The International Lender of Last Resort: What Are the Alternatives?

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I will offer some observations on the question of whether we need an international lender of last resort. And my answer will be yes, as long as we start putting the emphasis on *last*. We have had too much of an international lender of *first* resort in recent years, with too much lending from our international lender of last resort, the International Monetary Fund. Probably a package of measures and redesign could be undertaken to reduce the need for a real international lender of last resort, but in the final analysis we are still going to require one. Circumstances will arise where it will be important, even after we have taken better steps to take the burden off the IMF concerning the number of cases that it has to handle.

Analytically, a number of arguments can be distinguished for a lender of last resort in general, although they all come to the same basic theme, which is, of course, the concept of a true liquidity crisis. Among theorists, this concept is regarded with some skepticism, although I think that the case for it is quite strong. A liquidity crisis, in the most general sense, I would take to be a circumstance where a borrower cannot obtain short-term funds despite the fact that the rate of return on the short-term borrowing would exceed the market cost of capital. For some reason the market mechanism has broken down, and the borrower cannot obtain funds, even though there is, depending on the model framework or the conceptual framework, an equilibrium in which that flow of funds ought

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to take place. Such a liquidity crisis can be identified in at least three distinguishable cases, and it is important to keep them separate.

Identifying Liquidity Crises

The first, I would say, is financial panic. Financial panic is a circumstance where the level of short-term indebtedness is very high relative to short-term liquidity and, for whatever reason, a market equilibrium unfolds in which the short-term debt is called. And the borrower has no recourse to refinance the short-term debt. From a theoretical point of view, this is the kind of framework that we use to analyze bank runs in a domestic economy. It has also become one of the favorite vehicles for trying to understand a range of international crises, from Mexico to East Asia, in the last few years.

What has distinguished all of the international emerging market crises, in my view, is that they have hit countries where the level of short-term indebtedness to international banks is high and, in particular, where this short-term debt is a multiple of the value of foreign exchange reserves. For whatever reason, something triggers a massive withdrawal of the short-term capital. The trigger occurs in part because of the very observation that short-term liquid assets are not sufficient to cover the short-term debts, and you get a self-fulfilling liquidity crisis as a result. Now that interpretation is much debated, but it is the one that I would strongly favor for understanding these crises.

A second kind of liquidity crisis, which I would suggest is different from a financial panic, is a debt overhang liquidity crisis. By that I mean a case where you have a bankrupt debtor that still needs working capital. This concept is well-understood in bankruptcy law; just because you are bankrupt does not mean you do not need funds. In Chapter 11, we have Section 364 of the U.S. Bankruptcy Code, which is the debtor-in-possession finance vehicle. It provides a mechanism for the bankruptcy court to get short-term working capital to the bankrupt, understanding that markets cannot do it because any new creditor knows that without a special legal regime to cover the new lending, any new loans just get piled onto the massive mountain of bad debt.

This is a liquidity crisis according to the definition that I gave beforehand, but it is quite different from a panic because nobody is panicked, necessarily; you just have a bankrupt debtor that cannot get normal market access. This situation can be a case for a lender of last resort, as well. But as the bankruptcy law shows, you do not necessarily need a lender of last resort, you need a legal regime, in order to get working capital in such a circumstance. To apply that idea to the current context, of course, I am thinking about sovereign bankruptcy, about governments that are financially insolvent but still need working capital.

And, of course, the IMF does lend to such governments, and there may be a very legitimate role for such lending.

The third kind of liquidity crisis that I would distinguish is a class of problems that are very real but somewhat different from the other two. For want of a better title, I call this public sector collapse. The idea is that basic public order, the state's monopoly on the legitimate use of force, its ability to collect taxes and to provide basic public goods like law and order, collapses at various points in many countries around the world. It could be the result of a revolution, civil strife, a struggle for independence. In this very messy world that we live in, lots of states cannot perform as states, even to collect the minimal amount of tax revenues needed to run themselves. The collapse may not reflect an overhang of bad debt, and it certainly need not reflect a financial panic. But it still can create a condition that I would define as a liquidity crisis, where the return to working capital is very high, in that such funds would allow the state to consolidate its basic power, a step that may be vital to the survival of people in the midst of civil strife. And in that case also, the markets probably will not provide liquidity, and you may need a lender of last resort that is able to tie the loans to a consolidation of state power within the international system.

