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Towards a New International Financial Order: Why Reform Progress Is So Slow

The limited progress made so far in reforming the international financial architecture cannot be attributed to insufficient reform-mindedness of the institutions involved or to a lack of reform proposals in the literature. Rather, progress is slow as almost every step towards reform involves serious trade-offs, which must be analysed carefully before reforms are implemented. Some of these trade-offs are of immediate concern for defining the role of international financial institutions, notably the IMF, with respect to crisis prevention and crisis resolution.

There appears to be a growing discrepancy between the growth, sophistication and integration of international financial markets on the one hand, and the limited capacity at the national and multilateral level to control and regulate these markets on the other hand. This would not be problematic at all if international financial markets were working efficiently, i.e. if market failure were absent. Such a heroic assumption is increasingly questioned, however.[1]

It is not too difficult to find major local roots of currency and financial crises in emerging markets in the 1990s, starting with the Mexican crisis in late 1994. Yet, international lenders share responsibility with banks, business and policy-makers in emerging markets. The former tended to ignore risks and fuelled the boom in capital flows into emerging markets which typically preceded a crisis. Once crisis was looming, foreign lenders (as well as local investors) rushed for the exits. The dramatic consequences of sudden shifts from euphoria to panic are well known by now. We have witnessed crises spreading from one country to another, partly because the affected countries were plagued by similar fundamental problems, but partly also because different emerging markets were put into the same basket by foreign lenders.

This suggests that herding behaviour and contagion are not just 'nasty words',[2] i.e., unreasonable expressions for basically rational behaviour by foreign lenders. These expressions rather point to the failure of international financial markets to achieve a better allocation of world savings through cross-border capital transfers without, at the same time, giving rise to boom-and-bust cycles that are difficult to manage especially for emerging markets. For example, a sudden shortfall in capital inflows tends to undermine weak financial systems in emerging markets, with the ensuing credit crunch leading to the breakdown of basically sound enterprises.

To be sure, the affected countries can protect themselves against the vagaries of international financial markets by pursuing sound economic policies, by consolidating domestic financial markets, and by enforcing prudential standards. But the bunching of currency and financial crises has also to do with the institutional void prevailing at the global level, which is the topic of this paper. This institutional void has several dimensions:

- An international lender of last resort does not exist. As argued below, the International Monetary Fund (IMF) cannot – and, under current conditions, should not – pursue this role. This means that fighting systemic risk, i.e., a crisis threatening the global financial system, is more difficult at the international level than it is at the national level, where central banks play the role of the national lender of last resort.
- Similarly, institutional mechanisms in analogy to national bankruptcy proceedings do not exist at the international level. None of the existing multilateral organisations has the legal power of a national bankruptcy court judge, who can stop the run of creditors on a firm's assets by imposing a standstill

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[1] H. Reisen: After the Great Asian Slump: Towards a Coherent Approach to Global Capital Flows Policy Brief 16, OECD Development Centre, Paris 1999.

[2] D. Folkerts-Landau, P. M. Garber: The New Financial Architecture: A Threat to the Markets?, Deutsche Bank, Global Markets, Frankfurt 1999.

until a reasonable solution, including financial burden sharing, is worked out.[3]

☐ Financial market regulation is seriously deficient. Some internationally active financial intermediaries completely escape regulation. Highly leveraged hedge funds, frequently deemed to be involved in speculative transactions, are a case in point. Where regulation exists, it is often flawed or even counter-productive. For example, the capital adequacy regime codified in the Basle Accord has led to regulatory distortions.[4] According to The Economist, the accord, originally passed in 1988 to make banks safer, 'is so outdated that it may actually do the reverse'.[5] The current scheme of setting aside capital against different loan categories encourages short-term lending to emerging markets and cross-border interbank lending, i.e., exactly those loan categories that caused considerable problems in Asia.

The obvious challenge in reforming the international financial architecture is to overcome this institutional void. This is easier said than done, however. As we will see, the limited progress made so far cannot be attributed to insufficient reform-mindedness of the institutions involved or to a lack of reform proposals in the literature. Rather, progress is slow as almost every step towards reform involves serious trade-offs, which must be analysed carefully before reforms are implemented. Some of these trade-offs are of immediate concern for defining the role of international financial institutions, notably the IMF, with respect to crisis prevention and crisis resolution.

