How Can Future Currency Crises Be Prevented or Better Managed?

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I Introduction

The speed and the severity of the Mexican peso crisis, which the IMF Managing Director[1] characterised as "the first major crisis of the 21st Century", have started an important debate at all levels (including the BIS and IMF) on how to avoid crises like the Mexican one occurring again and to improve their management. It is noteworthy in this context that the G-7 Halifax Summit in July 1995 devoted much time and attention to the prevention and management of 'Mexican-style crises'; the high priority attached to this issue was clearly reflected in the Communiqué.[2] It is important also to stress that several valuable policy proposals were made.

This position paper will have two aims. Firstly, it will try to contribute to the discussion of proposals already made, particularly in aspects of crisis management. This is important, both because these proposals are still at a general level and - particularly - because the Mexican crisis (and possible future ones) have some new and relatively unknown features, linked to the modality, scale and speed through which capital flows to (and can flow out of) the emerging markets. The modality of these flows relates mainly to the securitisation of capital flows, globally and to developing countries.[3] Securitised flows seem to be far more volatile than bank loans, as in many cases the *stock* of the securitised flow can leave a country in a few hours, whereas in the case of medium-term bank loans, even in a very serious crisis like the 1982 debt crisis, the stock of the debt cannot leave the country. Furthermore, securitisation has made investors faceless and more diversified, thus making negotiations with them far more difficult, if not impossible. The speed with which capital flows in (and out) of countries also seems to relate to the growing importance of global institutional investors, which implies that flows to emerging markets are now predominantly driven by liquidity and short-term

1. Camdessus, M., "Press Conference of Managing Director", 2 February 1995, IMF, mimeo, 1995.
2. Halifax Summit, "G-7 Communiqué", 15-17 June 1995.
3. Griffith-Jones (1993).

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performance considerations, rather than by longer-term banking relationships.[4] The rapid and recent growth of these global institutional investors, which has coincided with a period of liberalisation of financial markets, has also implied that flows originating from those global institutional investors are almost completely unregulated in their source country, and even more internationally.

This leads us to the second, and perhaps more important, aim of this paper: to add some new proposals for policy action to the package already being discussed internationally. These relate to apparent gaps in the policy package connected with the lack of regulation and/or even lack of sufficient disclosure of many of the flows going to emerging markets, particularly those originating from global institutional investors. Such additional measures would perform two crucial roles. Firstly, if appropriately implemented, they would significantly reduce the likelihood of Mexico-style crises occurring by softening the 'herd behaviour' typical in general of financial markets, but apparently particularly characteristic of largely unregulated securities flows originating from global institutional investors, which characterise the 1990s. As the Halifax Summit declaration wisely says, 'the prevention of crisis is the preferred course of action'; perhaps one should add explicitly that prevention of crisis implies avoiding the massive costs for the countries involved, for investors and for the international community, which Mexico-style financial crises imply. Secondly, if regrettably a crises of this type does occur, a very likely component of the policy package will be large and speedy official lending (see more detailed discussion below). To facilitate this, the Halifax Communiqué has proposed the establishment of an Emergency Financing Mechanism to provide faster access to Fund arrangements with strong conditionality and larger up-front disbursements in crisis situations, and suggested that the G-10 and other countries develop financing arrangements to double the amount currently available under the GAB. This basically implies setting up a type of international lender of last resort which would perform the valuable function of contributing to the public good of stability internationally, in ways parallel to the way in which national central banks, by acting as domestic lenders of last resort, seem to have diminished the frequency of national financial crisis.[5] However, the serious problem with any explicit - or even implicit - international lender of last resort is that it encourages 'moral hazard', that is that both investors and recipients take additional risks, because they are confident of being bailed out if things go wrong. To contain - or ideally eliminate - such 'moral hazard', mechanisms need to be found to constrain cross-border flows to emerging markets. The IMF has rightly suggested that one such way will be for it to enhance and formalise its surveillance of recipient countries. Though this is a very valuable step, it may not be sufficient, particularly as countries with large access to capital markets do not

