pressure that develops in capital markets in other countries or because of developments in other parts of the world."⁹ Yet it is difficult to find a country that has succumbed to crisis that did not already have severe domestic economic problems. Thailand, South Korea, and Indonesia maintained pegged exchange rates that were impossible to defend after years of massive malinvestment in their domestic economies became evident. That malinvestment was itself a product of government-directed credit and implicit government guarantees to key sectors of their economies. Russia and Brazil maintained pegged exchange rates and consistently large budget deficits. Systemic crisis has not spread to countries with sound economic fundamentals. Had the CCL existed since 1997, it is not clear which country it would have saved.

It is worrisome enough that the IMF is expanding its lending on the theory that much economic turmoil has resulted from creditor panics rather than from the misguided policies of the countries in trouble. But given that the criteria for gaining access to CCL funds are based largely on IMF judgment calls, there is no guarantee that the money will not be used to support countries

whose economies are fundamentally unsound. For example, for a country to qualify for the CCL, the IMF must positively assess "its progress in adhering to relevant internationally accepted standards," and the country "should have constructive relations with its private creditors." The IMF has furthermore made clear that "in assessing whether an individual criterion is satisfied, the [IMF] would take into account a range of factors, and would exercise judgement as to whether a sufficient 'critical mass' of factors relevant to the criterion is in evidence."¹⁰

In short, the fund has expanded its self-ascribed mission to prevent crises by creating a bailout facility that will only increase moral hazard. Instead of bringing lenders and borrowers together to work on potential economic problems, the new credit lines will create perverse incentives on the part of both governments and investors.

Resolving Crises in the Post-Bretton Woods Era

The international rescue role of the IMF is a relatively new feature in global finance. Only after the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s did the fund find a new role for itself in managing the debt problems of poor countries on a global scale. With the outbreak of the Third World debt crisis in 1982, the fund seized upon that mission, which expanded its influence and resources. During that protracted crisis, authorities ruled out direct negotiations between debtor countries and creditors as unrealistic. The largest U.S. money-center banks had made sovereign loans that exceeded their capital. Most banks were eager for the IMF to provide funding, as were Third World countries that wished to avoid default and gain access to easier credit. Charles Goodhart expresses a widely held view of the situation:

The evidence seems incontrovertible that without the intervention of the

IMF, and the support of national Central Banks, the crisis in, and after, 1982, arising from these events, would have been contagious, far-reaching, and probably disastrous on a massive scale.¹¹

Initially, developed countries responded to the possibility of a Third World debt default by treating it as a liquidity problem and providing new loans both directly and through multilateral agencies. As part of the deal, commercial banks were to continue lending. In the early stages, IMF loans did not necessarily require structural adjustment since authorities believed that indebted nations needed some time to get their finances in order. Under IMF programs, countries thus raised taxes and tariffs and reduced government expenditures. By 1985, when it had become obvious that deep-rooted problems in the economies of developing countries were preventing them from growing out of their debt, U.S. Secretary of the Treasury James A. Baker announced a new strategy whereby new money from the IMF and commercial banks would be based on market conditionality. In exchange for that money, indebted countries were to liberalize their economies.

By 1987 it became evident that that strategy was not working. Countries did very little in the way of economic reform, though they continued to receive funding. Banks, though they continued to lend, were reducing their exposure in the region. Paul Krugman calculated that from 1982 to 1987 the stock of official creditor loans to the Baker plan countries increased from \$50 billion to \$120 billion, while that of bank loans remained at \$250 billion during that time, then fell to \$225 billion in 1988.¹² A slow transfer from private debt to public debt was occurring in the absence of a resolution to the underlying problems that caused the debt crisis.

