Financial Crises: Towards an Alternative Approach

Ariel Buira

I Introduction

In a world of increasingly integrated financial markets and high capital mobility, the loss of market confidence in a country or currency gives rise to severe financial crises with significant international effects. This paper suggests that the current IMF approach for dealing with financial crises not only falls short of the purposes of the Fund, as set out in its Articles of Agreement, but is ill-suited for dealing with crises of confidence which may be due as much to market misperceptions and overreactions to the news of the day as to policy shortcomings.

Since crises often provide an opportunity for reform, some suggestions are put forward for improving the policy response to speculative attacks for the benefit of the countries concerned, as well as for the international economy.

II The Fund's Current Approach to Financial Crisis

The purposes of the IMF are set out in Article I of its Articles of Agreement. Six purposes are enumerated including international monetary cooperation, the expansion and balanced growth of international trade, the promotion of exchange stability and of a multilateral system of payments, the mitigation of maladjustments in the balance of payments and the provision of resources to facilitate the correction of such imbalances.

"The promotion and maintenance of high levels of employment and real income and ... the development of the productive resources of all members (are) the primary objectives of economic policy" (Article I, ii). Further reference to these primary objectives is made in Article I(v) which specifies that a purpose of the Fund is "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity".

Although the intention was that the availability of the Fund's resources should prevent countries from experiencing financial crisis, in practice the

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institution has often found itself helping its members cope with crises after they occur (Boughton, 1997, p. 3). In recent years, four countries have requested the support of the Fund following a sudden reversal in market confidence: Mexico (in 1995), and Thailand, Indonesia and Korea in 1997.

These sudden reversals in market confidence have created a new kind of problem for emerging markets and for the Fund. Indeed, the Fund's Managing Director characterised the Mexican crisis as "the first financial crisis of the twenty-first century", recognising that it was different from earlier financial crises and implicitly suggesting that it called for a different response from the Fund.

How has the Fund responded to this new problem? The Fund has taken the view that "a financial crisis calls for a similar response ... as any other balance of payments problem, except that the response should be quicker and possibly much larger than in a more traditional case" (Boughton, 1997, p. 6). In its own words, the Fund has sought to provide "both directly and with the assistance of partners, a package of financing sufficient to promote a restoration of confidence in the framework of an adjustment programme. The latter programme would need to justify the confidence by insuring that the authorities were taking the steps necessary to correct the problems that had 'caused' the loss of confidence and adopting policies that would even otherwise permit a return to a sustainable growth path." (EBS/97/225 Supplemental Reserve Facility, pp. 2-4).

"In all four cases, the Fund provided resources in the credit tranches under the stand-by arrangements with very large and heavily front-loaded access. The size of the stand-by arrangement and the degree of front-loading reflected judgements regarding the amount necessary – given forceful strong adjustment measures and the financial resources made available by other participants in the packages – to restore confidence. In making such judgements, a view had to be taken of the amount of short-term exposure for which there was a significant risk of non-roll over." (EBS/97/225, p. 4). In practice, the above statements would seem to imply that: (i) the loss of confidence is due to poor policies on the part of the country and may be reversed by forceful adjustment measures; (ii) to restore market confidence, first let the crisis erupt and then adopt an economic programme backed with large financial support. To my mind these assumptions may be challenged. Let us consider them in turn.