4. IMF (1995).
5. Griffith-Jones and Lipton (1987).

require IMF funding at the time and are therefore less willing to accept policy advice from the Fund at that stage. It therefore would seem valuable as an additional measure to reduce 'moral hazard' to impose some additional regulatory and/or disclosure restrictions on investors, so as to contribute to avoiding excessive surges of easily reversible capital inflows to emerging markets. It would also seem appropriate to exercise some regulation and/or improved disclosure of flows by source countries affecting investors as a counterpart to an explicit lender of last resort, given that this latter facility - though made available to an emerging market country - would also benefit (or may particularly benefit) the investors. Thus, if the new package of policy measures does not include additional regulation, but does include increased or more explicit international lender of last resort facilities, the 'moral hazard' aspect - as it affects investors - will be significantly enhanced, which could make the flows more destabilising and an eventual future crisis more likely and more costly.

In what follows, we will first (Section II) examine those crisis prevention measures that have not yet been included in the policy package being discussed internationally. Then we will examine (Section III) proposals for currency crisis management.

II The Gaps in the Policy Package for Crisis Prevention

As pointed out above, the Mexican peso crisis has led to a number of valuable suggestions for crisis prevention. These include more emphasis on each country pursuing sound fiscal and monetary policies and an 'improved early warning system' internationally, with improved surveillance of national economic policies and fuller disclosure of information to market participants.[6]

An aspect that has been rather neglected in the discussion so far is the need for better disclosure of exposure of investors in different emerging markets, as well as the possibility of warnings or even some regulatory restrictions on investors by home country regulators, to avoid excessive surges of easily reversible capital inflows to emerging economies. Such regulations could - in the first place - be applied by home countries, but could at a later stage be coordinated by international forums such as IOSCO and the Basle Committee.

The justification for such measures is based on both historical and particularly recent experience of financial markets, as well as on economic theory. Though generally efficient, financial markets do have important imperfections.[7] Factors such as asymmetric information and disaster myopia may lead financial markets to over-invest or over-lend in certain markets; however, once the excessive nature of the over-investment is perceived (and this may be due to a fairly small change

6. See IMF Survey (1995), several issues; Halifax Communiqué, 1995.
7. For a very useful review, see Davies (1992); also, for some of the seminal works, see Stiglitz and Weiss (1981); Kindleberger (1978); Guttentag and Herring (1984) and Mishkin (1991).

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in the particular market), there can be a huge over-reaction, with flows not only declining sharply but even becoming negative.

Thus, the Mexican peso crisis not only shows the importance of pursuing appropriate monetary, fiscal and exchange rate policies at a national level. It also shows how rapidly perceptions in financial markets can change (e.g. on 20 December 1994), when there has in fact been relatively little change in the economic fundamentals. (However, throughout 1994, there had been two major changes relating to Mexico, one relating to increased real and perceived political instability and the other relating to increased US interest rates.) As a consequence, to avoid Mexico-style crises it is not only necessary to ensure that countries pursue appropriate macroeconomic policies, a task which is made more difficult by large surges in capital flows.[8] It is also necessary to help financial markets to work in a more efficient way by helping them to overcome certain imperfections to which they are prone.

The proposed provision of more accurate information on emerging markets will help overcome problems of asymmetric information. However, the key problem relating to over-optimism in Mexico, and other emerging markets, followed by over-pessimism was not lack of information, but the behaviour of fund managers, related to their incentive structure.[9] If a fund manager is wrong when everybody else is right (i.e. he/she does not take a very profitable opportunity that everybody else is taking), his/her institution will be punished by the market. However, if a fund manager is wrong when everybody else is wrong, this is not so serious, the market is less likely to punish his/her institution, and it may be backed by a bail-out. As a consequence, 'band-wagon effects' or 'herd behaviour' is common, as financial actors seek safety in numbers. This is illustrated by the fact that several fund managers interviewed in late 1993 said that their investment policy in Latin American emerging markets was 'safe', because they concentrated a very high proportion of this investment in Mexico! This 'safety' was not due to economic fundamentals, (as Mexico at the time already had a current account deficit of almost 8% of GDP), but was more related to the fact that the majority in the international financial community had decided that Mexico was safe.