IMF conditionality appeared to provide little incentive to reform. Sebastian Edwards, formerly the World Bank's chief economist for Latin America, referred to the IMF as

“participating in a big charade,” because fund programs imply that “there is a high probability that the country will attain balance-of-payment viability in the near future. For many countries this is not the case and everybody knows it.”¹³ Karen Remmer earlier noted the same problem:

The dominant theme to emerge from this analysis of IMF programs is not that of success, however, but of failure. Unsuccessful implementation of IMF recipes has been the norm in Latin America, not the exception. A high proportion of standby programs has failed to push key indicators of government finance and domestic credit even in the right direction. . . . The power of the IMF remains a useful myth for governments seeking a scapegoat to explain difficult economic conditions associated with severe balance of payments disequilibria, but the ability of the IMF to impose programs from the outside is distinctly limited.¹⁴

Despite the fund's inability to enforce the conditions it attached to its loans, lending continued. Some observers have noted that, despite temporary suspensions of credit, the IMF's “institutional incentives” to lend and its commitment to the “success” of a program undermine the credibility of the agency's conditionality.¹⁵ By financing governments that were uninterested in serious liberalization and structural adjustment, the fund actually delayed reforms in Latin America during the 1980s. Latin America became more indebted; private commercial banks in the United States were able to postpone recognizing losses; and the living standards of Latin Americans fell.¹⁶ As Anna Schwartz commented in her 1988 presidential address to the Western Economics Association, “The intervention of the official players has prolonged and worsened the debt problem.”¹⁷ Peter Lindert found that, as a result of IMF intervention, “most [debtor

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nations] have participated in a three-party stalemate, in which official agencies, private creditors, and debtor countries agree, after repeated struggles and much uncertainty, to reschedule in a way that postpones large net resource flows.”¹⁸

The end of the 1980s and beginning of the 1990s finally did see the introduction of far-reaching market reforms, a development for which the IMF often takes credit. But that outcome resulted from economic necessity in the wake of the collapse of development planning. As development economist Deepak Lal noted, it is simply not credible “that it was the ‘conditionality’ of the structural adjustment and stabilization programmes and the money which accompanied them which turned the debt crisis countries (and others), however haltingly, from the plan to the market. . . . The economic liberalisation that has occurred was due to the ‘crisis’ in governability which past dirigisme had engendered.”¹⁹

In Latin America, the center of the Third World debt crisis, the turning point came in 1987 when Citibank responded to Brazil’s debt default by announcing that it was building up loan-loss reserves of \$3 billion. That action prompted other money-center banks to do the same, thus weakening not only Brazil’s negotiating position with its creditors but also that of other developing country governments that until then had had little incentive take reform seriously. The failure of IMF programs to resolve the debt crisis, the continuing deterioration of Latin American economies, and the eventual willingness of private commercial banks to begin preparing for losses helped increase voluntary debt-reduction schemes and economic reforms. (The much-lauded Brady plan of 1989, which forced creditor banks to provide debt reductions in exchange for bonds securitized by the U.S. Treasury and international organizations, came after market solutions were well under way. Indeed, the Institute of International Finance charged that the Brady plan led to a slowing of voluntary debt reductions from \$18 billion in 1988 to \$11.3 billion in 1989. The Brady plan appears to have

brought about a pause in the move toward market reforms and market-based debt reduction.)²⁰

It is also doubtful that the IMF strategy helped avert an international financial disaster even though loans by the nine largest U.S. banks to 40 developing countries that are not members of the Organization of Petroleum Exporting Countries represented 222 percent of the banks’ capital. Because not all of that debt was in doubt (some major borrowers in Asia had little difficulty making payments), the real problem was due to concentrated lending to Mexico, Argentina, and Brazil, the countries with the largest debts. A few prominent figures in the financial community had by 1983 suggested that a better option than providing IMF aid to developing country governments would be for commercial banks to set aside loan-loss reserves and write down the value of their troubled loans—the solution that banks ultimately opted for at the end of the 1980s.²¹ If U.S. banks were indeed threatened by the Third World debt situation, a far more efficient solution would have been to allow them to borrow directly from the U.S. Federal Reserve Board at a penalty. Indeed, the central banks of rich nations are designed to serve as lenders of last resort to their commercial banks. For that reason, the Minneapolis Fed has recently noted that “the IMF is redundant to prevent worldwide financial crises.”²²