Roles of the International Lender of Last Resort

When we think about what the IMF actually does as our international lender of last resort, and how it does it, I find it helpful to distinguish these three types of cases and then to try to think through whether we have a reasonable regime for them. So, again, we have financial panic, debt overhang, and public sector collapse. Clearly, in response, an international lender of last resort will have multiple potential roles, at least analytically. Four come to mind from this three-way classification I just gave, because financial panic has two parts to it.

First, an international lender of last resort is supposed to forestall panic, simply by being there. One of the major functions of a lender of last resort is that you stop the panic from ever happening, in principle, because everybody says "No reason to panic, there is a lender of last resort standing in the background." So that is potential function number one. Potential function number two is to lend into a financial panic that is already occurring; thus, we see the Thai or the Indonesian or the Korean loans of the second half of 1997.

The third potential role of a lender of last resort is to lend into a debt overhang. By analogy, in the bankruptcy context, under American law, for example, we usually allow the bankrupt to gain access to working capital by prioritizing the new lending, the post-bankruptcy debt, under Section 364 of the Bankruptcy Code. Instead, we have the IMF lending into a bankruptcy situation, where the IMF is already assigned a privileged position in repayment. So we use the privilege as a way to get working capital into a bankruptcy situation. And the fourth potential role, of course, is to lend into a situation of public sector collapse, to help a state to consolidate power in a way that private markets will not be able to finance.

Alternatives to a Lender of Last Resort

Now having noted these multiple roles, it is also immediately evident that many functional alternatives to a lender of last resort exist. In every one of these categories, other ways can be found to handle the very same problem. And if we are going to analyze properly what the IMF, for example, should do, we should understand these different ways to handle the problems. So let me just run through them very briefly.

In Forestalling Financial Panics

First, forestalling a financial panic. Let us recognize that a number of ways exist to prevent a financial panic from happening in the first place. If you believe, as I do, that the essence of the recent crises was a very high level of short-term debt relative to liquid assets, which ended up triggering a panic because of a devaluation or bad political news or contagion, then the alternative to a lender of last resort is direct mechanisms to prevent the debt-to-reserve ratios from getting out of whack, reaching levels of two to one, for example, as in Asia in 1997 or in Latin America in 1994. Now for that reason, I believe that controls on short-term capital inflows to banking sectors of emerging markets, for example, make eminent sense. Direct limits, as a prudential measure, not as global macro capital controls but as a prudential measure, seem to me to be eminently sensible.

I also happen to believe that flexible exchange rates are the appropriate response, because if you actually look at the histories of these crises, in virtually every case a period of exchange rate pegging led to a drain of reserves, which caused the ratio of short-term debt to liquid assets to skyrocket. I do not see any compelling case for any of this pegging to begin with. And I also think that for many, many reasons, almost none of these countries qualify as part of an optimal currency area with any of the major industrial countries.

So my view is that prudential limits on capital inflows plus flexible exchange rates would have prevented a great many of these crises from ever having come to pass. With these two changes, the burden on the international lender of last resort could have been relieved. I should add that here, as in many other areas, we probably had a massive unintended consequence of our own regulatory environment. The BIS capital adequacy standards that give a risk-weighting of only 20 percent to interbank short-term lending probably contributed to the explosion of cross-border, short-term claims, which fueled the emerging market boom and afterward caused the emerging market bust.

So, as a contribution to the crisis, I would put a not inconsiderable weight on the BIS regulations, which are too asset-oriented and not adequately liability-focused in the first place. They do not focus on the risk of liquidity crises. And second, they cause a sharp bias toward short-term lending, because of the way that we do the risk weighting in the capital adequacy standards, giving such low risk to interbank short-term loans. These standards have made the whole system more vulnerable to financial panic.

