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Report to the Chairman, Committee on Banking and Financial Services, House of Representatives

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INTERNATIONAL FINANCIAL CRISES

Efforts to Anticipate, Avoid, and Resolve Sovereign Crises

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The Honorable James A. Leach
Chairman, Committee on Banking
and Financial Services
House of Representatives

Dear Mr. Chairman:

This report responds to your request concerning the advantages and disadvantages of initiatives and proposals to anticipate, avoid, and resolve future sovereign financial crises that might pose a threat to the international financial system. The report (1) identifies capital market and other mechanisms that are used to anticipate, avoid, and resolve sovereign financial crises as well as any limitations of these mechanisms; (2) assesses initiatives that international financial institutions and others are developing to improve anticipation and avoidance mechanisms; and (3) evaluates initiatives and proposals to improve methods of resolving sovereign financial crises.

We are sending copies of this report to the Ranking Minority Member of your committee, the appropriate congressional committees, the executive branch agencies, the international financial institution officials, and other interested parties. We will also make copies available to others on request.

This report was prepared under the direction of Susan Westin, Assistant Director, Financial Institutions and Markets Issues. Major contributors to this report are listed in appendix V. If you have any questions, please call me at (202) 512-8678.

Sincerely yours,

Thomas J. McCool

Thomas J. McCool
Associate Director
Financial Institutions
and Markets Issues

Executive Summary

Purpose

Mexico's 1994-95 financial crisis has prompted efforts by the Group of Seven countries (G-7)[1] to seek ways to improve the capability of the International Monetary Fund (IMF),[2] other official sector organizations,[3] and capital market participants to prevent or respond to sovereign financial crises—situations where countries have been unable or unwilling to pay their debts and, as a result, have lost access to global capital markets. Because of concern about anticipating, avoiding, and resolving crises of comparable magnitude to Mexico's recent financial crisis, the Chairman of the House Committee on Banking and Financial Services asked GAO to review improvement efforts in these areas by international financial institutions and the industrialized democracies.[4]

In this report, GAO identified factors that may increase or decrease the probability that a future sovereign financial crisis will threaten the stability of the international financial system and identified limitations of current market and governmental mechanisms for preventing and resolving sovereign financial crises. GAO also evaluated initiatives and proposals of the G-7[5] and others to better (1) anticipate and avoid future sovereign financial crises and (2) resolve these crises when they threaten the international financial system. GAO focused primarily on those proposals that have been implemented or are in the process of being implemented. These proposals include the establishment by IMF of voluntary standards that countries may use when disclosing economic and financial data to the public; an expansion of the General Arrangements to Borrow, which are lines of credit that IMF maintains with the Group of Ten countries (G-10);[6]

[1]The G-7 consists of seven major industrialized countries that consult on general economic and financial matters. The seven countries are: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

[2]IMF is an organization of 181 member countries that was established to promote international monetary cooperation, promote exchange rate stability, and provide short-term lending to member countries that experience balance-of-payments difficulties. IMF is funded by its members who make contributions on the basis of the size of their economies. IMF's Executive Board is the primary decisionmaking body, which comprises 24 Executive Directors who represent IMF member countries.

[3]The official sector includes international financial organizations, such as IMF, the World Bank, and the Bank for International Settlements, and sovereign governments, such as the United States.

[4]In connection with the Chairman's request, GAO has already issued a report entitled Mexico's Financial Crisis: Origins, Awareness, Assistance, and Initial Efforts to Recover (GAO/GGD-96-56, Feb. 23, 1996).

[5]These proposals are the products of the 1995 Halifax, Nova Scotia, G-7 economic summit and are contained in the communique issued at the summit.

[6]The G-10 consists of 11 countries, which are the G-7 countries plus Belgium, the Netherlands, Sweden, and Switzerland.

and an expedited IMF decisionmaking procedure to extend financing in exceptional circumstances to member countries.

Background

The international financial system brings borrowers of capital into contact with lenders in their own country or other countries, thereby facilitating the global availability of capital. In the last decade, as the international financial system has grown, many of the larger and more economically advanced developing countries, often called "emerging market" countries, have become increasingly important participants in the system. These countries generally have benefited from this inclusion but, in some cases, sovereign financial crises have occurred. These crises have harmed the debtor countries because they often have been accompanied by recession and loss of access to world capital markets. The crises also have harmed some creditors of such countries because they have not been repaid on schedule or in full.

Although the effects of a sovereign financial crisis may be limited to the debtor country and its creditors, some of these crises, such as Mexico's 1994-95 crisis, have affected other countries' financial and economic situations. This has occurred through a "contagion effect" when, in response to a crisis in one country, investors removed their funds from other countries. It can be difficult to predict whether and to what extent contagion will occur in a sovereign financial crisis and how long the contagion will last.

Some past crises also have posed a "systemic risk" to the international financial system. Systemic risk is the risk that a financial disturbance, which triggers substantial unanticipated changes in the prices of financial assets, may seriously harm the financial position of large financial firms, which in turn, could threaten to disrupt the global payments system[7] and the capacity of the international financial system to efficiently allocate capital. Department of the Treasury officials told GAO that systemic risk could also arise—even without disruption to the payments system—if an economic or financial shock were to lead to a sharp curtailment of capital markets' willingness to extend credit to a large number of countries despite their having relatively strong economic policies and performances. The precise extent to which the international financial system is vulnerable to systemic risk is subject to debate, and the degree of systemic

[7]The global payments system creates the means for transferring money between suppliers and users of funds, usually by exchanging debits or credits among financial institutions.

risk that a particular sovereign financial crisis could pose is difficult to determine.

In addition to these uncertainties, which have complicated decisions by the official sector over whether to intervene in a sovereign financial crisis to contain contagion and/or minimize systemic risk, a concern exists that intervention may create or increase "moral hazard." Moral hazard occurs when investors or debtor countries alter their financial decisions on the basis of a belief that the official sector will supply financial assistance to them in a crisis. Debtor countries may pursue risky economic or financial policies with the expectation that, if those policies lead to a financial crisis, debtor countries will not have to pay the full costs of their debts and investors will not lose the full amount invested. As is true with systemic risk, it is difficult to measure the degree of moral hazard present in any given situation and the effect on moral hazard of providing financial assistance in a particular crisis.

In large measure, the official sector determines whether to intervene in a sovereign financial crisis by weighing the trade-offs between stemming contagion and minimizing systemic risk to the international financial system and creating or by increasing moral hazard for investors or debtor countries. Mexico's 1994-95 crisis highlighted the effects of this trade-off because the need to contain the crisis' contagion was cited by the U.S. government and IMF as one justification for providing financial assistance, while critics of the assistance cited the increased moral hazard that they believed the assistance created.

To achieve its objectives, GAO interviewed officials from Treasury and the Federal Reserve Board; IMF; investment and commercial banks based in the United States; U.S.-based emerging market bond and equity funds; and experts in the areas of international finance, economics, and law at universities and private organizations. GAO also developed a conceptual framework containing a number of elements to assess the advantages and disadvantages of improvement initiatives and proposals. In particular, GAO used this framework to analyze the trade-offs among different elements, such as resolving crises quickly, minimizing moral hazard, and sharing the burden of resolving crises. In addition, GAO reviewed U.S. government, international organization, and private firm documents, including testimony, reports, books, and laws.

Results in Brief

The possibility that a future sovereign financial crisis may threaten the stability of the international financial system cannot be ruled out, and current mechanisms to anticipate, avoid, and resolve crises have limitations. Although some factors may have lessened the likelihood of such a systemic crisis, such as a recent decrease in potentially volatile portfolio investments in emerging market countries, other factors may have raised the likelihood of such a crisis, including continuing large funds flows into these countries, which may amplify the magnitude of individual crises. One limitation of mechanisms used to anticipate sovereign financial crises is that countries do not always supply the necessary information for market participants to accurately assess investment risks. Resolving crises can be impeded by, among other factors, investors' actions that may deepen the crisis if they quickly remove their funds from a country in crisis, and by IMF and creditor countries' governments having difficulty deciding whether to intervene to help resolve the crisis.

G-7 country initiatives may help anticipate and avoid some crises, but a number of obstacles may hinder the potential effectiveness of these initiatives. For example, IMF has developed a voluntary standard to improve countries' public disclosures of economic and financial data. Although IMF intends to enforce adherence to the standard, an IMF official told GAO that IMF lacks the authority and the resources to ensure the accuracy of these data and plans only limited monitoring to check for adherence to the data standards. Instead, IMF has stated its intention to rely on financial markets to monitor and enforce compliance with the standards by removing funds from countries that financial market participants believe have suspect data.

The G-7 has proposed an initiative to expand the General Arrangements to Borrow[8] to quickly make more resources available to help resolve sovereign financial crises that threaten the international financial system. The expanded lines of credit, which are to be called the New Arrangements to Borrow, would more than double the number of participating countries and increase the total funds potentially available from about $23.8 billion to about $47.6 billion. GAO's analysis indicated that this initiative could reduce the U.S. share of the burden of resolving future crises, but its use would involve several trade-offs for the United States.

Under this proposed initiative, the U.S. share would be slightly less than 20 percent of the new arrangements' funds, down from 25 percent under the

[8]The General Arrangements to Borrow are contingent lines of credit that IMF maintains with the 11 G-10 countries and, under a separate arrangement, Saudi Arabia.

General Arrangements to Borrow. However, although the U.S. share of the lines of credit would fall, the actual amount of funds the United States would contribute to the new lines of credit would increase. This increased U.S. commitment would require congressional authorization and an appropriation of $3.4 billion. However, a senior Treasury official told us that the additional commitment would not affect the size of the U.S. budget deficit because the budget treats the transfer of dollars to IMF as being offset by the U.S. receipt of a monetary asset (i.e., a liquid, interest-bearing claim on IMF that is backed by IMF's financial position, including its holdings of gold).

Use of the New Arrangements to Borrow would reduce the U.S. share of sovereign financial crisis resolution funding compared to the 51-percent share that the United States contributed to the 1995 multilateral financial assistance to Mexico. However, the reduced U.S. participation in the new arrangements could dilute U.S. influence by decreasing its voting power, which might make it harder for the United States to influence activation of the lines of credit by IMF. Similarly, the increase in participants could make it more difficult to obtain a consensus to use the lines of credit to stem contagion. Use of the lines of credit could help to stem a crisis' spread to other countries and forestall systemic risk, but such use could also increase investors' or countries' moral hazard.

GAO Analysis

Future Systemic Crises Are Possible and Existing Mechanisms to Anticipate, Avoid, and Resolve Crises Have Limitations

Some factors may have lessened the likelihood that a future sovereign financial crisis will threaten the stability of the international financial system, such as a recent decrease in potentially volatile portfolio investments in emerging market countries and a greater diversity in the sources of investments. However, Treasury officials emphasized that other factors may have increased the probability of such a crisis, including continuing large funds flows into these countries that may amplify the magnitude of individual crises, various trends that may contribute to the volatility of these funds, and the growing ability of countries to run large current account[9] deficits because private markets will finance the deficits. Total net private capital inflows to emerging market countries increased by more than threefold between 1990 and 1996, from about $60.1 billion to $193.6 billion. Thus, the possibility that a future sovereign financial crisis

[9]A country's current account measures its transactions with other countries' transactions in goods, services, investment income, and other transfers.

may threaten the stability of the international financial system cannot be ruled out. Treasury officials also said that many of the factors that increase the likelihood of a systemic crisis may also produce crises that would require more substantial official sector resources for their containment.

Current market and governmental mechanisms to anticipate, avoid, and resolve sovereign financial crises have limitations. As GAO learned in its review of Mexico's 1994-95 financial crisis, sovereign financial crises have been complex economic, financial, and political events that were difficult to predict. Capital market participants discipline countries that pursue what the participants perceive to be inappropriate economic or financial policies by lending to those countries with unsound or inappropriate policies only at higher interest rates. The increase in the cost of borrowing, along with the possibility that investors may stop lending funds altogether, can provide the incentive for a country's authorities to correct their policies, which could help avoid a sovereign financial crisis. Yet, capital market participants GAO interviewed said that sometimes countries do not supply, and investors have trouble obtaining from other sources, the necessary information for market participants to accurately assess investment risks. Furthermore, resolving crises can be hindered by, among other factors, investors' deepening the crisis by quickly removing their funds from a country in crisis. Also, GAO's analysis indicated that IMF and creditor countries' governments may have difficulty deciding whether to intervene to help resolve a crisis because at the same time they are debating whether the crisis warrants intervention, they are also considering the extent to which intervention could exacerbate moral hazard. Therefore, once creditor countries' governments and IMF decide to intervene, they may not have enough time to provide debtor countries with sufficient financial assistance to arrest a crisis.

Initiatives May Help Strengthen Crisis Anticipation and Avoidance, but Obstacles May Impede Their Effectiveness

GAO's analysis indicated that the G-7 country initiatives to aid in crisis anticipation and avoidance have the potential to help anticipate some crises, but obstacles may hinder the initiatives' full effectiveness. For example, to help improve the economic and financial data needed by market participants, IMF has developed a voluntary standard that countries may use when disclosing such data to the public. If countries provide these data in an accurate and timely way, then the standard should help to improve country data to financial markets, according to some market participants GAO interviewed. As of May 21, 1997, 42 countries had subscribed to the IMF standard, including a number of developing

countries, such as Argentina, Malaysia, Mexico, the Philippines, and Thailand. IMF began allowing countries to subscribe to the standard in April 1996.

To enforce adherence to the standard by subscribing countries, IMF has stated its intention to remove from the list of subscribing countries any nation that does not comply with the standard's specifications, although at the time of GAO's review, no countries had been removed from the list. IMF intends to rely on capital market participants to monitor and enforce countries' adherence to the standards because IMF said it lacks the authority and resources to verify the country data. Some market participants told GAO (1) that market participants, for the most part, do not intend to monitor countries' compliance with IMF's data standards and (2) that they generally do not expect to keep IMF informed of any compliance concerns they may have. Furthermore, financial markets' ability to discipline countries' policies to avoid sovereign financial crises has varied, as Mexico's 1994-95 crisis made evident. The absence of any ready means to monitor and enforce compliance with IMF's data dissemination standard may limit how well the standard actually improves country data. Furthermore, IMF has no system in place to regularly track market participants' concerns over compliance.

IMF Initiatives for Resolving Crises Would Involve U.S. Trade-Offs Relative to Stemming Contagion, Burden Sharing, and Minimizing Moral Hazard

Two G-7 initiatives would seek to make more resources available to IMF and to make these resources available more quickly in a sovereign financial crisis. GAO's analysis indicates that these initiatives would involve some trade-offs for the United States. Under one initiative, IMF plans to more than double the number of participants in the General Arrangements to Borrow lines of credit and double the resources potentially available under the lines of credit. Under the New Arrangements to Borrow, the number of members would be increased from 11 to 25 countries, and the amount of credit available would grow from about $23.8 billion to about $47.6 billion.[10] A congressional appropriation of $3.4 billion would be required to fund the U.S. portion of the expansion. The new lines of credit could be activated when participants, representing 80 percent of the credit lines' resources, determine that there is a threat to the international financial system and that IMF lacks the resources to provide the needed funds.

[10]Dollar values are converted from Special Drawing Rights (SDR) at the rate of 1.40 SDRs per dollar. (GAO took the May 30, 1997, rate of 1.3918 SDR/dollar and rounded it up to 1.4 SDR/dollar.) SDR is a unit of account that IMF uses to denominate all of its transactions. Its value comprises a weighted average of the value of five currencies, of which the U.S. dollar has the largest share.

GAO notes that, although the New Arrangements to Borrow would increase the official resources available to help resolve sovereign financial crises that may have a contagion effect on other countries' finances or that may pose some risk to the international financial system, U.S. influence in decisions to use the new lines of credit could be reduced, and the existence or use of the arrangement might worsen moral hazard.

Because the U.S. proportional share of the new lines of credit is to fall from 25 percent under the general arrangement to about 20 percent, U.S. voting share would decrease, and hence the United States' influence might be diminished. Similarly, the larger number of countries in the New Arrangements to Borrow could complicate activation, since more countries will likely have to consent to activate the new lines of credit.

However, to the extent that the new lines of credit can be activated by its participants, the United States might be less likely to be called on unilaterally to provide financial assistance to countries in financial trouble. On the other hand, to the extent that the expanded arrangements are difficult to activate, the United States may continue to face the difficult decision of whether to act unilaterally to assist financially troubled countries.

Furthermore, while activation of the New Arrangements to Borrow could stem contagion in a crisis, use of these funds could also exacerbate moral hazard for investors and debtor countries. However, the United States would more easily be able to block activation of the new lines of credit because their activation would require the votes of countries holding 80 percent of the new arrangements' resources, which is up from 60 percent under the General Arrangements to Borrow. Therefore, the United States, with its almost 20-percent share, would be able to prevent use of the lines of credit if it had the support of any one other large New Arrangements to Borrow participating country or two small participants. Treasury officials told GAO that moral hazard cannot be entirely eliminated but that it can be held to a minimum if official intervention in sovereign financial crises is rare and limited to exceptional circumstances. They also said that some moral hazard already exists due to the presence of IMF and other official sector organizations that provide financing to countries in crisis, but that policy conditionality and phasing of disbursements helps to limit that moral hazard.

IMF has implemented a second G-7 initiative that allows IMF's Executive Directors to expedite the Board's decisionmaking procedure to extend

financing to member countries. Called the emergency financing mechanism, use of the new procedure is limited to extraordinary situations that threaten member countries' financial stability, that have significant risks of contagion, and that require accelerated IMF-debtor country negotiations. The decisionmaking mechanism, among other purposes, is designed to help provide a speedy official response to stem contagion effects on financial markets in other countries and, possibly, to forestall or mitigate international systemic risk.

In some sovereign financial crisis situations, a faster IMF decisionmaking process could, by reducing systemic risk, reduce pressure on the United States to act unilaterally. However, the emergency mechanism may not facilitate speedier funding decisions because it may not lessen disagreement among IMF Executive Directors about the seriousness (i.e., the extent of potential contagion or systemic risk) of any particular crisis they confront.

Recommendation

GAO is not making any recommendations in this report.

Agency Comments

GAO obtained written comments on a draft of this report from Treasury and the Federal Reserve. These comments are described in chapter 1. Both Treasury and the Federal Reserve generally said that the report was a constructive and reasonably comprehensive contribution to the analysis of the issues. Both Treasury and the Federal Reserve suggested clarifications and technical changes, which GAO incorporated throughout this report, as appropriate.

Contents

Executive Summary		2
Chapter 1 Introduction		16
	Background	16
	Mexico's 1994-95 Crisis Threatened the Collapse of Its Public Finances and Banking System and Caused Contagion	20
	Mexico's 1994-95 Financial Crisis Led to U.S. and Multilateral Financial Assistance	22
	Financial Assistance to Mexico Was Controversial	23
	Objectives, Scope, and Methodology	26
	Agency Comments	28
Chapter 2 Mechanisms That Help Anticipate, Avoid, and Resolve Sovereign Financial Crises Have Limitations		29
	Sovereign Financial Crises Followed by Contagion and Systemic Risk Cannot Be Ruled Out	30
	Various Mechanisms Can Help Anticipate, Avoid, and Resolve Sovereign Financial Crises	37
	Mechanisms That Can Help Anticipate and Avoid Sovereign Financial Crises Have Limitations	45
	Mechanisms That Can Help Contain and Resolve Sovereign Financial Crises Have Limitations	52
Chapter 3 Initiatives Could Help Strengthen Crisis Anticipation and Avoidance, but Obstacles to Success Exist		57
	IMF's Voluntary Data Standards Might Help Improve Country Data, but IMF Cannot Ensure Compliance	57
	Initiatives to Improve Financial Stability in Emerging Market Countries May Not Achieve Timely Results	61
	Improving IMF Surveillance of Key Emerging Market Countries May Face Obstacles	63

Chapter 4 Most Resolution Improvement Approaches Might Reduce U.S. Burden, but Many May Not Help Stem Contagion

67
Initiatives Are Under Way to Improve the Provision of Official Financial Assistance 68
Bankruptcy-Based Proposals Might Reduce Public Financing Costs, but They Could Operate Too Slowly to Limit Contagion 83

Appendixes

Appendix I: Our Conceptual Framework for Analyzing Initiatives and Proposals to Resolve Sovereign Financial Crises 94
Appendix II: IMF's Special Data Dissemination Standard 96
Appendix III: Comments From the Department of the Treasury 98
Appendix IV: Comments From the Board of Governors of the Federal Reserve System 99
Appendix V: Major Contributors to This Report 100

Table

Table 4.1: Proposed NAB Participation 73

Figures

Figure 2.1: Net Private Capital Inflows to Emerging Market Countries (1990-96) 32
Figure 2.2: Net Portfolio Investment and Foreign Direct Investment in Emerging Market Countries (1990-96) 35
Figure 4.1: Participant Credit Commitments Under the General Arrangements to Borrow 70
Figure 4.2: Participant Shares Under the General Arrangements to Borrow 71
Figure 4.3: Participant Credit Commitments Under the Proposed New Arrangements to Borrow 74
Figure 4.4: Participant Shares Under the Proposed New Arrangements to Borrow 75

Abbreviations

BIS	Bank for International Settlements
ESF	Exchange Stabilization Fund
GAB	General Arrangements to Borrow
G-7	Group of Seven
G-10	Group of Ten
IMF	International Monetary Fund
NAB	New Arrangements to Borrow
SDR	Special Drawing Rights

Chapter 1

Introduction

Mexico's financial crisis of 1994-95 prompted Group of Seven (G-7) country[1] initiatives[2] to improve existing mechanisms to anticipate, avoid, and resolve sovereign financial crises as well as proposals to create new mechanisms. This report responds to the request of the Chairman of the House Committee on Banking and Financial Services that we review and evaluate these improvement initiatives and proposals. The Chairman also requested that we review various aspects of Mexico's financial crisis. We provided the results of our review of the Mexico crisis in an earlier report[3] that focused on the origins of the financial crisis; the awareness of U.S. government and International Monetary Fund (IMF)[4] officials of Mexico's situation during 1994; and the financial assistance package provided by the United States, IMF, and others to help resolve the crisis.