The IMF Under Attack

Among international financial institutions, it is mainly the IMF which is blamed for having failed to prevent financial crises in the first place, and for having failed in its fight against the deepening and spreading of crises once they had erupted.[6] The critique of the IMF has been harsh and widespread with regard to the policy conditions attached to financial support to troubled countries in Asia.[7] The criticism has been most fundamental, though not undisputed in the economics profession, when it comes to moral hazard. According to the critics, financial support by the IMF has induced reckless behaviour on the part of emerging markets and their private lenders and, thereby, added to the likelihood of financial crises. Some critics, including Lal[8] and Meltzer,[9] consider the Asian crisis to be the logical consequence of IMF support granted to Mexico in 1995. To them, the existence of IMF lending is the major problem, rather than part of the solution to financial crises in emerging markets.

The moral hazard critique is central to the reform of the international financial architecture in general, and the future role of international financial institutions in particular. On analytical grounds, there is nothing to quarrel with about the moral hazard argument. IMF support in times of crisis may be anticipated by both IMF borrowers and private lenders. As a consequence, governments of borrowing countries would be tempted to pursue economic policies that involve a higher risk of financial crisis, the costs of which will be partly covered by the international community. Likewise, private lenders would be tempted to ignore risk and to overlend, expecting that bailouts will reduce or even eliminate potential loan losses.

However, the critics of the conventional crisis management have not come up with evidence on the empirical relevance of IMF-induced incentive problems. Quite the contrary, a recent attempt to assess the empirical relevance of moral hazard suggests that incentive problems tend to be overrated in the ongoing debate on reforming the international financial architecture.[10] Major findings of this study are summarised here, as they have important implications for the future role of the IMF:[11]

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[3] H. Siebert: How to Improve the Incentive System to Prevent Currency Crises, Institute of World Economics, Kiel, mimeo 1999.

[4] H. Reisen, op. cit.

[5] 'Basle Brush', in: The Economist, May 1, 1999, p. 73.

[6] On the point of crisis prevention, see, e.g., H. Siebert: The Future of the IMF: How to Prevent the Next Global Financial Crisis, Kiel Working Papers 870, Institute of World Economics, Kiel 1998; on the point of aggravating existing crises, see, e.g., J. Sachs: Power unto itself?, in: Financial Times, December 11, 1997.

[7] The IMF has defended its case in T. Lane, A. R. Ghosh, J. Hamann, S. Phillips, M. Schulze-Ghattas, T. Tsikata: IMF-Supported Programs in Indonesia, Korea and Thailand: A Preliminary Assessment, International Monetary Fund, Washington, D.C. 1999. The appropriateness of policy conditions is not discussed here, as this issue is of less relevance in the context of this paper.

[8] D. Lal: Zeit zum Abschied für den Währungsfonds, in: Frankfurter Allgemeine Zeitung, October 1, 1998, p. 19.

[9] A. H. Meltzer: Asian Problems and the IMF, in: The Cato Journal, Vol. 17, No. 3, 1998, pp. 267–274.

[10] P. Nunnenkamp: The Moral Hazard of IMF Lending. Making a Fuss about a Minor Problem?, Kiel Discussion Papers 332, Institute of World Economics, Kiel 1999.

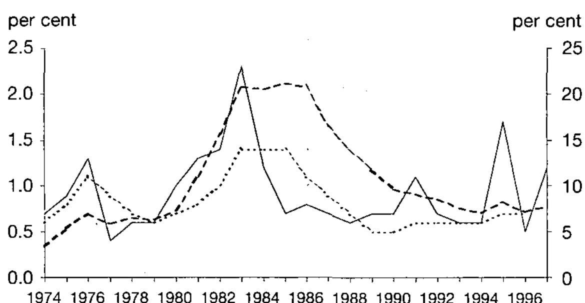
[11] Note that moral hazard eludes quantification. It is unknown how IMF borrowers and private lenders would have behaved in the absence of IMF support. It is also impossible to determine the costs of misguided economic policies and the costs of overlending that could have been avoided if international financial institutions had abstained from bailing out emerging markets and their private lenders. Therefore the evaluation is based on indirect evidence derived from the pattern of IMF lending since the mid-1970s.