Had the IMF not been involved in the debt crisis of the 1980s, it is probable that the crisis would have been over as early as 1983 or 1984. Indeed, creditors and debtors would have had little choice but to do what they ultimately did at the end of the 1980s to resolve the crisis. Unfortunately, as Lindert and Peter Morton noted in 1987, “The intervention of the Fund and the [World] Bank has impeded the striking of bilateral bargains between debtor governments and the creditor banks.”²³ Shortly before being named the number-two person at the IMF, MIT professor Stanley Fischer expressed apparent agreement with that assessment: “I believe that the debt crisis would have been over sooner had

the official agencies not been involved.” Fischer added, however, that he thought that in the absence of official intervention the adjustment crisis would have been deeper.²⁴ But it is hard to imagine that Latin America would have suffered more had the liberal reforms that were eventually introduced in the late 1980s and early 1990s been implemented seven or eight years earlier.

International Rescues in the 1990s

Official intervention in the 1990s has continued to sever the relationship between borrowers and lenders. Investors have avoided incurring wealth losses and countries have avoided, or delayed, open default on their foreign debts. This strategy has been claimed a success for some countries including Mexico and Korea, but it has been accompanied by large and avoidable costs.

When the Mexican peso fell in 1994 as a result of expansionary fiscal and monetary policy that was inconsistent with its pegged exchange rate, moral hazard was already well established. In 1995 the IMF and the U.S. Treasury decided, for the fourth time in 20 years, to rescue the Mexican government and investors from the consequences of irresponsible election-year policies. The bailout allowed Mexico to repay in full about \$25 billion in dollar-indexed bonds. The investors suffered no risk or losses because they were able to pass the bill on to ordinary Mexicans in the form of greater debt. The redistribution of wealth from the poor to the rich has been a feature of subsequent bailouts.

The IMF-led intervention precluded a less-expensive solution that would have left Mexicans better off. In the absence of official funds, Mexico City and its creditors would have had little alternative to dealing directly with each other to renegotiate the country’s debt by extending the payback period on bonds and introducing monetary and structural reforms. One financier estimates that such a workout would have immediately cre-

ated a market in the new notes at around 80 percent of par—a loss equivalent to less than two days’ variation on the value of Intel.²⁵ A successful renegotiation would have instilled confidence in the market, taken pressure off the peso, and led to a speedy recovery.

The official response to the Mexican peso crisis, however, not only initiated a new era of massive bailouts; it also allowed Mexico to avoid key reforms. The petroleum industry, for example, remains a government-owned monopoly. Its privatization could have helped meet Mexico’s debt obligations while further liberalizing the economy. Any pressure to liberalize the economy the Mexican government may have faced was removed by official funds. Alternatively, oil revenues could have been used as collateral to guarantee loans from the private sector. Indeed, the U.S. Treasury negotiated precisely that arrangement for the aid it made available to Mexico City—a measure undercutting its argument that there was no way Mexico could have arranged financing from the market in the midst of crisis. The shaky banking system, which remains troubled to this day, was also saved. Rather than come up with a timely plan to deal with insolvent banks and liberalize the financial sector, the Mexican government has purchased about \$70 billion of Mexican banks’ bad debts and until 1999 maintained regulations that protected the largest banks from foreign competition (the government may still protect domestic banks in other ways). The experience has confirmed Charles Calomiris’s view that “in practice, crisis countries will always find it easy to promise (but never deliver) true banking reform. Instead, they will tax quickly and deeply, pay back their loans to the IMF, replenish the poker chips of their risk-loving conglomerates, and return to business as usual.”²⁶

In Asia and elsewhere, the record is the same or worse. Moscow has been sustained by IMF aid for years even though it has not complied with IMF conditionality. Indonesia has gone from one IMF agreement to another since 1997 without implementing neces-

