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International Lender of Last Resort

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Abstract. This comment discusses the issues regarding the scale of conditional finance offered by the International Monetary Fund in recent rescue packages, and the related issues regarding a true lender of last resort. It reviews critiques of the Fund's performance in recent emerging-market crises, noting that they come from opposite directions.

The G-7 and the rest of the international financial policy-making community has, over the last eight months, made a variety of modest reforms to try to reduce the frequency and severity of international financial crises such as those of 1997-98 (East Asia), 1994-95 (Mexico), and 1992-93 (European Exchange Rate Mechanism, or ERM). The reforms include steps to improve transparency, strengthen financial systems, and involve the private sector more fully in rescue packages. Some critics have pronounced these measures too small to merit the title New Financial Architecture, and have said they are more like remodeling the house, or at most redoing the wiring and plumbing. Whether or not this characterization is right, I consider these steps to have been useful.

There are several areas where reform would be so fundamental as to merit unquestionably the appellation "financial architecture." One is the question of further liberalization of international capital flows, and how rapid it should be. Another is the question of exchange rate regimes, and how flexible they should be. A third, the subject of this session, is the question of a global lender of last resort, and how big it should be.

My comments will focus on the International Monetary Fund (IMF). The Fund does not meet the narrow definition of a Lender of Last Resort (LoLR) because it does not print money. Nor does it follow the classic Bagehot rules for a LoLR response to a banking crisis: "lend freely, quickly, usually at punitive rates, and usually against good collateral" (Little and Olivei, this volume). In theory the IMF can create SDRs, but this is done infrequently, and never on short notice or to help specific problem debtors.[1] Even in the case of the supra-normal financing packages that we have seen in some IMF

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[1] David Lipton has recently proposed a 2-step innovation: (i) a new round of SDRs are issues, and (ii) major industrialized countries pool their SDRs into a crisis-defense fund. The latter is to be used only for systemic threats, as Lipton (somewhat confusingly) also urges returning the genie of supra-normal financing back into the bottle. "The Financial Role of the IMF," in <u>Key Issues in Reform of the International Monetary System</u>, Conference at the International Monetary Fund, Washington, D.C.,

country rescues in recent years, there is seldom same-day response, and there is never true collateral.

The principle of penalty interest rates was introduced with the US loan to Mexico in February 1995 and subsequently the Fund's Supplemental Reserve Facility. The creation of the new Contingent Credit Line could be viewed as another step in the direction of LoLR function for the Fund. But a massive quantitative expansion of IMF resources (as would be necessary to play LoLR in today's global capital markets) is unlikely even under current rules, and a qualitative expansion of the IMF's role into a true LoLR is even less likely politically. The world is not ready for it. Nevertheless, the big issues surrounding the role of the Fund -- its existence, scale of financing, policies on which loans are conditional -- are similar to the big issues concerning a LoLR narrowly defined. Of particular interest is the trade-off between cushioning the effects of any given crisis and the dangers of moral hazard in the longer run.

Critics of the Fund's role in recent crises are legion, and their criticisms are not limited to observations of where the institution could have done a bit better. Some blame the entire crisis on the Fund. But they differ on the nature of the offense. My law is that "for every critique of the Fund, there exists an equal and opposite critique coming from the other direction." Many of them fit into the framework of charging that the Fund is either too generous (provoking moral hazard) or too severe (inflicting needless recessions). It is true that cushioning the blow does, on the margin, encourage borrowers and lenders to be a little less careful in the future. But as has been explained by numerous authors and analogies (especially those concerning cars, boats and planes), moral hazard is not a reason to refrain from ameliorating the effects of a given crash, to the extent that you can do so. As Ricardo Hausmann said earlier, moral hazard cannot be *the* fundamental market failure. Current international differences in capital/labor ratios and rates of return suggest that the efficient neo-classical solution is more capital flows than currently, not less.

Among those who see discipline under the current system that is too harsh, one plausible version is that the root market failure is the absence of international bankruptcy proceedings, to give troubled debtors a stay against the onslaught of demanding creditors. But it is hard to believe that all would be right with the world if it were only not for this lacuna, or it were it not for the other shortcoming of our system of cross-border investment. Countries can get into severe domestic banking crashes, for example, even without any international help.