Improved disclosure and some regulation of capital flows would need to be done in ways that discourage destabilising flows but that maintain incentives for the valuable increase in international capital mobility that has occurred in recent years, as both investors and emerging markets benefit from it.

Any additional disclosure or regulations need to focus on securities' flows, which are now such a dominant part of flows to emerging markets and which are far less regulated than banking flows. An appropriate initial point for improved disclosure requirements and some additional regulation would seem to be at the

8. Ffrench-Davis and Griffith-Jones (1995).

9. This is illustrated by the fact that one large merchant bank pulled out of investment in Mexico on its own account well before it told its clients that a problems was likely.

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level of existing regulation of collective investment schemes carried out by the securities' regulator in the major source countries. A second level for regulation could be carried out by the international forums that coordinate regulations, such as IOSCO and/or the Basle Committee.

A problem is that these regulators (and especially national securities' regulators and IOSCO) focus to an important extent on regulation geared to avoiding criminal or incorrect behaviour relating for example to avoiding conflict of interest,[10] and deal far less or not at all with instances when many investors are wrong at the same time. Furthermore, in assessing emerging markets, their concern seems to focus on the quality of regulation of stock exchanges, etc. without practically any analysis of the macroeconomic situation, potential imbalances, etc. of that country. On the other hand, institutions like the IMF which have in-depth knowledge of, and focus their analysis on, macroeconomic trends and policies in all countries have no regulatory powers over investors or financial institutions. The BIS is in an intermediate position, in that it has strong links with regulators, though relating particularly to banks (via the Basle Committee), and also has a fairly strong in-house capacity for macroeconomic analysis, though with far fewer staff than the IMF allocated for this purpose.

Given these institutional realities, it would seem most appropriate that the lead initially be taken by the national securities' regulators, especially of the major source countries, but that they coordinate with the IMF and the BIS. Also, because of the relative lack of experience of securities' regulators in macroeconomic trends, the suggestions and rules initially designed for this purpose should be simple, whilst trying to avoid being simplistic.

Such rules could for example discourage or forbid investment by collective investment schemes in emerging markets whose current account deficit as a proportion of GDP was for the second year higher than 3%; exceptions could be made for those countries whose exports grow at a very rapid rate and/or for countries where a somewhat higher current account deficit was funded mainly by direct investment flows and in other special circumstances. Such exceptions could be defined in consultation with the IMF and/or the BIS, though IOSCO as the international coordinator of securities' regulators could also play a role. Another rule could limit the proportion of short-term Treasury Bills of a particular emerging market country that can be held by persons or institutions domiciled abroad; for example, regulators in source countries could discourage or forbid investment in a particular emerging market country to finance their short-term Treasury Bills if for example foreigners already hold more than 20% of those short-term Treasury Bills. Also a maximum ratio could be fixed for the proportion of short-term Treasury Bills in total Treasury Bills that the recipient country should have for it to be eligible for funding them externally.

10. IOSCO (1995).

These rules are proposed tentatively and partly for illustrative purposes. More definite rules could be elaborated and reviewed by the IMF and/or the BIS, institutions where some work is reportedly already being carried out for defining 'red light' warnings. Close coordination would be required with the major securities' regulators, to verify that the necessary information would be available to them in a timely fashion and that they could implement such rules with relative ease.

Such rules need to be complemented by better disclosure requirements and by more precise information, issued by collective investment schemes to their investors, for example in their prospectuses and publicity material. In the case of funds with large investments in emerging markets, this should provide information about the country - and other - distribution of such investments, some basic macroeconomic information on the countries where most of the investment is concentrated and some analysis of risks involved (as well as the traditional emphasis on likely high yields). The major securities' regulators (such as the US Securities' Exchange Commission) already tend to review prospectuses and publicity material of collective investment schemes,[11] so their task would just be broadened to review these new dimensions. This, as well as the design and verification of rules described above, may possibly require some additional staff in securities' regulators, to carry out this additional work. However, any additional costs would be easily compensated by savings on far larger costs that would be incurred if large crises occurred.