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sary reforms. The bailout of Brazil did not discipline policymakers in Brasilia or avert a currency crisis. In Thailand and Korea reforms have been more forthcoming, but progress in implementing bankruptcy procedures and addressing banking-sector problems has been slow. According to *The Economist*: “The speed and strength of recovery in East and South-East Asia . . . reflect that natural propensity of economies to bounce back. . . . What it does not reflect is fundamental, structural reform, in any country in the region.”²⁷ Economist Catherine Mann of the Institute for International Economics recently summed up the outlook for Korea:

The bottom line is that Korea has made relatively little progress toward reforms that will create a more market-oriented economy. In fact, institutional reforms, such as to bankruptcy law and to the social safety net, have tended to impact the smaller chaebol [business conglomerates] the most, while leaving the large chaebol unscathed. This may hollow out from the Korean economy the firms that could pose a competitive threat to the biggest chaebol. In this environment, developing an active financial system that allocates credit according to risk and return will be difficult, if not impossible. Indeed, some of the large chaebol are looking to buy banks.

. . . The chaebols would not restructure themselves, the forces of competition from at home and abroad were too weak, so the Korean government’s Financial Supervisory Committee presented to each chaebol a detailed plan of divestiture, area of specialization, change in financial leverage, and greater financial transparency. In the end, if these reforms go through, Korea will have fewer firms in each line of business, and maybe lower leverage and greater

transparency. But it is unlikely to have a much more competitive or market-oriented economy.²⁸

IMF and G-7 officials have expressed a desire to get the private sector more involved in crisis resolution—indeed, investors with money to lose are less patient in dealing with insolvency or illiquidity. But officials continue to justify official intervention on the grounds that bailouts are needed to overcome spillover effects, collective action and free-rider problems, and other apparent market failures. Referring to international financial stability as a global public good, IMF managing director Michel Camdessus stated: “All have an interest in reforms that will improve the system for the global public benefit. And, as is so frequently true for public goods, not many people care for, and even fewer are prepared to pay for, its improvement even if many comment about it.”²⁹ Moreover, financial officials view it as their responsibility to ensure repayment of debts and prevent default. As former treasury secretary Robert Rubin emphasized, the measures financial officials take “must not undermine the obligation of countries to meet their debts in full and on time.”³⁰

Yet recent events do not support the case for official intervention. Only after Brazil’s currency crisis—two months after the IMF bailout—did the government there take tentative steps to address the country’s problems. The collapse of the Russian ruble and subsequent debt default—which an IMF bailout did not prevent—rattled world markets and likely reduced moral hazard. Successive interest rate cuts by the Federal Reserve and other central banks then helped calm world markets, raising questions about the utility of the IMF in both preventing defaults and dealing with their global effects. Indeed, the Brazilian devaluation did not have the colossal consequences that the IMF and the U.S. Treasury predicted, probably in large part because of the effects of the Russian crisis.

Market discipline has also been at work in Korea. As Jeffrey Sachs notes, the IMF

responded to the Korean crisis by providing a tranche of credit in late 1997, but “the Korean debacle ended only when Korea ran out of IMF money, forcing the international bank creditors to agree to roll over the debts owed by Korean banks.”³¹ Even so, the restructuring was “far from ideal” since the newly restructured debt was generously guaranteed by the Korean government at interest rates that were higher than those on the original debts.³²

Morris Goldstein also questions the IMF approach in Korea. According to him, it is not “clear that the first round of rollovers that did take place . . . would not have happened anyway in the absence of a promise of accelerated disbursements from the official sector. The argument that creditors are too numerous and dispersed to make such discussions feasible did not seem to apply in this case. If the rescue package for South Korea were smaller . . . and disbursements were not accelerated, a larger amount would have had to be rescheduled.” Moreover, losses in Korea would not have made Western banks insolvent.³³