1. *Reasons for the Loss of Confidence*

The assumption that any loss of confidence is due to poor policies on the part of the country is questionable. While Thailand had a large current account deficit and the bhat was probably overvalued, the current accounts

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of other countries in the region that came under attack – Taiwan, South Korea and Hong Kong – were much stronger and Japan continues to run the largest current account surplus in the world. Yet, they all suffered speculative attacks. In fact, short-term capital movements often appear to be less dependent on economic fundamentals than on investors' search for profit, based on perceptions of vulnerability which may arise from a misreading of current national or international political events. More generally, there is wide recognition in the literature, including the papers of the Fund, that capital flows to emerging economies are often volatile for reasons that bear little relation to country risk. Among the more widely accepted economic reasons for this volatility are:

1. Exogenous and unanticipated changes in the financial conditions of the industrial countries can produce severe destabilising effects in capital importing countries, which are unrelated to their policies or creditworthiness. Industrial countries generally formulate their economic policies based on domestic considerations, with little regard to the international repercussions of their actions. On several occasions, this has led to unforeseen rises in the level of real interest rates and exchange rate fluctuations that have increased the cost and sharply diminished the availability of international financing to developing countries.
2. Capital inflows and commercial bank lending have been markedly procyclical, reflecting macroeconomic conditions in both capital-exporting and capital-importing countries. Capital flows from the former when returns are low due to low levels of domestic activity or to low rates of interest. Capital comes to the latter most readily when economic and business prospects are good, while capital flows tend to decline when the economy slows down or when problems or uncertainties of any kind appear in the horizon. Thus, capital markets themselves tend to undermine the creditworthiness of countries. As the BIS stated some time ago, "It may be useful to imagine what would happen in a national context if during the recession banks were suddenly to cut off the flow of new credits to the corporate sector and to begin closing off existing short-term credit lines. The inevitable result will be a financial collapse which will frighten even soundly managed firms, including banks ... Such a financial collapse would therefore not permit any easy inferences with respect to the quality of the pattern of bank lending and of corporate investment before the outbreak of the crisis, whereas the conclusion could safely be drawn that something had gone seriously wrong with the macroeconomic management of the economy."
3. Market behaviour is often characterised by information asymmetries and contagion effects. Country risk analysis, which is far from perfect, is often dominated by "herding" behaviour. Recent episodes of financial

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market turbulence illustrate that a country might lose its creditworthiness overnight, leaving authorities little time to react. In a number of cases, the sudden loss of creditworthiness may be unjustified. Countries may face abrupt changes in the cost and availability of liquidity when unexpected events, such as major macroeconomic or financial shocks, trigger sudden shifts in market sentiment. As the market liquidity dries up, the country may face excessive adjustment costs. Moreover, as we have seen repeatedly in Latin America and more recently in Asia, there is a tendency to evaluate a country's creditworthiness as a function of its regional location or stage of development rather than on its own merits. When a country in a certain region experiences difficulties with payments markets often tend to suspend new credits to all countries in the same region or with similar characteristics.

The 'bandwagon' effect, which abruptly reduces liquidity across the board, can produce harmful effects on capital-importing countries, and have a destabilising impact on the international economy and monetary system. In many cases, the process of restoring creditworthiness is unduly delayed as investors hold back and wait for the recovery, thus making it more protracted and uncertain. Being cautious, bank regulatory agencies and credit rating agencies may wait to see the compliance with the economic programme over a period of, say, a year before revising their appraisal.

2. Restoration of Confidence and the Costs of the Current Approach

Too often, the current approach seems to imply that the best way to deal with a financial crisis arising from a loss of confidence is to let the crisis erupt and then try to restore confidence with an economic programme and with large financial support.

Typically, a crisis of confidence in a country's capacity to make payments leads to a run on the currency, thus provoking a sharp devaluation (i.e. Mexico 115% in 1994-1995, Thailand 87%, Korea 96%, Indonesia 228%). Such devaluations go well beyond any that might conceivably have been postulated as necessary to restore a sustainable balance on the external accounts.

The sequel to such devaluations is well known – as domestic prices of tradables adjust to reflect their international price, inflation rises sharply and domestic interest rates follow. Wages typically lag behind, leading to a fall in consumer demand and because of uncertainty, falling demand and higher interest rates, a decrease in investment takes place. As these factors lead to a decline of GDP and rising unemployment, the country falls into a recession.