Background

The International Financial System Connects Lenders to Borrowers in Different Countries

The international financial system brings international lenders of funds, in their own country or other countries, into contact with borrowers—thereby permitting an increased flow of scarce funds toward their most productive uses. This system, which is dominated by central banks, government agencies, the largest commercial and investment banks, security and foreign exchange dealers, and major brokerage houses, has grown enormously in the 1990s. Global foreign exchange

[1]The G-7 consists of seven major industrialized countries that consult on general economic and financial matters. The seven countries are: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

[2]The initiatives were the product of the 1995 G-7 economic summit in Halifax, Nova Scotia, and were discussed in the communique issued at that meeting.

[3]Mexico's Financial Crisis: Origins, Awareness, Assistance, and Initial Efforts to Recover (GAO/GGD-96-56, Feb. 23, 1996).

[4]IMF is an organization of 181 member countries that was established to promote international monetary cooperation, promote exchange rate stability, and provide short-term lending to member countries that experience balance-of-payments difficulties. A country with a balance-of-payments deficit experiences an excess demand for foreign currencies, i.e., an excess supply of its own currency. In such cases, countries do not take in enough foreign currency to pay for what they buy from other countries. Absent central bank intervention, the country's exchange rate will depreciate in value.

trading—fueled by floating foreign exchange rates[5] and the expansion of world commerce—now exceeds $1 trillion a day.[6]

Many of the larger and more economically advanced developing countries, often called "emerging market" countries,[7] which in the past did not participate much in the international financial system, have become important players in the last decade. Private capital flows to developing countries increased by more than threefold between 1990 and 1996, rising from $60.1 billion to about $193.6 billion, according to IMF. These countries' entry into the global financial system has been fueled by technological advances that make investment across national borders easier, financial deregulation and economic liberalization, and other factors.

Sovereign Financial Crises: Causes and Effects

Developing countries have benefited from their increased access to world capital markets. Nonetheless, financial crises in developing countries still have occurred. For purposes of this report, the term "sovereign financial crisis" refers to a state of affairs in a country characterized by the following:

- the inability or unwillingness of a country to honor its debt obligations and
- the loss of confidence in that country's capital and other markets, which can happen when the country does not honor its debts, expressed by the flight of capital from the country and a general unwillingness of new investors to invest in the country.

According to a financial risk rating firm, 70 countries defaulted on various kinds of debt between 1975 and 1995; in 1995 alone, 36 countries were in default on some of their debts. All of these countries were either developing countries or countries that were part of the Soviet Union or Soviet-dominated Eastern Europe.

Sovereign financial crises have had a variety of causes and effects. As we learned in our review of Mexico's 1994-95 financial crisis, many such crises have had complex economic, financial, and political origins, including

[5]Under a floating exchange rate system, the value of a country's currency in relation to other currencies changes in response to market supply and demand for the currencies, rather than at a rate set by that government.

[6]International Capital Movements and Foreign Exchange Markets, Group of Ten (Rome, Italy: Apr. 1993).

[7]"Emerging markets" or "developing countries" are usually those countries whose production sector is dominated by agriculture and mineral resources and countries that are in the process of building up industrial capacity. In this report, we use these two terms interchangeably.

events inside of the country, outside of the country, or both. Internal events that have contributed to sovereign financial crises have included the adoption of macroeconomic policies that are inconsistent with exchange rates, and political shocks, such as assassinations in Mexico in 1994. External contributing events have included loss of the confidence of investors from other countries; rising interest rates in other countries, such as occurred in the early 1980s; and sudden increases in petroleum prices, which happened in the 1970s.

Sovereign financial crises can harm both the indebted country and its creditors. If a country in financial crisis has debt-servicing problems, creditors who hold the country's debt must wait longer than they anticipated to get paid and may not get paid the full value of their investments. A country undergoing a financial crisis may experience severe inflation, recession, a rise in unemployment, and other harm. Also, a sovereign financial crisis can lead to substantial harm to a country beyond the short term because the crisis can impair the country's access to international capital markets for years after the immediate crisis is resolved.

The Contagion Effect: The Spread of One Country's Financial Crisis to Other Countries

The effects of a sovereign financial crisis largely may be limited to the country in which it arose and to the country's creditors. For example, Venezuela's financial crisis in 1995 did not have financial effects on other countries' finances, according to international financial experts.[8] However, some crises have affected other countries' financial situations through a "contagion effect." Contagion has occurred when investors, who could be domestic or foreign, have removed their funds from other countries, or reduced their new lending to them, in response to a sovereign financial crisis in another country. Contagion from Mexico's 1994-95 financial crisis had a negative impact on the finances of Brazil, Argentina, and other countries. It can be difficult to predict whether, and to what extent, contagion will occur in a sovereign financial crisis and how prolonged the contagion will be. Delay by public authorities in acting to contain a sovereign financial crisis' contagion may or may not have long-term consequences on the countries that are affected by the contagion.

[8]This may have been in part because, according to one financial risk rating firm, Venezuela, in 1995, defaulted only on local currency-denominated debt held by Venezuelans, while it continued to service its foreign-currency-denominated debts.

Systemic Risk to the International Financial System

Some sovereign financial crises may have threatened the stability of the international financial system. This "systemic risk" is the risk that a disturbance in financial markets, which triggers substantial unanticipated changes in the prices of financial assets, might seriously harm the financial position of financial firms, which could in turn threaten to disrupt the payments system[9] and the capacity of the international financial system to allocate capital.

For example, collapsing asset prices might lead to the financial failure of one or more of the large securities firms that hold the assets. Because of the interrelationships among large financial companies, this initial financial failure might lead to further failures by other securities firms and commercial banks. A series of such failures by banks and other financial firms might disrupt the flow of payments in the settlement of financial transactions throughout the world. Such a breakdown in international capital markets might disrupt the process of saving and investing, undermine the long-term confidence of private investors, and disrupt the normal course of international economic transactions. Department of the Treasury officials told us that systemic risk can also arise—even if there were no disruptions of the payments system—if a financial, economic, or political shock were to lead to a sharp curtailment of the willingness to extend credit to a large number of countries despite their having relatively strong economic policies and performance.

The precise extent to which the international financial system is vulnerable to this systemic risk is subject to debate. Furthermore, it can be difficult to predict the degree of systemic risk to the international financial system that would result from a particular sovereign financial crisis.

Moral Hazard: Altered Incentives for Investors and Borrowing Countries

Investors may alter their investment decisions and countries may change their economic policies if they expect assistance from international financial institutions or other governments. This is often called "moral hazard." Investors may believe that the risks of investing in a particular country or group of countries are lowered if they expect that, at times of sovereign financial crisis, official assistance will be forthcoming and sufficient to guarantee their expected investment return. Debtor countries may be more willing to have unsustainable financial and economic policies if they expect they can get financial assistance without severe consequences at some later date.

[9]Broadly, the payments system is the financial system that creates the means for transferring money between suppliers and users of funds, usually by exchanging debits or credits among financial institutions.

Decisions to Act May Balance Concerns About Systemic Risk and Moral Hazard

Countries with financial problems may seek financial assistance from IMF or other countries. Those asked to provide financial assistance may consider the trade-off between (1) systemic risk, i.e., the extent to which the financial problems of an individual country are a threat to the international financial system and (2) moral hazard, i.e., the impact of any assistance provided on the future behavior of countries and investors. To the extent that systemic risk is judged to be small, IMF or other official sector organizations may decide that the country and its creditors should be left to work out a solution on their own. To the extent that the official sector judges that the threat of systemic risk is great, they may provide assistance to safeguard the international financial system. Those who would provide financial assistance may also consider the extent to which a decision to provide assistance to a country experiencing financial difficulties could influence the future behavior of both debtor countries and investors. These judgments are difficult ones given that the extent to which both systemic risk and moral hazard are present in any particular set of financial circumstances is uncertain.

Mexico's 1994-95 Crisis Threatened the Collapse of Its Public Finances and Banking System and Caused Contagion

Mexico's financial crisis of 1994-95, which was a result of the interplay of complex financial, economic, and political factors, threatened the collapse of Mexico's public finances and banking system. The 1994-95 crisis spread to other emerging market countries, thereby negatively affecting the financial stability of those countries. At the beginning of 1994, which was a presidential election year in Mexico, Mexico was experiencing a boom in foreign investment—much of it equity and debt portfolio investments[10] that could be withdrawn quickly. However, investor confidence in Mexican debt and equity securities was shaken throughout 1994 by political events, including the March 1994 assassination of the leading Mexican presidential candidate. Also, U.S. interest rates began to rise, which made Mexican debt securities relatively less attractive to investors.

To continue to attract foreign investment, the Mexican government could have raised interest rates, reduced government expenditures, or devalued the peso. However, raising interest rates and reducing government spending were politically unattractive approaches in 1994, and devaluing the peso would have altered agreements among government, labor, and

[10]Portfolio investments are assets held in the form of marketable equity and debt securities. Portfolio investment, in contrast to direct investment, tends to be more liquid in nature and is more likely to be short term. However, this is not to suggest that selling pressures on a currency are more likely to arise or to be more severe in the presence of substantial foreign portfolio investment. Historically, market-forced devaluations have occurred even when portfolio investment has been almost nonexistent.

business and would have hurt foreign investors. Rather than adopt any of these options, the Mexican government, in the spring of 1994, increased issuance of short-term, dollar-linked bonds, called tesobonos. The short-term maturity of tesobonos enabled holders of the bonds to choose not to roll them over[11] if they perceived either an increased risk of a Mexican government debt-servicing problem or higher returns elsewhere. Many tesobono purchasers were portfolio investors who were sensitive to changes in interest rates and risks.

Following the August 1994 election, foreign investment flows did not recover to the extent expected by the Mexican government. Foreign exchange reserves held by Mexico's central bank, which amounted to about $29 billion in February 1994, fell to $12.5 billion in the beginning of December 1994, with Mexican tesobono obligations of nearly $30 billion maturing in 1995. On December 20, 1994, Mexico devalued the peso. The discrepancy between (1) the Mexican government's long-standing pledge not to devalue the peso and (2) the sudden devaluation, absent an announcement of appropriate accompanying economic policy measures, contributed to a sharp, sudden loss of investor confidence in the newly elected government and a growing fear that a Mexican government default was likely in 1995. Investor confidence collapsed as investors sold Mexican equity and debt securities, and foreign currency reserves at the Bank of Mexico were insufficient to meet the demand of investors seeking to convert pesos to U.S. dollars. The peso devaluation precipitated a crisis that continued into 1995.

Early in Mexico's crisis, financial markets in a number of emerging market economies were affected by Mexico's problems as investors began to limit capital flows to these countries. According to a later analysis by IMF, portfolio investment flows to emerging markets declined dramatically in the first quarter of 1995. Also, risk premiums on developing countries' bonds increased, equity prices in emerging markets fell sharply, and currency pressures were felt, at least temporarily, in a geographically dispersed group of economies, which ranged from Argentina and Brazil to Hong Kong and South Africa. In our report on Mexico's crisis, we noted that stock markets in Argentina and Brazil were especially hard hit by contagion, and that no new international equities were issued in six major emerging market countries in the first quarter of 1995.

[11]We use the term "roll over" here to mean repurchase of tesobonos when the tesobonos held by the investor matured.

Mexico's 1994-95 Financial Crisis Led to U.S. and Multilateral Financial Assistance

Citing risk of contagion and the threat to U.S. interests of a prolonged Mexican recession, among other concerns, U.S. and IMF officials orchestrated a large financial assistance package to Mexico. The assistance package consisted of up to $48.8 billion from the United States, Canada, IMF, and the Bank for International Settlements (BIS).[12] The primary goal of the assistance package was to enable Mexico to overcome its short-term liquidity crisis, and thereby to prevent Mexico's financial collapse, and to prevent the further spread of the crisis to other emerging market countries. U.S. officials also were concerned that Mexico's crisis could escalate into a prolonged and severe economic downturn that would damage U.S. interests, including trade, employment, and immigration. U.S. officials—who said that they viewed Mexico as a paradigm for countries striving toward a free market economy—also believed that if Mexico's difficulties spread to other emerging market countries, the global trend toward market-oriented reform and democratization could have halted or even reversed.

The assistance provided by the United States and IMF was large in amount and quickly provided. On January 31, 1995, which was less than 6 weeks after Mexico's financial crisis began, President Clinton announced that Treasury's Exchange Stabilization Fund (ESF)[13] and the Federal Reserve's swap network would be used to provide up to $20 billion to Mexico.[14] Both sources of funds could be activated without additional legislation[15] by Congress.[16] The next day, February 1, 1995, IMF approved an 18-month standby arrangement for Mexico of up to $17.8 billion. IMF's quick approval

[12]BIS is an organization of central banks that is based in Basle, Switzerland. It is the principal forum for consultation, cooperation, and information exchange among central bankers.

[13]ESF is a currency reserve fund under the control of the Secretary of the Treasury that is employed to stabilize the dollar and foreign exchange markets. ESF holds foreign currencies, such as the Japanese yen and German mark, as well as U.S. dollars and Special Drawing Rights (SDR). SDRs are units of account issued by IMF to supplement gold and currency reserves. The value of special drawing rights fluctuates relative to five major currencies. In the past, ESF has been used to buy and sell foreign currencies, extend short-term swaps to foreign countries, and guarantee obligations of foreign governments. ESF use must be consistent with U.S. obligations in IMF regarding orderly exchange arrangements and a stable system of exchange rates.

[14]An initial proposal by the President on January 12, 1995, for up to $40 billion in loan guarantees to Mexico from the United States failed to gain sufficient congressional support. These funds would have come from a congressional appropriation specifically for that purpose, in contrast to the Treasury and Federal Reserve funds that were used to assist Mexico.

[15]Subsequently, in the spring of 1995, the Mexican Debt Disclosure Act was passed, requiring the President to submit a report before any funds under this program could be extended.

[16]Some Members of Congress questioned the administration's authority to use ESF to assist Mexico without congressional approval. In our report on the Mexican crisis, we found no basis to disagree with the administration's position that the Secretary of the Treasury, with the President's approval, had the requisite authority to use ESF in this manner.

of this arrangement was unusual, considering that arrangements for IMF financial assistance to indebted countries typically required months of detailed negotiations among IMF, the country, and the country's creditors. Although the U.S. and IMF portion of the assistance package totaled almost $38 billion, Mexico eventually used about $13.5 billion of the U.S. funds and about $13 billion of the IMF funds. Mexico has repaid all of the funds it borrowed from the United States.

IMF's contribution to the assistance package was the largest financing package ever approved for an IMF member country, both in terms of the amount and the overall percentage of a member's subscription quota.[17] About 688 percent of Mexico's subscription quota was provided over 18 months (under ordinary circumstances, the usual cumulative limit is 300 percent). The United States' contribution of $13.5 billion represented about 51 percent of the total assistance package used.

The financial assistance helped to arrest the crisis and restore financial market confidence in Mexico. Although Mexico's economy went into a recession as a result of the crisis, the contagion to other countries ceased and most of the affected countries recovered from the contagion within a few months. In the spring of 1995, Mexico regained access to international capital markets.

Financial Assistance to Mexico Was Controversial

Some observers argued that the United States should not have provided financial assistance to Mexico, often citing one or more of the following reasons: (1) the threat Mexico's crisis posed to other countries was insufficient to justify the assistance; (2) the assistance would inappropriately shield investors and countries from the consequences of their financial decisions and thereby increase moral hazard; and (3) the threat posed to U.S. trade, employment, and immigration interests was insufficient to justify the assistance.

Extent of Threat to the International Financial System Was in Dispute

Some critics of U.S. financial assistance to Mexico argued that the effects of Mexico's crisis on other countries did not justify risking up to $20 billion of U.S. funds or the large amount of IMF funds. The critics said

[17]As a condition of membership, each IMF member is required to contribute to the general resources of IMF. These contributions are referred to as that member's subscription quota and determine the voting power of each member. Members usually pay up to 25 percent of their subscription quota in SDRs or a convertible currency and the other 75 percent or more in the member's domestic currency. The United States' quota, about $36 billion, is the largest in IMF and constitutes about 18 percent of the total quotas.

that the contagion effect was either (1) a temporary market overcorrection that would have reversed itself before seriously harming U.S. investors or other emerging markets or (2) an appropriate market correction of overinvestment in these markets. One study, by an association of commercial banks, investment banks, and other financial institutions, argued that the Mexican crisis' contagion was mostly ephemeral because some affected countries were able to borrow in international capital markets within 6 months after the crisis.[18] Investment flows to emerging market countries—including some hardest hit by the contagion—have been large in the 2 years since Mexico's crisis. Some analysts also argued that the diversity of the holders of Mexico's debt in 1994-95, as well as the diversification of investment and loan portfolios, meant that the crisis did not pose a systemic threat to the international financial system because it did not threaten the health of any large, creditor country financial institutions.

Proponents of the assistance to Mexico argued that the contagion effects of the crisis were short lived, at least partly, because of the stabilizing effect of the multilateral financial assistance to Mexico (i.e., the assistance stopped the contagion from deepening or spreading). Furthermore, Treasury officials told us that they believed that Mexico's 1994-95 crisis would have threatened the stability of the international financial system had it endured because, in their view, other major emerging market countries would have lost access to world capital markets for an extended time.

Effect on Moral Hazard Was Controversial

Some opponents of the U.S. financial assistance to Mexico have argued that the assistance has created substantial moral hazard for debtor countries as well as investors in those countries. The opponents have said that providing the Mexican government with the foreign currency it needed to redeem matured tesobonos exacerbated moral hazard for investors in emerging market countries by protecting tesobono holders from losses on those bonds.[19] Some observers have also argued that moral hazard may have contributed to Mexico's 1994-95 financial crisis (i.e., earlier assistance to Mexico had encouraged Mexican officials to pursue a mix of risky macroeconomic and financial policies and encouraged

[18]Resolving Sovereign Financial Crises, Institute of International Finance, Inc. (Sept. 1996).

[19]Holders of tesobonos, along with other investors in Mexico, may have experienced financial losses on other investments in Mexico as a result of the crisis, including losses on equity investments in Mexico's stock market. Mexico's stock market dropped by two-thirds (68 percent) in dollar terms between December 19, 1994, and March 9, 1995.

investors to purchase large amounts of tesobonos and inadequately monitor the risks of these and other portfolio investments in Mexico).[20]

According to our analysis, these assertions could be countered with three arguments. First, administration officials said that the 1995 U.S. and IMF assistance was conditioned upon Mexico's adhering to strict economic, financial, and reporting requirements. These conditions may have helped to mitigate any increased moral hazard for Mexico and other debtor countries. These officials also noted that the assistance did not prevent the crisis from causing a severe recession in Mexico. Mexico's severe recession could underscore for Mexico and other countries the negative consequences of risky financial policies. Second, some financial analysts have asserted that moral hazard existed, to some extent, before Mexico's recent crisis and that it will continue to exist no matter what policymakers do or say. The analysts said that both investors and debtor countries will continue to consider in their borrowing and lending decisions the availability of financing from IMF as well as financing from major creditor country governments with an interest in the financial stability of the debtor country. Third, investors and debtor countries may interpret the controversy surrounding the decision to assist Mexico as evidence that such action is unlikely to be repeated. Officials within the administration and some Members of Congress disagreed about assisting Mexico. Furthermore, officials representing the U.S. government disagreed with officials from other major IMF member country governments. In May 1996, the Group of Ten (G-10)[21] governments stated that investors, including bondholders, and governments should not expect the Mexican financial assistance to be repeated.

The Seriousness of Threats to U.S. Trade, Immigration, Employment, and Other Interests Was Debated

Some critics of the U.S. financial assistance to Mexico have also argued that the threat the crisis presented to U.S.-specific interests, such as trade, employment, and immigration, was insufficient to justify the assistance. Some critics of the assistance to Mexico argued that the potential losses in U.S. jobs would not have been great and that a large influx of illegal immigration may not have followed if Mexico had worked out the crisis without outside assistance. U.S. government officials, citing the growth in the Mexican economy and the economic interdependence of the United

[20]For example, in 1982 the United States, some BIS central banks, IMF, and international commercial banks provided financial assistance when Mexico became unable to make loan payments to U.S. and other foreign commercial banks.

[21]The G-10 is made up of 11 major industrialized countries that consult on general economic and financial matters. The 11 countries are: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

States and Mexico, argued that the United States had an interest in protecting trade with Mexico—which they said would limit U.S. job losses stemming from the crisis—and in preventing a Mexican economic collapse. Moreover, the officials said, a Mexican economic collapse would have led to a surge of illegal immigration into the United States.

Objectives, Scope, and Methodology

The Chairman of the House Committee on Banking and Financial Services requested that we review and evaluate initiatives and proposals to improve the means of anticipating and resolving financial crises. One of our objectives was to identify (1) factors that may increase or decrease the probability that a future sovereign financial crisis will threaten the stability of the international financial system and (2) any limitations of current market and governmental mechanisms for preventing and resolving sovereign financial crises. Our other objective was to evaluate initiatives and proposals of the G-7 and others to better (1) anticipate and avoid future sovereign financial crises and (2) resolve such crises that threaten the international financial system.