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Critiques of the management of the crisis

Critiques of the strategy that the G-7 and the IMF followed can be classified into three areas: those concerning the efficiency of financial markets, those concerning the amount of financing, and those concerning policy conditionality. Many of the critiques contradict each other. One cannot claim that they necessarily cancel each other out. But when a member of the public reads so many attacks on the Fund, he or she might be tempted to conclude that where there is smoke there's fire. Thus it is important to realize that the critiques come from different directions, and to consider carefully the

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specifics of each one.

Regarding efficiency of financial markets

Critique 1: Financial markets work best with no government interference. There is no need for government action in this crisis.

This is the view of the no bailout crowd. But I disagree that governments and the IMF have no role to play in a crisis such as this.

There are three reasons why we need to be involved, and should not simply try to allow the market to solve the problem on its own.

X First, there was the risk of financial contagion, and not always to countries that deserved it..

X Second, there was a large negative effect on our net exports to East Asia. I would not say that this is tremendous concern as regards impacts on aggregate US growth or employment. Our economy had so much momentum going into this crisis -- and still has -- that we can withstand the loss of net exports (without necessarily losing much output and employment relative to what otherwise would have happened). But there was the danger that the fall in the trade balance, particularly the bilateral balances vis-a-vis East Asia, will lead to an isolationist or protectionist political backlash within the United States, which would in itself be harmful.

X Third is the geopolitics. We have a stake in East Asian economic success, both as a source of stability and progress in the region itself (Korea and Thailand have been and are military allies, and Indonesia is a potential site of social instability) and as an example to other developing countries (as developing countries around the world have opted for capitalism over state planning, they have been inspired by the example of East Asian success).

So we can't walk away from East Asia.

Critique 2. This crisis shows that financial markets work badly; the countries shouldn't have opened up to international investors in the first place, and we shouldn't press them to continue to do so now.

This critique takes the diametrically opposed view of the efficiency of financial markets from Critique 1.

I would not claim that modern financial markets work perfectly. Even though some of the contagion in this case can be explained by cycles of competitive devaluation, it is true that it is hard to explain all the contagion in this way. Investors appear to have had excessive optimism up to last year, and to suffer from excessive pessimism now. But we are better off with modern financial markets than without them.

There is a useful analogy from Robert Merton, which I will embellish. Today's financial markets are like superhighways. They get you where you want to go fast. By this I mean that they are useful: they help countries finance investment and therefore growth, and they smooth and diversify away fluctuations. But accidents do occur, and they tend to be big ones -- bigger than they used to be when people were not able to drive so fast. The lesson is not that superhighways are bad. But drivers need to drive carefully, society needs speed limits or speed bumps, and cars need air bags.

Regarding financing

Critique 3: Too much public finance in response to the crisis (vs. Critique 4: Not enough)

There are two versions of the complaint that too much money is being channeled to the crisis countries. The first is the question "Why should we bail out countries that are such tough competitors for our own firms on world markets?" The second variety of the critique has to do with moral hazard. Both raise important questions. But both have answers.

In the years prior to 1996, US exports to East Asia grew very rapidly. We would like to return to that path. The crisis strategy ultimately helps our firms sell to East Asia in three ways: short-term, medium-term, and long-term.

X providing finance, so that the countries can continue to buy our goods this year (even if at reduced levels).
X helping to restore growth, so that they can buy more next year, and
X pursuing fundamental market-opening, so that buy still more in the long term.

[Everyone has now learned about moral hazard, the principle that bailing out investors and borrowers reduces their incentive to be more careful next time. The moral hazard point is a correct one, and it enters in to the East Asia developments in a number of ways. But there is a danger of exaggerating it. It is a standard principle of economics that actions in one area can generate partly offsetting reactions in another. That is not in itself a reason not to take action. In our highway example, there is research demonstrating that drivers react to seat belts and airbags by driving faster and less safely than they used to. But that is not a reason to dispense with air bags. If it were, that logic would say that to discourage dangerous driving, we should put a spike in the steering wheel (as Michael Mussa of the IMF says).]