☐ The prominent and exceptionally large rescue operations in Mexico (1995), Russia (since 1996), East Asia (1997) and Brazil (1998) tend to obscure the fact that overall IMF resources are probably too small to create serious incentive problems on a broader scale. Even during the boom of IMF lending in 1995-1997, annual average drawings of all developing countries on IMF resources amounted to just 0.3 per cent of their GNP. At the same time, IMF lending was also marginal when related to the claims of BIS reporting banks vis-à-vis all developing countries (about 2 per cent).

☐ In contrast to widespread belief, IMF lending has not increased steadily since the mid-1970s (Figure 1). Longer-term developments reveal cycles in IMF lending, with major crises (e.g., the Latin American debt crisis of the early 1980s) resulting in temporary lending springs. It is difficult to conceive that high IMF lending during earlier crisis episodes could have been reduced to pre-crisis levels for a fairly long period of time if it had added significantly and permanently to moral hazard.

☐ In a longer-term perspective, IMF lending (in per capita terms of the recipient countries' population) was not biased towards large emerging markets, which is again in conflict to what has been concluded from a few big deals recently. In other words, 'too-big-to-fail' considerations related to country size do not appear to have played a major role, even though they may have influenced IMF lending in particular instances.

Figure 1
IMF Operations in Developing Countries in Relative Terms, 1974-1997



—— purchases plus loan disbursements in per cent of the average of exports and imports of developing countries (left-hand scale).

········ credit and loans outstanding in per cent of international banking (average of deposit banks' foreign liabilities and foreign assets) (left-hand scale).

------ credit and loans outstanding in per cent of international reserves of developing countries (right-hand scale).

Source: IMF: International Financial Statistics, Washington D.C., various issues.

☐ It seems unjustified to blame the IMF for having encouraged borrowers to pursue misguided economic policies. Taking the inflation rate as an indicator of the soundness of macroeconomic policy, the correlation with drawings on IMF resources turns out to be insignificant. Furthermore, IMF lending was not biased towards countries with inflexible exchange rate regimes, which are widely considered to be a major cause of recent currency and financial crises.

☐ Likewise, there is no convincing evidence supporting the view that imprudent bank lending to developing countries is largely because IMF rescues have been anticipated by foreign creditors. It is inconsistent with this view that the structure of external financing of developing countries has shifted significantly towards equity financing and away from loan financing, although equity investors are most unlikely to benefit from bailouts. Correlation analyses reveal that the IMF and international banks decided independently of each other on their lending to developing countries, if bank exposure and IMF operations are adjusted for country size (Table 1). Put differently, IMF lending does not seem to have been motivated by bailing out foreign creditors in the first place.

All this suggests that moral hazard has been a minor problem in the past. This leads us to reject the radical proposal to put an end to IMF lending, advanced by some critics of the IMF in order to eradicate moral hazard. Even if these critics were right in arguing that there would be fewer crises in the absence of emergency lending by international financial institutions, there would still be some. Without a safety net, the remaining crises are likely to have more dramatic international repercussions than we have witnessed in the past. In other words, eradicating moral hazard tends to increase the systemic risk of crisis contagion. Hence, the relevant question is not whether a safety net is needed, but rather how to improve the existing crisis management.

The Future Role of the IMF

Why not empower the IMF to act as a true international lender of last resort if moral hazard has been a less serious problem than much of the current discussion suggests? The obvious advantage of having an international lender of last resort would be that fighting systemic risk would become easier.[12,13]

[12] S. Fischer: On the Need for an International Lender of Last Resort, 1999 (http://www.imf.org/external/np/speeches/1999/010399.htm).