To achieve these objectives, we interviewed U.S. government and international financial institution officials from Treasury, the Federal Reserve, the Department of Commerce, IMF, and the World Bank.

We collected and analyzed documents and interviewed international investors and investment experts from the following:

- commercial and investment banks based in the United States,
- U.S.-based emerging market bond and equity mutual funds,
- professional organizations representing capital market participants,
- a U.S.-based law firm that represents countries in financial distress, and
- international finance and economic experts at universities and private research organizations.

We reviewed documents and interviewed officials to obtain information about the following:

- the investment flows to and from emerging market countries;
- the history of sovereign financial crises;
- the workings of the international financial system and threats to its stability;
- the genesis of sovereign financial crises and their effects on the finances and economies of other countries;

- the trade-off between systemic risk and altered incentives for investors and emerging market countries;
- how financial markets assess the risks of investing in emerging markets, and how markets try to anticipate and avoid sovereign financial crises;
- the efforts under way by governments and the international financial institutions to improve anticipation and avoidance of sovereign financial crises;
- the current and proposed mechanisms for resolving sovereign financial crises; and
- the U.S. budgetary implications of expanding the General Arrangements to Borrow.

The documents that we collected and analyzed included books, articles, reports, and testimony. We attended several conferences dealing, in part, with sovereign financial crises. Finally, we used information that we had previously gathered for our February 1996 report on the 1994-95 Mexican financial crisis.

To evaluate initiatives and proposals to better resolve future financial crises, we developed a conceptual framework with 10 elements. We received written comments on the draft framework from officials representing the public and private sectors and incorporated their comments to finalize the framework. As a part of our analysis, we sought to determine whether and how each initiative and proposal could

(1) limit contagion and systemic risk to the international financial system, including responding to a crisis with sufficient speed and quantity of resources;

(2) affect moral hazard;

(3) induce appropriate country economic and financial policies;

(4) address the cost-effectiveness associated with development and implementation;

(5) share burdens among parties in a sovereign financial crisis;

(6) facilitate coordination and communication among parties in a crisis;

(7) be flexible enough to deal with various types of financial crises;

(8) apply principles consistently to countries in similar financial distress;

(9) address the legal requirements needed for development and implementation; and

(10) apportion the administrative burden of development and implementation.

We did not use the conceptual framework to endorse or reject any particular initiative or proposal. Appendix I provides more detail on how we developed the framework. We conducted our work between March 1996 and March 1997 in accordance with generally accepted government auditing standards.

Agency Comments

We obtained written comments on a draft of this report from Treasury and the Federal Reserve. Comment letters are reproduced in appendixes III and IV. Both agencies generally said the report is constructive and a reasonably comprehensive analysis of these issues. In addition, both Treasury and the Federal Reserve provided suggestions for clarifications and technical changes. Treasury's clarifications and technical comments included suggestions from the U.S. Executive Director's Office at IMF. We discussed Treasury's comments with Treasury officials in a meeting on May 30, 1997. We incorporated the suggestions throughout this report, as appropriate.

Mechanisms That Help Anticipate, Avoid, and Resolve Sovereign Financial Crises Have Limitations

The possibility of a future sovereign financial crisis threatening the stability of the international financial system cannot be ruled out, and current mechanisms for anticipating, avoiding, and resolving sovereign financial crises have limitations. Some factors may have lessened the likelihood of such a systemic crisis, such as a recent decrease in potentially volatile portfolio investments in emerging market countries and a greater diversity in the sources of investments. Yet, other factors may have increased the probability of such a crisis, including continuing large funds flows into these countries, which may amplify the magnitude of individual sovereign financial crises and various trends that may contribute to the volatility of these funds.

There are a variety of official and private sector mechanisms that can help anticipate, avoid, and resolve sovereign financial crises. Debtor country economic and financial policies that retain investor confidence can help avoid sovereign financial crises. Debtor country provision of information about their economic and financial situations can help anticipate and avoid sovereign financial crises. When investors avoid or sell country-related investments, this can signal a country that its policies are inappropriate or unsound. Economic monitoring and advisory activities by IMF and some major industrialized creditor countries can help emerging market countries adjust policies and practices that may lead to future problems. Major mechanisms to help resolve sovereign financial crises include IMF financial assistance, along with its conditions, and conventions for negotiations between debtor countries, the official sector, and commercial bank creditors.

Mexico's 1994-95 financial crisis and other sovereign financial crises have shown the limitations of mechanisms designed to help anticipate and avoid sovereign financial crises. Sovereign financial crises have been complex financial, economic, and political events that are difficult to anticipate, despite the various risk assessments and monitoring efforts of market participants, IMF, and creditor countries. When debtor countries or investors expect official funding to resolve a sovereign financial crisis—a situation known as moral hazard—they may pursue risky policies and risky investments. Also, weak commercial banks and lax bank supervision in emerging market countries can turn away investors. IMF and creditor country government surveillance of emerging market countries may not sufficiently focus on country financial policies.

Problems have also impeded official and private sector mechanisms to contain and efficiently resolve sovereign financial crises when they do

occur. When a country has debt-servicing problems, investors can have strong incentives to sell their country-related investments even though investors might be better off as a group if they continue to hold their investments. Resolution may also be delayed by difficulties in organizing interim funds that indebted countries sometimes need in a crisis. Some smaller creditors may seek to be bought out by other creditors and delay negotiations. IMF and creditor country governments may have difficulty deciding whether to intervene to help resolve a sovereign financial crisis as decisionmakers debate whether the crisis warrants intervention and the extent to which intervention could create improper expectations about how the official sector may act in the future. Finally, creditor country governments and IMF can experience difficulties in providing sufficient financial assistance quickly enough to arrest a crisis.

Sovereign Financial Crises Followed by Contagion and Systemic Risk Cannot Be Ruled Out

The possibility of contagion and systemic risk in a future sovereign financial crisis cannot be ruled out. Broader and stronger linkages between international and domestic financial markets mean that crises can erupt much more quickly in today's markets and can be far larger in scope than in the past, according to the G-10. Factors that indicate a potential for sovereign financial crises with contagion and systemic risk include, among others, continuing large funds flows into emerging market countries, which may amplify the magnitude of financial crises and various trends that may contribute to volatility in the flow of funds. Factors that may lessen the likelihood of a sovereign financial crisis leading to contagion and systemic risk include, among others, recent changes in the composition of investment flows to emerging market countries, a decrease in potentially volatile portfolio investment funds flowing to emerging market countries, decreased reliance on commercial bank lending, and a greater diversity in the sources of investment.

Factors That May Increase the Likelihood of Sovereign Financial Crises Threatening the International Financial System

We identified some capital market trends in emerging market countries that may increase the risk of sovereign financial crises that threaten the international financial system.

Large Funds Flows Continue to Go to Emerging Market Economies

Investors have been attracted to opportunities in the developing world. Flows of capital to emerging market economies in the form of purchases

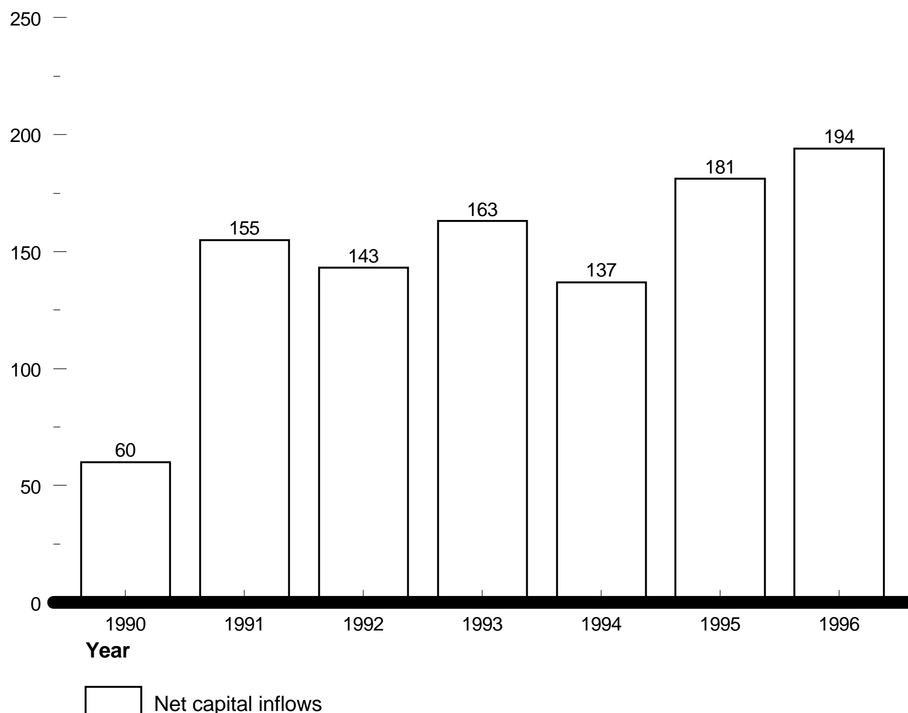
of securities have increased greatly in size over the years, according to the G-10. Despite the serious disruptions in early 1995 as a result of the Mexican crisis, total net capital flows—both public and private—to developing countries and countries in transition reached a record $228 billion in 1995. According to the G-10, economic liberalization and reform in the developing world have greatly increased the size and volatility of cross-border investments. The G-10 has stated that emerging market countries have a firmer grasp on fiscal conditions and, in many emerging market countries, inflation is coming under control. For example, macroeconomic reforms in the early 1990s in Latin America have led to soaring private capital flows, according to a senior U.S. Treasury official. Financial deregulation by country regulators has led to the opening up of domestic financial markets, to borrowing and lending abroad, to the development of stock markets, and to invitations to foreign investors to participate as well as diminishing capital controls.[1] Monetary policies in many creditor countries have led to lower interest rates in those countries, which then stimulated investors to search for higher yields abroad.

Large funds flows into emerging market countries may amplify the magnitude of financial crises, contagion, and any effect on the international financial system. Total net private capital inflows to emerging market countries increased by threefold between 1990 and 1996, from about $60.1 billion to about $193.6 billion, with the largest increase taking place between 1990 and 1991. (See fig. 2.1.) A Treasury official told us that countries are more able to finance large current account[2] deficits than in the past because private capital is now much more readily available.

[1]Capital controls are limits placed by countries on cross-border capital flows. Capital controls may limit the types of flows that come into or out of a country as well as limit the speed at which funds can enter or exit a country.

[2]A country's current account measures its transactions with other countries' transactions, services, investment income, and other transfers.

Figure 2.1: Net Private Capital Inflows to Emerging Market Countries
(1990-96)



Source: IMF.

Net private capital inflows include net portfolio investment, net direct investment, and other net flows, including short- and long-term trade credits, loans, currency and deposits, and other accounts receivable and payable. Net capital inflows for the years 1985-89 were about $40.6 billion, $50.4 billion, $48.7 billion, $40.1 billion, and $59.1 billion, respectively.

Mutual Fund Manager Constraints

Emerging market mutual funds—institutional investors with a fiduciary responsibility[3] to shareholders—are an increasing source of funds for borrowers in emerging market economies. Fund managers are expanding their portfolios into new markets. As of September 1995, mutual funds dedicated to emerging market equities alone had about $100 billion of

[3]Fiduciary responsibility is the responsibility to invest money wisely for the beneficiaries' benefit.

securities in their portfolios. Because fund investment guidelines require mutual fund accounts to hold liquid or marketable assets, fund managers may immediately attempt to dispose of assets in a crisis, thus contributing to volatility in capital markets.

Elimination of Capital Controls

A trend toward the elimination of capital controls in emerging market countries is allowing investor funds to move more quickly in and out of countries. Such movement can increase the amount of funds that can be withdrawn suddenly from a country when financial problems become apparent. The capital controls that are being eliminated were imposed by individual countries and were intended to limit the kinds of funds coming out of a country and the speed with which the funds could leave a country. One concern was that the funds withdrawn quickly could put downward pressure on asset prices and have a destabilizing effect on the countries' financial markets. Despite the appeal of (1) capital controls as speed bumps to dampen inflows, (2) taxes, and (3) other measures to transform short-term volatile money into long-term secure investment, the experience with capital controls suggests that the economic distortions and macroeconomic costs induced by controls are more costly than the potential benefits, according to a senior Treasury official.

Liquidation of More Diverse Investments

According to the G-10, emerging market country external investments are widening beyond debt into a whole array of assets—including domestic bank certificates of deposit, government debt denominated in local currency, and portfolio equities—none of which was significant in the 1980s. In countries that allow local currency to be freely converted into foreign currency and withdrawn from the country, the financial instruments may be sold for local currency, converted to foreign currency, and transferred abroad. These activities further increase the amount of investment in a country that can be removed quickly from a country.

Bank Lines of Credit and Liabilities

Banks in emerging market countries may have extensive foreign-currency-denominated international interbank lines of credit as well as large liabilities to foreign nonbanks. In times of diminishing confidence, banks may have difficulty refinancing these credit lines and liabilities, which can harm the banks' financial positions. Foreign currency lending to domestic borrowers can add to the scale of a banking crisis when a devaluation makes it more expensive for borrowers and banks to acquire the foreign currency necessary to repay the loans. Also, maturity mismatches may take place when bank funding for long-term projects is drawn from short-term deposits.

Factors That May Lessen the Likelihood of Sovereign Financial Crises Threatening the International Financial System

A study by an association of commercial banks, investment banks, and other financial institutions; multinational firms; and trading companies concluded that the risk of sustained contagion from a sovereign financial crisis is small because the international financial system appears relatively immune to systemic defaults by emerging market countries.[4] The report states that severely adverse economic conditions on a global scale were required to precipitate the international bond defaults of the 1930s and the Latin American debt crisis of the 1980s, and that the probability of similar conditions is low in the medium term.

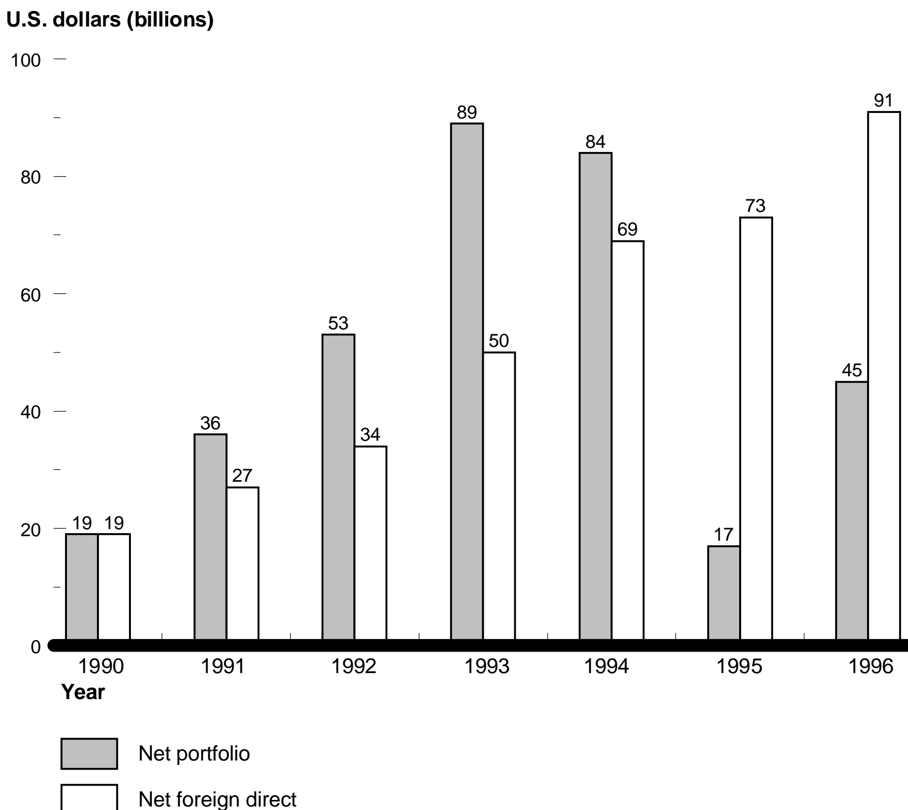
Changing Funds Flows

The composition of funds flows to emerging market countries has changed since Mexico's recent crisis, with a drop in portfolio investment in emerging market countries. Portfolio investment in emerging market countries fell sharply—from about $89.3 billion in 1993 to about $44.5 billion in 1996. (See fig. 2.2.) According to some international financial experts, direct investment[5] tends to be more stable and less likely to be withdrawn quickly. Much direct investment appears to be motivated by multinational corporations' locating production facilities in countries with low labor costs. Federal Reserve officials told us that the recent decrease of portfolio investments in emerging market countries may be transient and not sustainable over time.

[4]Resolving Sovereign Financial Crises, Institute of International Finance, Inc. (Sept. 1996). The study also noted that no contagion ensued when Venezuela, the fourth largest debtor country in Latin America, fell into arrears to private creditors and lost ready access to international capital markets in 1995.

[5]Foreign direct investment implies that a person in one country has a lasting interest in and a degree of influence over the management of a business enterprise in another country.

Figure 2.2: Net Portfolio Investment and Foreign Direct Investment in Emerging Market Countries (1990-96)



Source: IMF.

Net portfolio investment for the years 1985-89 was about $5.1 billion, $1.4 billion, $5.2 billion, $1.8 billion, and $10.3 billion, respectively. Net foreign direct investment for years 1985-89 was about $8.6 billion, $8.6 billion, $12.1 billion, $17.6 billion, and $20.4 billion, respectively.

The pattern of these capital flows changed in 1995, with a larger share going to those countries that had stronger economic fundamentals—including more open investment climates.[6] These trends indicate that investors began to be more aware of the risks of investing in

[6]World Debt Tables: External Finance for Developing Countries, 1996, World Bank, Volume One (Washington, D.C.).

emerging market countries than they were before Mexico's 1994-95 crisis, according to the report.

Decreased Reliance on Commercial Bank Lending and a Greater Diversity of Investors

Commercial bank lending to sovereign borrowers has been decreasing relative to loans to private firms, according to several international financial experts. As syndicated long-term loans from banks to country governments have fallen, bonds and foreign holdings of domestic currency debt have risen, and short-term bank credits have risen along with trade. Diminished sovereign reliance on commercial bank lending means less commercial bank exposure and less of an impact on these banks if countries have difficulty servicing their debt obligations. Also, commercial bank loan portfolios in the 1990s have become more diversified and do not contain large proportions of loans to emerging market governments as they did in the 1980s, according to a commercial bank official.

More Varied Investor Base

According to the G-10 and the Institute of International Finance, emerging market debt and equity is more widely held by a more varied investor base—including insurance companies, pension funds, and mutual funds. A more diverse investor base means that any sovereign debt-servicing problem would affect a wider variety of market participants than was the case in the 1980s when commercial banks were the dominant providers of funds for developing countries. But a more diverse investment base also means that the effects of a failure of any individual creditor financial institution would be small. Thus, losses would be more easily absorbed and unserviceable debt more easily written down without threatening the health of creditor country financial institutions, as was the case in the 1980s.[7]

Given these factors, it is unclear whether the likelihood of a sovereign financial crisis in emerging market countries that leads to substantial contagion to other countries has increased or decreased. However, World Bank officials told us that the global economy in the 1990s has not been tested by the major economic or financial shocks that occurred in previous decades, such as the sudden oil price increases in the 1970s. Such shocks have contributed to past waves of sovereign financial crises. Furthermore, even in the absence of shocks to the global economy, the composition and direction of investment flows to emerging market countries and economic conditions within those countries can change, sometimes rapidly and unexpectedly, as can investor behavior in a crisis. For these reasons, we find no basis to rule out the possibility of future sovereign financial crises' having substantial contagion effects on other

[7] Financial Crisis Management: Four Financial Crises in the 1980s (GAO/GGD-97-96, May 1997).

sovereign economies that might, in turn, threaten the stability of the international financial system. Treasury officials told us that the likelihood of sovereign financial crises is greater now than in the past because of increased capital flows to developing countries, increased volatility of those flows, and the growing ability of countries to run large current account deficits because private markets will finance the deficits. They also said that these factors may produce crises whose containment would require more substantial official sector resources.

Various Mechanisms Can Help Anticipate, Avoid, and Resolve Sovereign Financial Crises

A variety of public and private sector mechanisms can help capital market participants anticipate, avoid, and resolve sovereign financial crises. Major mechanisms that can help anticipate and avoid such crises include the following:

- debtor countries' governments can retain investor confidence by using the appropriate monetary, fiscal, debt management, and exchange rate policies;
- debtor countries' governments can provide information about their economic and financial situations;
- investors' avoiding or selling country-related financial instruments can signal emerging market countries' governments that their policies are inappropriate or unsound; and
- international financial institution and industrialized country governments can provide economic monitoring and advisory activities to debtor countries.

Major mechanisms to help resolve sovereign financial crises include the following:

- IMF and industrialized countries can provide financial assistance and
- debtor countries and their creditors (either official creditors or commercial bank creditors) can use existing conventions for negotiations between them.

Debtor Country Governments' Policies and Investor Behavior Can Help Avoid Sovereign Financial Crises

Debtor country macroeconomic, financial, and exchange rate policies that attract investment and promote investor confidence are the best safeguards against sovereign financial crises, according to several international financial experts we interviewed. In their views, policies that can enable a country to attract and hold portfolio investment flows are generally those policies that maintain low inflation, small or declining

fiscal deficits, few restrictions on capital movements into and out of the country, a prudent debt management strategy, and a flexible foreign exchange system that allows the country's authorities some macroeconomic policy flexibility in the setting of interest rates. A country's ability to maintain such policies depends in part on its ability to maintain domestic political support for the policies and on the strength of its commercial banking system. Political stability can also influence investor confidence in a country. Also, structural weaknesses in the banking systems of debtor countries can seriously aggravate sovereign liquidity crises, according to the G-10.

