Floor Discussion of the Griffith-Jones Paper

Jack Boorman wondered whether it would be feasible, let alone advisable, to establish international rules for global capital flows. "I have difficulty with the idea that you have to regulate these flows putting in rules, were such rules formulable - I doubt that they are for the same reasons I gave previously about trying to find numerics, for example for the appropriate level of the current account, that apply across a large number of countries. It seems to me that if you then had marketeers who followed those rules, the burden of proof of the official community to act as a lender of last resort would go up enormously. For that reason alone, I would argue strongly against that. It ought to be the market out there, fighting the issue out."

Boorman also disagreed with Griffith-Jones' point that, when a crisis emerges, the first and main response should be to activate quickly a sufficiently large international lender of last resort. "I think not. The first and most important activity in the context of any crisis is to formulate a policy package and to convince the markets that policy is in the end what's going to deal with the situation, not so much the financing, and certainly not primarily the financing that is going to be associated with it. The short-term financing facility that I made reference to was a non-starter and I think it will probably continue to be a non-starter."

Boorman agreed that the discussion about bankruptcy is extremely useful. "If only because it signals the markets that the official community would like to see mechanisms that make the private community take a hit in instances such as Mexico. If there had been a way of isolating the Tesobono holders and getting them to voluntarily extend their maturities as part of a package of policies and financing from the official community in the restructuring of that debt, you could have had a very different solution. And that could be part of the kind of orderly work-out processes that people have in mind."

Finally, Boorman thought that Griffith-Jones' reference to a 'stock of securitised flows that can leave the country within a few hours' might be confusing. "I sometimes think that here language gets in the way. The securities are not even in the country, for the most part. Brady bonds, for example, are trading in New York - they are not going to leave anywhere. They are only going to go down in price. That also holds for securitised credit which is in the country as well. And that's the point. In the extreme, you do not need any funding whatsoever. You can just let the price adjust. What we are trying to do is find that happy medium between funding which provides confidence, so that the price adjustment isn't such

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

that it becomes dangerous to the social and political fabric of the country. So I think we do have to step back and ask what it is we are talking about in terms of magnitudes when we think about the potential problems that confront us here."

Charles Siegman endorsed the view that the regulation of capital flows may not be possible or desirable. "The issue of capital inflows and how to 'filter the good and eliminate the bad' has been a task for all investors. The question is whether government officials or international institutions have the ultimate wisdom to make that filter just fine enough so as not to eat into the bone or to allow the 'bad' to come in. This is the delicate part of any form of regulation. I am hesitant about giving a vote of confidence on the ability of regulators, whether domestic, national or international civil servants, to achieve this. It is a very slippery road."

Siegman dwelled on the issues of the risk of a seizure of assets and of an orderly work-out arrangement. "With regard to attaching assets, the issue Bill White asked me to comment on briefly: you are quite right, Bill, that one of the underlying fears during the December-January period of 1994-1995 was of a default by Mexico, with implications that then the risk of attachments would arise. It was most remarkable that in the post-resolution of the 1980s debt crisis there were no attachments. But then you were dealing with a group of very large banks which did a lot of arm-twisting to the smaller banks. Moreover, the full range of debtor countries themselves, from the very responsible countries to perhaps even less responsible ones, wanted to avoid defaulting on their debt and preferred seeking a work-out. But there was a self-interest motive involved. People avoided the word 'default' and emphasised moratorium or suspension of payments and sought debt restructuring instead. Default did not occur because it was to the mutual interests of both the debtors and the creditors to avoid the attachment of assets and legal entanglements, because an attachment provokes a sequence of events: creditors line up, commerce is paralysed, spreading quickly to other parties.

But in 1994, the problem was more acute, because the group of creditors was far more diversified and much more difficult to assemble - whom should you address? The Brady bond holders - whom do you call? Or other securities? The problem with mutual funds is that they are not the final owners. So the objective of the exercise was to avoid attachment of assets with the consequent spiralling effects of unwinding commerce which would have affected much more than just the debtor country or the individual creditors. Whether such a chain reaction would have happened, how bad it would have been - one could draw a very bleak scenario, but it was not inconceivable that such a thing could happen.

With regard to work-outs, Stephany Griffith-Jones points out in one of her comments that it is too late to talk about these in public. We are talking about it here, it is in the newspapers, it is being discussed in various forms. In fact, it is impressive that we are able to discuss this at the same time a country such as Mexico and others are issuing new government securities. And people are buying them! One of the big problems of work-outs is that we have a stock of old debt. Even if you get the best work-out arrangement, how do you draw those people into your orbit? That's not easy. People did not sign a contract with a work-out clause, but if they eventually sign such a contract, there may be certain risks associated with lending, and there will be a premium and costs associated. The market will sort that out easier on new debts - and people are to this day absorbing new debt, from countries of which we do not know whether the terms of repayment will be assured in the future.