Table 1
Cross-country Distribution of IMF Financing and Bank Lending to Developing Countries: Correlation Results[1]

	Outstanding claims of BIS reporting banks (as of June 1998)		
	in absolute terms	in per-capita terms[2]	in per cent of GNP[3]
Accumulated purchases plus loan disbursements, 1974-1997			
– in absolute terms	0.74** (114)	–	–
– in per-capita terms[2]	–	0.15 (114)	–
– in per cent of GNP[3]	–	–	–0.12 (104)
IMF credit and loans outstanding, end 1997			
– in absolute terms	0.69** (110)	–	–
– in per-capita terms[2]	–	0.17* (110)	–
– in per cent of GNP[3]	–	–	–0.14 (103)

[1] Number of observations in parentheses; ** and * denote significance at the level of 1 and 10 per cent respectively (two-sided test).

[2] Population of borrowing countries as of 1996.

[3] GNP of borrowing countries as of 1996.

Sources: IMF : International Financial Statistics, Washington D.C., various issues; Bank for International Settlements: International Banking and Financial Market Developments, Quarterly Review, Basle, November 1998.

Currently, the IMF cannot perform this role. Usable IMF resources are 'a trickle if an extended crisis develops, for instance if Japan or Euroland would need financial assistance'.[14] As a true international lender of last resort, the IMF would have to command essentially unlimited resources.

However, it is rather unrealistic to assume that this will happen in the foreseeable future: 'Policy-makers of the big countries will prevent it'.[15] They have good reasons not to supply the IMF with unlimited resources:[16]

☐ An international lender of last resort could be justified only if potential borrowers accepted high standards of external oversight and discipline.[17] These standards would have to cover financial regulation, bankruptcy legislation and enforcement, disclosure of information, and macroeconomic policies. The Asian crisis clearly revealed that these prerequisites are currently far from being fulfilled.

☐ An international lender of last resort should counter only a liquidity crisis threatening the global financial system. However, it is notoriously difficult to distinguish between 'illiquidity' and 'insolvency' in the international context. In contrast to national lenders of last resort, the IMF does not lend to markets but to governments running into trouble or threatening default. Given the difficulties in defining a systemic crisis, unlimited IMF resources might increase the risk that the IMF will become 'a funding agency for countries in self-made trouble, so to say the troubled countries' global bank'.[19]

☐ More generous IMF lending may render it more difficult to achieve two desirable goals of reforming the international financial architecture, namely (i) dissuading countries from excessive reliance upon exchange rate pegs and (ii) inducing private lenders to take their share in orderly debt workouts.[20]

In summary, unlimited IMF lending would run the risk that moral hazard problems become more serious than they have been in the past. Defining the future role of the IMF thus involves a fundamental dilemma. The conflict is between dealing forcefully with emergencies that come along by providing sufficiently large and timely support in order to fight systemic risk, and discouraging emergencies from happening in the first place by credibly refusing official support to governments and foreign lenders which are in self-made trouble. Crisis mitigation may require more IMF lending, whereas crisis prevention calls for limited IMF lending.

There is no easy way out of this dilemma. Consequently, the IMF is likely to remain 'neither fish nor fowl'.[21] The only firm conclusion to be drawn from the previous discussion is that two extreme positions

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[13] Claassen argued well before recent financial crises that a liquidity problem of internationally operating banks may not be handled effectively by national central banks. The division of labour between national central banks becomes 'more complicated and thus less workable if the concerned central bank ... has to encounter a liquidity problem in terms of a currency other than its own. In that case, it may not possess sufficient international reserves' (E. M. Claassen: The Lender-of-Last-Resort Function in the Context of National and International Financial Crises, in: Weltwirtschaftliches Archiv, Vol. 121, No. 2, 1985, pp. 217–237, here p. 232 f.)

[14] H. Siebert: How to Improve the Incentive System to Prevent Currency Crises, op. cit., p. 5.

[15] M. Wolf: The Last Resort, in: Financial Times, September 23, 1998.

[16] For a different view, see S. Fischer, op. cit., and Korea, Ministry of Finance and Economy: New International Financial Architecture: Korea's Perspective, Seoul 1999.