Investor behavior can also help in the avoidance of sovereign financial crises, according to some international financial experts. Investors can influence countries to adopt policies that they believe to be sound by insisting on lending to countries with unsound or inappropriate policies only at higher interest rates. The increase in the cost of borrowing, along with the possibility that investors may stop lending funds altogether, can provide the incentive for a country's authorities to correct their policies, which could help avoid a sovereign financial crisis. This investor behavior and country reactions are forms of market discipline. If the authorities of the country wanted to continue to borrow in international capital markets without substantial risk premiums, they would have to alter those policies to reassure investors. To the extent that debtor countries and investors expect official sector intervention in the event of problems, this market discipline can be undermined.

IMF and Creditor Country Governments Use Surveillance to Help Avoid Financial Problems

International financial institutions, such as IMF and the governments of the G-10 countries, also play a role in anticipating and avoiding financial crises in emerging market countries. Among international financial institutions,[8] IMF plays a major role in monitoring country economic and financial situations. The Executive Board requires the organization to (1) conduct "firm surveillance" over the exchange rate policies of member countries and (2) adopt specific principles for the guidance of all members with respect to those policies.[9] IMF surveillance procedures include examining the macroeconomic and related structural policies of individual countries, assessing the consequences of individual countries' policies for both the country and the operation of the global financial system, and encouraging countries to adopt policies that improve their financial and economic

[8]Other international financial institutions include the World Bank and the Bank for International Settlements.

[9]Articles of Agreement, International Monetary Fund, Article IV, Section 3(b).

situation as well as enhance the functioning of the international monetary system.

IMF's Articles of Agreement requires it to conduct a variety of surveillance and oversight activities. The two principal activities are regular consultations with member countries, which are known as "Article IV consultations" because they are related to Article IV of IMF's Articles of Agreement, and multilateral discussions with countries' officials to be held twice yearly as part of IMF's preparation of its World Economic Outlook reports.

Article IV consultations typically involve an annual visit to the member country by IMF staff. During that visit, the IMF staff are to confidentially consult with the country's officials on how effective their economic policies have been during the previous year and what changes might be anticipated during the coming year. The IMF staff are then to prepare a nonpublic report on their findings, which is to be reviewed by IMF's Executive Board.[10] The Board's discussion of the IMF staff's findings, with country representatives present, is to constitute the Article IV consultation with the member.

IMF's World Economic Outlook reports are to be issued twice yearly. The reports contain IMF staff economists' analysis of global economic developments during the near term and medium term, with separate report chapters devoted to, among other topics, an overview of the world economy and issues affecting both industrial and developing countries. These reports, and the IMF staff studies that support them, are publicly available from IMF. The reports provide the basis for multilateral economic outlook discussions at the Group of Seven countries' meetings.

Other tools of IMF surveillance include reviews of international capital market developments, which are to result in annual public reports,[11] and informal Executive Board sessions on world economic and market developments, which are held about every 6 weeks, according to an IMF document. Under IMF policy, IMF's Executive Board is to review the principles and procedures that guide its surveillance every 2 years, to see if any changes are needed. The latest such review, which covered the 2

[10]A recent IMF Executive Board decision provides for voluntary release of factual information after the conclusion of an Article IV consultation. This release would provide information on the member country's economy and IMF's assessment. IMF's assessment is to reflect the Executive Board's discussion of the nonpublic staff report prepared before the Article IV consultation.

[11]International Capital Markets: Developments, Prospects, and Key Policy Issues, Takatoshi Ito and David Folkerts-Landau, IMF (Washington, D.C.: Sept. 1996).

years following Mexico's recent crisis, was completed in early 1997, according to an IMF official.

Some major industrialized countries also monitor the economic and financial situations of debtor countries. These industrialized countries analyze the economic and financial situations and policies of emerging market countries in which they have substantial interests, such as trade or security interests, and suggest policy changes to country officials when incipient problems are detected. In the case of the United States, reports from the U.S. embassy are to be sent to Treasury and the Department of State in Washington, D.C. Some monitoring may take place from the capitals of creditor countries or at international conferences where debtor countries may describe and discuss their economic policies. Policy advice to countries may be delivered in multilateral forums or in bilateral meetings with the countries' heads of state or officials from other parts of the governments, such as the finance ministry or central bank.

IMF Financing Can Help Resolve Crises

IMF member debtor countries that cannot meet their financial obligations and that find capital markets or sovereign lenders unwilling to provide new financing, can ask IMF for financial assistance. IMF financial assistance is intended to provide the country, over the short term, with sufficient foreign currency to continue to service its debts, restructure its economy, stabilize its currency, and maintain the necessary trade flows. As of the fall of 1995, about 60 countries were receiving assistance from IMF, and about 20 other countries were actively negotiating with IMF for assistance. Most IMF programs are in the form of loans that are not financed through quota resources. Crisis resolution funding would usually be undertaken through quota resources. As of May 1997, there were 34 loan arrangements and 25 programs funded through quota resources.

IMF member countries with balance-of-payments problems ordinarily are allowed to withdraw,[12] without policy conditions, up to 25 percent of the funds that they contribute to IMF, according to IMF documents. That is, countries may withdraw funds without performance criteria or phasing of disbursements. Member countries that want additional IMF credit are subject to these conditions. A member country that needs more than 25 percent of its contribution may request more funds from IMF and may borrow cumulatively up to 3 times its contribution in any one year or 300 percent, cumulatively. IMF policy allows a country to exceed this maximum level of borrowing in extraordinary or exceptional

[12]Member withdrawals are purchases of SDRs or convertible currencies with their own currencies.

circumstances. IMF determined that such extraordinary circumstances existed when IMF made available about 688 percent of Mexico's contribution in 1995.[13] Countries that borrow from IMF are expected to repay the borrowed funds as soon as they resolve their payments problem. Before IMF will agree to extend financing, the country seeking assistance has to demonstrate how the funds will be used to solve its payments problem, thereby providing for repayment of the funds within 3 to 5 years, according to IMF documents.

To ensure that the member country uses the borrowed funds effectively, IMF financing arrangements require borrowing countries to (1) undertake a series of economic and other policy reforms—called "conditionality"—that are intended to eradicate the source of the payments difficulty, (2) lay a firmer foundation for economic growth, and (3) ensure that the country will be able to repay the funds in a short period, according to IMF documents. In some cases, these conditions are quite stringent and politically difficult for countries to implement. Policy commitments of the member country government are embodied in a letter of intent, which is the outcome of policy discussions between IMF staff and the member country government. Policy commitments embody performance criteria focusing on budgetary and credit ceilings, reserve and debt targets, and avoidance of restrictions on payments and transfers. Typically, countries applying for IMF financing present IMF with a reform plan to lower the value of their currency, encourage exports, and reduce government expenditure. IMF Executive Directors are to determine both the sufficiency of the reform measures and whether IMF can reasonably expect repayment. Following the approval of IMF Executive Directors, the loan is to be disbursed in installments—usually over 1 to 3 years—and disbursements are tied to the borrowing member's progress in implementing the planned reforms. Borrowing members pay charges to cover IMF expenses and to compensate the member whose currency it is borrowing. As of May 1996, borrowers pay commitment fees of 0.5 to 1 percent and interest charges of about 4 percent.

Different types of IMF financing arrangements are available to address various balance-of-payments problems.[14] IMF can provide this assistance

[13]Current rules permit an IMF member to borrow an amount equal to 100 percent of its quota per year, with a cumulative limit of 300 percent, unless exceptional circumstances exist. IMF potential lending to Mexico was about 688 percent of Mexico's quota over an 18-month period or 459 percent of its quota on an annual basis.

[14]Other facilities include the extended fund facility, which makes credit available for longer periods of time; the systemic transformation facility for economies in transition from centrally planned to market-based systems; the structural adjustment facility to support macroeconomic adjustments and structural reforms in low-income countries; and other facilities.

before debt-servicing problems arise. The most common arrangement, which is called a “standby arrangement,” is to be provided to a member country that is having trouble staying current in its foreign obligations and is to be a conditional line of credit for up to 3 years that allows the country to reorganize its finances. Standby arrangements typically focus on macroeconomic policies, such as fiscal, monetary, and exchange rate policies. If conditions are not met, access to further drawings is to be interrupted. Another IMF facility makes funds available at low interest rates to poor nations. Loans under this facility, which is administered separately from regular IMF resources, require close cooperation with the World Bank and its programs for economic development of the world’s poorest nations.

IMF generally has not lent to a country until the country reached agreements to settle debt claims of creditors in both the private and official sectors; in other words, IMF has seldom “lent into arrears,” according to IMF documents. However, IMF has made exceptions to this policy, particularly after 1987. At that time, IMF relaxed conditions attached to its own disbursements, thereby making disbursements before the country had reached agreements with banks and approving adjustment packages that involved less than full payment to banks. This policy change was intended as a means of inducing commercial banks to conclude negotiations with debtor countries. The purpose of the policy change was to shift bargaining power in debt negotiations from the commercial banks to debtor countries and to hasten resolution of debt crises, according to IMF documents.

U.S. Initiatives and Financial Assistance Can Help Resolve Crises

The U.S. government has worked both directly and indirectly with debtor countries to help resolve sovereign financial crises. To stabilize foreign exchange markets, the United States has provided currency swaps to emerging market countries through Treasury’s Exchange Stabilization Fund and the Federal Reserve’s currency swap network.

Also, the U.S. government has two initiatives that it has used to deal in general with the problem of developing country debt.[15] In 1985, the United States used the Baker plan to try to revive economic growth in developing countries by arranging for debtors to borrow even more funds from both private commercial banks and multilateral development banks. In 1989, the United States, recognizing that these debtors could not fully service

[15]Since each initiative was launched by a Secretary of the Treasury, the plans bear each Secretary’s last name.

their debts and restore growth at the same time, used the Brady plan to seek permanent reductions in the debtors' existing commercial debt-servicing obligations. Under the Brady plan, Mexico's government reduced its debt-servicing burden to commercial banks by reducing its stock of debt, lengthening maturity, and lowering interest payments.[16] Creditor countries may also help resolve sovereign financial crises less directly, by working within existing conventions for negotiating settlement of debts.

Existing Conventions for Negotiating Settlement of Debts Can Help Resolve Sovereign Financial Crises

In some cases, developing countries have been unable to meet their financial obligations. A country with debt-servicing problems typically may suspend payments and obtain legal representation to protect the country from its creditors and to help it negotiate a settlement with those creditors. An indebted country sometimes has lacked a clear understanding of its true debt situation and its ability to pay those debts and would seek assistance from IMF or a private firm employed to advise the country. According to our analysis, the country's creditors would either sell the country's debt to other investors, accepting any losses incurred, or prepare for negotiations with the country by assessing the country's debt situation and its ability to pay those debts. The indebted country would have multiple objectives in these negotiations, including rescheduling some or all of its debts or having debts forgiven; continuing the normal operation of its economy; maintaining political stability; preserving an adequate level of foreign currency reserves; and hastening a reestablishment of access to international capital markets, according to an international legal expert. Creditors would seek to maximize the amount of money they may receive by minimizing changes to the terms and conditions of the debt—except for interest payments, which they would usually try to increase.

The negotiations have often been conducted using existing conventions that have evolved to help resolve actual or imminent sovereign defaults. One mechanism, known as the Paris Club, has been used to facilitate negotiations for bilateral official credits or debts owed to governments—usually governments of industrialized countries. A second mechanism, known as the London Club, has been used to facilitate negotiations for debts owed to commercial banks.[17]

[16]Mexico's bank loans were converted into new bonds—with reduced principal or reduced interest rates.

[17]During the developing country debt crisis of the 1980s, the Paris and London Clubs were the principal venues and forums for negotiations between debtor countries, commercial bank creditors, and the official sector.

The Paris Club is a forum established in the 1950s for the rescheduling or refinancing of credits issued, guaranteed, or insured by creditor country governments. Although it is not a formal institution but rather an informal group of creditor country governments, the Paris Club operates according to an agreed-upon set of policies and procedures. There is no international statutory law that governs these policies and procedures. The Paris Club's membership has been determined on a case-by-case basis; however, its membership always has included the G-7 countries and often has included some of the other larger industrialized countries.

An indebted country applies to the Paris Club to negotiate the rescheduling or refinancing of debts it cannot pay. IMF has been integrally involved in Paris Club negotiations. Indeed, an IMF forecast showing that a country cannot meet its debt-service obligation is a precondition of opening a Paris Club negotiation. Furthermore, the Paris Club has required the debtor country to conclude an agreement with IMF that specifies policy reforms the country must make before rescheduling negotiations may begin. Paris Club negotiations have generally taken about 6 to 8 months but some cases have evolved into long, drawn-out negotiations. Paris Club negotiations culminate in a nonbinding understanding that provides the framework within which individual creditors conclude binding agreements with the debtor. This framework is intended to ensure that no creditor receives preferential treatment.

The London Club, which first was used in 1976, is a framework for negotiating the rescheduling of credits extended by commercial banks to governments, central banks, and other public sector institutions. Like the Paris Club, the London Club is a set of conventions, rather than an institution. The London Club has no fixed venue or secretariat but rather a body of procedures and conventions extablished by precedents. The participants in these negotiations vary with the commercial banks that have extended credits and are exposed to losses. Commercial banks participating in London Club negotiations form a steering committee of typically 15 members, each of which represents a number of other creditor banks. These creditor banks tend to be more numerous than the sovereign creditors involved in Paris Club negotiations. This steering committee makes its own forecast of the country's ability to repay its debts and negotiates policy changes that the country is to make as a condition of the rescheduling. In the past, these commercial banks have relied on IMF to monitor countries' adherence to the policy conditionality, and the banks have insisted on some form of IMF "seal of approval" before conducting a restructuring. In practice, the banks, sovereign creditors, and IMF all

engage in negotiations about the share and nature of debt relief each will grant to the debtor country.

In London Club negotiations, agreements between the debtor country and the commercial banks' steering committee can be approved by banks holding 90 to 95 percent of total bank exposure to loan losses. Banks on the steering committee must at each stage of the agreement get approval from the banks that they represent. Often, each bank is represented by its own legal counsel who must scrutinize all agreements. Dissenting banks and other entities are not compelled to accept the agreements, and creditor banks or assignees of bank debt can sue debtor countries for enforcement of the terms of the original loan agreement. Therefore, dissenters can hold up the negotiation process until they are bought out by the debtor or other creditors. For this reason, London Club negotiations have been lengthy. For example, Poland required almost 14 years to complete its London Club debt restructuring, which began in 1981.

Venues such as the Paris or London Clubs do not exist for renegotiating bonded debt. Although defaults by sovereigns on foreign-currency-denominated debt took place on a substantial scale throughout the 19th century and as recently as the 1940s, since World War II only a very small number of defaults by countries on foreign-currency-denominated bonds have occurred although there have been numerous sovereign debt-servicing problems, according to international finance experts. Negotiations to resolve these arrears have been handled on a case-by-case basis, usually in conjunction with settlements of other types of debts, such as commercial bank loan debt. During the 1930s, a wave of defaults occurred on sovereign bonds, which was triggered by the Great Depression. To negotiate settlements of these defaults, bondholders organized into committees. These committees, with the support of the United States and other creditor country governments, successfully negotiated settlements with the affected countries' governments, although some of these negotiations took years to complete.

Mechanisms That Can Help Anticipate and Avoid Sovereign Financial Crises Have Limitations

The effectiveness of these public and private sector mechanisms to anticipate, avoid, and resolve sovereign financial crises can face various limitations. These limitations include (1) moral hazard, (2) inadequate public provision of information by borrowing countries, (3) insufficient analysis by investors of the information that countries do provide, (4) domestic obstacles that can prevent countries from adopting appropriate economic and financial policies, and (5) inadequate

surveillance of countries' economic and financial policies by IMF and creditor country governments.

Distorted Incentives Can Undermine Anticipation and Avoidance Mechanisms

Some of the international financial experts we spoke with said that the expectation that public authorities will insulate lenders and borrowers from adverse consequences of their actions can entice investors to lend and countries to borrow while inadequately monitoring their risk. This is known as moral hazard. The presence of moral hazard in a financial market can cause market discipline to deteriorate and countries to prolong bad policies. If official sector intervention is expected, then investors are more likely to purchase risky country debt. Moral hazard can be a factor in international financial markets, especially for portfolio investors, because, unlike direct investors who may build production facilities in other countries, portfolio investors may not have a permanent stake in the country's financial health.

Information That Countries Provide to Investors May Be Inadequate

The globalization of financial markets has increased the importance of disclosure and the public reporting of sovereign economic and financial data. A regular and timely flow of relevant economic and financial data plays a critical role in helping a country's government develop and implement sound policies. A regular flow of accurate and timely economic and financial data to capital market participants seems likely to promote the smooth functioning of international capital markets. One way that countries improve their acceptability in capital markets is to publicly provide data.[18] Investors may use this information to assess the risk of investing in countries and to help manage their investments. The better a country is in providing accurate and timely data, the better investors will be able to assess the risks of investing in the country. Some market participants are not aware of all the information that is currently available and do not adequately use the available information in the investment analyses, according to the G-10. Better risk assessments can improve investors' abilities to identify countries with financial problems, and the investors' behavior of avoiding or selling investments in such countries may encourage the authorities of those countries to make needed policy corrections. In addition, IMF and other international financial institutions and the governments of major creditor countries can use this information for surveillance purposes.

[18]In some cases, countries supply these data only to companies that specialize in assessing sovereign risk, and the companies then sell their assessments to other businesses.

Information problems may have contributed to Mexico's 1994-95 financial crisis. An often-noted problem in Mexico's data reporting in 1994 involved its infrequent reporting of foreign currency reserves. Specifically, before the crisis, Mexico reported the foreign currency reserve holdings of its central bank only three times annually. Since Mexico's crisis, country data have improved—in some cases, substantially—according to one analysis. The previously mentioned 1996 study[19] by an association of financial companies found that, for 28 emerging market countries that received the greatest share of funds flows to emerging market countries, the adequacy of the data these countries supplied to markets had improved since the 1994-95 Mexican crisis. However, that same study found that the reporting of certain data remained poor for many countries—notably for external debt statistics.

Investors May Not Use Available Information to Monitor Risks

Companies that invest in emerging markets, including institutional investors who invest their clients' funds, have a stake in accurately estimating the risks of such investments. Nevertheless, in some cases, investors appeared to disregard or ignore available information that may have helped them assess the chances of a sovereign financial crisis.

In Mexico's case, data on the buildup of the Mexican government's short-term, dollar-linked debt were not widely publicized by the Mexican government, but were available to investors, according to numerous sources. The differential between interest rates on Mexican and U.S. government securities indicated that during much of 1994, financial markets perceived a low likelihood of Mexico's devaluing its currency or having debt-servicing problems. Between August and October, 1994, this differential narrowed, which suggests that markets believed that these risks were decreasing. We know now that the risks of a sovereign financial crisis were increasing during this time period. Representatives from some large, private investment firms told us that, before Mexico's crisis, their firms' risk assessment systems did not properly take into account short-term capital flows and other liquidity considerations.

According to some international finance experts, the following factors may have affected international investors' willingness to demand better and more timely information from Mexican authorities in 1994:

- The increasing magnitude of funds available to managers of emerging market investment funds put pressure on them to invest in countries with

[19] Resolving Sovereign Financial Crises, Institute of International Finance, Inc. (Sept. 1996).

high rates of return without adequately analyzing the risks of these investments.

- Investors did not fully appreciate how quickly securitized investments could be removed from a country and, therefore, may have underestimated the importance of a regular flow of key data from Mexico.
- Investors appeared to have had excessive faith in the ability of Mexico's leadership to change inadequate policies quickly.
- The odds of a country's having debt-servicing problems or defaulting on any particular debt were generally low.

Countries May Face Domestic Obstacles to Attractive Policies

International financial experts have cited weak domestic commercial banking systems as obstacles to policy changes that would retain investor confidence in emerging market countries. Banks are at the center of economic and financial activity in emerging market countries. A well-functioning banking system is important for the effectiveness of macroeconomic policies, and unstable macroeconomic environments can make it difficult for banks to assess credit risk. A sound banking system is one that is able to withstand adverse events and is a system in which most banks are solvent and likely to remain so. Solvent banks are profitable, well-managed, and well-capitalized. Even with many emerging market banks free of government intervention, years of government control of banks and inadequate competition left many banks unable to properly evaluate credit risks in some countries, according to international banking experts. The IMF Managing Director has said that the Mexican crisis demonstrated that countries with weak and inefficient banking systems are more vulnerable to contagion and less able to manage the effects of volatile capital flows and exchange rate pressures.

Banking problems in emerging market economies can have serious consequences for local economies and can spread to other countries, according to international banking experts. In some emerging market countries, structural weaknesses in the banking system and inadequate supervision and regulation of commercial banks have made the countries vulnerable to financial crises and have seriously aggravated such crises when they did occur.

Since 1980, over 130 countries have experienced significant banking sector problems.[20] Banking crises in emerging markets have usually been more severe than in industrial countries. Resolution costs or losses from

[20]Banking Crises in Emerging Economies: Origins and Policy Options, Morris Goldstein and Philip Turner, Bank for International Settlements (Basle, Switzerland: Oct. 1996).

country banking crises have ranged from 3 percent of gross domestic product[21] in industrial countries to more than 25 percent of gross domestic product in emerging market countries, according to international banking experts.

A legal system that facilitates bank supervision and regulation is important for healthy emerging market banking systems. The legal system must facilitate bank seizures and the transfer of collateral behind delinquent loans. Bank supervisors that need to curtail excessive risk-taking and limit bank rescue costs, need the statutory authority to (1) issue and enforce sanctions, such as cease-and-desist orders to banks; (2) specify accounting practices; (3) and close insolvent banks.