In Handling a Financial Panic

Now in terms of handling a financial panic, beyond preventing panic, functional alternatives to IMF lending also exist. The first one is suspension of payments. Instead of just lending large amounts of money to a country in the midst of a panic, one alternative is that the country stop paying on the short-term debt. While that idea may sound horrifying, that is of course how most of these crises actually end. The Korean crisis did not end on December 4, 1997, when a $57 billion IMF package came into shape, but on December 29, 1997, when the Fed engineered a rollover of short-term debts and everybody breathed a sigh of relief that we were no longer playing on a day-to-day basis in Korea. So the normal way that these panics end is not necessarily through infusion of new capital, but rather suspension of repayment of short-term debt. This outcome has a hallowed history in finance, both domestic and international. It is not the horrifying element that it seems to be, but often a natural way that short-term panics get resolved.

Even in the 1999 Brazil crisis, I think one of the best parts of the rescue package was the informal agreement that the commercial banks would keep their lines of credit in place. In other words, we saw not a big lending package but rather an agreement not to take out funds. This is how, I think, normal banking ought to work in these contexts. The idea that big bailout packages are needed would be much less persuasive if the banks would agree to stand pat as a normal part of their behavior (which I think they would do, by the way, if the IMF were not in there telling them that they can get everything out). All in all, it seems to me normal that banking should proceed through suspension or orderly rollover of outstanding debt.

In Debt Overhang Crises

If I turn to the third category requiring lender of last resort loans, the debt overhang case, here again we find functional alternatives to IMF loans, although the IMF can readily play a role because it has this privileged position in lending when a mountain of debt is already present. What are the functional alternatives? First is the option of a standstill on debt repayments. Of course, the normal first thing in a bankruptcy workout is to stop the outflow of debt repayments. At this moment we still do not have an international regime that can handle standstills appropriately. I think it is a terrible, terrible loss in the current system that obviously bankrupt debtors can be absolutely pursued, without any recourse to a standstill.

Second, instead of an IMF loan, we could arrange debtor-in-possession financing, à la Section 364. A key point is that you do not need an official creditor to lend. The bankruptcy judge does not make an IMF-style loan; what the bankruptcy judge does is to say that the next $100 million tranche is going to have priority over the pre-bankruptcy debt. And we could have an international system that set these priorities. I think such arrangements would have an advantage over the current regime, where we only put in official money in such bankruptcies, because it would keep the action closer to the market. And you would still have a market test on lending. We do not have an official mechanism for giving priority to new loans, but it is at least conceivable that we could authorize an international regime to make such arrangements.

The third point about a debt overhang is that in domestic bankruptcy law you end up by canceling debt. We do this in the international system through the Brady plan or through Heavily Indebted Poor Country (HIPC) programs, or through other devices, but we do it just dreadfully. And I say, as one who has been watching the process for 15 years, one can name 25 countries where it was obvious for more than a decade that they were bankrupt before the debt was actually canceled. Yet the process drags on for 10 or 15 years before we acknowledge the fact, because we still do not face up to sovereign bankruptcy.

We have no concept for sovereign bankruptcy, we have no regime for it, we fake it, until the political pressures become intolerable or until the Ponzi scheme finally reaches the point where you simply cannot find anyone to lend more money to pay off the old debt. That is the situation we are in with 42 HIPC countries right now, but we are still playing the Ponzi game with them. One way to relieve the burden on an international lender of last resort would be to actually get rid of bad debt. And we do not have a clean system for doing that yet.

In Public Sector Collapse

Then finally, we get to the fourth category, public sector collapse. It is conceivable, of course, that you could have J.P. Morgan syndicates that could lead the recovery of societies undergoing civil strife, but I do believe, from my own experience in a lot of crisis countries and from what I can gather from the public evidence, that here is a role where the IMF or some other public agency is absolutely needed. When you have desperate humanitarian conditions and you have states that do not function as states, you cannot rely on private markets to sort out the consolidation of public power. So it seems to me that this is a clear case where the IMF or something like it has a vital role to play, and where the IMF has often played it decisively.