At a time of recession, all theories would advise an expansionary fiscal

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stance. However, the fiscal policy at the centre of the Fund-supported programme invariably requires fiscal retrenchment or equilibrium and is markedly pro-cyclical. By then, due to the lack of access to non-inflationary sources of finance, this has become the only response available to the authorities, since deciding to relax fiscal policy could lead to a collapse of confidence in the viability of public finances and deepen the crisis.

The conjunction of sharp currency depreciation, inflation, recession, falling real incomes, higher unemployment, rising interest rates and falling asset values, almost inevitably leads to a banking crisis. Mortgage holders, who typically account for 20-25% of banks portfolios, often find that they are unable to meet payments that have become a multiple of those originally envisaged. Moreover, the value of real estate given as collateral has fallen to well below the value of the loan it guarantees. Payment difficulties are also encountered by many firms as sales fall and debt service payments rise due to higher interest rates, or to the dramatic increase in the domestic value of their dollar denominated debt following the exchange rate depreciation. In turn, the banking crisis hinders economic recovery as credit becomes scarce and the need to support banks adds to the difficulties of public finances.

The heavy costs of a financial crisis triggered by a loss of market confidence may be illustrated by the Mexican experience. Asian countries that have recently suffered financial crises may be expected to face similar problems.

Following the sudden interruption of capital inflows in late 1994 and early 1995, economic activity in Mexico contracted by 6.9% in real terms in 1995. This was the sharpest decline in six decades, since the Great Depression, and was reflected by a marked rise in unemployment which, coupled with an upturn in inflation, cut the living standard of the population considerably.

Throughout 1995, GDP showed marked declines – compared with the respective quarters of the year before. The worst drop took place in the second quarter when GDP fell by 10.5%, with respect to the same quarter of 1994. Large decreases continued in the third and fourth quarters, even though with 9.6% and 6.6% they were not as large as that of the second quarter.

The diminished availability of foreign resources in 1995 brought about a marked decrease in aggregate demand that was passed on to production. The absorption of the economy – the sum of private and public consumption and investment – fell 15.9%. This contraction was only partially offset by larger exports of goods and services. Therefore, aggregate demand, at 1980 prices, declined by 10.2% in 1995.

Average industrial wages in 1995 fell by some 44% below their 1994 level and rose only modestly in real terms in 1996. Their decline and the

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rise in unemployment brought about the most severe fall in private consumption ever recorded in Mexico, i.e. 12.9%, with expenditure in durable goods falling 45.7%, whereas the decline in non-durable goods was 8.3%.

Gross fixed capital formation decreased 30.9% in 1995. Its two components reported declines of 33.9% in private investment and 18.9% in public investment. Spending on domestic capital goods fell sharply, 29.4%, particularly on purchases of transportation equipment, 93.5%. Expenditure on imported capital goods fell 35.3%. In order to attain the fiscal balance envisaged in the programme, public sector spending declined 8.4% in real terms, thus contributing to a further decline in activity.

The crisis gave rise to a sharp increase in banks' non-performing assets. The authorities have estimated the cost of the bank rescue programmes at $48 billion or about 13.5% of GDP, while private estimates run higher. Notwithstanding efforts at bank recapitalisation (because the level of non-performing loans has not declined as expected), the banking system remains fragile and fresh credit is scarce.

What started as a speculative attack against the currency, that might have been defeated, developed into a crisis of confidence, which gave way to an economic collapse with grave social, political and redistributional effects and to a major banking crisis, the costs of which will be paid for many years to come.

The Mexican recession was deep, but thanks to the structural reforms of the last decade and the government's determination in the pursuit of the economic programme, it was also short and the recovery strong, with GNP growing at 7% in 1997. Nevertheless, in reviewing what has been generally considered a successful adjustment, one cannot help asking: Was the high cost of this adjustment really inevitable? Could the country have been "provided with the opportunity to correct maladjustments in the balance of payments without resorting to measures destructive of national or international prosperity"?