According to a study by a G-10 Working Party,[22] problems have arisen when banks funded sizable amounts of long-term domestic lending with short-term foreign currency borrowing in the wholesale interbank markets of the main international financial centers. According to our analysis, this type of bank funding could act as a major deterrent for a country to make a needed devaluation because a devaluation, which increases the domestic currency value of a bank's liabilities, might threaten bank insolvency. Decisions by the creditors of banks not to refinance such funding could generate a banking crisis because emerging market governments may be constrained from offering support to the banking system because the government's own financial position could deteriorate significantly. Such banking problems may present emerging market governments with the prospect of a large, public sector liability if these governments should take on the bad debt of their banks.

Also, bank operations in emerging market countries tend to suffer from (1) poor accounting systems; (2) lack of implementation of appropriate loan valuation and classification practices; (3) nonadherence to the Basle risk-weighted capital standard; (4) lack of limits on loans to bank owners and directors and bank-related businesses; (5) lack of competition from new entrants; (6) bank loan portfolios that are too concentrated by client base or geographic region; (7) owners who do not share the risk to which they expose their depositors; and (8) supervisory rules, if any, that do not require regulators to impose remedial measures on banks as their capital drops below specified levels, according to an international banking expert. Once a banking system becomes fragile, the host country may feel

[21]Gross domestic product is the total value of goods and services produced in a country's economy in a year.

[22]The Resolution of Sovereign Liquidity Crises, Group of Ten (Basle, Switzerland: May 1996).

constrained in using interest rates as an equilibrating mechanism to deal with shifts in market sentiment by raising interest rates because higher interest rates can harm banks by raising the number of nonperforming loans on their books. A weak domestic banking system was part of the reason Mexican government officials were reluctant to raise interest rates to continue to attract investor flows.

Poor oversight of emerging market banks has also been a problem, according to international banking experts. Supervisory guidelines have been lax or easy to evade. Resources have been inadequate to monitor banks. Lax entry standards have led to excessive expansion and widespread subsequent failures. Entry standards that create competition among banks have been allowed in foreign banks that are highly competitive and have reduced the overall profitability of banks. Supervisory authorities have not had the power to revoke bank licenses. Capital adequacy ratios have not been high enough to safeguard bank assets. Accounting and auditing standards have often been lax and ill defined in the developing world. Accurate accounting practices have not included current and complete recognition of nonperforming assets.

International financial experts have also cited political considerations as impediments to policy changes that would retain investor confidence in emerging market countries. Domestic political opposition can block policy changes necessary to attract and maintain investment. Our report on Mexico's crisis found that such obstacles occurred in Mexico in 1994. Due in part to an upcoming presidential election, Mexican authorities were reluctant to raise interest rates, devalue the peso, or take other action that could have reduced the inconsistency that had developed between Mexico's monetary and fiscal policies and its exchange rate system.

Activities of IMF and the U.S. Government Can Be Weakened by Inadequate Information

Mexico's 1994-95 financial crisis revealed inadequacies in IMF's monitoring and advisory activities and in the U.S. government's monitoring of Mexico's situation. Treasury and IMF officials told us that IMF did not keep a close watch on developments in Mexico during the latter half of 1994, did not see a compelling case for devaluation before December 1994, and did not foresee the financial crisis that occurred after Mexico's devaluation.

According to an IMF official we interviewed, IMF commissioned a postcrisis study,[23] which concluded that among the causes of the deficiencies in IMF surveillance of Mexico were that IMF was not monitoring countries on a real-time basis and IMF had become too tolerant of a falloff in the quality and timeliness of data provided by member countries that were no longer in an IMF-supported adjustment program. IMF public documents discussing the deficiencies of IMF surveillance of Mexico provided more details about the deficiencies. According to these documents, Mexican authorities' delays in reporting key data to IMF and reluctance in discussing policy issues when difficulties became apparent were key elements of the crisis. Furthermore, according to these documents, certain aspects of IMF's "culture," as well as IMF's close relationships with its members, had contributed at times to less effective surveillance.

A Treasury official we interviewed identified the following factors that may also have contributed to deficiencies in IMF's monitoring of Mexico:

- IMF staff tended to give Mexico "the benefit of the doubt" because Mexico had a highly respected economic team.
- IMF's Article IV consultation with Mexico took place early in 1994, which was before Mexico faced obvious financial problems.
- IMF staff were not paying enough attention to private market borrowing by countries.
- IMF staff doing financial market analysis were working independently from IMF country teams.

The U.S. government was more aware than IMF of the deterioration of Mexico's financial situation in 1994. Treasury and Federal Reserve officials monitored events in Mexico; by summer 1994, their analysts had concluded that the peso was overvalued. However, like IMF and most financial market participants, U.S. officials underestimated the potential of a large amount of outstanding tesobonos to precipitate an investor panic if Mexico unexpectedly devalued its currency.

[23]In 1995, IMF commissioned a former senior IMF official to conduct a postcrisis study to determine why IMF did not anticipate the Mexican crisis. We were unable to obtain a copy of the study from IMF. However, an IMF official discussed some of the study's conclusions with us, and some of the study's findings have been discussed in various IMF publications.

Mechanisms That Can Help Contain and Resolve Sovereign Financial Crises Have Limitations

Once a country's financial difficulties become acute, investors may overreact, precipitating or deepening a crisis, according to international financial experts. According to some financial experts, governments and IMF may have difficulty deciding whether to intervene to help resolve a sovereign financial crisis because decisionmakers may disagree over (1) the extent of the threat a crisis poses to the international financial system and (2) whether such a threat warrants intervention, which may create additional moral hazard. Also, after an agreement to intervene has been reached, creditor country governments and IMF may find it difficult to provide sufficient financial assistance quickly enough to arrest the crisis.

Investor Reactions May Precipitate or Deepen a Crisis

Investors in liquid securities that are confronted with uncertainty have a strong incentive to sell their securities, according to international finance experts. Investors may react to news of a country's deepening financial difficulties by selling their country-related financial instruments, and thus precipitate a crisis that would not have otherwise occurred or seriously aggravate a crisis that already has begun. In response to adverse information, individual investors in a country may face powerful incentives to liquidate their investments immediately, before other investors do the same and cause the country to run out of funds to repay its debts. Individual investors have an incentive to sell their investments even if the creditors would be better off as a group if the investors continued to hold the debt of the country. This behavior may be more common with portfolio investment, such as mutual and pension funds, because (1) investments in emerging market country securities are usually more readily sold than direct investments, such as production facilities, and (2) the managers of these funds may have a fiduciary responsibility to sell poorly performing assets. Other investors, upon seeing funds exit a country, may interpret these funds flows as evidence that the country is in serious financial trouble.[24] If enough investors withdraw funds, what began as a market disruption could quickly become a self-fulfilling crisis. Investors' overreaction to Mexico's crisis may have contributed to the spread of the crisis to other countries, to the extent that investors pulled funds out of other countries because investors wrongly concluded that these countries faced problems similar to Mexico's, according to international financial experts.

[24]According to bank regulators, the likelihood of a loss of investor confidence is greater when investors know that a country's banking system is weak, and that the country may have trouble tolerating prolonged financial trouble.

Negotiations May Be Troubled by a Scarcity of Information and Negotiating Strategies

Various obstacles to expeditiously resolving a sovereign financial crisis may develop during the negotiations between a country that is having debt-servicing problems and its creditors. Two such obstacles are a lack of information that creditors may use to verify claims made by the debtor country, which may lead to delays in negotiations, and delays in resolution due to creditor holdouts.

Scarcity of Information and Delaying Tactics

Creditors of a country that is having debt-servicing problems may not have access to the information they need to verify the country's financial situation and to independently estimate the country's economic ability or political willingness to adopt economic reform measures that would allow debts to be repaid, according to several international finance experts. In the case of a sovereign default or difficulties with debt servicing, where the lending is not backed by collateral, this information can be crucial in helping investors to develop their negotiating positions. Furthermore, when a country's creditors have complex and conflicting claims, they may not believe that it is in their interest to share key information among themselves about a country's ability to honor its debts. In addition, debtor governments may be unsure of how much of a loss bondholders are willing to accept. In such an environment, both a debtor country and its creditors can engage in strategic bargaining, posturing, delaying tactics, and other actions that could prolong negotiations to the detriment of one or both sides.

There is evidence that efforts to resolve some past financial crisis were troubled by these information-related problems. For example, in the 1930s, negotiations over defaulted Latin American bonds were protracted, taking over a decade to complete in some cases, according to an international finance expert. This situation happened, in part, because incomplete information problems led to strategic bargaining and delaying tactics. Also, according to this expert, in the 1980s' developing country debt crises, creditor banks lacked key information on the financial position of debtor countries, which also prolonged negotiations and harmed both the banks and the debtor countries. This situation did not occur in Mexico in 1995 because the multilateral financial assistance package prevented Mexico from defaulting on any of its debts.

Creditor Holdouts

After a country reaches agreement with the majority of its creditors, a final problem can develop: a small number of creditors, seeking to maximize their returns and hoping to be bought out by larger creditors, can block the settlement. This occurred in the 1980s' developing country debt crisis, according to an IMF official, when a small number of banks involved in

syndicated loans to developing countries held out and delayed settlements that had been reached by the majority of banks involved in the loans. Most bond contracts require unanimous approval of bondholders to alter the bonds' core provisions, which also creates a potential holdout problem for bond debts.

Debtor Countries May Be Unable to Attract New Funds

Another problem that can develop in capital markets involves the provision of new money to a country with debt-servicing problems, according to international financial experts. Often a country experiencing a financial crisis requires new money to restructure its old debts or to allow the adoption of policy changes that are necessary to aid its ability to pay its debts. Yet, these investors, who are concerned about liquidity, have a disincentive to providing additional funds to a country, largely because they would be concerned that any new funds they supply would be used—at least in part—to pay off old creditors. New funds were needed in Mexico's 1982 and 1994-95 financial crises. In 1982, commercial banks and others provided new funds; in 1995, new funds came from the U.S. government, IMF, and Canada.

Organizing the provision of new funds to an indebted country can be particularly difficult in the case of bond financing, where it is necessary to coordinate the actions of a large number of debt holders. Another reason it can be difficult to organize the provision of new funds is that bondholders—with their concern for rates of return and liquidity—are less likely to see an advantage in a long-term lending relationship than are banks or direct equity investors. Both the 1930s' bond negotiations and the 1980s' debt crisis were prolonged due to creditor reluctance to provide new money.

Governments and IMF May Have Trouble Helping to Resolve Crises

Our analysis showed that governments of creditor countries and IMF may be limited in their abilities to respond to sovereign financial crises. The governments of leading creditor countries lack procedures for responding to a crisis in an emerging market country, according to an international financial expert. Policy disagreements within a country's government or between countries over whether a country's financial crisis will lead to contagion or systemic risk problems can impede the speed with which creditor countries and IMF respond. Disagreements may also arise about whether the threat posed by the crisis warrants intervention that may alter future incentives for investors and countries. A consensus was not achieved among major creditor countries that Mexico's 1994-95 financial

crisis posed systemic risk, according to international financial experts. Officials disagreed about whether there was a threat to banking systems in countries other than Mexico and whether Mexico's problems would result in a shock to nondepository financial institutions around the world. Creditor countries also disagreed about the risk to economic activity around the world and the risk to the global trend toward market-oriented reforms. The German and Japanese governments were concerned that official assistance to emerging market countries would encourage reckless lending and overborrowing.

Debates on the use of resources of creditor countries and IMF can also hinder the speed of country response to sovereign financial crises. In Mexico's recent financial crisis, the United States' response was slowed by policy disagreements between the executive branch and Congress. After an initial financial assistance package failed to receive sufficient congressional support, the Exchange Stabilization Fund and the Federal Reserve swap network was used to assist Mexico. Use of the Exchange Stabilization Fund does not require the consent of Congress.

Individual countries also may find it difficult to provide the financial resources necessary to respond to a financial crisis. The United States can respond to some degree to sovereign financial crises with the resources of the Exchange Stabilization Fund and the Federal Reserve swap network. As of September 30, 1996, the Exchange Stabilization Fund had the equivalent of $38 billion in Japanese yen, German marks, special drawing rights, and dollars. The Federal Reserve swap network has various reciprocal currency arrangements available to different countries. To the extent that the resources of the Exchange Stabilization Fund are not already being used in helping countries that are currently experiencing financial crises, the Fund could be available for assisting additional countries in trouble. Other potential creditor countries may not have the legal authority or resources to provide assistance to countries experiencing financial crises.

The ability of IMF to respond to a sovereign financial crisis is also dependent upon its available resources. IMF's various resources for assisting countries in trouble may at any given time already be committed. If this is the case, according to our analysis, IMF options would include asking for additional funds from its members, suggesting that debtor countries ask individual countries or other organizations for assistance, or telling the debtor country that IMF resources are not available and that no assistance will be forthcoming.

Individual countries and IMF may find it even more difficult to provide the magnitude of financial resources that would be necessary to respond to multiple, simultaneous sovereign financial crises. Simultaneous sovereign financial crises may be beyond the available resources of the United States and IMF—especially if the countries in crisis are large emerging market economies.

Initiatives Could Help Strengthen Crisis Anticipation and Avoidance, but Obstacles to Success Exist

International financial institutions and governments of the industrial democracies have three principal initiatives under way to help anticipate and avoid sovereign financial crises. These initiatives are market-based efforts to address weaknesses in mechanisms to anticipate and avoid sovereign financial crises. Our analysis indicated that, while these initiatives appear to have the potential to contribute to helping countries and their creditors anticipate and avoid some future sovereign financial crises, significant obstacles could hinder their full effectiveness.

One G-7 initiative is IMF's effort to promote the provision of more reliable and complete information for investors and others by borrowing countries. IMF developed a voluntary standard that countries may use in disclosing economic and financial data to the public. IMF has said that it expects countries that subscribe to the standard will comply with its requirements, and has stated its intention that IMF will remove nonadhering countries from the list of subscribing countries. However, no ready means exist to monitor countries' adherence to the standard.

A second initiative, which was put forward by a G-10 Working Party and, at the time of our review was in an early stage of development, is aimed at strengthening the supervision and regulation of commercial banks in developing countries. This effort, if successful, would help those countries overcome weak commercial banking systems, which is a major obstacle they can face in adopting and maintaining policies that attract investors. However, the initiative may take much time for a variety of reasons, including reported entrenched domestic opposition in some developing countries. A third G-7 initiative is aimed at improving IMF's surveillance of member countries' economic and financial situations and policies. This initiative may also face a number of obstacles, most notably IMF's lack of leverage over countries that are not receiving IMF funds.

IMF's Voluntary Data Standards Might Help Improve Country Data, but IMF Cannot Ensure Compliance

One factor that has been cited as contributing to Mexico's 1994-95 financial crisis was Mexico's inadequate public disclosure of key economic and financial data. In 1995, IMF officials began considering what role IMF might play in improving countries' provision of such data. IMF's ability to encourage better data disclosure by countries was limited because, according to IMF, it had no authority under its charter to require member countries to publish economic or financial data. Nevertheless, IMF's Executive Board decided in April 1995 that it was appropriate and consistent with IMF's articles of agreement for IMF to establish two voluntary standards that IMF member countries could use when disclosing

key economic and financial data to markets. IMF's intent was that the use of these standards would encourage dissemination of comprehensive, timely, accessible, and reliable economic and financial statistics from countries to financial markets.

One standard is to be called the General Data Dissemination Standard and is intended for use by countries that are not yet active in global capital markets—the majority of developing countries. IMF is in the process of developing this standard and hopes to have approval from the Executive Board by fall 1997, according to an IMF official.

The second standard, called the Special Data Dissemination Standard, is stricter than the General Standard and is intended for use by countries that are, or aspire to be, active in world financial markets. IMF began allowing countries to subscribe to the Special Standard in April 1996, with a transition period that is to end on December 31, 1998. During the transition period, a country may subscribe to the standard even if its data dissemination practices are not fully in compliance with the Special Standard. This transition period is intended to give subscribing countries time to adjust their practices to comply with the Special Standard. As of May 21, 1997, 42 countries had subscribed to the Special Standard, including all of the G-10 countries and a number of developing countries, such as Argentina, Malaysia, Mexico, the Philippines, and Thailand.

The Special Standard has (and the less strict General Standard is to have, when it is completed) four dimensions: (1) public access to the data; (2) integrity of the data; (3) quality of the data; and (4) the actual data, in terms of their coverage, frequency, and timeliness. The requirements for both standards are to be identical for the first three of these dimensions. The Special Standard prescribes—and the General Standard is to prescribe—ready and equal public access to country data through advance public notice of release calendars and simultaneous release of data to all interested parties. For the integrity dimension, both standards are to require (1) countries to identify the terms and conditions under which official statistics are produced, (2) internal government access to the data before release, and (3) ministerial commentary on the occasion of statistical release. Integrity is to be further ensured by a requirement that countries disclose information about revisions to their data and give advance notice of major changes in methodology. For the quality dimension, countries are to disseminate documentation on methodology and sources used for their statistics, component details of the data,

reconciliations with related data, and statistical frameworks that support statistical cross-checks and provide assurance of reasonableness.

For the data dimension, the Special Standard lists 17 categories of mandatory data that cover the four sectors of a country's economy: the real, fiscal, financial, and external sectors.[1] For each data category, the Special Standard specifies how often the country is to report the data and how timely the reporting must be (the permitted lag). For example, one type of data that must be reported for the external sector is a country's international currency reserve levels. The Special Standard specifies that a country must report its gross official international currency reserves, denominated in U.S. dollars, on a monthly basis with no more than a 1-week lag. Appendix II of this report shows all of the Special Standard's 17 data categories and their reporting requirements. These reporting requirements are more rigorous than those planned for the General Standard.

IMF does not plan to publish the country data. Instead, IMF has established a data dissemination electronic bulletin board on the Internet that displays information about the IMF data standards and individual countries' data, and that explains how interested parties may obtain the data.[2] For 7 of the 42 subscribing countries, the descriptions of the data on IMF's bulletin board are linked electronically to the data themselves, which are maintained by the country. IMF plans eventually to link its electronic bulletin board to all subscribing countries' data.

Capital market participants and other experts with whom we spoke generally praised IMF's efforts to create standards for countries' provision of data to the public. An official from an association of commercial and investment banks and other financial institutions told us that he believed IMF's standards will improve the flow of key information to financial markets. IMF's data dissemination standards appear to be a market-based effort to address a specific problem in capital markets that can interfere with markets' ability to anticipate and avoid sovereign financial crises.

[1]The IMF Special Standard encourages, but does not require, that data be reported in two other categories: population and forward-looking indicators, such as qualitative business surveys.

[2]The bulletin board's Internet address is http://dsbb.imf.org.

IMF Is to Rely on Financial Markets to Monitor and Enforce Adherence to the Data Standards

IMF publications state that IMF expects countries that subscribe to the standards to comply with them. Furthermore, IMF's data dissemination standards electronic bulletin board informs users that, after the Special Standard's transition period ends at the end of 1998, IMF will remove countries from the list of subscribing nations if IMF finds serious and persistent noncompliance.[3]

However, citing both resource constraints and a lack of authority to require member countries to publish data, an IMF official said that IMF does not plan to (1) verify the data that countries publish under the data dissemination standards or be responsible for the data's accuracy or (2) regularly monitor countries' compliance with the data standards. Instead, IMF plans to rely on financial market participants to monitor countries' compliance with the data standards. According to the IMF official, when market participants have concerns about countries' compliance, IMF will expect them first to bring their concerns to the attention of the authorities of the country in question. However, IMF officials do plan to monitor the data to some extent because IMF staff plan to use the data that the countries publish for a variety of purposes and, in doing so, may detect discrepancies. Also, IMF officials said that IMF will devote some attention to observance of the data dissemination standards as a part of its official surveillance of member countries' economic and financial policies and also during its annual Article IV country consultations.

Furthermore, IMF officials have stated that IMF will rely primarily on capital market participants to enforce compliance with its data standards. This enforcement is to occur through the process of market discipline, whereby market participants would remove or threaten to remove funds from a country if they suspect it is not providing accurate, timely data to markets and, thus, would induce the country to comply.

Financial Market Participants May Not Help Monitor Standards

Market discipline exercised by capital market participants may help enforce adherence to IMF's data dissemination standards to some extent. In some cases, individual investors may become suspicious of a country's data quality, and remove some or all of their funds from the country. This act might discipline the country to improve its data by signaling other market participants to question the data and remove their funds from the country, as well. However, the ability of market discipline to anticipate

[3]At the time of our review, IMF had not determined the process by which IMF would decide to disqualify a member country from the Special Standard. IMF plans to determine this process by the end of the transition period.

and avoid sovereign financial crises has varied in the past, as Mexico's 1994-95 financial crisis demonstrated.

Furthermore, we were told that financial market participants will not be able to monitor, or be willing to help IMF enforce, IMF's data standards to the extent that IMF hopes. Financial market participants can be expected sometimes to inform IMF when they have compliance concerns, especially in cases where the market participants have raised their concerns with officials from the country in question and have not received a satisfactory response. Increased contacts between IMF officials and capital market participants could facilitate IMF's learning about these events. However, many financial market participants with whom we spoke said (1) that market participants, for the most part, do not intend to monitor countries' compliance with IMF's data standards and (2) that they generally do not expect to keep IMF informed of any compliance concerns they may have. Moreover, to the extent that individual capital market participants perceive that knowing a country's published data are inaccurate might give them a competitive advantage over other market participants, the participants may have a disincentive to inform IMF of their compliance concerns.