[17] M. Wolf, op. cit.

[18] R. E. Litan: Does the IMF Have a Future? What Should It Be?, Paper presented at the IMF/Federal Reserve Bank of Chicago Conference on the IMF, mimeo 1998.

[19] H. Siebert: How to Improve the Incentive System to Prevent Currency Crises, op. cit., p. 3.

[20] D. Lipton: The Financial Role of the IMF, Conference on Key Issues in Reform of the International Monetary and Financial System, mimeo 1999.

[21] M. Wolf, op. cit.

are to be rejected: while those who suggest abolishing the IMF altogether ignore the systemic risk of crises that would still come along, the suggestion of having a true international lender of last resort underrates the ensuing moral hazard problems.

Striking a balance between crisis prevention and crisis resolution is the intricate task of reformers of the international financial architecture. Trade-offs abound when it comes to finding a reasonable middle course in defining the future role of international financial institutions. Two practical steps towards reform may serve as examples: the Contingent Credit Line (CCL) of the IMF and active signalling by international institutions.

The IMF's Executive Board agreed to create the CCL in April 1999. This new facility shall prevent the spreading of financial crises by offering precautionary credit to countries that may suffer contagion although their economic situation is fundamentally sound. IMF members will have to prequalify for CCL assistance. They have to meet 'some minimum standards of information disclosure and transparency, as well as of economic health'.[22] By providing support ex ante (and not ex post, as the IMF has traditionally done), the CCL may help restore confidence before it is too late. By assisting only eligible countries, the CCL may provide for the right set of incentives and minimise moral hazard.

Yet it is open to question whether the CCL will achieve its objectives; it may even give rise to new risks.[23] The CCL seems to be prone to adverse selection, since applications for CCL support are likely to come from vulnerable countries with – possibly disguised – economic problems in the first place. At the same time, the prequalification mechanism may create an illusory security on the part of private lenders that could lead to a misallocation of international capital flows. Most importantly perhaps, the CCL might precipitate further crises if economic policies in prequalified countries took a turn for the worse so that the IMF had to revoke its preapproval.

Likewise, the request for more active signalling by international institutions to financial markets that borrowing countries are encountering economic problems involves serious trade-offs. It is striking indeed that the Asian crisis has led to opposing comments on the IMF's information policy. In the Korean context, for example, Sachs argued that 'a better approach would have been for the IMF to stress the strengths rather than the weaknesses of the Korean economy, thereby calming the markets rather than further convincing them of the need to flee the country'.[24] It is highly questionable whether a strategy of hoaxing financial markets would have succeeded in mitigating the Asian crisis. It is equally questionable, however, whether 'blowing the whistle' early on[25] will do the trick in preventing crises in the future. True, the threat of public disclosure of emerging problems by the IMF and other international agencies provides the country concerned with stronger incentives to correct misguided policies before it is too late. On the other hand, active signalling by authoritative bodies such as the IMF may be the trigger to crises that could otherwise have been prevented.

The delicate task of signalling may be handled best if various international agencies share responsibility in providing relevant information in their respective areas

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[22] S. Edwards: Abolish the Fund, in: Financial Times, November 13, 1998.

[23] B. Eichengreen: Toward a New International Financial Architecture. A Practical Post-Asia Agenda, Institute for International Economics, Washington, D.C. 1999, p. 99 ff.; S. M. Golder: Precautionary Credit Lines: A Means to Contain Contagion in Financial Markets?, Kiel Discussion Papers 341, Institute of World Economics, Kiel 1999; H. Siebert: How to Improve the Incentive System to Prevent Currency Crises, op. cit.

[24] J. Sachs: Power unto itself?, in: Financial Times, December 11, 1997.

[25] H. Siebert: The Future of the IMF: How to Prevent the Next Global Financial Crisis, op. cit.