Two-Party Crisis Resolution

The historical record also provides evidence that collective-action and other problems have often been resolved by creditor-debtor bargains in the forums of banking clubs, lending syndicates, and bondholder committees. Indeed, in the 19th century, the Corporation of Foreign Bondholders, a private entity in Great Britain, was formed to represent bondholders in negotiations with borrower nations. The United States later saw the formation of the Foreign Bondholders Protective Council. When countries had difficulties repaying their debts, bondholder committees would negotiate new terms and conditions with foreign governments—a process relied on during repeated Latin American defaults, for example, from the late 1800s through the 1930s.³⁴

The private sector showed that it was fully capable of organizing itself, bargaining

directly with debtors, and enforcing new conditions based on the acceptance of some initial losses. Contrary to the conventional perception of that era, gunboat diplomacy was relatively rare, except when creditor governments justified intervention mainly on political rather than economic grounds, as was the case when the French occupied Mexico in the 1860s or the British occupied Egypt in the 1880s. The United States followed that general pattern as well, intervening only in the Caribbean.³⁵ British foreign secretary Lord Palmerston summed up the European attitude when U.S. states defaulted in the 1840s: “British subjects who buy foreign securities do so at their own risk and must abide the consequences.”³⁶

History also shows that, although countries have incentives to avoid crises with their lenders, defaults have repeatedly occurred, but they have usually been partial rather than complete, and lending has often resumed soon after the defaults.³⁷ That process need not be traumatic for lender or borrower. Indeed, Rudi Dornbusch has suggested that had Korea defaulted rather than relied on the IMF in 1997, Koreans today would be in much better shape. Such a move would have stopped the won from plunging, forced investors to take some initial losses, and quickly brought lenders and borrowers together to work out illiquidity and insolvency issues. Instead, the Koreans got the worst of all worlds—a prolonged currency and financial crisis and greater debt.³⁸

Without official third-party intervention, a system of real conditionality and reform would evolve. If sovereign bonds were at issue, for instance, bondholder committees could renegotiate debt, and the bonds themselves could be traded in the market, taking on a value that reflected people’s confidence in the negotiations.³⁹ While creditors may not prefer entering into such negotiations to receiving bailout money, the absence of official third-party financing gives them little choice. The same is true of private international loans made entirely to the private sector, where creditors may not wish to get

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involved in reorganization of firms or their liquidation if official funds might be forthcoming. Direct two-party negotiations would reduce incentives to stall progress on reforms—including instituting bankruptcy procedures in countries that do not already have them—since both parties have much to lose if they fail to act quickly.

The fact that bond contracts require the unanimous consent of bondholders to restructuring has led many people to believe that sovereign bond defaults would today be messy and drawn out since a minority of bondholders could stall the process and bring legal action against the country. Yet since the 1980s there have been several successful voluntary sovereign bond restructurings that have overcome those problems. Moreover, creditors have limited ability to enforce any court decisions on foreign countries beyond attempting to seize foreign assets outside a sovereign's legal territory. The cost of taking legal action may well be higher than that of entering into debt renegotiations.⁴⁰

Were official bailouts less prominent, we might already be seeing more such workouts. One market solution would be to include in bond contracts clauses concerning majority voting or workout procedures in the event of a default.⁴¹ No doubt that will raise the cost of borrowing for some countries, but some countries *should* be discouraged in this way from gaining access to easy credit. Another market solution that might arise in the absence of official financing during crises is the creation of private standby lines of credit to countries. For a fee, banks have provided such loans—to Argentina, for example—to allow a country to withstand any outside shocks. The very existence of that type of insurance may help create greater investor confidence. Since banks would not provide such a service to all countries, the very provision of such loans (unlike that of IMF loans) would be a useful signal to the markets about which countries can be expected to have more sound economic fundamentals in place.