Moreover, IMF does not have a system in place to collect and assess market participants' concerns over countries' compliance with the Special Standard. IMF's data dissemination standards Internet site encourages users to comment on the standards initiative, but the site does not solicit users' concerns about countries' compliance with the standards.

Initiatives to Improve Financial Stability in Emerging Market Countries May Not Achieve Timely Results

Following Mexico's crisis of 1994-95, a G-10 Working Party concluded that the financial systems in emerging market economies—especially the banking sector—should be strengthened to reduce the risk they might pose in the event of a sovereign liquidity crisis. More attention needs to be paid to incipient problems in the banking sector, the G-10 said. According to a Treasury official, strong bank supervisory regimes are essential to avoiding sovereign financial crises. This official said that emerging market banking systems need to have ownership distributed widely, to be free from credit control and credit allocation guidelines, and to be open to foreign banks. He said the best approach is to address underlying weaknesses by ensuring a sound incentive and ownership structure, developing human resources, requiring banks to hold adequate risk-weighted capital, maintaining good accounting standards, and establishing an effective system of bank supervision.

In response to an initiative at the Lyon, France, summit in June 1996, representatives of the G-10 countries and of some emerging market economies have sought to develop a strategy for fostering financial stability in countries experiencing rapid economic growth and undergoing substantial changes in their financial system.[4] A G-10 document that lays out the Working Party's strategy[5] states that countries have incentives to work toward robust financial systems because such a system increases access to global financial markets and provides benefits in the form of more stable and often faster economic growth. The document points out that the ultimate responsibility for policies to strengthen financial systems lies with national governments and financial authorities in the countries concerned and that the role of the international community is to provide advice, incentives, and a yardstick against which progress can be measured. The document acknowledges that the discussion is general in nature and that specific priorities and time frames in any given country or group of countries will often differ. The document also states that legal and judicial reforms will take longer to achieve than revising capital adequacy requirements. The four components of the strategy are:

- the development of an international consensus by G-10 and emerging market country representatives on the key elements of a sound financial and regulatory system;
- the formulation of norms, principles, and practices by international groupings of national authorities;
- the use of market discipline and market access channels to provide incentives for adoption of sound supervisory systems, better corporate governance, and other key elements of a robust financial system; and
- the promotion by multilateral institutions, such as IMF, the World Bank, and regional development banks, of the adoption and implementation of sound principles and practices.

Obstacles Exist to Improving Emerging Market Banking Supervision

A recent G-10 report found that progress in upgrading banking supervision has not yet been widespread or substantial enough for the banking system to serve as an ally to financial stability and sustainable economic growth in emerging market countries. Critics of supervision improvement efforts have contended that international organizations lack knowledge of

[4]Representatives of Argentina, France, Germany, Hong Kong, Indonesia, Japan, Korea, Mexico, the Netherlands, Poland, Singapore, Sweden, Thailand, the United Kingdom, and the United States participated in developing this strategy.

[5]Financial Stability in Emerging Market Countries: A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems, Group of Ten (Apr. 1997).

emerging market banking systems and have no powers to enforce bank regulatory standards. According to these critics, because entrenched opposition domestically and considerations of competitiveness with other banks and countries prevent bank supervisors in developing countries from acting unilaterally, an international standard for emerging market bank supervision and regulation developed by the Basle Committee for Bank Supervision offers the best hope for improvements. However, many years were required for completion of the Basle Committee's effort to create and gain adherence for capital adequacy standards to mitigate banks' exposure to market risks. Current initiatives to improve bank supervision in emerging markets may also require considerable time.

Improving IMF Surveillance of Key Emerging Market Countries May Face Obstacles

At the June 1995 summit held in Halifax, Nova Scotia, the G-7 governments recommended that IMF improve its surveillance. A background document prepared for the Halifax summit recommended that IMF:

- devote greater resources and attention to those countries of global significance, including both industrial and emerging market countries;
- devote more attention, in general, to financial and banking sector developments and, in particular, to the pattern of capital flows and their maturity;
- offer clear and direct policy advice to all governments, especially those that appear to be avoiding necessary policy measures (where IMF's country surveillance is ineffective, IMF's managing director and/or the representatives to IMF from the country in question should pass a strong message to the country's officials); and
- where feasible, be more open and transparent in its assessments and policy advice.

To carry out these recommendations, IMF is pursuing a number of changes to its surveillance policies and procedures. According to an IMF official, these improvements involve changes to the focus of IMF surveillance, the continuity of this surveillance, the information IMF requires member countries to disclose to IMF, and IMF's "culture." IMF plans to refocus its surveillance to emphasize countries whose economic problems could have a systemic impact on the world's financial system.[6] To this end, IMF has created within its research department a new division that focuses on

[6]An IMF official told us that IMF has not created, nor does it plan to create, a "watchlist" that identifies which countries would threaten global financial stability if they encountered a financial crisis. According to the official, IMF's Executive Board was concerned about the consequences if financial markets were to learn which countries were on such a list and that the existence of such a list might cause IMF to focus unduly on those countries even when situations change.

capital flows and on fast-growing emerging market countries. IMF staff are to pay greater attention to countries' capital accounts—especially their debt structures and financing policies and the risks of overreliance on easily reversible capital flows—and the soundness of their financial sectors. To help in this, IMF analysts are to make greater use of data generated by financial markets.

Regarding continuity in surveillance, IMF is trying to increase the frequency and timeliness of its surveillance. An IMF official told us that the proportion of member countries that have an Article IV consultation every 15 months rose from 71 percent in 1993 to 77 percent in 1996. Several IMF officials also said that surveillance between Article IV consultations has been enhanced. They said that informal IMF staff visits to countries occur more frequently now, especially to countries that are not receiving funds from IMF, and that IMF now tries to send missions to countries as problems develop, rather than waiting for the next annual Article IV cycle. Also, an IMF official told us that there are now more frequent IMF Executive Board meetings to review situations in particular countries. At monthly meetings, on a rotating basis, IMF department directors brief board members on situations in the countries under their jurisdiction. A department director now can request a special meeting of the Executive Board to discuss a country, as well. Finally, an IMF official told us that every 6 months staff in IMF's Policy Development and Review office prepare a report for the Executive Board's consideration that assesses the extent to which selected member countries have implemented some of IMF's policy recommendations. These reports, which have included reviews of some emerging market countries, allow the Executive Board an opportunity to review situations in nonprogram countries in addition to those countries' annual Article IV consultations, the IMF official said.

In addition, IMF has revised its policies on the data that countries are required to provide IMF for surveillance purposes. In its post-Mexico crisis review of surveillance, IMF found that, although data provision to IMF was adequate for the majority of member countries, deficiencies existed for many members. In September 1995, IMF's Executive Board agreed to a set of 12 core data categories, representing "the absolute minimum" set of categories to be provided by all members to IMF on a regular and timely basis for continuous surveillance.[7] The categories include exchange rates, international currency reserves, the external current account balance, and

[7]The requirements of the 12 data categories are different from, and less strict than, the requirements of IMF's Special Standard for publicly disclosing data. The reason for this is that all countries are required to furnish these data to IMF, whereas the Special Standard is designed for countries that are active in global capital markets and, therefore, could be made more demanding.

external debt and debt service.[8] IMF is in the process of defining the appropriate coverage, periodicity, and timeliness for these data. However, IMF anticipates that it will require that as many of the data categories as possible be reported monthly, especially those relevant for monetary policy, and that at times of exchange market tension, certain types of data, such as foreign exchange reserves and foreign debt, might have to be reported more frequently. Furthermore, IMF anticipates that, for many countries, the list of 12 data categories will need to be supplemented with other required data. In September 1995, IMF's Executive Board decided that all member countries should at least maintain their current levels of reporting of data to IMF. According to an IMF official, all Article IV staff appraisals now are to have a section on data quality and timeliness. This official also said that Article IV reviews will be used as a "consciousness-raising exercise" to encourage better transmission of data by countries receiving IMF funds, both to IMF and to financial markets.

An IMF official told us that IMF will be less tolerant of countries in an IMF program when these countries allow their data quality or timeliness to deteriorate. To enforce this, IMF plans to use a graduated approach. When members are reluctant to provide data that would allow effective surveillance, IMF staff and management, with assistance from the country's representative to IMF, are to discuss the matter with the country's authorities. If this does not resolve the problem, the matter may be elevated to IMF's Executive Board. Where insufficient data provision is caused by weak statistical infrastructures, IMF staff are to work with the country's officials to improve data systems and offer technical assistance, where desirable.

IMF also has attempted to change IMF's culture. According to both an IMF document and an IMF official, a 1995 internal IMF study reportedly found that IMF's culture tended to encourage close relationships between IMF staff and country authorities, and that IMF staff tended to give country authorities the benefit of the doubt when they had concerns over the country's policies. An IMF official told us that IMF staff are now more candid with country authorities, especially during Article IV consultations, and that IMF staff are less likely than before Mexico's recent crisis to give country authorities the benefit of the doubt.

[8]The other categories are: central bank balance sheet, reserve or base money, broad money, interest rates, consumer price index, external trade (i.e., exports/imports), fiscal balance, and gross national product or gross domestic product.

Some Factors May Limit IMF's Efforts to Help Avoid Future Sovereign Financial Crises

It appears that the steps IMF has taken to improve its country monitoring represent a conscientious effort to address weaknesses in surveillance and could improve the quality of IMF's surveillance. If successful, these initiatives might contribute to the avoidance of future sovereign financial crises. However, IMF's improved surveillance and related advisory services may be subject to some limiting factors already familiar to IMF. Notably, it is likely that IMF will continue to have only limited influence over countries that are not in an IMF program. This may be especially true for nonprogram countries that are receiving large private capital inflows. Such countries, as Mexico was in 1994, would not likely anticipate having to borrow funds from IMF and might conclude that financial markets will continue to lend them funds. Therefore, such countries could resist adopting policy changes recommended by IMF. Another factor is that some sovereign financial crises are the result of a complex interaction of economic, financial, political, and other factors that are difficult for anyone to anticipate. And, IMF's surveillance is likely to continue to be limited by the quality of IMF's analyses of countries' situations and policies, which in the past has varied.

Most Resolution Improvement Approaches Might Reduce U.S. Burden, but Many May Not Help Stem Contagion

At the time of our review, the G-7 and a G-10 Working Party had proposed three IMF initiatives to improve existing mechanisms to help resolve sovereign financial crises, and a number of proposals to create new mechanisms had emerged. Our analysis indicated that, if these initiatives are implemented, they might reduce the U.S. burden in resolving crises compared to the 51-percent share of the multilateral financial assistance provided to Mexico in 1995. However, the use of the initiatives could involve some trade-offs for the United States.

The G-7 initiatives were to: (1) expand the General Arrangements to Borrow (GAB) lines of credit to give IMF access to more funds should they be needed to resolve a crisis that threatens the international financial system and (2) create a new, expedited decisionmaking procedure at IMF, called the Emergency Financing Mechanism, for use in extraordinary circumstances. The G-10 Working Party proposal is to change IMF's policy to permit IMF to extend financing in extraordinary circumstances to an indebted country before the country has settled claims with its nonbank private creditors, as a way to encourage such settlements (such extension of financing is known as “lending into arrears”). During the time of our review, these initiatives were in various stages of development.

The proposed expanded GAB, which is to be called the New Arrangements to Borrow (NAB), could reduce the U.S. share of crisis resolution funding compared to the proportion the United States contributed to the 1995 assistance to Mexico. However, because the United States would contribute a smaller share of NAB's resources than under GAB, U.S. influence in NAB might be diminished because its voting power also will decrease. This reduced influence might make it harder for the United States to obtain activation of NAB in cases where the United States believed activation was desirable. Similarly, the increase in the number of countries that would participate in decisions to activate NAB might not facilitate consensus decisionmaking required for the use of the funds to stem contagion. On the other hand, because activation of NAB would require the votes of countries holding a larger percentage of resources than under GAB, the United States would more easily be able to block activation of the new lines of credit. Also, although use of an expanded GAB could help minimize contagion effects in a sovereign financial crisis, having NAB could increase moral hazard for debtor countries and investors. IMF's expedited decisionmaking procedures might speed IMF assistance to prevent contagion in a crisis and reduce pressure on the United States to act quickly unilaterally.

An IMF lending into arrears policy for nonbank private debts might speed resolution of some crises and perhaps help reduce IMF funding for crisis resolution. However, this policy change could harm creditor interests in future sovereign financial crises and raise the price of international capital to developing countries.

Various improvement proposals suggested ways to encourage capital markets to create mechanisms to apply principles of U.S. bankruptcy law to international sovereign default, including a proposal for the development of an international bankruptcy court for countries. Although these proposals might eliminate or reduce public sector financing costs and simplify some crisis resolution procedures, they may be difficult to implement or may operate too slowly to limit contagion.

Initiatives Are Under Way to Improve the Provision of Official Financial Assistance

In May 1995, leaders of the G-7 countries recommended two initiatives to improve the way the official sector can provide financial assistance to countries that experience financial difficulties. The initiatives were to: (1) create the NAB credit lines to give IMF access to more funds should they be needed to resolve a crisis that threatens the international financial system and (2) create the Emergency Financing Mechanism for use in extraordinary circumstances. In May 1996,[1] a G-10 Working Party proposed a change in IMF's policy to permit IMF to extend financing in extraordinary circumstances to an indebted country before the country has settled claims with its nonbank private creditors, as a way to encourage such settlements. IMF has implemented the emergency financing mechanism. The creation of NAB awaits approval from the participating governments. At the time of our review, IMF was in the process of determining whether to change its lending into arrears policy.

Supplementing GAB With NAB Would Reduce the Relative U.S. Share of IMF Funding to Resolve Crises, but Would Involve Trade-Offs

One initiative by the G-7 is to increase official resources available to IMF for responding to financial emergencies or impairments of, or threats to, the international monetary system. For 35 years, IMF has had GAB to help ensure that IMF is able to meet urgent and potentially large demands on its resources.[2] GAB is a borrowing arrangement[3] between IMF and a group of 11 industrialized countries or their central banks that allows IMF to

[1]The Resolution of Sovereign Liquidity Crises, Group of Ten (May 1996).

[2]GAB was originally established in 1962 out of concern for the adequacy of official resources of international liquidity and the disruptive effects of short-term capital movements.

[3]Treasury officials told us that both GAB and NAB are a set of contingent lines of credit and not a single, comprehensive line of credit.

(1) borrow currencies from these countries under specific conditions and (2) lend the funds either to other GAB countries or to non-GAB IMF member countries.[4] The 11 participants of GAB are: Belgium, Canada, France, Deutsche Bundesbank (German Central Bank), Japan, Italy, the Netherlands, Switzerland (Swiss National Bank), Sveriges Riksbank (Swedish Central Bank), the United Kingdom, and the United States.[5] A country receiving funds from IMF under GAB is charged a market interest rate and pays interest quarterly. A country is required to repay the amount of the loan within 5 years.

GAB funds are meant to supplement ordinary IMF resources, which amounted in 1996 to $203 billion.[6] The total of GAB resources are $23.8 billion, with an additional $2.1 billion available under a separate agreement with Saudi Arabia.[7] Under GAB, the U.S. share is about $6.0 billion, or 25 percent, of GAB; the German Central Bank share is about $3.3 billion, or 14 percent, of GAB; Japan's share is about $3.0 billion, or 12.5 percent, of GAB; and the share of France and the United Kingdom is each $2.4 billion, or 10 percent each, of GAB. Other country and central bank shares are less.[8] These contributions broadly reflect each country's size and role in the international economy as well as the ability of each country to provide financing. See figure 4.1 for the credit commitments of other countries and figure 4.2 for relative country shares.

[4]GAB can be activated to supplement IMF resources to help finance (1) conditional or unconditional drawings by countries participating in GAB to forestall or cope with an impairment in the international monetary system or (2) conditional drawings by nonparticipants when an exceptional situation exists that could threaten the stability of the international monetary system.

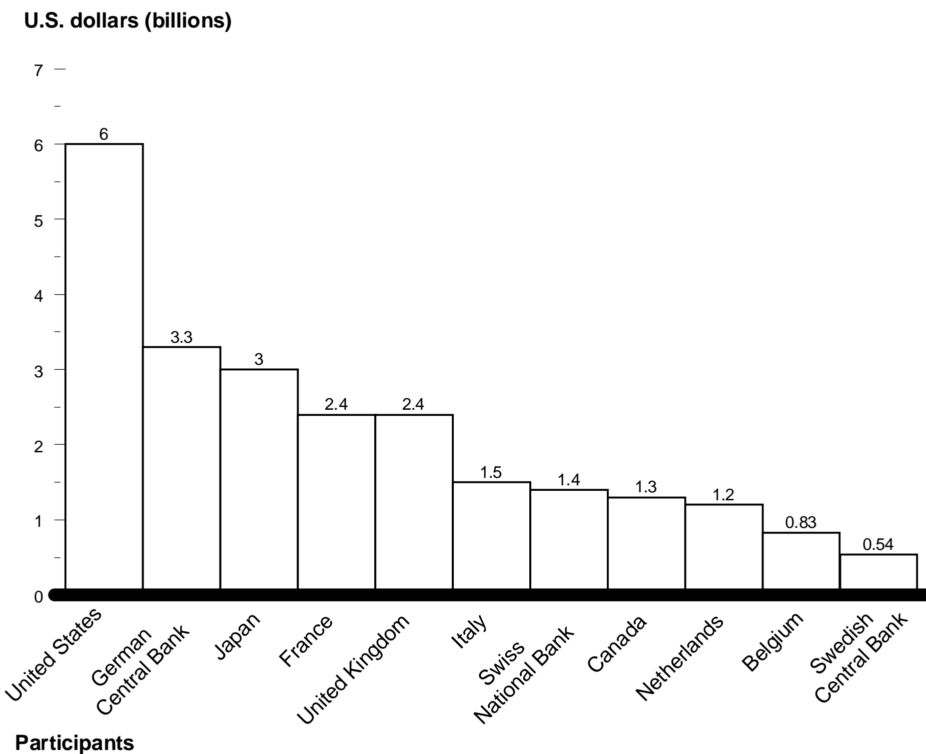
[5]The German Central Bank, Swedish Central Bank, and Swiss National Bank are empowered by domestic legislation to lend to IMF.

[6]This dollar figure and GAB/NAB dollar values are converted from Special Drawing Rights (SDR) at the rate of 1.4 SDR/dollar. We took the May 30, 1997, rate of 1.3918 SDR/dollar and rounded it up to 1.4 SDR/dollar. SDR is a unit of account IMF uses to denominate all its transactions. Its value comprises a weighted average of the value of five currencies, of which the U.S. dollar has the largest share.

[7]Saudi Arabia has an associated arrangement whereby it will lend to IMF for the same purposes and in the same circumstances as prescribed by GAB, except in three ways. First, IMF is not authorized to call on GAB to finance transactions with Saudi Arabia. Second, Saudi Arabia is free to accept or reject any proposal by the IMF Managing Director. Third, GAB and the arrangements with Saudi Arabia may be activated separately.

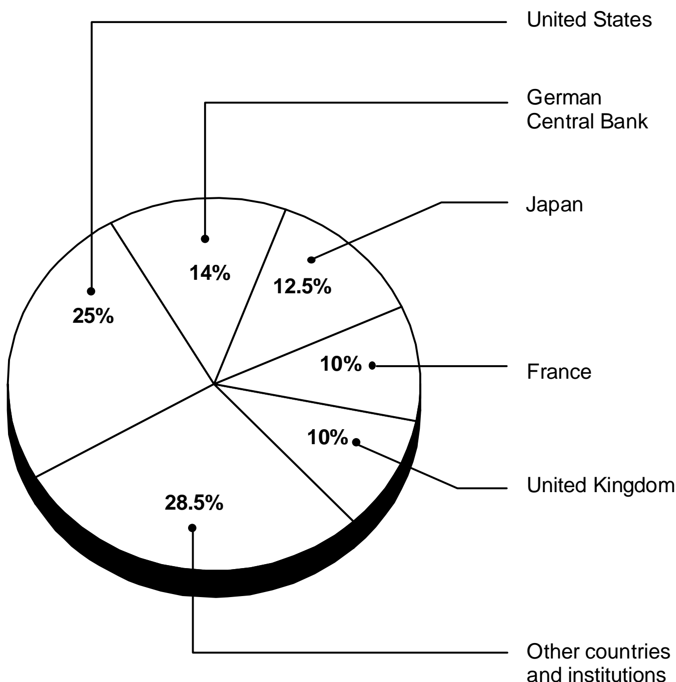
[8]Other GAB-participant contributions are: Italy, 6.5 percent; the Swiss National Bank, 6 percent; Canada, 5.25 percent; the Netherlands, 5 percent; Belgium, 3.5 percent; and the Swedish Central Bank, 2.25 percent.

Figure 4.1: Participant Credit Commitments Under the General Arrangements to Borrow



Source: IMF.

Figure 4.2: Participant Shares Under the General Arrangements to Borrow



Source: IMF.

Conditions for Activating GAB

GAB can be activated if IMF's Executive Board and GAB participants representing three-fifths, or 60.0 percent, of the total of credit arrangements and two-thirds, or 66.6 percent, of the participants determine that the following two conditions are met: (1) the international monetary system is threatened and (2) IMF lacks sufficient resources to extend the needed financing. Individual GAB participants can opt out of GAB participation if they are having balance-of-payments problems. A GAB participant may not vote on a proposal to activate GAB to finance an IMF transaction with that participant.

No formal criteria exist for determining the existence of a threat to the international monetary system. IMF officials said that the nature of threats to the international financial system changes as that system evolves. As illustrated by the controversy that arose during Mexico's 1994-95 financial crisis, countries can disagree about the existence or extent of a potential

threat to the international monetary system. With its 25-percent share of GAB resources, the United States can block GAB activation if it obtains the support of other GAB participants that have credit commitments large enough to reach 40 percent of the total resources.