The whole question of work-out arrangements is to redistribute the burden of risk- taking. It is not necessarily a governmental obligation to deal with this problem, but whether you have national regulations on capital or not, eventually there may be systemic international risks, and that is where the international community gets involved. Stephany's point is that we have all these preparatory steps, including regulations on capital transactions. But what happens if a country is so important that there are systemic effects - it signs up or it does not sign up and it fails? Do we let that country sink because it did not follow the prescribed preconditions or otherwise? Then we would be back to where we started from in 1994."

Peter Kenen elaborated further on the issue of work-out arrangements. "Some of the talk about analogies with Chapter 9 and Chapter 11 of the US Bankruptcy Code derive from a paper by Jeffrey Sachs. Sachs drew an analogy between Macy's, that was able to raise 750 million dollars in new working capital after declaring bankruptcy, and Russia, which in the same period of time raised much less. He was also somewhat exasperated by the time taken in negotiating Russian debt rescheduling. But I do think that the case he had in mind was rather unique. Indeed, any number of countries have had access to what was essentially working capital from the Fund in periods in which they had difficulty. But the argument in favour of a special procedure to keep working capital flowing to a country is not the key issue. The real issue in debt work-out situations is the one Charles Siegman has just referred to, namely the problem of attachment, which is even greater when there are so many private sector entities. A large number of foreigners have claims. And here I come to the point that Jack Boorman made. It is not simply a question of price adjustment. If I'm holding equities in Mexico or bonds issued by some Mexican entity - not necessarily the government - and there is a crisis (which implies that there will be a price adjustment), I can sell them and go to the foreign exchange market. I will then demand that the Mexican government provide Mexican reserves - unless the exchange rate is freely floating. So even when there is a price adjustment there is still a foreign exchange problem. Mexican nationals will do the same thing - they will liquidate the various claims they have on other Mexican entities and flee the country. So you have a double problem of price adjustment and exchange rate adjustment. I don't see how a work-out arrangement can deal with this problem.

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

Let me make one other remark on the suggestion that Stephany made concerning the administration of controls, of guidelines by the capital exporting country's authorities. Quite apart from the problem of devising such rules, there are all kinds of practical problems. Suppose that I have money invested in a country fund and the fund is suddenly told that the country's current account deficit has hit 3.5% for two years running, which implies that no more investments can be made in that country. What should the country fund do? What will happen to my equity? There are very serious problems in the case of instruments like that. How do you deal with Mr. Soros' Quantum Fund, which is an offshore entity? And there are many more funds like that. Finally, I doubt whether it is the responsibility of the securities regulators to administer such controls when it is their principal job simply to protect institutions and investors within their own countries. They are not, after all, empowered to administer controls on behalf of some foreign entity. The idea appeals to me in that it would create jobs for my students, but I really think it is way out of the ball park in terms of practicality, and the administrative problems are enormous."

Johannes Witteveen supported the idea of having a kind of pre-crisis arrangement or a stand-by with the Fund if certain conditions are satisfied. "Bill White feels this to be all very difficult, yet I remember that during my time at the Fund, there were a few countries which regularly had a stand-by with the Fund without needing the money at all, just to have the assurance. (Also, I suspect, because often the Minister of Finance liked to have these conditions because it strengthened his position in relation to his colleagues.) That worked in a number of countries and therefore I wonder whether it would be a good idea to have the possibility - connected to the Article VIII consultations - that countries can resort to a certain additional amount of stand-by that, if necessary, would be available immediately. I think it would work quite well."

Jean-Jacques Rey argued that, before new approaches are discussed, it would be useful to assess what the successes and failures of the current practice have been. "Looking at what was done in the case of Mexico, I have tried to align the pluses and the minuses in retrospect and have found that what was done was fairly successful after all. On the side of the pluses, I have five items. There was the speed of reaction; there was the fact that we indeed avoided contagion - and I agree that there is a difference between systemic risk and contagion, but you cannot push the argument too far because the more contagions you have the more you risk turning back to systemic risk; there was little or no moral hazard on the side of the debtors - conditionality was there and we heard how strong it was; there was very quick recovery of capital market access both for other Latin American countries and I believe for Mexico itself; and, very likely, there are hardly any costs associated with bridging finance since, as Bill White pointed out, it is just a liquidity provision, and nobody thinks that Mexico will not eventually repay, so why not bridge the problem?