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of competence, while leaving it up to financial markets to evaluate this information and to draw appropriate conclusions. The IMF's Special Data Dissemination Standard represents one step in this direction. Improved debt recording by the Bank for International Settlements is another one. Regular reporting should also cover institutional aspects of financial sector soundness, such as legal provisions and actual enforcement of prudential standards. A clear division of labour among international institutions, as well as between international institutions and financial markets, would prevent the IMF from becoming a global rating agency.[26] It would definitely be too much to demand from one single international institution what various private rating agencies have failed to deliver, namely timely and comprehensive risk assessments.

How to Involve the Private Sector

It should be evident by now that the reform of the international financial architecture must go beyond redefining the role of multilateral agencies. The unpleasant trade-offs discussed above imply that the institutional void characterising global financial markets cannot be overcome by multilateral agencies alone. That is why private sector involvement in international crisis management represents another major issue in the current reform debate. It may not come as a great surprise that progress in this area is as difficult to achieve as with respect to multilateral agencies.

Most of the recent proposals to involve private lenders in crisis resolution attempt to design mechanisms that may compensate, at least partly, for the lack of bankruptcy procedures concerning sovereign borrowers. The principal objective is to achieve a fair burden sharing, by 'bailing in' the private sector once crisis is looming. Underlying is the widespread belief that foreign lenders have been sheltered from losses so far, even though their boom-and-bust behaviour has contributed significantly to recent crises. Proposals range from ad hoc measures agreed upon voluntarily to fairly Draconic measures such as 'automatic haircuts' for all private lenders engaged in a country experiencing payment problems.[27] Two ways of private sector involvement can be distinguished: the US government and the international banking community favour a discretionary approach under which agencies such as the IMF encourage lenders and borrowers to restructure debt on a case-by-case basis, whereas a rules-based approach to debt workouts and restructuring is preferred by most European governments.

The former approach has been adopted in Korea, for example. Foreign banks and the Korean government negotiated the restructuring of debt 'under the stewardship and with the moral suasion of G-7 central banks'.[28] This agreement is credited with having facilitated Korea's rapid return to international capital markets. However, foreign banks did not shoulder any financial burden; they merely agreed to extend the maturity of their claims, and were compensated for this concession. Furthermore, various lenders had left the country well before negotiations started. In other words, the agreement was not effective in bailing in the private sector. The approach taken in Korea is likely to prove still less effective in countries with a large number of heterogeneous lenders (and not just a few banks as in Korea). It will then be extremely time-consuming, if not impossible, to reach a consensus on ad hoc measures. This suggests that debt work-outs must be rules-based, to some degree at least, in order to achieve a fair burden sharing.

This is not to say that the European approach would be without costs. Two proposals may exemplify the rules-based approach:

☐ Buiter and Sibert have proposed a universal debt-rollover option with a penalty (UDROP).[29] The idea is that all foreign-currency debt should have attached to it an option, exercisable at the discretion of the borrower, to roll the liability over for some months at a penalty rate of interest.

☐ As concerns bond contracts, it has been suggested that majority voting and sharing clauses be included and rules on collective representation of bondholders designed in order to facilitate the restructuring of bonds. These provisions would help overcome collective action problems and would prevent litigation by individual bondholders.

[26] See also S. M. Golder, op. cit., p. 18 who pleads 'for a decreasing involvement of the IMF in areas of less direct operational concern such as accounting, auditing, bankruptcy regulations as well as corporate governance'.

[27] For an overview, see B. Eichengreen: Involving the Private Sector in Crisis Prevention and Resolution, Conference on Key Issues in Reform of the International Monetary and Financial System, mimeo 1999. For a critical review from the perspective of international banks, see Institute of International Finance: Involving the Private Sector in the Resolution of Financial Crises in Emerging Markets, Washington, D.C. 1999 (http://www.iif.com/pressrel/1999 pr6.htm).

[28] B. Eichengreen: Involving the Private Sector in Crisis Prevention and Resolution, op. cit.

[29] W. Buiter, A. Sibert: UDROP: A Small Contribution to the New International Financial Architecture, Discussion Papers 425, Centre for Economic Performance, London School of Economics and Political Science, London 1999.