A market for credit risk insurance and restructuring insurance could also develop in response to market participants' diverse tastes for risk. In times of crisis, not all investors would behave in the same way, thus reducing the severity of financial turmoil. As Mann points out: "In the current situation, the more difficult, drawn-out, ad hoc, and therefore costly are the financial disaster workouts, the greater are the incentives for investors to demand and institutions to offer instruments ex ante that will help to generate a market-oriented solution to the workout process. So rather than intervening more frequently, official institutions must stand aside."⁴²

Conclusion

Since the collapse of the Bretton Woods system, international financial crises have become more frequent and severe. Official intervention has been at the center of the response to these crises, ostensibly to help the market overcome problems in coordination, information, and insurance and to help prevent crises from expanding and deepening. Yet such interventions, usually led by the IMF, have interfered with direct creditor-debtor bargains that would have provided those so-called public goods. Official assistance has also undermined the evolution or creation of market institutions that could do much to stabilize the international financial system.

Third-party intervention has also largely favored creditors and thereby created a more fragile global economy. The IMF's reaction to this criticism is to consider "bailing in" the private sector by lending into arrears so as to put more pressure on it to take losses. In the market, measures to bail in the private sector would not be necessary since the private sector would already be bailed in. Official efforts to bail in the private sector, however, may precipitate the financial turmoil they were designed to prevent since lenders would have an incentive to pull out of a country whenever

er they sensed that international authorities would force losses on them.

In a world where open default was a real possibility and official intervention was not, the market would naturally require some measure of debt relief. But private creditors need not fear such an outcome. In many cases debt relief can improve the financial standing of both creditor and debtor. As University of Chicago economist Randall Kroszner has observed: "It may indeed be better to forgive than to receive. Asking for less can result in receiving more while also making the distressed country better off."⁴³ Bankers may have made money during the 1980s debt crisis, but surely they would have made more had there been no "lost decade" of growth—something that could have been prevented by allowing debtors and lenders to recognize effective default and move on from there. Repairing the relationship between creditors and borrowers in international finance requires that official third parties move out of the way.

Notes

1. See, for example, Leland B. Yeager, *International Monetary Relations: Theory, History, and Policy* (New York: Harper and Row, 1976); Leland B. Yeager, "How to Avoid International Financial Crises," *Cato Journal* 17, no. 3 (Winter 1998): 257–65; Milton Friedman, "'No' to More Money for the IMF," *Newsweek*, November 14, 1983; Alan Walters, *Do We Need the IMF and the World Bank? Current Controversies*, no. 10 (London: Institute of Economic Affairs, 1994); Rudi Dornbusch, "A Bailout Won't Do the Trick in Korea," *Business Week*, December 8, 1997; Deepak Lal, "Don't Bank on It, Mr. Blair," *The Spectator* (London), September 26, 1998; and Robert J. Barro, "The IMF Doesn't Put Out Fires, It Starts Them," *Business Week*, December 7, 1998.

2. International Monetary Fund, *International Financial Statistics* (Washington: IMF, various issues).

3. The IMF downplays its role in creating moral hazard, citing the fact that market participants have taken great losses in Asia, but that view is not shared by all members of the IMF. See, for example, Onno de Beaufort Wijnholds, "Maintaining an Indispensable Role," *Financial Times*, March 1,

1999; and D. Wessel, "Rubin Says Global Investors Don't Suffer," *Wall Street Journal*, September 19, 1997. The fund's consideration of lending into arrears is an implicit recognition that the private sector should bear a greater burden when financial crises erupt.

4. An additional problem is that the fund faces a conflict of interest since in many cases it would be evaluating a country in which it has its own money at stake. Thus, Barro predicted, for example, that "the IMF will come up with a way to keep up the chain-letter game in which it provides Russia, Ukraine, and Indonesia with enough money to keep payments 'current.'" See Barro.

5. Michael D. Bordo and Anna J. Schwartz, "Under What Circumstances, Past and Present, Have International Rescues of Countries in Financial Distress Been Successful?" National Bureau of Economic Research, Working Paper no. 6824, December 1998, p. 43.

6. Federal Reserve Bank of Minneapolis, *1998 Annual Report: Asking the Right Questions about the IMF* (Minneapolis: Federal Reserve Bank of Minneapolis, May 1999), pp. 6, 3.