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

On the side of the minuses: One very evident minus is the issue of channels of communication. The whole thing was very speedy, so speedy that it created a lot of irritation and some lessening of confidence between authorities. Something must be done about that. There was an important moral hazard problem on the side of private creditors (repayment at par whereas prices of securities went down), which one should not under-estimate. There is a minus in terms of equal treatment. Mexico virtually emptied the official funds available for this sort of thing. We must find some sort of replenishment for future countries. And here I reach an issue - I don't know whether it is a plus or minus - and that is the degree of stress put on institutions by these situations. The Congress of the United States refused to deliver so it went back to the Exchange Stabilisation Fund (ESF) and now Congress is trying to tie the ESF. The IMF, too, was pressed into a role which nobody had an opportunity to discuss beforehand and now the G-7 summit in Halifax has urged a doubling of GAB as a most urgent matter. While such a doubling is quite reasonable and could have been reasonable on other grounds, I am concerned that we are now signalling that there are opportunities for doing a sort of Mexican operation again. To that extent, I think that there is a valid counterbalancing argument in working hard on work-out procedures. This will be terribly difficult, indeed. I think the function of this is to enlarge the availability of options for the authorities, not to devise a procedure which will henceforth substitute for and improve on what has been done in the past. But at least when authorities are confronted with such a situation, if they can get together in some form and decide on the basis of various arguments whether the financing road is better in that particular case or whether perhaps private creditors could be enlisted, to come in and share the burden, that may be indeed in itself desirable."

Bernd Goos stressed that he was concerned about resorting to the IMF as a kind of lender of last resort. "I agree with Bill White that the lender of last resort function of central banks is set up on the basis of constructive ambiguity. I am concerned about the Fund becoming a kind of international lender of last resort because the facility which is now discussed in the Fund is not based on constructive ambiguity. There is an attempt to spell out clearly access conditions to this facility, and to that extent it is bound to be counter-productive because it will create moral hazard problems."

Goos did not agree with those who had argued that it is now much harder to restructure debt because it is owned by a very diverse group of bond holders, while most of the debt that was rescheduled in the 1980s was owned by a more homogeneous group of private banks. "There was repeated reference to the difficulties of corralling creditors with securitised credits, and that the world has become much more diverse compared with the 1980s. But I would like to draw attention to a Fund paper which refers to a number of recent cases where rescheduling of bonds was done in a very effective way. One example was one of the Mexican airlines which rescheduled outstanding bonds in a matter of two months, and there

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

were also other examples of official debt held in bonds that was rescheduled in a short period with rates of consent by the creditors of up to 97%. So apparently there are ways and means to handle such crises, without a formalised procedure necessarily being required."

Goos thought that the idea of establishing international work-out arrangements was not realistic. "In Europe, efforts have been made for a number of years to harmonise bankruptcy procedures for private firms. This has proved to be an impossible task. The conclusion has been that the legal systems are so different and the perceptions of the problem so different that an agreement is impossible. The idea has since been abandoned. To imagine that it would be possible on a worldwide scale to design and implement work-out and bankruptcy agreements strikes me as unrealistic."

Ariel Buira, however, did not think one should go for constructive ambiguity on the road of the international lender of last resort. "I think we should have a fully developed scheme and work-out facility and so forth. The reason for constructive ambiguity, it was suggested, was that it would minimise the risk of moral hazard. But this is best dealt with by an appropriate balance between costs and benefits, in which costs and benefits are shared in an appropriate way by lenders and debtors. If you look at the Mexican case, the Mexican crisis occurred on December 20, and the final package - with all the interest the Fund and the US had in putting it together - was more or less in place on March 9. Now, Mexico is a special case, for reasons obvious to all of you. It has a large economy, it is a major trading partner of the US, it was a model reformer, it could send several million immigrants to the US - whatever. But it took some time to get all this in place. In the process, the exchange rate moved from 3.50 to 7.50. This was too much, and too costly. I think the risk we are running is not of moral hazard but of doing too little too late. For a smaller country you may not even have made this effort. The problem is one of not doing enough, leading to scarce funds and, even in the case of Mexico, a situation yielding a sharp drop in GDP, a huge rise in unemployment, and rising social and political tensions. I think in future we must be ready with a more structured approach which can be put in place quickly and minimise the unnecessary cost."

Reply by Stephany Griffith-Jones

"A couple of years ago in a previous FONDAD seminar somebody who was sitting here said that the problem with private flows was not a serious problem because if there was a crisis, there would be no bail-out, because it was private investors investing in private companies in developing countries. But in fact, in the case of the recent Mexican crisis there was - it doesn't matter what we call it - a major lending, a major commitment of official resources. So I think we have a problem with these very volatile capital flows and none of us has very clear

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

answers. We cannot dismiss the problem. I don't think I was presuming market failure. I am just saying that on occasions markets which may work well do fail. And again, I think that is completely evident.

