

## On Responding to the Challenges of Globalisation

Submission to the Treasury Committee of the House of Commons by Marcus Miller, Department of Economics and Centre for the Study of Regionalisation and Globalisation, University of Warwick. He is grateful to Santanyan Ghosal for his comments.

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### 1. Background and causes of crises

In his current book on globalisation, George Soros (2002) argues that it is the rapid evolution of capital markets that is the major issue. He identifies four key steps in the recent historical process of the globalisation of these markets:

- i. The progressive *removal of capital controls* following the ending of the Bretton Woods system in 1973;
  - ii. the sharp *rise in offshore financing* after the first oil price in 1973 (as petro dollars were recycled as countries borrowed to buy oil);
  - iii. the acceleration of capital movements in the 1980s under the free-market, deregulatory administrations of Ronald Reagan and Mrs Thatcher;
- and
- iv. the *collapse of Communism* in 1990, after which financial markets became truly global.

While this process has liberated innovative and entrepreneurial abilities and accelerated global economic growth, it has a negative side. For, as Soros puts it, financial markets can be ‘unstable’ or prone to crisis<sup>1</sup>. The well-known phenomenon of ‘bank runs’ is consistent with this view<sup>2</sup>: so too was the excessive rate of company liquidations seen in nineteenth century London, and in America during the Great Depression. These runs and excess liquidations are handled at the national level by the institutions which have evolved for the purpose, including the Central Bank, Federal Deposit Insurance Corporation (FDIC), Bankruptcy Courts, etc. as summarised in Table 1 in the Annex.

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<sup>1</sup> The concept Soros uses to characterise this instability is ‘reflexivity’. It seems to correspond, broadly speaking, to the economist’s notion of multiple equilibria.

<sup>2</sup> Perhaps the position taken in the Treasury Report on the UK and the IMF 2001 is too. It notes that “Greater capital mobility has the potential to raise welfare ... However, undertaking liberalisation too quickly, before the necessary conditions are in place, can jeopardise stability”. Paragraph 3.22

What about global capital markets, where crisis may occur for two main reasons: (i) problems of *creditor coordination* exemplified by a bank run (see for example Sachs 1995) and (ii) those of *debtor's moral hazard* characteristic of sovereigns who misuse funds raised by issuing debt on terms of sovereign immunity. Because banks who lent to emerging markets took large losses under the Brady plan of the late 1980s, emerging market finance has since then been mainly in the form of New York bonds which are very difficult to 'restructure'. This may be useful as a check on debtors 'moral hazard', but it poses serious problems of creditor coordination when debt service capacity is impaired by events largely outside the debtors control.

The rapid growth of global markets has outpaced the competence of global institutions to handle them and the latter have been forced to play 'catch-up'. (Table 2 in the Annex provides an overview). But there have been successive crises: Mexico 94/5: East Asia 97/8: Brazil 99: Turkey and Argentina in 2001 – and now possibly Ecuador and Brazil --again. These market failures not only imply some resource misallocation: much more, they represent shocking setbacks in the growth prospects for many promising emerging markets, with serious implications for income distribution and living standards of their citizens, Stiglitz (1999).

To achieve greater financial stability without undermining incentives for efficient allocation of capital is surely one of the principal economic challenges posed by globalisation. (Another is achieving the redistribution objectives set by the Millennium Development goals; Birdsall and Williamson, 2002.) As noted by the UK Executive Director to the IMF in his answers to the Treasury Committee, this involves measures for both crisis prevention and crisis resolution.

## **2. Crises prevention**

The agenda for crisis prevention was summarised by John Williamson (2000) as including:

- a. macroeconomic discipline
- b. standards and codes for the financial sector -- and incentives for emerging market countries to implement them

c. a CCL -- with an automatic right to draw by countries satisfying certain standards

d. active encouragement by the IMF for the use of price-related measures to *limit capital inflows* in inappropriate forms and excessive quantities

e. a *switch in the form of lending* from short-term loans to instruments that effectively place much of the risk on the lender.

#### Remarks

In this context it is worth noting that sustainable ratios of Debt -to- GDP relevant for emerging markets may be substantially lower than those for the OECD countries. Since interest rates paid by emerging market governments are both higher and more variable by those paid by industrial country governments (and since borrowing costs tend to increase sharply with the Debt -to- GDP ratio), Stanley Fischer (2001, Chapter 2) concluded that the upper limit of 60 percent of GDP “that seems to have gradually gained status as a norm” is too high for an emerging market country for whom “ratios nearer 30 percent are much safer”. (Brazil currently provides case in point: with Government Debt close to 60 percent of GDP and much of it short-dated, interest rates rising over 18 percent pose serious problems of sustainability).