7. International Monetary Fund, "IMF Tightens Defenses against Financial Contagion by Establishing Contingent Credit Lines," Press release no. 99/14, April 25, 1999.

8. See Onno de Beaufort Wijnholds and Arend Kapteyn, "The IMF: Lender of Last Resort or Indispensable Lender?" Paper presented at the Cato Institute conference, "The Crisis in Global Interventionism," Washington, June 10, 1999; and Anna J. Schwartz, "Time to Terminate the ESF and the IMF," *Cato Foreign Policy Briefing* no. 48, August 26, 1998.

9. Quoted in "Boorman Discusses IMF's Transparency Initiatives, Explains Rationale for Contingent Credit Line," *IMF Survey*, May 10, 1999, p. 145.

10. International Monetary Fund, "IMF Tightens Defenses."

11. Charles A. E. Goodhart, *The Evolution of Central Banks* (Cambridge, Mass.: MIT Press, 1988), pp. 48–49.

12. Paul Krugman, "LDC Debt Policy," in *American Economic Policy in the 1980s*, ed. Martin Feldstein (Chicago: University of Chicago Press, 1994), p. 700.

13. Sebastian Edwards, "The International Monetary Fund and the Developing Countries: A Critical Evaluation," in *IMF Policy Advice, Market Volatility, Commodity Price Rules and Other Essays*, ed.

The cost of taking legal action may well be higher than that of entering into debt renegotiations.

- Karl Brunner and Allan H. Meltzer, Carnegie-Rochester Conference Series on Public Policy (Amsterdam: North Holland, 1989), p. 39.
14. Karen L. Remmer, "The Politics of Economic Stabilization: IMF Standby Programs in Latin America, 1954–1984," *Comparative Politics* 19, no. 1 (October 1986): 21.
15. See Ian Vásquez, "The Record and Relevance of the World Bank and the IMF," in *Delusions of Grandeur: The United Nations and Global Intervention*, ed. Ted Galen Carpenter (Washington: Cato Institute, 1997), p. 243; and Allan H. Meltzer, "What's Wrong with the IMF? What Would Be Better?" in *The Asian Financial Crisis: Origins, Implications, and Solutions*, ed. William C. Hunter, George G. Kaufman, and Thomas H. Krueger (Boston: Kluwer Academic Publishers: 1999), p. 246.
16. Meltzer, p. 246. Rudi Dornbusch noted that "the IMF set itself up to save the system, organizing banks into a lender's cartel and holding the debtor countries up for a classical mugging." Rudiger Dornbusch, *Dollars, Debts and Deficits* (Cambridge, Mass: MIT Press, 1986), p. 140.
17. Anna J. Schwartz, "International Debts: What's Fact and What's Fiction?" *Economic Inquiry* 27, no. 1 (January 1989): 4.
18. Peter H. Lindert, "Response to Debt Crisis: What Is Different about the 1980s?" in *The International Debt Crisis in Historical Perspective*, ed. Barry Eichengreen and Peter H. Lindert (Cambridge, Mass.: MIT Press, 1990), pp. 250–51.
19. Deepak Lal, "Foreign Aid: An Idea Whose Time Has Gone," *Economic Affairs* 16, no. 4 (Autumn 1996): 12.
20. See Ian Vásquez, "The Brady Plan and Market-Based Solutions to Debt Crises," *Cato Journal* 16, no. 2 (Fall 1996): 233–43.
21. Those suggestions were made by George Champion, former chairman of Chase Manhattan Bank, and William Simon, former secretary of the U.S. Treasury. See William Simon, "Cut Off the International Loan Lushes," *Wall Street Journal*, April 6, 1983.
22. Federal Reserve Bank of Minneapolis, p. 6. Deepak Lal also observed that "the fear that bank failures triggered by Third World defaults could lead to another Great Depression is only reasonable if it is assumed that the national authorities would allow bank failures to affect their national money supplies." Deepak Lal, "The 'Debt Crisis': No Need for IMF Bailout," *Wall Street Journal*, April 27, 1983.
23. Peter H. Lindert and Peter J. Morton, "How Sovereign Debt Has Worked," in *Developing Country Debt and Economic Performance*, ed. Jeffrey D. Sachs (Chicago: University of Chicago Press, 1987), p. 75.
24. Stanley Fischer, "The Mission of the Fund," in *Bretton Woods: Looking to the Future* (Washington: Bretton Woods Commission, 1994), p. C-169.
25. Peter Ackerman, Address to the University of California at Los Angeles Center for International Relations, December 1998. See also Peter Ackerman and James A. Dorn, "Dose of Financial Morphine for Mexico," *Financial Times*, February 15, 1995.
26. Charles W. Calomiris, "The IMF's Imprudent Role as Lender of Last Resort," *Cato Journal* 17, no. 3 (Winter 1998): 280; see also Charles W. Calomiris, "A Welcome to Foreign Banks Could Energize Mexico," *Wall Street Journal*, July 16, 1999, p. A15.
27. "Asia's Bounce-Back," *The Economist*, August 21, 1999, p. 11.
28. Catherine L. Mann, Testimony before the Subcommittee on International Trade and Finance of the Senate Banking, Housing, and Urban Affairs Committee, March 9, 1999. Likewise, the Economist Intelligence Unit reported: "The bottom line is that the chaebol virtually are the economy. In 1998 the top seven chaebol accounted for more than half of all South Korean exports. The biggest are too big to fail; they know it, and they know the government knows it too. Indeed, chaebol dominance means they can continue to joust with the government over reforms. These basic truths of the balance of power limit Kim Dae-jung's ability to impose change. In the final analysis, state and business in Seoul remain as intertwined as they have ever been. Their interdependence will and must adapt to a changing world. But a truly free market is a chimera." Economist Intelligence Unit, "South Korea: On the Leading Edge of Free-Market Reform?" February 17, 1999.
29. Michel Camdessus, "International Financial and Monetary Stability: A Global Public Good?" Remarks at the IMF research conference, "Key Issues in Reform of the International Monetary and Financial System," Washington, May 28, 1999. Undersecretary of the U.S. Treasury for International Affairs Timothy Geithner has also stated that "a more expansive definition of this concept of global public goods seems in order." Timothy Geithner, "The World Bank and the Frontier of Development Challenges," Remarks at Northwestern University, May 14, 1999. See also Charles Wyplosz, "International Financial Instability," in *Global Public Goods: International*