The crisis countries already pay large penalties under the current system. Standards of living were severely reduced in Latin America after the 1982 crisis and in Mexico after the 1994 crisis; and incomes were also sharply depressed in East Asian countries as a consequence of the 1997-98 crisis. The countries would not willingly choose to repeat the experience.

Beyond that, as we consider what if anything should be done to modify the international financial

system so as to reduce the frequency and severity of accidents in the future, perhaps we should consider that bank loans appear to be one of the more danger-prone modes of international capital flows. Foreign Direct Investment has the advantage of greater stability. Securities investment has the advantage that risk is efficiently shared: in the event of trouble, market prices automatically decline. Statistical tests show that the percentage of capital inflows that are bank loans, especially short-term or floating rate loans denominated in foreign currency, has a statistically significant effect on the probability of a currency crisis, while FDI has a significant beneficial effect.

Regarding policy conditionality

Too much exchange rate flexibility, vs. Not enough.

The exchange rate policy debate in the current context has some of the flavor of the similar debate after the Mexican peso crisis. At that time you could read in any newspaper that a foolish mistake had been made regarding the currency; you had to read more carefully to figure out that half the commentators were saying that the mistake was not to have devalued the peso earlier and the other half that the mistake was to have devalued at all.

In the East Asian episode, there is justice in the statement that Thailand should have allowed its currency to depreciate earlier. But here as elsewhere, there is danger of exaggerating in hindsight how obvious this was. Most of the East Asians had long been described as successfully preventing their currencies from becoming overvalued in the way that Latin Americans have historically done. Many westerners in fact had urged them to *appreciate* their currencies, in response to balance of payments surpluses and consistent with the Balassa-Samuelson argument that rapidly-growing countries should experience increases in the relative price of non-traded goods, and therefore real appreciation of their currencies. The main point I wish to make with regard to exchange rate policy is that neither currency boards on the one hand nor pure floating on the other is appropriate under all circumstances. Following good policies is a complicated matter, with lots of pieces to the puzzle; one cannot solve all problems with a single wave of the currency wand. And it is important to realize that a fervent belief in the virtue of free markets does not help settle the debate. Free-market monetarists are just as passionate in their belief that currencies should float, on the grounds that central banks have no business buying and selling foreign exchange, as are free-market supply-siders in their belief that exchange rates should be fixed, on the grounds that central banks have no business exercising independent monetary policy.

But it is true that the combination of an overvalued currency and a lot of debt denominated in foreign currency (particularly short-term debt) was a major contributing factor, perhaps the major precipating factor, to the crisis in Thailand, much as it was in Mexico 3 years earlier.

Too much macro austerity, vs. Not enough

Macroeconomic retrenchment is not the central aspect of the country programs. The austerity and hardship that the countries are undergoing in these programs is the consequence of the crisis and the

loss of investor confidence, not of the IMF's response to the crisis. It is probably inevitable, in circumstances where the priority is to reverse capital flight and attract wary investors, that interest rates be raised. If the programs are successful, the interest rates can soon be brought back down before they do lasting damage to the real economy. Initial targets may indeed have been too contractionary. As regards fiscal austerity, it is true that the initial agreements with the IMF were predicated on hopes regarding economic growth and corresponding budget surpluses that soon proved overoptimistic. The targets were soon modified.

Too much required structural reform

The IMF is not simply applying the same cookie-cutter to East Asia that it applied in the past to Latin America or other problem debtors. The new country programs do emphasize structural reform more than macroeconomic austerity. This is entirely appropriate, in that these countries have historically followed good monetary and fiscal policies. The Fund has evolved during its history -- shifting from the balance-of-payments problems of industrialized countries in the 1950s and 1960s, to the currency problems of developing countries post-1973 and their debt problems post-1982, and then adding the broader problems of the transition economies post-1989. Better that it continue to evolve post-1997, to address the financial and other structural problems in East Asia, than that (like some institutions) it fail to change with the times.