Financial collapses make deflations and depressions possible because they destroy the confidence on which economic activity depends. The Fund's approach to financial crisis, which is based on austerity, i.e. tight credit, higher interest rates and fiscal retrenchment, does not help avoid recession and banking crises. Thus, it increases uncertainty and compounds the problem. Yet, as we shall see, the Fund could help avoid financial crises by helping sustain confidence in critical moments.

III The Need for a More Prudent Approach

A prudent approach would be for the country, possibly in consultation

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with the Fund, to determine the level of capital inflows that it is able to absorb without pressures on domestic prices or the balance on current account. Capital flows beyond that level could be discouraged, for instance, through the requirement of non-interest bearing deposits of a given proportion of the amount to be invested, so as to reduce the return on such flows. Over a number of years countries like Chile and Colombia have successfully applied a non-interest bearing deposit requirement to limit portfolio capital inflows.

The liberalisation of capital flows is generally positive for the world economy as it provides greater opportunities to both borrowers and lenders. However, financial markets have shown a tendency towards great swings. Divergent macroeconomic conditions in capital-importing and capital-exporting countries give a cyclical character to private capital flows. Thus, there are periods of overshooting and of inadequate expansion or even contraction of liquidity for a country or a group of countries. To deal with this phenomenon, it has been suggested that countries receiving substantial capital flows should, as a precaution, sterilise a significant proportion of these by holding them in their international reserves. While this policy has been followed by many of the countries concerned, it is a very costly form of self- insurance that may give rise to heavy losses in the central bank – a quasi fiscal deficit – due to the interest rate differentials existing between domestic and reserve currency denominated paper. Like other forms of self-insurance, this one could be replaced by a less costly group insurance, if the Fund or some other organisation were to make it available to countries.

Financial market volatility and overreactions pose new and difficult challenges for which, in many cases, both national financial authorities and the international community are unprepared. Indeed, these problems are often difficult to resolve if not to comprehend fully. Thus, one may well ask whether in present conditions, the full liberalisation of capital movements now propounded by many, is appropriate in all cases. Will countries awash in domestic savings, such as some Asian countries, benefit? Would countries with a weak financial system benefit from full liberalisation? Can a distinction also be made between long-term and short-term capital flows? Should a distinction be made between opening of financial services to competition and full freedom of portfolio flows?

Jagdish Bhagwati of Columbia University, argues, "(Capital markets) are very volatile. Suddenly expectations can turn around. You may be very healthy but suddenly you catch pneumonia. And then you may have to do unspeakable things to your economy just to regain that confidence because you are now hooked to the system ... Markets may do something when you have done nothing wrong and you may have to do something wrong in

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order to convince the markets that you are doing something right! I would put off (capital account) convertibility for quite a while." Bhagwati observes that many countries have grown well without capital account convertibility, including Western Europe and Japan earlier and China today. "In my judgement it is a lot of ideological humbug to say that without free portfolio capital mobility, somehow the world cannot function and growth rates will collapse" (Interview in The Times of India, 31 December 1997).

The new challenges posed by the growth and integration of financial markets call for a parallel development of international financial institutions to allow them to provide sufficient financial support to member countries and to act as overseers, and when appropriate, as regulators of international capital flows.

IV Toward An Alternative Approach to Confidence Crises

In order to deal with the major issues raised above, an alternative approach to confidence crises could be developed with the following two components: (i) elimination of foreign investors' protection from market risks; (ii) changing the IMF approach.

1. Eliminate the Protection of Foreign Investors

An issue that is implicit in the approach taken in recent Fund supported programmes is the notion that foreign investors should be protected from market risks. The rescue packages provided to Mexico, Korea, Thailand and Indonesia by the Fund and the authorities of certain industrial countries have been tailored to meet all payments to foreign creditors falling due in the short term, thus keeping them from suffering any losses. This raises the issue of moral hazard.