It should be emphasised that regulations from source countries would clearly be complementary with regulations or other measures for discouragement of short-term capital inflows existing in recipient countries. Several studies[12] have shown how regulations of short-term capital inflows in some countries - like Chile, Colombia and Malaysia - have been a contributory factor to a relatively more successful management of capital inflows; furthermore, these countries have continued to attract high levels of long-term flows, such as FDI. It is interesting that both the IMF and the BIS[13] have recently very explicitly recognised that - though having some limitations - measures taken by recipient governments to discourage short-term capital flows may, when combined with other policies leading to sound macro- economic fundamentals, play a positive role in managing effectively capital flows and thus reducing the likelihood of a costly financial crisis or of severe macroeconomic distortions.

The question could be asked whether measures to discourage short-term capital inflows by recipient countries would not be enough. There are two reasons, though, why some complementary action by source countries is necessary. Firstly, several major recipient countries do not discourage short-term capital inflows; others, like Mexico, took some measures to discourage those inflows, but made

11. See IOSCO (1995).
12. See, for example, Ffrench-Davis and Griffith-Jones (1995) and Khan and Reinhart (1995).
13. IMF (1995) and BIS (1995).

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themselves more vulnerable to financial crisis by, for example, a very short maturity structure of Treasury Bills, a high proportion of which were denominated in dollars and owned by foreigners. Second, even those recipient countries - like Chile, Colombia and Malaysia - which have deployed a battery of measures to discourage or limit short-term capital inflows have on occasions found these measures insufficient to stem very massive inflows, with problematic effects on variables such as the exchange rate. It therefore seems advisable for source countries to take some measures (as outlined above) to discourage excessive and potentially unsustainable short-term capital inflows into emerging markets, so as to avoid possible future costly financial crises. This is particularly justified because, as a recent IMF study[14] points out, due to the difficulty of restructuring securitised exposures owned by a diversity of investors, if a major emerging market country is experiencing debt-servicing difficulties, it will far more probably than in the past be forced to seek official funding to allow it to continue servicing its external debt in full, rather than being able - as in the past - to renegotiate such debt. Indeed, one could argue that as the IMF will play such a large role in providing funding during any such crisis, it should also influence both source and particularly recipient countries to discourage excessive short-term capital inflows that may become unsustainable, and which pose a risk that a rapid outflow could lead to a costly financial crisis. A similar argument could be made for the BIS, to the extent that it too is likely to play some (probably smaller) role in providing emergency short-term finance in case of a future Mexico-style financial crisis, and therefore has both an institutional and a systemic strong interest in crisis avoidance.

Finally, it should be emphasised that restrictions or discouragement of excessive short-term capital flows to emerging markets may seem 'second best' if compared to an ideal neo-classical utopia of perfectly efficient financial markets and sound macroeconomic policies. As very unfortunately such a utopia does not exist, a 'second best' world of some discouragement of excessive flows which may prove unsustainable is *far superior* to either a world of more frequent and very costly, as well as disruptive, financial crises and/or a world where countries unilaterally (or with support of the international community, through some internationally agreed bankruptcy procedures as discussed in Section III below) restructure their debt or other liabilities. As regards the latter option, the IMF[15] is completely correct in arguing that capital controls on inflows by emerging market countries are far superior to highly undesirable capital controls on outflows in times of crisis. It should be added that ex-post capital controls on outflows in times of crisis imply a far greater and more fundamental violation of free-market principles than do ex-ante measures to discourage some capital inflows. Similarly, large and costly foreign

14. IMF (1995).
15. IMF (1995).

exchange crises also are very disruptive for market economies and may lead to unjustified criticisms of the overall market model and of market reforms.