The most important source of moral hazard is between the Asian governments and their financial institutions and large corporations. Thus we are doing the right thing in pushing them to increase transparency and supervision, improve governance, open their financial markets, and loosen banking relationships (directed lending and connected lending). It is a historic opportunity to get them to undertake important structural reforms they would not otherwise have done.
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International financial markets certainly have their own failings. But I believe that the primal market failure is moral hazard at the national level, not at the international level. I have in mind such practices as directed lending, and implicit government guarantees for domestic banks and corporations, which we now call "crony capitalism." It has quickly become conventional wisdom that the Anglo-American market system works better, with financial institutions operating on an arms-length basis, and the government role limited to enforcement of rules and strong prudential supervision of banks. One must acknowledge the dangers of American triumphalism. As Jeff Sachs has paraphrased Nehru, "Financial history is written by the creditors." Still there is a lot of truth in this conventional wisdom.

What is the role of the international financial community? It can make this market failure either worse, if it gives emerging markets more rope with which to hang themselves, or better, if it provides the discipline by withholding money from countries that do not have the rule of law, functioning bankruptcy systems, and so on. The key to whether the international financial community makes things better or worse can be the policy of the IMF. If financing lacks appropriate conditionality, it will exacerbate the moral hazard problem. With appropriate conditionality, including on financial structural reform, the

entire contribution of the international sector can go the direction of disciplining the domestic market failure.

At the domestic level, we are accustomed to working backwards from the constraint of knowing ex ante that we will protect individual bank depositors ex post. Public statements to the contrary would be futile. So we require of banks capital adequacy, minimum reserves, and deposit insurance. Similarly at the international level: We (the G7) are always going to do something to help countries that are following better-than-average policies but that encounter serious financial problems with systemic implications. The alternative to having the IMF do it would be highly politicized bilateral rescues with less extensive and less appropriate conditionality. It might be guided by such considerations as US ethnic ties, CNN film clips, and partisan political scandal mongering. In short, the process would be a lot worse without a professional IMF to carry it out.

Currently there is an ambiguity or indeterminacy surrounding the availability of bailout finance. After the Mexico package of January 1995, a reasonable interpretation of US policy and politics was "no more large bailouts." The claim that investors in East Asia had a crash in mind but were counting on being bailed out in light of Mexico doesn't fit what people were saying, as Sachs and Radelet have noted. The exception, all agree, is that investors treated Russia as something of a "moral hazard" play. The Mexican bailout had elicited great congressional opposition, and East Asia is not as close or as clearly relevant to US interests as Mexico. Indeed a legislative amendment introduced by Senator Alfonse d'Amato effectively precluded Treasury use of its Exchange Stabilization Fund at the time of the Thai crisis in July 1997. Subsequently this legislation expired, so that the ESF could be used for second-line-of-defense financing for Korea. Even then, the Senate refused to authorize the New Arrangements to Borrow and the IMF quota increase. The leading explanation for the contagion that spread from Russia in August 1998 -- hitting even far-removed and unrelated countries like Brazil -- was the revelation that the G7/IMF either was willing to let important countries fail, or had to (because the cupboard was almost bare). Only after the Russian default and contagion did the Senate finally get scared enough to vote through the NAB and quota increase. The year added up to a good lesson in signal-extraction for investors, albeit an expensive one. The combination of (i) the Thai and Korean bailouts in 1997, (ii) the decision not to throw good money after bad in Russia in August 1998, and (iii) the approved increase in resources in the fall of 1998, together sent the correct signal to investors: the international community could and would help countries that made good efforts to help themselves in their policy choices. In the last 9 months we have seen that the strategy worked (with some help from easier monetary policy, in the US and around the world).

Things could have gone differently. The ambiguity seems dangerous. But there is an advantage to keeping investors guessing, in that it limits moral hazard. Just as the Federal Reserve seeks to preserve a shred of ambiguity regarding the "too big to fail" doctrine domestically, so has the international community succeeded in preserving genuine ambiguity about its bailout policies. The international version is truly credible, because nobody knows for sure what the political process will produce, until it happens.