Investors must share the risks arising from the volatility of capital – which currently fall largely on the recipient country. The moral hazard arises from the rescue of investors by financial support packages. Under the current arrangements, they are protected from market forces by the IMF and certain industrial countries, thus allowing them to undertake operations without any risk.

Under market rules, investors take risks and may gain high returns, or suffer heavy losses. However, when foreign risks have materialised they have been saved from their mistakes by international rescue operations organised by the champions of the market. Thus, gains are private but losses are socialised and absorbed by the capital-importing country whose development may be set back several years as result of a crisis of confidence.

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Investors must be made aware of the impact of their actions on the economy of the country and provided with incentives to act responsibly from a social point of view. This could mean that if a sudden massive reversal of capital flows, a run on the country, were to cause a financial crisis, the authorities of the country in consultation and under the supervision of the Fund, could force creditors to take certain losses through a bankruptcy type procedure or, impose certain limitations on transfers, i.e. reschedule capital withdrawals in a manner consistent with the country's ability to pay without disruption of its economic activity.

2. The Policy on the Use of Fund Resources

The current Fund approach was designed to deal with balance of payments crises that resulted largely from significant imbalances in the fiscal or monetary accounts, but is not well suited to deal with confidence crises in today's financial markets, that often are not the result of such imbalances. By placing emphasis on the contraction of demand and the rise in interest rates to strengthen the balance of payments, this approach discourages investment, compounds the difficulties faced by banks and public finances and, generally, adds to the recessionary impact of the reversal in capital flows on domestic economic activity. Typically, this policy stance deepens the domestic crisis as the problem is allowed to become much greater and more costly before it is resolved.

The essence of the problem is that financial markets may overreact to any ambiguous signal and aggravate the "bad" news. Given the volatility of capital flows, countries often face a confidence crisis in their currency that may bear little relation to their economic fundamentals. Indeed, when markets are nervous, the authorities may freeze their policy stance for fear that a policy shift might be interpreted as an admission of weakness and unleash or intensify a speculative attack that might snowball and get out of hand. However, if the authorities were seen to be in a position of strength, as could be the case if they are known to have ample support from the Fund or other sources, they would be able to show greater policy flexibility in response to changing circumstances.

Essentially, an alternative approach to dealing with financial crises would aim at preventing a speculative attack from developing into a full-fledged crisis by the timely provision of sufficient financial support to sustain confidence coupled, if appropriate, with a policy reform package.

The Fund could provide member countries with good economic fundamentals with a readily available stand-by credit to be drawn in the event of a significant speculative attack on the currency. The amount of such a credit should be sufficiently large to discourage speculators, say the equiva-

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lent of no less than six months of imports and interest payments. The money would be available "in toto" at very short notice and drawings should not be subject to tranches or prior performance conditions.

In exchange for the support received, the country would commit to undertake any policy adjustments that might be appropriate over a predetermined period, starting shortly after the resources are made available and normally not exceeding six months after the drawing.

The order of magnitude of the financial support to be provided by the Fund under this scheme may be illustrated with reference to Mexico. Recall that Mexico's quota in the Fund is SDR1.7 billion or about $2.5 billion. Mexican imports of goods in 1994 were some $79 billion and external interest payments amounted to $15 billion. Thus, the provision of the equivalent of six months of imports and debt service payments would have amounted to some $47 billion, a sum somewhat larger than the financial package put together by the US, the Fund and Canada.

Obviously, for the Fund to be able to sustain a much increased level of financial support to its members and remain credible, the size of the Fund or its borrowing capacity would have to be increased substantially. However, in practice, most of the Fund's support would – like the nuclear deterrent – remain unutilised. Indeed, if Fund support is timely, sufficient and fully credible, the resources provided are unlikely to be drawn – or if drawn, unlikely to be used since speculators would know they cannot win.