Therefore it can be concluded that a smoother and more efficient functioning of the market economy in emerging markets can best be achieved with some discouragement and/or regulation of excessive and potentially unsustainable short-term capital inflows. Such measures will be most effective if they are applied both by source and recipient countries, if they are designed in ways that avoid any discouragement of more long-term flows, and if the rules designed are simple and clearly targeted at unsustainable flows and can be justified on prudential grounds.

III How Can Future Currency Crises Be Better Managed?

We now enter the undesirable world of 'third' and even 'fourth' best, which arises when crisis prevention has failed and a major currency crisis is starting.

The first -and main response -in such a situation is to activate quickly a sufficiently large 'international lender of last resort' to provide the important public good of stability; such an action is justified because private flows have become globalised and financial markets are prone to speculative changes of mood.

It therefore seems appropriate that in their Halifax Meeting,[16] the G-7 approved in principle that, 'the IMF establish an "Emergency Financing Mechanism", with strong conditionality and larger up-front disbursements in crisis situations'. (This "Mechanism" has also been approved in broad terms by the IMF Executive Board.) They also asked G-10 and other countries to develop financial arrangements to double as soon as possible the amount available under the GAB to 'respond to financial emergencies', and support 'continued discussions on a new IMF quota review'.

Bagehot's[17] classic advice on a national lender of last resort may throw some light on the complex issues raised by establishing and operating an International Lender of Last Resort (ILOLR). Bagehot argued for a lender of last resort that would lend freely (that is, without limits), but at a penalty rate to an illiquid yet solvent debtor facing a creditor panic. Bagehot's conditions need to be adapted to the fact that the problem is international and that the ILOLR would support a country, instead of a creditor financial institution (even though indirectly investors and financial institutions may be the main beneficiaries).

A first issue to resolve is which countries would have access to the facility, and under what conditions. A recent paper by Williamson[18] suggests that such an ILOLR facility should be addressed to all IMF member countries that have a high level of involvement in the international capital markets. Such a broad definition,

16. Halifax Summit, "G-7 Communiqué", 15-17 June 1995.
17. Bagehot (1873).
18. Williamson (1995).

though valuable in the sense of protecting more countries from destabilising flows, could further increase the potentially massive scale of such an ILOLR (see below); a more limited facility, designed for the less stable but smaller emerging markets, would initially seem to be a better option.

As Bagehot[19] stressed, the terms of access are crucial, and should imply 'penalty rates' or 'onerous terms' to help avoid moral hazard; in this case, this refers in the first instance to countries mismanaging their economy in the knowledge that they will be bailed out if markets panic. The 'onerous terms' refer not so much to the level of interest rates (though these should be above market rates) but to 'the policy conditionality' attached to the ILOLR. It is, however, crucial that policy conditionality be attached particularly *before* the crisis breaks out, to try to avoid it, though naturally continued conditionality would be important once the ILOLR operates. The former is not so easy to implement, as normally when countries have abundant access to international private markets they do not have recourse to IMF facilities. As a consequence, a proposal made in an IMF[20] paper seems very useful; it suggests that a request for the right to borrow under an ILOLR type of facility would be made before a crisis happens, and during the time of an Article IV consultation. The IMF paper suggests that its Board could approve the availability of a credit line for a specified period (which could be a year), if 'the country had a good record of economic policies and there was no fundamental balance of payments problem'. However, if these conditions had been implemented rigorously, Mexico would *not* have been eligible for such a facility in early 1994, when its last Article IV consultation with the Fund before the peso crisis occurred. Therefore it would seem essential that for such a facility to be approved for a particular country, the Fund should also be entitled (even though this was merely a 'shadow programme' and would not imply immediate but potential disbursements) to request policy changes as a precondition for approval. It should be noted that the IMF has positive experience with shadow programmes in somewhat different contexts. This somewhat onerous imposition for the recipient country would be compensated by the fact that, in the event of a major crisis, the country would have an automatic right to draw off a large credit (or at least a first tranche), with an immediate report to the Fund's Board, but with *no* need for Board approval of the drawing. This procedure would have the *great advantage* for the country (and for the international community) that the facility could be immediately activated and used if the need arises, and could therefore have far more potential to reassure the markets. This quicker reassurance of the markets would hopefully reduce the scale of any potential crisis, and thus its cost both to the country and to the international community. For the Fund to make such an open-ended commitment, it would seem essential that previously the country would have made any necessary