Over the course of the 35 years that GAB has existed, it has been activated nine times to assist the United States, France, Italy, and the United Kingdom. An IMF official said that GAB was activated in the 1960s and 1970s both to resist and assist devaluations of these countries' currencies. GAB was last activated in 1978, when the United States drew more than $2.9 billion from its own reserve tranche, including $994 million in funds from loans under GAB and more than $1.9 billion from IMF currency holdings.[9] Since 1983, GAB resources have been made available to assist countries that do not participate in GAB, but such use has not occurred, nor has it been proposed. GAB is considered an insurance policy and is not intended to be a regular source of financings, according to a U.S. Treasury official.

NAB Would Increase Official Resources for IMF Resolution of Financial Crises

The G-7 proposed that the G-10 and other countries increase IMF resources through the use of the proposed NAB. NAB would increase the resources available under the GAB credit lines to about $47.6 billion, up from the current GAB level of about $23.8 billion. NAB participants would include the 11 countries and central banks in GAB plus the following 14 new participants: 6 new European participants, 6 new Pacific Rim participants, and 2 Middle Eastern countries. (See table 4.1.) The wider participation under NAB reflects the changing character of the global economy and a broadened willingness to share responsibility for managing the international monetary system.

[9]These funds were part of a package to defend the dollar, which also included funds from gold sales and special financial instruments issued in foreign currencies. The General Arrangements to Borrow, Michael Ainley, IMF (Washington, D.C.: 1984).

Table 4.1: Proposed NAB Participation

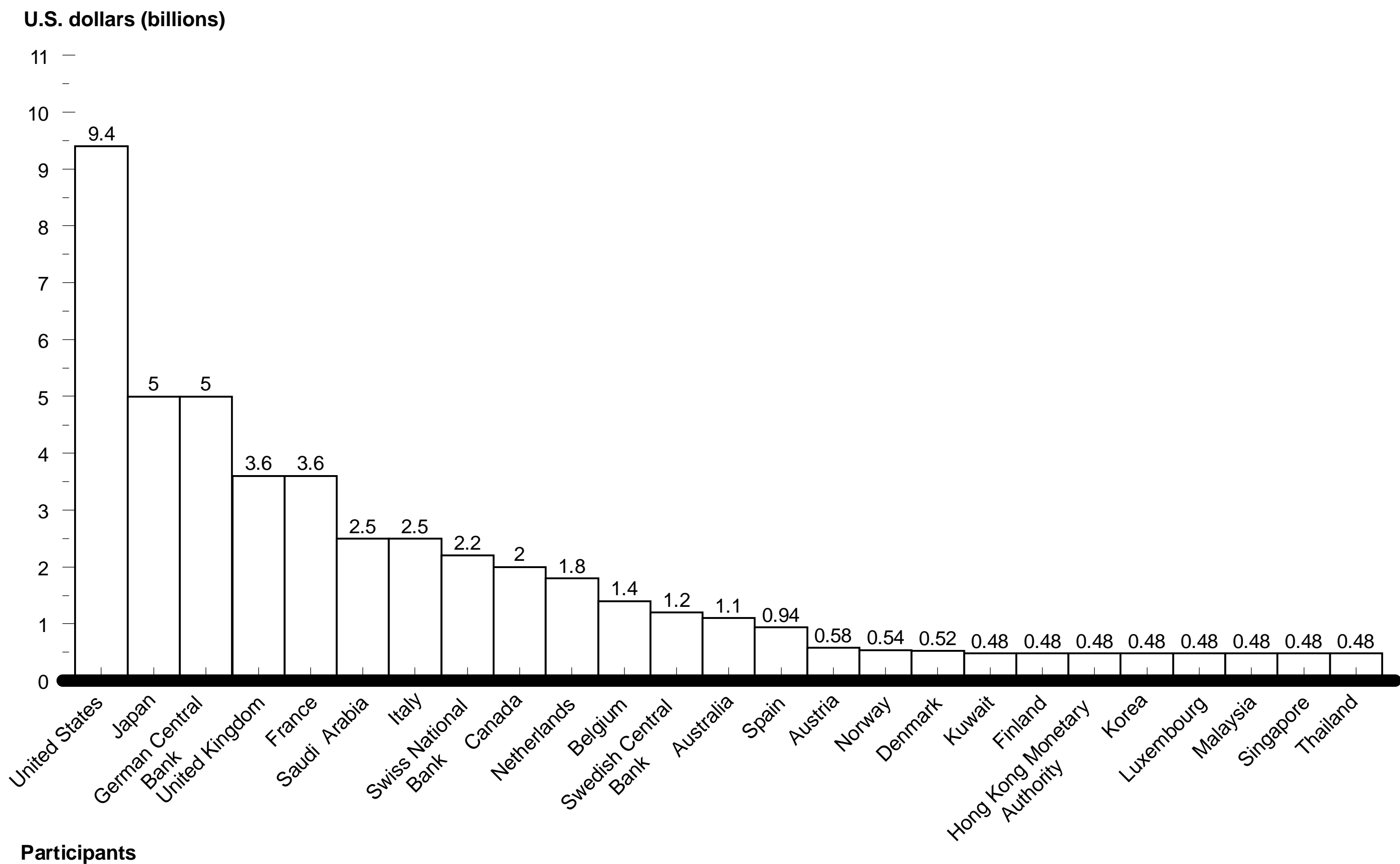
	Geographic regions and participating countries			
Participation	Europe	Pacific Rim	North America	Middle East
Existing GAB participants	German Central Bank United Kingdom France Italy Belgium Swedish Central Bank Netherlands Swiss National Bank	Japan	United States Canada	None
Additional participants joining NAB	Austria Denmark Finland Luxembourg Norway Spain	Australia Hong Kong Monetary Authority[a] Korea Malaysia Singapore Thailand	None	Kuwait Saudi Arabia

[a]The Hong Kong Monetary Authority's participation in NAB is subject to the consent of the member whose territories include Hong Kong. Hong Kong was a territory of the United Kingdom until June 30, 1997, after which Hong Kong reverted to China.

Source: IMF.

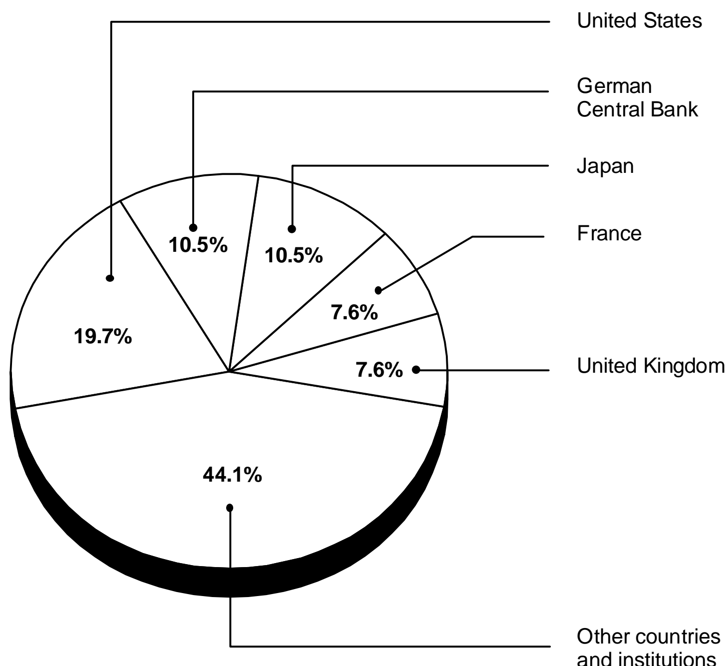
The anticipated amounts of credit commitments and relative shares for each of the NAB participating countries are provided in figures 4.3 and 4.4. The proposed amount for the United States is $9.4 billion, which represents slightly less than 20.0 percent of the total NAB resources. The German Central Bank and Japan each are to contribute about $5.0 billion, or 10.5 percent, of NAB. France and the United Kingdom are to each contribute $3.6 billion, or 7.6 percent, of the total.

Figure 4.3: Participant Credit Commitments Under the Proposed New Arrangements to Borrow



Source: IMF.

Figure 4.4: Participant Shares Under the Proposed New Arrangements to Borrow



Source: IMF.

NAB would not replace GAB, but it would be the facility of principal resource—that is, a proposal for assistance would first be considered under NAB; if rejected, the proposal could be made to GAB participants.[10] The maximum amount of funds available under NAB would be $47.6 billion. One-half of this amount, or $23.8 billion, would be available under GAB.

Conditions for Activating NAB

Under the NAB proposal, the following criteria used for NAB activation would not change from the criteria used for GAB activation: IMF Executive Board and NAB participants must concur with the IMF Managing Director's determination of an impairment in the international monetary system and impaired IMF resources. However, activation of NAB is to require a larger

[10]Activation to finance an IMF transaction with a G-10 country is an exception to this rule in that either GAB or NAB can be considered first.

majority voting share than for GAB activation—80 percent of the total credit arrangements, which is up from GAB's 60 percent. The United States can block activation if joined by any one other large participant or two small participants. Under the envisioned composition of NAB participants, if one large or two small NAB participants do not vote, then the United States can unilaterally block NAB activation, according to Treasury officials. Unlike GAB, NAB activation would not require a second majority of two-thirds of the number of participants voting.

As with GAB, NAB resources could be used to assist either NAB participants or nonparticipants. Individual countries and participating institutions would be able to opt out of NAB participation if they were having balance-of-payments problems. Members that did not participate for this reason would lose their "vote" in decisionmaking, and the voting share of the other participating members would increase. In addition to any meetings needed for activation, NAB participants are to meet annually to discuss macroeconomic and financial market developments that could lead to requests for NAB activation. NAB would enter into force when adopted by participants with credit arrangements totaling about $40 billion, including the five participants with the largest credit arrangements.

U.S. Participation in NAB Would Require Congressional Authorization and an Appropriation

Congressional approval would be necessary for the increased U.S. resources pledged to NAB. According to established U.S. budget procedures, U.S. participation in NAB would require congressional authorization and appropriations. Because $6.0 billion of the $9.4 billion needed to fund NAB have already been appropriated by Congress to fund GAB, NAB funding requires an additional $3.4 billion in new appropriations. A transfer of dollars to IMF would not be scored as a budgetary outlay because the United States receives in return for the transfer a monetary asset (i.e., a liquid, interest-bearing claim on IMF that is backed by IMF's financial position, including its holdings of gold). A senior Treasury official told us that U.S. participation in NAB would not affect the size of the U.S. budget deficit. That is, an exchange of monetary assets is not scored as a budgetary outlay, and therefore, does not have an impact on the budget deficit.

Our Analysis of NAB

In our analysis of the proposal to establish NAB, we found two significant trade-offs. First, NAB could ease the relative U.S. burden of crisis resolution funding through increased burden sharing among a greater number of countries when IMF resources are impaired and the international monetary system is at risk. Although the dollar amount of the U.S. share in NAB

would increase, the U.S. share of the funding burden would be lower under NAB than under GAB—about 20 percent compared with 25 percent. Also under NAB, the proportional U.S. burden would be significantly less than the 51-percent share that the United States contributed to the 1995 multilateral financial assistance package for Mexico. However, at the same time, the larger number of NAB participants could dilute the influence of the United States by decreasing its voting power. The reduced U.S. voting share in NAB might make it more difficult for the United States to convince others to activate NAB.

Similarly, the larger number of countries in NAB could complicate activation, since more countries will likely have to consent to activate NAB. Reaching a consensus among a sufficient number of countries about whether the financial difficulties of one or more countries pose a threat to the international monetary system might be difficult, especially given the greater diversity of NAB membership compared to GAB membership.[11] No specific formal criteria exist for determining a threat to the international financial system. Uncertainty about the circumstances under which NAB will be used helps diminish moral hazard on the part of countries and investors. As in the past under GAB, NAB participants may be more likely to view a financial crisis in their geographic proximity as a threat to the international monetary system than a financially troubled country that is geographically, economically, or strategically distant from the member country. IMF and Treasury officials told us that NAB participants who view the world regionally are shortsighted because countries that expect help from outside their region now must be willing to assist countries in other regions later. To the extent that NAB can be activated by its participants, the United States might be less likely to be called on unilaterally to provide financial assistance to countries in financial trouble. To the extent that NAB is difficult to activate, the United States may continue to face the difficult choice of whether to act unilaterally to assist financially troubled countries.

Treasury officials told us that another one of NAB's new voting rules could help compensate for the reduced U.S. voting power in NAB. Under NAB, the GAB requirement that two-thirds of member countries concur in activation is to be eliminated. According to Treasury officials, the dropping of this requirement would offset to some extent the increased difficulty in activating NAB that would be caused by the increase in the share of

[11]Treasury officials said that GAB was not used in the 1994-95 Mexican crisis primarily because IMF had sufficient liquidity to supply its share of the needed funds. However, the officials also said that some GAB participants believed that the Mexican crisis did not pose a threat to the international financial system and, therefore, did not meet the second GAB activation criterion.

contributions needed for activation from 60 percent under GAB to 80 percent under NAB.

Second, NAB could help minimize contagion effects of a sovereign financial crisis because investors may have more confidence that the official sector will have sufficient funds to prevent a specific country's financial difficulties from impairing the international monetary system. However, NAB could increase moral hazard for debtor countries and investors. For example, NAB could increase moral hazard by providing an incentive for financial officials in debtor countries to develop ill-advised financial, monetary, and exchange-rate policies because NAB resources would be available to bail them out if their policies failed. Other critics have maintained that moral hazard for investors would be increased if NAB resources were used to shield investors in emerging market countries from any financial losses.

Treasury officials told us that moral hazard cannot be entirely eliminated but that it can be held to acceptable levels if official involvement in dealing with sovereign financial crises is rare and limited to exceptional circumstances. In the case of standing financial arrangements, such as GAB and NAB or IMF itself, moral hazard is limited through the imposition of features such as policy conditions and phasing of disbursements, according to the Treasury officials.

Others have said that the structure of NAB would not create or increase incentives for debtor countries and investors to make imprudent decisions because there is no certainty that NAB would be activated for any particular country or set of circumstances. Treasury officials told us that the G-7 was careful to design NAB with built-in redundant mechanisms to minimize moral hazard, notably, criteria that NAB shall only be used in cases of a threat to the international monetary system and the larger, 80 percent, majority required to activate NAB. In fact, with an 80-percent voting share required for activation, the United States would more easily be able to block activation of the new credit lines despite having a smaller voting share than under GAB. Under NAB, the United States and any other large NAB participant or two small NAB participants would have sufficient votes to block the credit lines' use, according to Treasury officials. Furthermore, NAB funding may not create or increase moral hazard for countries because IMF imposes stringent economic and financial conditions on countries, according to a U.S. Treasury official.

Expedited Decisionmaking Could Speed IMF Assistance to Limit Contagion

With the speed at which capital flows can be reversed, debtor countries can quickly find themselves considered poor credit risks and excluded from international capital markets. Under certain circumstances, the official sector may need to act quickly to prevent the collapse of a country's finances, forestall contagion, and help minimize the time that the debtor country may be excluded from capital markets. The approval of IMF support, from the onset of Mexico's crisis in 1994, took 6 weeks. This experience underscored the need for earlier IMF decisions. Also, some G-10 members said that they were not adequately consulted in the process of developing IMF assistance.

The G-7 recommended that IMF accelerate its decisionmaking process about funding to countries experiencing a financial crisis. The IMF Executive Board agreed in September 1995 to establish exceptional procedures in what the Board has called an emergency financing mechanism. The new procedures are limited to exceptional situations that threaten member financial stability, with significant risks of contagion, and require accelerated negotiations. Such situations may or may not include NAB activation. According to an IMF document, it is not the purpose of the emergency financing mechanism to provide guarantees of any kind against sovereign default.

After the Executive Board agrees that extraordinary circumstances are at hand and activates the emergency financing procedures, the Board is to review a report describing the member country's current economic situation. The Executive Board is to be regularly briefed on negotiations with the country, and key creditors are to be consulted. Rapid negotiations and quick IMF decisionmaking is critically dependant on the readiness of a country to take measures to deal with the crisis. A member's past cooperation with IMF is to have a strong bearing on the speed with which IMF can assess the situation. When agreement between the borrowing country and IMF is reached, agreement documents are to be circulated within 5 days and the IMF Executive Board is to meet within 48 to 72 hours. Members who overcome their crises quickly are to repay IMF on an accelerated basis.

Our Analysis of Expedited IMF Decisionmaking

The expedited IMF decisionmaking process could help provide a speedy official response to stem contagion effects on financial markets in other countries and, possibly, to forestall or mitigate international systemic risk. In some crisis situations, a speedier IMF decisionmaking process could reduce pressure on the United States to act quickly unilaterally. To the

extent that the new emergency financing mechanism would speed official resources to debtor countries in crisis, it would also be responsive to criticisms that mechanisms for responding to country crises are too cumbersome and slow. However, although the emergency mechanism could speed funding decisions, it is not likely to lessen disagreement among IMF Executive Board members and those they consult about the seriousness—i.e., the extent of potential contagion or systemic risk—of any particular financial crisis the Board confronts. To the extent that IMF Executive Directors have difficulty reaching a consensus on whether the extraordinary circumstances needed to use the emergency financing mechanism are present, IMF assistance may not be quick enough to stem contagion and minimize systemic risk. IMF Executive Directors have noted the lack of objective criteria for advance identification of financial crises requiring rapid response, according to an IMF document.

The moral hazard effects of an expedited IMF decisionmaking process are unclear, according to our analysis. An expedited consultative and decisionmaking process at IMF might heighten incentives for debtor countries to seek official financing, if the possibility of a more timely decision about whether or not a country would get assistance makes such financing more desirable. However, the financial and economic conditions that necessitate IMF assistance, as well as the conditions that follow from IMF assistance, are often severe. Countries often prefer not to devalue their currency, limit credit, reduce budget outlays, and increase taxes, which are measures that IMF often requires as a condition of assistance. The existence of an emergency financing mechanism would guarantee neither IMF support nor unusual access to IMF funds, according to an IMF document.

Changes in Lending Policy Could Speed Resolution, but May Harm Creditor Interests and Raise the Cost of Capital

IMF officials told us that they are considering a G-10 recommendation that IMF expand its existing policy of lending, in exceptional circumstances, to countries that are behind on their payments of principal and interest to noncommercial bank private creditors. This policy is called lending into arrears. Such a policy is intended to prevent a failure to reach an agreement with creditors from holding up implementation of IMF assistance. Since 1970, IMF policy has been to provide assistance only after a country has reached an agreement with private creditors on a timetable for eliminating arrears. The first exception to the no-arrears policy provided that arrears to official creditors would not preclude disbursements under an IMF program if a Paris Club agreement covering those arrears had been reached. The policy was revised in the late 1980s when there was a problem of widespread arrears and IMF assistance was

being delayed as some small commercial banks sought to hold up debt restructuring agreements with debtor countries, with the objective of being bought out by other larger banks. The policy was amended to provide that arrears to private bank creditors would not preclude disbursements under an IMF program if a critical mass of the arrears were the subject of an agreement among the banks. According to the G-10, a policy of lending into arrears may provide IMF and the official sector with an opportunity to manage a crisis by signaling confidence in debtor country policies.

As a general rule, current IMF procedures require clearance of arrears or imminent clearance of arrears before IMF disbursement of financial assistance. In most cases, for arrears to commercial banks, IMF will not disburse funds before actual or imminent agreement on clearance of arrears. For arrears to official creditors, IMF typically waits for imminent agreement in the Paris Club before assisting a debtor country. However, IMF policy does permit lending into arrears for debts owed to sovereign creditors and commercial banks in exceptional circumstances. Therefore, in situations where a debtor country is late in payments on its financial commitments, and there is neither imminent agreement nor extraordinary circumstances, its access to IMF assistance is blocked. This can be a serious problem for countries who have no other source of financing than IMF and whose economic situation is deteriorating. Lending into arrears can provide financing that can jump-start a debtor country's economy in an environment where private creditors are difficult to mobilize. In some cases, member countries that agree to follow a program monitored by IMF will receive help in obtaining bank creditors and other loans to clear its arrears. An IMF official told us that clearance of arrears takes an average of 3 years, with a minimum of 6 months and a maximum of 7 years.

Sharing the Burden of Country Refinancing

IMF's prohibition against lending into arrears was developed as a mechanism to ensure that all groups of creditors share the burden in country refinancing, according to IMF documents. IMF has only been partially successful in achieving this goal because (1) not all commercial banks have contributed commensurate with debtor country needs and (2) the exposure of the bilateral and official sector has grown substantially. Creditor groups not willing to contribute should not be able to accumulate claims that are ultimately paid out of the resources other creditor groups are providing, the IMF documents stated. The abrupt termination of commercial bank loans creates financing needs that the official sector may not be prepared to fully meet, and that the official sector may not want to be seen as bailing out banks.

In May 1996, a G-10 Working Party recommended that IMF's Executive Board consider extending IMF's lending into arrears policy to noncommercial bank private debts, i.e, to permit such lending in exceptional circumstances, as is the case for official debts and commercial bank debts. An IMF official said that the lack of a negotiating venue or group for financial instruments not held by commercial banks or the governments of countries complicates negotiations to end arrears. A G-10 Working Party wrote that allowing IMF to lend into arrears could strengthen the bargaining position of debtor countries and signal that debtor country adjustment efforts are satisfactory to IMF and, thereby, warranting support from creditors. Without IMF lending into arrears, policy pronouncements by debtor countries concerning monetary, fiscal, and exchange rate policies may have little credibility with creditors.