In fact, the Fund would play a role similar to that played by central banks in the national context when they act as lenders of last resort. Experience shows that when the central bank is openly prepared to support a bank facing a liquidity problem, a run on the bank is preempted and the amount of support required from the central bank, if any, is much smaller than would otherwise have been the case.

Would a policy of readily available credit or "payment in advance" give rise to a problem of moral hazard? This seems very unlikely. Recall that major recipients of capital from the markets are successful countries that generally follow sound policies and that this support would be limited to countries that, in the view of the Fund, pursued generally good policies.

Moreover, consider that a country that did not comply with its policy commitments to the Fund would, in all likelihood, become prey to a costly financial crisis as it would probably suffer an outflow of capital and forfeit access to all forms of external credit. Thus, the political and economic costs of non-compliance are likely to be considerably greater than those of adopting any additional policy measures the Fund might recommend.

In fact, the opposite case is more likely. As the Fund, in the normal course of surveillance or in Article IV Consultations suggests policy adjustments, a country desiring unchallenged and immediate access to Fund

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resources in the event of a speculative attack would be likely to adopt the policy measures suggested promptly, for this would be a small price to pay in order to ensure that it not fall prey to a crisis of confidence. Thus, the scheme proposed could lead to an improvement in the quality of policies pursued by an important and growing group of countries.

Since 1952 the Fund has maintained that it cannot insure that it is "making its resources temporarily available to members" unless it makes its lending conditional on the adoption of adequate macroeconomic policies. Implicit in this approach is the belief that a financial crisis is always and everywhere the result of poor economic policies. Therefore, unless those policies are corrected, the country will not be in a position to repay the Fund. In this approach, the Fund would appear not to have sufficiently adapted its policies in response to the new nature of the financial risks faced by many emerging market economies in a world of volatile capital.

Is conditionality required to ensure repayment to the Fund and thus to preserve the revolving character of Fund resources? Note that neither the World Bank nor the regional development banks have made demands on borrowing countries of the type characteristic of the IMF programmes. Yet no one imagines that repayment of their loans is less assured than that of loans made by the Fund. In practice, repayment is insured not by project appraisal, but by the fact that no country would willingly risk the drastic consequences for its access to all forms of credit that would result from a default to any one of these banks. The same consideration applies to repayments to the Fund whether or not the loans involved carry upper credit tranche conditionality.

As shown by the experience of France in 1992, international support can fend off a speculative attack and prevent a crisis in a country with sound fundamentals. Thus, the liberalisation of capital markets and the increased scale of international capital flows are recent phenomena that should be matched by an increase in the financial support available to countries. Since the flow of capital is crucially dependent upon the confidence of international investors, ample and timely financial support may prevent a crisis. Thus the Fund should be ready to act quickly before countries fall prey a to a financial crisis, rather than coming in after the event to pick up the pieces.

As provided by Article I(v) of the Articles of Agreement, a purpose of the Fund is "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity". Surely, the avoidance of a financial and exchange market crisis is an objective covered by this provision.

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V Conclusion

Timely international support, which could prevent a crisis and save a country from its high costs in terms of output, inflation and employment, should be available to countries with good fundamentals and sound economic policies (thereby increasing the incentives for their adoption). In certain other cases, support could go hand in hand with the adoption of an economic programme designed to strengthen fundamentals.

If speculators become aware that a country has the full support of the international community and therefore that their chance of success is nil, they will not bother to mount an attack on a currency. This outcome would be in keeping with the purposes of the Fund and the interests of the international community, which inevitably shares the costs and risks of a deep crisis in one or several of the emerging market economies.

As Keynes once said "this is not a Red Cross philanthropic relief scheme, by which rich countries come to the rescue of the poor, it is a piece of highly necessary business mechanism which is at least as useful to the creditor as to the debtor". A development along the lines suggested would permit the world to benefit from the considerable contributions that the liberalisation of international capital flows may make to world economic development, while reducing the risks posed by unbridled speculative capital movements.

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