Evaluating Our Current System

Let me conclude by asking, given the foregoing, how we are actually doing currently. In terms of preventing financial panic, I think we do very, very poorly. First, we have too many pegged exchange rate regimes. The IMF has championed many of them, as in Russia in 1997 or Brazil at the end of 1998. These were situations where it was clear the currencies were on the verge of collapse and yet we lent money, even to sustain collapsing currencies. This action just invited a financial crisis, by allowing countries to run out of reserves.

Second, I think we have handled short-term debt very badly. Both the BIS regulations and the way that liberalization has been done have exposed vulnerable countries to massive amounts of short-term debt. Third, I think that the way that the IMF has intervened, in situations where the panic is just starting, has often inflamed the panic or exacerbated it rather than calmed it. In a lender of last resort circumstance, subtlety and art are of the essence, and so maybe bailing out Long-Term Capital Management makes sense if you are worried about a rapidly growing liquidity crisis and want to stop the panic. I happen to believe that was a good call. Closing 16 commercial banks on November 1, 1997, in Indonesia, when there was no deposit insurance, is what I would call a bad call. It set off one of the most virulent banking panics in modern history in Indonesia, and it is one of the reasons the country ended up in flames. So in terms of preventing financial panic, I would give very low marks to the current system. It is just not geared toward addressing the real issues that cause these panics to take place.

In terms of handling financial panics, here again the evidence shows, if you look at it dispassionately, that the big bailout loans have generally not functioned very well. Some have said they have not functioned because they have been too small, even though they were very big in dollar terms, but in any event they certainly have not stopped the outflow of capital. That was true, interestingly, even in the Mexican bailout, which was probably the cleanest of all of these rescues and the one where the U.S. Treasury put in the most money. It was not that the money that was put up stopped the panic through a return of confidence. No, the money was drawn down to repay the outflow in short-term capital, pure and simple. After it was gone, then confidence started to return.

But the evidence is that the bailout plans, the $57 billion for Korea, the $41 billion for Brazil, the $22 billion July 1998 program for Russia, the Mexican bailout, in no case actually stopped the outflow of financial capital. What I think has been more successful, actually, is rollovers of debt. When the situation gets bad enough, the Fed calls in the parties and says, "Everybody smile, we're rolling over the debt." And when this happens, it seems to me it has had a wonderful effect. All of a sudden, in a weird kind of way, the press says, "Ah, we avoided default." Of course, that *is* default. But since we put such a pleasant smile on it, confidence gets restored. So the magic of managing crises is exactly that—you call them something else, and then the myth becomes that we avoided default in Korea. Fabulous, if that is what you want to say, do it. And it works, it works a lot better than the first $57 billion worked, because that did not stop the panic; that led to a miserable Christmas weekend for Rubin and Summers in 1997, precisely because Korea ran out of money and therefore forced the Fed to act.

So in terms of handling panic, I do not think we have done a good job. The tactics are inflammatory, the big bailouts do not work, and now we are going toward what are called private sector bail-ins, as if this idea is anything more than a normal market response, which is a much better way in general.

In terms of debt overhang problems, there are many. Probably 40 or more countries around the world have governments that are really insolvent right now. We play a very complicated institutional international game, but it does not work very well because we have no international regime for insolvency of sovereign governments, comparable to Chapter 9 for U.S. municipalities. I will not elaborate, except to say that this problem has been going on for about 150 years, and it remains true today. We are playing games, at very, very high costs.

Finally, let me stress that in circumstances of public collapse, as I mentioned before, the stakes are usually extremely high. The IMF recently inaugurated new contingency lending mechanisms for countries in conflict or in immediate post-conflict circumstances, and I want to applaud that initiative because these are often the most delicate humanitarian circumstances in the world. It is extremely important to get money into those countries, to consolidate state power as fast as possible.

Bottom line, do we need an international lender of last resort? The answer is yes, because we are always going to have liquidity crises. But do we need an IMF that is managing 70 countries around the world? The answer is no. The reason we have such an institution is that we have made no provision for discharge of unpayable debt. That keeps an endless routine of IMF programs going. We have also allowed the highly volatile short-term capital to rule the system in recent years, through dangerous exchange rate and capital account policies. The combination has made these financial panics much more prevalent than they need to be.