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30. Robert E. Rubin, "Remarks on Reform of the International Financial Architecture to the School of Advanced International Studies," delivered at Johns Hopkins University School of International Studies, Washington, April 21, 1999.

31. Jeffrey Sachs, "Stop Preaching," *Financial Times*, November 5, 1998.

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33. Morris Goldstein, *The Asian Financial Crisis: Causes, Cures, and Systemic Implications* (Washington: Institute for International Economics, 1998), p. 43.

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Signalling: Lending Resumption in a Reputational Model of Sovereign Debt," *International Economic Review* 36, no. 2 (May 1995): 369.

37. Herschel I. Grossman and John B. Van Huyck, "Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation, and Reputation," *American Economic Review* 78, no. 5 (December 1988): 1088.

38. Rudi Dornbusch, Remarks at a Brookings Institution Trade Policy Forum conference on "Governing in a Global Economy," Washington, April 16, 1999.

39. Rory Macmillan, "New Lease of Life for Bondholder Councils," *Financial Times*, August 15, 1995.

40. Marco A. Piñon-Farah, "Private Bond Restructurings: Lessons for the Case of Sovereign Debtors," IMF Working Paper 96/11, February 1996.

41. As Barry Eichengreen asks, "If this is such a good idea, why have the markets not done it already? One answer is that, so long as the markets continue to believe that they will always get 100 cents on the dollar courtesy of the IMF, they are perfectly happy with the status quo." Barry Eichengreen, "Is Greater Private Sector Burden Sharing Impossible?" *Finance & Development*, September 1999, p. 18.

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