But it is clear from the above list of measures<sup>3</sup> that things have moved on a long way from the days when IMF advice could be --and was-- caricatured by the phrase “**It’s Mostly Fiscal**”! The East Asian Financial crises 1997-8 marked a decisive change – for the simple reason that most of the countries involved did not initially have significant fiscal problems, as measured by Deficits and Debt relative to GDP<sup>4</sup>, while their poorly regulated financial systems and their short-term liquid liabilities in dollars left them dangerously vulnerable to capital outflows. .

As was confirmed by the representatives from the Treasury in their evidence to the Committee, the IMF has backed away from its advocacy of rapid capital

<sup>3</sup> Which corresponds fairly closely to the conditions for capital account liberalisation described by the UK Executive Director to his evidence to this Committee.

<sup>4</sup> There were nevertheless significant contingent liabilities – to bail out the banking system for example – which have added substantially to the ex post debt figures. Some have argued that these off-balance-sheet liabilities should be included in the ex ante Debt figures: but this poses the risk of labelling as fiscal events whose origins lie elsewhere.

account liberalization prior to the Asian crisis in favour of a more carefully sequenced approach. As John Williamson (2000) has put it, however, “the question now is whether it should go further and actively urge members to implement controls when capital inflows are excessive”. He continues: “The precedent here is Chile<sup>5</sup> in the 1990s and its *encaje* (also Colombia and Malaysia). ..., Chilean-style capital inflow taxes can provide a useful instrument to emerging markets suffering actively urge its members to use when threatened by excessive inflows.”

### 3. Crisis management and resolution:

As the Treasury document notes “the IMF has an important role resolving financial crises, but the availability of official resources is limited in relation to private capital flows. This increases the importance of securing the involvement of private sector creditors in crisis resolution. The way crises are resolved today may have important implications for the behavior of the public and private sectors in the future.”

#### a. IMF as an International Lender of last resort

Two new facilities have been designed to provide credit in crisis conditions, subject to prequalification or higher interest rates to avoid overuse. First is the **Contingency Credit Line (CCL)** introduced in April 1999 to provide precautionary credit facilities for countries hit by financial contagion -- conditional on sound macro policies, adherence to financial standards, and good relations with private creditors. Although in September 2000 interest charges and commitment fees were reduced, there are still no takers, probably because of the “signalling problem”-- if you ask for the credit line investors fear the worst. Second is the introduction during the Asian Crisis of **Supplementary Reserve Facility (SRF)** to offer larger sums for shorter periods at higher interest rates than traditional IMF lending.

It is widely agreed that easy availability of liquidity in the form of ‘bail outs’ can lead to moral hazard on the part of both creditors and debtors and undermine the proper functioning of capital markets. In Ghosal and Miller (2002) we argue that bail-outs do

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<sup>5</sup> Also cited as a good example of well-sequenced capital account liberalisation by the Treasury witness to the Committee.

not necessarily solve the underlying causes of a sovereign debt crisis. In fact bail-outs may end-up increasing the probability of a sovereign default.

b. Collective action clauses, Sovereign Debt Restructuring Mechanism (SDRM), and a Sovereign Debt Forum

Both self-organising creditors (i.e. sovereign debt contracts with collective action clauses) and international bankruptcy procedure are ways of creating commitment devices which prevent and resolve sovereign debt crisis. Recent proposals for the former by John Taylor of the US Treasury and the SDRM of Anne Krueger of the IMF are discussed in some detail in Miller (2002), already circulated to the Committee. Which will work better?

Collective action clauses have the advantage that they can more easily be implemented: after all, they have been incorporated in London bonds since the late nineteenth century. But there are two major problems, referred to as those of *Transition* and *Aggregation*. Because most existing sovereign debt instruments have been issued under NY law, they do not contain such clauses: how they are to be changed? Some have suggested that bond swaps be used to solve this problem of Transition.

Perhaps more serious is the fact that collective action clauses operate *within one class of debt*, while a sovereign debtor typically has many types of debt in issue, e.g. Argentina has more than 80. How can agreements to restructure be reached across the different classes of debt? JP Morgan Chase and Company have suggested a two-stage bond swap could in principle be used to handle this Aggregation problem. But this has not been put to the test.

The Sovereign Debt Restructuring Mechanism advocated by M. Krueger of the IMF is meant to solve both these problems. Her proposals require international agreement to major institutional change however, and will surely imply giving more power to the IMF and less to Wall Street. The stand taken by the United States is crucial as it has a blocking vote on the necessary Amendments to the IMF's articles (which require an 85% super majority vote and the USA alone has 17% of the votes). But the signals given so far are unclear. On the one hand, Mr O' Neil apparently encouraged the IMF to explore the avenue of institutional change; on the other hand, John Taylor of the

US Treasury countered this initiative with proposal for collective action clauses. It appears that the latter is more “market-friendly”: an open letter signed by the IIF (Institute for International Finance) the EMTA (Emerging Market Trading Association) and the EMCA (Emerging Market Creditors Association) has come out with a clear preference for Taylor’s approach.