19. Bagehot (1873).
20. IMF (1994).

policy changes that the Fund requests to try to avoid the crisis, in exchange for the potential, but crucial, automatic availability of Fund credit should a crisis break out. This may require some extension and improvement of the Fund's analytical capacity to judge whether or not a country's policies are sustainable. Indeed, it can be argued[21] that the Fund's warnings to Mexico in its 1994 Article IV consultations on the dangers of its large current account deficit were far too weak. However, there is no reason why, given its expertise, the Fund's analytical capabilities could not be improved and adapted, particularly as it could also liaise with expertise from other institutions like the BIS or even draw on academic economists.

A second crucial issue relates to the scale of such a facility. Since Bagehot, analysts of lenders of last resort have argued that - to be effective in convincing the markets - such a facility must be able to 'lend freely', that is be virtually open-ended, or at least extremely large. The scale of the package for Mexico is illustrative. The IMF lending of $17.8 billion was equal to around seven times the Mexican quota at the Fund; this was only a bit over a third of the total package that Mexico needed, which reached around $50 billion. Similarly, during the 1992 crisis of the ERM, the Bundesbank and other institutions used massive amounts of funds (reportedly over $120 billion) to defend the parities of several European countries.

This massive scale for an international lender of last resort poses a very serious problem for the governments and central banks of the major countries, not so much for assembling a funding package (via, for example, the GAB, the expansion of IMF quotas and other mechanisms) but more in case such a facility is to be used several times.

As a consequence, an ILOLR must be established very carefully, with very precise and stringent conditions for its use and with very strong emphasis on crisis prevention measures, such as discussed in Section II above. Such prevention measures also will help limit 'moral hazard'. Moral hazard for countries would be reduced both by the dramatic economic, social and political costs which a nation like Mexico has to bear in the aftermath of a currency crisis and by the pre-crisis and past-crisis IMF conditionality suggested above. More problematic could be the moral hazard for investors and fund managers. Indeed it should be noted that in particular holders of Tesobonos (which represent assets of almost $30 billion) have *not* had any losses as a result of the massive Mexican crisis, precisely due to the scale of the IMF-US Treasury package. (However, foreign investors in Mexican ADRs - if they sold during the crisis - have suffered some losses.) For this reason, it is essential that moral hazard for investors, fund managers and other financial institutions is curbed by preventive measures by source countries to regulate and/or discourage short-term and apparently unsustainable flows. Indeed, to

21. Williamson (1995).

establish an explicit and large international lender of last resort *without* accompanying measures to curb moral hazard, both on the country and the investor side, would seem unacceptable for the taxpayers of the industrial countries who would fund it. It would also seem morally incorrect to establish such a large and even open-ended facility without sufficient *quid pro quo* at a time when many developed countries' governments are cutting back on aid flows to the poorest countries and people in the world. These arguments are not against the establishment of an explicit international lender of last resort per se, as such a facility seems essential in a time of large, globalised speculative capital flows. They just stress the need for rigorous ex-ante conditions, both on recipient countries and on investors, for access to such a facility to be made available. To further reduce the risk of moral hazard as it relates to investors and investing institutions, and to help reduce the scale of ILOLR operations, it may also be necessary to prepare in advance some measures that would, however, be implemented after a crisis begins to happen. The G-7[22] have hinted at such measures, somewhat cryptically, by encouraging 'further review of other procedures that might also usefully be considered for their orderly resolution'. Senior figures in the United States, like Congressman James Leach, Chairman of the US House of Representatives Banking and Finance Committee, have called for the IMF to create some international equivalent of US bankruptcy arrangements.[23] Robert Rubin, the US Treasury Secretary, is reported to have requested a 'cautious exploration' of a special facility to work out international debt crises in an orderly way.[24]

Academics[25] have gone further in explicitly arguing for the IMF or others to play a role like an international bankruptcy court.