The rules-based approach may be flawed in two major respects.[30] First, if loan agreements and bond contracts were to include standard provisions making it easier for borrowers to restructure their debt, foreign lenders might fear that borrowers would make use of the restructuring option arbitrarily. Hence, foreign lenders might withdraw at the first sign of trouble and, thereby, precipitate a crisis. Second, such provisions might result in adverse selection. For example, UDROPs are unlikely to be used extensively on a voluntary basis, since only borrowers expecting a high probability of having to restructure their debt might wish to include them in their loan contracts. Creditors anticipating that demand will be from risky borrowers in the first place would not offer UDROPs, since the option cannot be priced adequately.

However, neither problem appears to be insurmountable and international agencies may help to overcome them. Moral hazard on the part of borrowers is reduced, though not eliminated, since restructuring options such as UDROPs can only be exercised by the borrower at a penalty. Moreover, the experience with British-style bonds, which (in contrast to the predominant American-style bonds) incorporate many of the proposed collective action provisions, is rather encouraging: 'It does not appear that issuers (of British-style bonds) succumb to the temptation to reschedule at the first sign of trouble. Moral hazard may exist, but there is no sign that it is overwhelming'.[31] Hence, it is rather unlikely that borrowers would suffer significant costs, in terms of larger interest rate spreads or impaired access to bond markets, if collective action clauses were applied universally.

Adverse selection can be minimised in several ways. Safe borrowers such as major industrialised countries could set a precedent and incorporate collective action clauses into their own bond contracts. Emerging markets could take a joint initiative, rather than moving ahead individually. The IMF could support such an initiative and provide incentives by lending at relatively favourable interest rates to countries issuing bonds with collective action clauses.

Crisis Prevention at Different Levels

Compared to crisis resolution and burden sharing, the case for private sector involvement may be less obvious with respect to crisis prevention. Major responsibility for crisis prevention rests with policymakers in borrowing countries and international regulators. The former have various instruments at their disposal to reduce the risk of currency runs and financial crises:[32] fiscal and monetary policy to ensure macroeconomic soundness, flexible exchange rates to discourage speculative currency attacks, foreign reserves management to prevent a shortage of international liquidity, debt management to avoid excessive reliance on short-term borrowing, sequencing capital account liberalisation to promote long-term capital inflows, supervision of banks to enforce prudential standards, as well as information disclosure to stabilise market expectations.

International regulators face an immense task in enforcing transparency and accountability, including disclosure requirements for offshore financial centres, non-bank financial institutions, and for transactions involving highly leveraged institutions.[33] Multilateral bodies such as the Basle Committee on Banking Supervision need to develop and implement practices for supervising hedge funds and financial relations of banks with these funds. They must address the shortcomings of existing standards on banking supervision. It is open to question whether merely amending the evident regulatory distortions created by the 1988 Basle Capital Accord will do the trick. Critics are concerned that minor changes in the guidelines, e.g. increasing the risk weights for certain loan categories, are an attempt 'to fine tune a mechanism that has some fundamental flaws. ... The principal and defining defect of the Basle risk-based guidelines is that ... they are and always will be essentially arbitrary'.[34] These critics argue that incorporating market-based measures of bank risk into prudential regulatory standards is essential.[35]

Yet private lenders, too, have a role to play in preventing crises spreading from one emerging market to another. For example, foreign banks might commit themselves ex ante to providing new credits to countries threatened by contagion.[36] Stand-by

[30] B. Eichengreen: Involving the Private Sector in Crisis Prevention and Resolution, op. cit.

[31] Ibid., p. 13 f.

[32] See also H. Reisen, op. cit.

[33] For an overview, see IMF: A Guide to Progress in Strengthening the Architecture of the International Financial System, Washington, D.C., April 28, 1999 (http://www.imf.org/external/np/ exr/facts/arch.htm).

[34] C. W. Calomiris, R. E. Litan: Statement of the Shadow Financial Regulatory Committee on Revising the Basle Capital Standards, Statement No. 154, April 26, 1999 (http://www.aei.org/shdw/shdw154.htm).

[35] See also 'Basle Brush', in: The Economist, May 1, 1999, p. 73.