Despite the apparent dissonance however, it may be that the approaches taken by the IMF and the US Treasury are complementary rather than contradictory --both being elements of what is referred to as a two track approach. The first track is to proceed with contractual changes, while keeping the second track -- statutory intervention-- as a live option. It could well be that the threat of statutory change gives lawyers and the markets the incentive they need to write ingenious contracts for creditor co-ordination. Should the contracts solution fail, further institutional change would be necessary.

#### Remarks

As interim measure, it has been proposed that a Sovereign Debt Forum (SDF) be established to facilitate restructuring. Its supporters argue firstly that bondholders realise institutional change is required; and second that an informal procedure, where those who have money at stake make the deal, may be more effective than the legal procedures proposed by Krueger. Richard Gitlin (2002), for example, has formulated principles to guide a Forum along these lines, principles which include changes to bond contracts (to include collective action clauses with super majority voting and provision for the appointment of Trustees to promote restructuring). Although the Paris and London Clubs offer interesting precedents for such an approach, it is widely believed that bargaining goes better “in the shadow of the law”.

In the absence of decisive measures to improve the performance of global capital markets (such as a credible bankruptcy procedure, which takes account of both moral hazard of the sovereign debt and creditor co-ordination) capital controls may be necessary to prevent further crises. In the words of the Hippocratic oath, Dani Rodrik (1998)<sup>6</sup> has warned that “where knowledge is limited the rule for policymakers should be, first, do no harm”; and, in the light of the East Asian financial crisis, he

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<sup>6</sup> In his contribution to essays on the topic “Should the IMF pursue Capital Account Convertibility”

concluded there is a compelling case for maintaining controls or taxes on short-term borrowing. Inflow controls along Chilean lines are not too controversial. But outflow controls may also be necessary in times of crisis as Anne Krueger's proposal recognises<sup>7</sup>. It is believed for example that Argentina experienced enormous capital outflows while the overvalued peso was still pegged at one to one with the dollar and wealthy citizens were free ship dollars across the Rio de la Plata into private bank accounts, out of the sight and out of reach of the sovereign state. It seems clear that the benefits of capital mobility in these circumstances accrue to a small and privileged elite while the costs of the crises are borne by the whole population. As Tobin warned in 1999, these activities can threaten the viability of the currency peg and the divergence between private and social costs can justify public intervention.<sup>8</sup>

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<sup>7</sup> The Treasury Document on the IMF and UK 2001 notes that "We should be prepared to support a country that must impose temporary capital controls, as part of an orderly process of crisis resolution". This presumably includes outflow controls.

<sup>8</sup> "The Central Bank, committed to honor the peg and to maintain the country's terms of trade, has to protect its reserves. It cannot be indifferent to the claims on those reserves negotiated by private parties, domestic and foreign, who ignore the social costs" Tobin (1999)

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### Annex: Summary of Domestic Procedures and International Parallels

As a background to the present debate on the international financial architecture, it may be useful to summarise institutional mechanisms devised to handle domestic liquidity crises, such as bank runs and creditor grab races. Table 1 lists mechanisms used for banks and non financial co-operations inside a nation state. These include the lender of last resort role for the Central Bank as recommended by Walter Bagehot, bank deposit insurance and regulation as practised in the U.S by the Federal Deposit Insurance Co-operation, and the role of the bankruptcy system.

**Table 1: Bank runs and creditor grab races**

For whom?	What action?						Who does it?
	Supply Liquidity	Co-ordinate a Rollover	Suspend Convertibility	Provide Insurance	Impose Regulation	Supervise Workout	
Domestic <b>BANKS</b>	LOLR						Central Bank (CB)
			Bank Holiday				Govt
				Deposit Insurance			CB/FDIC
					Prudential Regulation		CB/FDIC/ FSA
Non-Bank <b>CORPORATIONS</b>		Debtor-in-poss'n finance					Bankruptcy Court (Chap 11)
			Automatic Stay				
						Debt equity swap	

Table 2 on the next page uses the same framework to see how such actions are taken at the global level and by whom.

**Table 2: Handling Sovereign Liquidity Crises and Ken Rogoff's list of "8 Ways to Save the World"!**

What action?						Who is to do it?	Memo item
Supply Liquidity	Co-ordinate a Rollover	Suspend Convert'y	Provide Insurance	Impose Regulat'n	Supervise Workout		Rogoff's List (JEP'99)
IOLR						IMF/G7	(1)"Deep Pockets ILLOR"
	Forced Rollover/ Standstills					G7 IMF?	(2)"Crisis Manager"
		Capital Controls				Sovereign State	(3)Capital controls
			?			World Bank?	(4)Global FDIC
				Basle Accords		BIS  Sovereign State	(5)Global Financial Regulator (6)Transparency and Regulation
					Debt Restructuring	Paris & London Clubs IBC	(7)IBC (8) Rogoff's plan – an ex ante debt equity swap

Key: The headings in the last column refer to the various points made in Rogoff's article.