These proposals draw close parallels with Chapter 11 and Chapter 9 of the US Bankruptcy Code. Chapter 11 recognises that there are three stages in a restructuring of an insolvent corporation, each of which is prone to deep collective action problems. The first stage occurs when bills cannot be paid. This stage is prone to 'a creditor grab race', as liquidation is accelerated - or even partly caused - by creditors trying to get their money before others do, provoking collective inefficiency. Assuming there is no liquidation, there is a restructuring phase. During this phase, the enterprise needs credit; however, no lender or investor has an incentive to provide new money unless it has preferential status. The third stage implies adjusting the balance sheet by debt reduction or debt equity. The collective action problem is that each creditor is happy if other creditors make concessions, while individually holding out for full repayment. To deal with these problems, American bankruptcy laws provide an appropriate framework for a corporation or even a municipality in financial difficulties. This includes

22. Halifax, "G-7 Communiqué", 15-17 June 1995.
23. Wall Street Journal, 11 April, 1995.
24. Financial Times, 25 April, 1995.
25. In particular Sachs (1995), but also, Raffer (1990)

a debt freeze to prevent 'the creditor grab race', a legal provision to allow for borrowing new money that is senior to the old and, if necessary, a mechanism to write down existing obligations. In the view of Sachs and Raffer, such a framework can also be applied to a sovereign borrower in financial distress to overcome similar collective action problems to those that affect corporations. It is proposed that such a framework would involve a debt service standstill, fresh loans, and possibly some reduction. It has further been argued that the IMF could possibly authorise such procedures in the framework of its Articles of Agreement. Suggestions for using Article VIII, Section 2b, which relates to exchange restrictions that would not be subject to challenge in the courts of member countries, have been made, though current analysis seems to show that it would not be appropriate.

This proposal has some important advantages. The main one is that it could completely eliminate or significantly reduce the cost to rich countries' central banks and/or governments of massive bail-outs. A secondary advantage could be that, if explicitly announced ex-ante, it could curb excessive short-term capital flows and reduce moral hazard of investors for an ILOLR. However, the danger is that it could throw out the baby of capital flows to emerging markets in general with the bath water of more speculative or less sustainable flows.

More broadly, we agree with the IMF[26] that ex-post restrictions on capital outflows are the least desirable option because they will be viewed by market participants as some type of confiscatory measure. In this context a bankruptcy type of procedure seems too 'market unfriendly' and too radical, and therefore should be used, if at all, only as an *absolutely last resort.* It would also seem more appropriate if an 'orderly work-out approach' was to be used only in very extreme circumstances, if it was used more for extending maturities than debt reduction, and if it was used in combination with (and not as a substitute for) an international lender of last resort. The advantage of the latter combination would be that the costs of a financial crisis would be shared by the country affected, by international official support and by the investors. This would be in contrast with how the 1994 Mexico crisis was handled, where practically all the costs and strains were taken by the official international support and the Mexican economy. In spite of all the above reservations about using 'international bankruptcy procedures', it may be desirable to prepare the framework for such a mechanism in any case, so as to enlarge the availability of options, but to do so without giving much publicity to it, particularly in this current phase when capital flows to many emerging markets are just beginning to recover from the crisis of early 1995, and where market confidence needs to be bolstered. Finally, it is crucial to stress again that in international private capital flows - as in medicine - prevention is far more desirable, effective and cheaper than curing avoidable illnesses. Therefore emphasis must be placed on the relatively less radical, less costly and less disruptive measures outlined

26. IMF (1995)

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above in Section II (as well as those discussed internationally) for crisis avoidance. It would seem essential to include amongst them not just improved surveillance of countries, but also some regulation and/or discouragement of unsustainable short-term capital flows. These measures will also act to reduce significantly the 'moral hazard' which the existence of an explicit (or even of an implicit) international lender of last resort generates, as well as to diminish greatly the likelihood of the very radical 'international bankruptcy procedures' having to be implemented.

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