[36] M. Feldstein: Self-Protection for Emerging Market Economies, NBER Working Papers 6907, National Bureau of Economic Research, Cambridge, MA 1999.

credit lines granted by banks to Argentina, Mexico and Indonesia represent a prototype of this kind of insurance against sudden reversals in capital flows. As with any insurance, precautionary credit lines are prone to adverse selection and moral hazard. In addition, it cannot be ruled out that foreign banks reduce their other credit exposure when agreeing to precautionary credit lines.[37] However, these problems may be contained if emerging markets clearly signal their creditworthiness, and if they are prepared to pay a penalty rate of interest when drawing on these credit lines.

Finally, private lenders might be obliged to set up and finance emergency funds for borrowing countries with a relatively high default risk.[38] Creditor councils would be responsible for collecting the contributions of individual lenders to these funds; contributions could be fixed as a certain percentage of capital transfers into the respective country. The IMF could draw on these private funds once a crisis was looming. In this way, two problems could be tackled at the same time. First, more financial resources could be mobilised in the case of emergencies. The IMF would command a larger pool of financial resources without inducing more serious moral hazard on the part of private lenders. The fight against contagion would no longer be delayed by time-consuming ex-post coordination. Second, the obligation to set aside private funds ex ante for dealing with emergencies would strengthen the incentive of private lenders to pursue prudent lending strategies. This would help prevent speculative bubbles in the first place.

Conclusions

Two years after the Asian crisis erupted in Thailand in July 1997, the progress achieved in reforming the international financial architecture is fairly limited. This is especially true as to the involvement of the private sector in the prevention and resolution of financial crises.[39] The institutional void, mentioned at the beginning of this paper, still exists, although experts have suggested various reforms and the agenda has been discussed by various official bodies.

The principal reason for the rather poor outcome so far is that almost all steps towards reform involve trade-offs. The most serious trade-off is between mitigating crises that come along and preventing further crises. Especially international financial institutions, notably the IMF, are confronted with this dilemma. On the one hand, financial support by these institutions should be limited, in order to keep moral hazard low. On the other hand, more emergency funding may be needed to fight contagion forcefully.

Critics of the IMF tend to overshoot in two directions. Some of the attacks of those critics who blame the IMF for having aggravated, or even caused, recent financial crises may well be on target. Yet, abolishing the IMF would do more harm than good. Without an international safety net, remaining crises are likely to have still more serious global repercussions and may threaten the financial system as a whole. Other critics who claim that the IMF must prevent the next crisis, after having failed to prevent recent crises, tend to overcharge this institution. Note that the economics profession as a whole, not only the staff of the IMF, was caught unawares when the Asian crisis hit. It is far from obvious that the IMF will command superior knowledge to anticipate the next crisis, which may again differ from the previous ones.

It follows that, even though international financial institutions do play a critical role in crisis resolution and crisis prevention, they cannot shoulder this task alone. Their efforts must be complemented by various other actors. First of all, national policymakers have to do their homework and must learn the lessons from recent crises (notably as concerns exchange rate policy, capital account liberalisation and financial market supervision). Furthermore, multilateral bodies must systematically review financial regulatory standards. This daunting task goes beyond merely amending obvious regulatory distortions.

Finally, private lenders must be more closely involved in crisis resolution and prevention. 'Bailing in' the private sector is a fairly tricky issue. Draconic measures aiming at a fair burden sharing may have unpleasant side effects; it may become more difficult or expensive for emerging markets to access international capital markets. Nevertheless, some basic rules on private sector involvement seem to be required, in order to avoid excessive lending in the future and in order not to let private lenders off the hook in times of crisis. In this way, bailing in the private sector helps alleviate the dilemma confronting international financial institutions.

[37] B. Eichengreen: Involving the Private Sector in Crisis Prevention and Resolution, op. cit.

[38] For a detailed presentation of this proposal, see P. Nunnenkamp: El FMI, origen de la crisis? Créditos del FMI, riesgo moral y la reforma del sistema financiero internacional, Institute of World Economics, Kiel, mimeo 1999.

[39] IMF: A Guide to Progress in Strengthening the Architecture of the International Financial System, op. cit.