It is true, as Bill White argues, that it is maybe more a problem of contagion and not of systemic risk. However, having said that, we then talk about financial fragility in major developing countries like Mexico, Argentina and possibly others. And surely if we were going to have crises in banking systems of countries like Mexico and Argentina, there would have been some systemic risk. In a way, the fact that we have an international lender of last resort operating, whether because of systemic risk or contagion, shows that there is obviously a problem.

The other point that we were discussing with Bill at coffee was that he said that the issue the BIS had accepted was that countries should liberalise slower and that Chile was an example of that. I happen to know the Chilean case very well, and what has actually happened, independent of how the Chileans sell this internationally, is that the Chileans have acted pro-cyclically. I think that is correct. It is what the Asians do as well: when capital flows in very quickly, they tend to impose more discouragement measures. The Chileans have now put reserve requirements on secondary purchases of shares and so on, and when there is stringency with regard to new money coming in, they re-liberalise. But it is not true that they liberalise completely. The Chileans are, overall, very committed to a free market economy, but on capital flows they are very pragmatic. And this is also true of other successful countries like Colombia, South Korea, Malaysia. They are counter-cyclical in their measures. They react to flows. In my judgement that is correct. Obviously, if you have too little money coming in, you will want to encourage it. But when you have these surges of excessive inflows, I think there is a case for reserve requirements or other measures. There is a problem in the way, say, the OECD code of liberalisation presents this, because it presents this as a continuum - we are always going towards this long-term goal. Maybe in the year 2100 we can go toward this goal, but we are still quite far away because these are fragile economies, with weak financial markets, etc.

Bill White also makes the point that because most capital flowing into emerging markets in the 1990s is provided by non-banks, this implies that there is far less systemic risk than there was in the case of bank flows in the 1980s. However, none of us believes that the massive devaluation and the massive increase in interest rates that followed the Mexican crisis was either desirable or positive. There was clearly a case of overshooting, which had more damaging effects, as Bill points out, due to the fragility of the Mexican financial system.

I do not agree entirely with Bill's points to counteract the possible need for an international lender of last resort (ILOLR). Though there may be uncertainty that the ILOLR will lend, at least for the larger countries (like Mexico), there will be quite a high likelihood; there will also be the risk that ultimately the country is - or may become - unable to pay all its debts to the ILOLR. Indeed, we learnt in

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

the 1980s that the distinction between illiquidity and insolvency is very unclear for developing countries. Consequently, there is a 'moral hazard' problem of an ILOLR (however cleverly defined) and therefore a need for some *ex-ante* regulation to diminish it.

I agree that it is difficult to define an 'unsustainable' current account deficit. However, in recent papers (for example by John Williamson, William Cline, Helmut Reisen and in World Bank documents), valuable attempts have been made which give fairly logical - and similar - suggestions.

I agree that supervision and regulation cannot provide all answers, but they can be a very valuable complement to other measures being discussed. Furthermore, bank supervision - and its coordination internationally improved - much *after* the debt crisis of the 1980s. It would be valuable to improve regulations before new crises occur!

As regards Jack Boorman's comments, I would like to elaborate on what Peter Kenen said. It is not just a matter of the impact that selling securities has on their price - or worse, not renewing short-term securities at any price, as occurred during several weeks with the Tesobonos - but their crucial impact on the foreign market and on the balance of payments. This is precisely what happened in Mexico.

Peter Kenen demonstrated concern that controls could be avoided by people like Soros and so on. However, a recent IMF report shows that these people, although they played a major role in the ERM crisis, played a very small role in the Mexican crisis, so that if one did not manage to control the hedge funds, it would not have affected Mexico all that much. A more serious problem is that of capital flight, but I suspect that even a lot of the capital of the Mexicans and the others which flies in and out would very often use the same instruments as the foreigners coming in. I am not saying that the 'bad' foreign investors should be discouraged, but that certain modalities of investment should be discouraged, whether it is Mr. García (nationals) or Mr. Smith (foreigners). Because they may be using the same instruments. Mr. García, I suspect, may be coming in through the mutual funds, because that gives him more protection.

I agree with the point Charles Siegman makes about diversified investors, who are difficult to assemble. This seems to me to be another reason to emphasise far more than has been done this year the role of crisis prevention.

Finally, in reply to Jean-Jacques Rey, I would like to stress, when he draws a balance of the Mexican peso crisis, a key element which he omits. This is the tremendous cost to the Mexican economy - and people. GDP will fall in 1995 by around 6% (more than during any of the years of the debt crisis!); real wages and investment by far more. This, in spite of the massive financial package put together by the international community."

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org