Our Analysis of Lending Into Arrears

Creditors strongly oppose IMF's extending its lending into arrears policy to cover noncommercial bank private debts. One association that represents commercial banks, investment banks, and other financial institutions has written that IMF lending into arrears is an official sector approval for a breach of contract. This is because changes in IMF procedures that improve the bargaining position of debtor countries may force investors to renegotiate debt with diminished principal and interest payments. According to the association, this runs contrary to investor expectations and may increase the riskiness of bond financing and bank loans to countries and their central banks. Furthermore, according to the association, lending into arrears raises the risk of moral hazard on the part of debtor country officials by letting them know that they may be able to make principal and interest payments at rates lower than originally agreed. Therefore, extending the policy to noncommercial bank private debts would increase the risks to investors in emerging market countries and would likely reduce the supply and raise the price of international capital flows to emerging economies. Therefore, according to the association's report, extending IMF's lending into arrears policy to noncommercial bank private debts may harm creditor interests in future sovereign financial crises.

However, such a policy could have the advantage of strengthening IMF's ability to more quickly contain and resolve sovereign financial crises, which could diminish the potential for future crises to pose a risk to the international financial system. Furthermore, extending IMF's lending into arrears policy in this manner could reduce moral hazard for investors. Such a policy might diminish investor perceptions that in a future

sovereign financial crisis, public financial assistance would fully insulate them from financial losses.

Private creditors have an incentive to demand full payment according to the original terms and condition of their bond contracts and are less concerned about the impact on the debtor country or impact on the international financial system. It is not certain that creditors as a group would fare worse if they were pressured to settle outstanding claims with a country. If such a settlement were being impeded by individual creditors' delaying negotiations or holding out and blocking implementation of a completed settlement, then creditors as a whole could get more of their money back or get their money back more quickly were IMF to induce them to complete a settlement.

Bankruptcy-Based Proposals Might Reduce Public Financing Costs, but They Could Operate Too Slowly to Limit Contagion

Several proposals suggested ways to reduce the need for official sector assistance to resolve future financial crises by requiring or encouraging capital markets to create mechanisms to apply principles of U.S. bankruptcy law to international default situations. For instance, one proposal suggested that an international bankruptcy court be developed. Other proposals suggested ways to apply specific bankruptcy principles, and we categorized these proposals into three groups: (1) giving IMF authority and responsibility to apply the principles; (2) making statutory changes so that country officials and creditors would abide by the principles; and (3) encouraging the private sector to develop market mechanisms, such as bond covenants and bond committees, to apply the principles.

One objective in applying principles of U.S. bankruptcy law to sovereign default situations would be to resolve creditor claims without the need for official sector financing. Three principles of U.S. bankruptcy law that could be applied to sovereign default situations are commonly referred to as the following: (1) automatic stay, (2) postpetition creditor preference, and (3) "cramdown."[12] These principles are briefly described as follows:

- The automatic stay principle prohibits creditors from attempting to collect a debt or obligation that was incurred by the debtor within a certain time before the bankruptcy petition was filed. One effect of this principle is to

[12]Chapter 9 of the U.S. Bankruptcy Code, 11 U.S.C. section 901, et seq., protects municipalities against creditor panics by providing a process for adjustment of the municipalities' debts without interference by the bankruptcy court in the exercise of the municipalities' governmental powers. Chapter 11 of the Code provides for the reorganization of the debtor (typically a business) as an alternative to asset liquidation.

allow a company or municipality to suspend payment of its debt to creditors. Generally, the stay remains in effect until the bankruptcy court lifts it or the case is closed. The stay is a measure that is intended to protect the debtor from attempts by individual creditors to seize assets at the expense of all creditors.

- The postpetition creditor preference principle allows for the extension of "administrative priority" to new loans (made after the bankruptcy proceeding has begun) so that the debtor can obtain working capital to remain in operation. Such credit generally is a first-priority administrative expense to ensure repayment of new loans ahead of any prebankruptcy loans.
- The cramdown principle provides a way to prevent a minority of creditors from blocking a settlement of claims. Where a qualified majority of creditors accepts a plan for reorganizing or rescheduling debt, the bankruptcy court can approve the plan as long as it is fair and equitable with respect to dissenting creditors. This mechanism provides a way to control dissident creditors who otherwise could prevent the reorganization of the debtor or adjustment of its debts.

According to some public and private sector officials, the application of these bankruptcy principles to international sovereign debt might foster investor confidence and could result in more orderly and efficient resolutions of future debt crises, without the need for official sector financing. For example, an automatic stay could provide "breathing room" to enable debtors and creditors to examine the circumstances of a crisis and determine a resolution strategy without the need for public financial assistance or the threat of multiple lawsuits and the fear of losing much return on investments. However, some public and private sector officials also believed that an underlying problem in applying these principles is that debtor nations and their creditors would have to subordinate their interests to the process used to interpret and implement these principles. As suggested by several proposals, this could be accomplished by either a judicial-type body or other neutral, competent institution or by other arrangements, such as market-based, contractual commitments. Sovereign debtors and their creditors might not be willing to do this.

International Bankruptcy Court Proposal Is Not Fully Developed and Has Received Mixed Appraisals

One proposal suggested that an international bankruptcy court or similar formal procedure be established to apply principles of U.S. bankruptcy law to sovereign financial crises. Such a court or procedure might help capital markets overcome the problems they sometimes have resolving sovereign financial crises.

Although some officials representing academia, nonprofit organizations, and the private sector have studied several issues surrounding this proposal, specific implementation details were either not available at the time of our review or varied as to how to set up such a court and what institution, if any, should oversee its operations. Furthermore, the bankruptcy court proposal did not break out the operational costs and who should provide funding for these costs.

To determine how such a court might be developed or operated, we interviewed public and private sector experts and officials and reviewed numerous reports and studies on the issue. Some officials said that such a court could be modeled after the operations of existing institutions, such as the International Court of Justice.[13] Our review of some of the International Court of Justice's operations showed that it has experienced numerous problems and has been used relatively rarely. We found no clear consensus regarding which institution should act as or oversee an international bankruptcy court. However, some officials suggested that IMF or the World Bank could perform this function because of their universal memberships and significant experience in the debt-restructuring process. However, other officials questioned whether these institutions are the best candidates. For example, one academic reported that IMF has not kept pace with changes in the world financial system and did not do a good job in leading the debt restructurings in the 1980s. Also, questions have been raised about whether these institutions have adequate resources to take on this responsibility and whether they could be impartial due to their alleged susceptibility to political pressure from member countries. Finally, officials noted that there could be challenges associated with specific implementation procedures or processes, such as how a court could consistently apply requirements to debtors and diverse groups of nonbank creditors with different attitudes toward risk and commercial and legal doctrines for debt-rescheduling.

Although an International Bankruptcy Court May Not Pose a Moral Hazard, It Also May Not Limit Contagion Effects

Proponents of developing an international bankruptcy court believed that such a court would not pose a substantial risk of moral hazard on the part of the debtor country. The G-10 reported that bankruptcy procedures do not substantially increase moral hazard on the part of the debtor country if they do not significantly alleviate the pain for the debtor that is associated with insolvency. Some private sector officials we interviewed said that country officials would not default on debt obligations merely because a

[13]The International Court of Justice was established in 1945 as the principal judicial body of the United Nations to settle disputes peacefully among member nations.

court action might allow them to suspend debt payments or obtain new working capital. However, some other officials said that there could be a potential for moral hazard on the part of the debtor country due to the difficulties of defining and measuring the insolvency of a sovereign nation and distinguishing between sovereign governments that "cannot pay" from those who "will not pay."

Even though moral hazard might not be increased, several public and private sector officials believed that an international bankruptcy court may not limit contagion effects or systemic risks in a timely manner. Although supporters of this proposal hold that a court could improve coordination and communication among debtors and creditors during a workout process and the potential for investor panics could thus be reduced, the court might have difficulty responding to and resolving sovereign financial crises in a timely manner. Disagreements between debtors and creditors could be inevitable regarding the purpose, formulation, and interpretation of bankruptcy standards and procedures. Furthermore, debtor countries might use the court as a delaying tactic, and creditors might sue within their own countries' legal systems to override the judgments of the court. These issues, coupled with the likelihood that a court would not have sufficient power to enforce a workout plan, could add even more time to crisis resolution. Timeliness could be further impaired should the court get bogged down in adjudicating single-country debt crises that pose only a small threat to the international financial system at the expense of crises that pose a more substantial systemic risk.

An International Bankruptcy Court Could Reduce the Need for Official Sector Financing, but Countries May Never Use the Court

Supporters of developing an international bankruptcy court, or a similar formal procedure, point out that one principal advantage of such a mechanism is that a bankruptcy court could ensure that capital markets deal with sovereign default with little or no need for official sector financing. From this point of view, less official funding would be needed to assist countries in default because debtors and creditors would be bound to resolve their claims in court. Moreover, sovereign borrowers would have to rely on private capital markets, and the court could help supervise administrative priority to new loans to ensure that countries in financial distress would be in a good position to obtain much-needed working capital.

An international bankruptcy court might offer two other advantages. First, supporters have asserted that such a court could provide structure and

predictability for sovereign default workouts. Several academic experts in this field have written that capital markets are not efficient in dealing with sovereign bankruptcies due to the many complex and often competing creditor claims, and that a court could help creditors and debtors reach agreements. Second, some officials believe that a bankruptcy court for countries could make the burdens of settlements more equitable. With the protection afforded by the bankruptcy court or procedure, these officials have argued, creditors could be made to share the burden of adjustment more fairly with debtor countries.

Although a formal bankruptcy court or procedure for countries might yield several advantages to the United States, the G-10 governments and officials from other organizations have rejected the idea. A G-10 Working Party on resolving sovereign liquidity crises concluded in its report that such procedures do not in current circumstances or in the foreseeable future provide a reasonable way of dealing with such crises. The report argued that there are numerous challenges associated with a bankruptcy court's development, implementation, and enforcement, and that bankruptcy principles should not necessarily be applied to international default situations because there is a false analogy between helping bankrupt companies and governments' experiencing financial difficultly. However, the report acknowledged that international sovereign bankruptcy procedures may warrant additional study by other interested parties.

Also, critics of this proposal have questioned whether nations would (1) be willing to give up their sovereignty and agree to an international body of bankruptcy law or (2) surrender their financial and economic interests to the judgment of an international bankruptcy court. According to various legal experts, the International Court of Justice has had a problem with this issue because, among other reasons, governments have preferred to keep all law-creating and law-defining processes firmly within their control. The experts questioned whether a common international law could be developed due to the many different sets of cultural and legal values that operate globally. As a result, the United Nations' member countries have infrequently used the International Court of Justice—only about 40 disputes have been submitted to the Court during the last 47 years.[14]

[14]One well-known case that illustrates the reluctance of countries to use the International Court of Justice occurred when the United States withdrew from court proceedings in the case concerning Military and Paramilitary Activities in and against Nicaragua in January 1985. In its withdrawal notice, the United States alleged that "the Court lacked jurisdiction and competence."

Critics also have argued that, even if countries were willing to give up their sovereignty and use an international bankruptcy court, the effectiveness of such a court could be limited unless it had the inherent power to enforce its decisions. Moreover, they pointed out that a court might not ever be able to guide required policy changes in government operations the way a national bankruptcy court guides the reorganization plans of firms. As a result, an international bankruptcy court might only be able to serve as an advisory body, which is the same problem that has been experienced by the International Court of Justice.

Other Bankruptcy-Based Proposals Face Implementation Challenges

Additional proposals to reduce the need for financial assistance from the public sector pertained to applying specific U.S. bankruptcy principles to international sovereign default. We categorized these proposals into three groups: (1) giving IMF authority and responsibility to apply the principles, (2) making statutory changes so that country officials and creditors would have to abide by the principles, and (3) encouraging the private sector to develop market mechanisms, such as certain bond covenants and a standing committee to represent bondholders to apply the principles.

Proposal Giving IMF the Authority to Apply Specific Principles Is Not Being Pursued

Two proposals by international financial experts suggested ways to give IMF the authority to apply specific bankruptcy principles. One proposal was for IMF to reinterpret its mandate to allow it to sanction and enforce countries' suspension of debt payments to creditors. This proposal, in essence, would apply the automatic stay principle of the U.S. Bankruptcy Code. IMF Article VIII(2)(b) provides that IMF has some authority over exchange contracts that involve the currency of any of its members. Under this article, exchange contracts that (1) involve the currency of a member and are contrary to exchange control regulations of that member and (2) are maintained or imposed consistently with the IMF Articles of Agreement are unenforceable in the territory of members. Supporters of this proposal have argued that IMF could interpret this provision in such a way as to formally endorse the existence of a member's arrears. According to this view, IMF could use its authority under the article to render exchange contracts unenforceable, and, in effect, sanction a standstill, thus protecting a country from its creditors. However, critics question whether IMF can legally interpret the article to give it authority to sanction a standstill. Another proposal suggested that IMF develop a mediation service to apply the cramdown principle to help debtors and creditors renegotiate debt settlements.

Both of these proposals are at an early stage of development so they lacked sufficient information for detailed evaluation. Furthermore, IMF officials told us that they were not pursuing these proposals as viable options. Although the proposals suggest interesting possible ways to help resolve future crises, they might be difficult to develop. There are two primary potential benefits to the first proposal. IMF (1) might be in a good position to sanction an automatic stay because it has authority and expertise to evaluate a country's policies and financial needs and to judge whether a stay is justified and (2) would have more control over contagion effects because it could actively signal to financial markets that a country's temporary debt payment suspension is appropriate, which, in turn, could assure markets that the country will pursue sound policies in the future. Therefore, the country would not lose access to new capital in the future. However, critics question the legal acceptability of IMF's reinterpreting its Articles of Agreement to give it authority to suspend country debt payments. Several academic experts reported that the articles would probably have to be amended and that doing so could be a difficult, time-consuming task. These experts also noted that approval would be required from one-half of IMF's member countries with most of the total voting power, and that most member countries probably would resist the amendment on behalf of the rights of their investors.

Regarding the second proposal, IMF might be able to offer mediation services similar to those offered by the World Bank's International Center for the Settlement of Investment Disputes.[15] An IMF official said that this is not a viable option because there are many mediation services available and that mediation services are not part of IMF's mission. Also, critics of this proposal have raised questions as to whether IMF could be neutral serving in a mediation capacity.

Proposal Suggesting Statutory Changes to Apply Specific Bankruptcy Principles Must Overcome Many Challenges

Another proposal suggested that the U.S. Sovereign Immunities Act be amended in a way that, in essence, would apply the cramdown principle of U.S. bankruptcy law to sovereign default situations. Generally speaking, the act currently allows creditors to sue a foreign state for default on its debt payments where the state has waived its sovereign immunity or

[15]The International Center for the Settlement of Investment Disputes was created in 1966 to provide conciliation and arbitration facilities for disputes between governments and foreign private enterprises.

where the suit relates to the state's commercial activity.[16] To eliminate the possibility of future lawsuits, this proposal suggested that the act be amended to render a foreign state immune from suit by creditors while a restructuring plan was being negotiated by a majority of creditors or after their acceptance of the plan.

Proponents of this proposal have maintained that a new legal framework could facilitate workouts within the United States because the threat of lawsuits or other pressures from dissenting creditors would be eliminated. Also, they contended that amending the act could facilitate restructuring by preventing a small minority of creditors from holding up a negotiated settlement. However, critics have said that implementation of this proposal faces serious obstacles because all major creditor countries would have to adopt appropriate changes to produce the desired effect universally. This consensus could be difficult to accomplish because numerous countries have different laws, legal traditions, and legal philosophies.

Certain Bond Covenants or a Permanent Bondholder Committee Could Apply Bankruptcy Principles

Two proposals suggested ways that capital markets could establish mechanisms to change conditions of debt contracts so that creditors could accept a reorganized repayment plan, should a country be faced with debt-servicing problems. Specifically, the proposals encouraged (1) the establishment of a standing bondholder committee or committees and (2) the revision of certain bond covenants. With respect to the latter proposal, covenants that generally require unanimity would be revised to provide that a qualified majority of creditors could make changes in the payment terms and conditions of bonds, thus facilitating workouts.

Establishing Bondholder Committees

One proposal suggested that a representative bondholder committee or committees be established to facilitate negotiations between bondholders and debtor governments when the latter fail to pay principal or interest according to the bonds' original terms and conditions.[17] Such a committee

[16]The pertinent provisions of the Sovereign Immunities Act are contained at 28 U.S.C. sections 1602-1610. In general, the act sets forth the conditions and circumstances under which U.S. courts have jurisdiction over lawsuits against foreign states, their agencies, and instrumentalities. Among other things, the act allows for such lawsuits where sovereign immunity has been waived and where an action relates to the foreign state's commercial activity in the United States or outside the United States (when such activity causes a direct effect in the United States).

[17]"Symposium—The New Latin American Debt Regime—Towards a Sovereign Debt Work-out System," Journal of International Law and Business, Rory Macmillan (Volume 16, 1995) and Crisis? What Crisis? Orderly Workouts for Sovereign Debtors, Barry Eichengreen and Richard Portes (Jan. 1996).

would avoid a proliferation of committees,[18] resolve conflicts among classes of bondholders, and appoint representatives to negotiate with bankrupt governments to restructure their debts. Such a committee might contain permanent and temporary members, representing large bondholders, mutual funds, pension funds, and other market participants, and could be modeled after similar committees, such as the London Club. In addition, the proposal suggested that the governments of the major creditor countries may want to recognize a single, standing international bondholder committee.[19] The proposal suggested a specific charter for this committee that would specify the committee's operations, a set of conventions, a core of permanent members, a permanent secretariat, and an appointed representative to conduct negotiations. The proposal stated that, under certain conditions, IMF could play a role in helping such a committee reach its goal by providing temporary liquidity during the restructuring process that could be repaid as part of an agreement to a final restructured payment plan.

Bondholder Committee Effect on Moral Hazard Unclear, Although Unlikely to Stem Contagion

Criticisms of the proposal to create a bondholder committee for international bonds include that such a mechanism would create moral hazard for countries that issue sovereign bonds. The critics assert that creating a mechanism to specify how the bonds would be restructured could provide more incentive for countries to default on principal and interest payments than having no mechanism at all. However, proponents of bondholder committees do not concede this point. They say that the consequences of debt-servicing problems for a country are so severe (e.g., possible loss of access to international capital markets) that the existence of a bondholder committee would not provide an incentive for debtor countries to announce that they are having debt-servicing problems.

Because bondholder committees have historically taken a long time to reach agreement on how sovereign bonds should be restructured, the committee would neither diminish contagion effects on other countries' financial instruments nor forestall systemic risk to the financial system. A bondholder committee may not contain contagion effects because creditors could still rush for the exits. Defenders of a standing bondholder

[18]In the past, multiple committees, with diluted bargaining power, negotiated with governments over bond issues. These committees competed against one another for subscriptions and commissions. Bondholders hesitated to subscribe to the services of a committee because they were aware that competition reduced the likelihood of successful negotiations. Committee organizers had an incentive to maximize their commission, rather than the return to bondholders.

[19]There are historical precedents for such mechanisms in the United States (i.e., the Foreign Bondholders Protective Council, which was created in 1934 and closed its doors in the 1980s) and the United Kingdom (i.e., the Corporation of Foreign Bondholders, which was created in 1868).

committee respond by saying that the existence of a mechanism to resolve sovereign debt arrears could eliminate some of the uncertainty that leads to contagion and damage to the financial system.

Communication and Burden Sharing Could Improve

Proponents of a bondholder committee say that burden sharing could be fairer, depending on the extent to which different types of creditors are represented on the committee. Also, supporters say that burden could be more appropriately shifted from creditor country taxpayers to the creditors themselves. One opponent of the committees responded that the mechanism may have trouble overcoming the diversity of bondholders. For example, such a mechanism would likely not appeal to mutual fund managers who have a short-term perspective and who often prefer to sell bonds that are not performing as expected. A bondholder committee could improve coordination and communication between parties in a crisis because of the committee's attempts to minimize uncertainty about the locus of authority in negotiations. In addition, administrative burdens could be minimized because such committees could be developed, based on previous experience with existing institutions, such as the London and Paris Clubs. According to critics, the committee would not have the power to induce policy adjustments in debtor countries that would make the country less vulnerable to a future financial crisis.

Establishing Bond Covenants That Specify How Debt-Servicing Problems Are to Be Resolved

Another proposal incorporating the cramdown principle suggested that specific covenants be included in sovereign bonds to facilitate potential future workout situations. The market could then lead the way to ensure that creditors and debtors agree, before a bond is issued, on specific repayment conditions should a country be faced with a potential debt-servicing problem. The proposal suggests that specific covenants could address issues such as: how majority voting would take place to alter the terms and conditions of the debt contract (usually, unanimous consent of bondholders is required to change core bond covenants); how objections from creditors or debtors would be handled; and how payments should be shared among creditors.[20] We were told that some Eurobonds governed by English law already have qualified, majority-voting clauses. The G-10 supported the idea of establishing bond covenants and reported that the private sector could take the lead in establishing such covenants with official sector support as appropriate.

Moral Hazard and Contagion

Proponents of establishing these bond covenants pointed to several advantages that they say the covenants would convey in resolving future

[20]One report noted that to make such covenants palatable to lenders, dissenting creditors should have recourse to an arbitral tribunal. The proposal also noted that such clauses may be easily implemented because a form of bond covenants already exists.

sovereign financial crises. They believe that such bond covenants could speed up the process of debt restructuring and could therefore limit the potential for contagion effects. Bond covenants could limit the ability of some creditors to stall or block the resolution process because they agree to abide by majority rule on possible repayment terms. However, bond covenants, unless they are activated extremely quickly, may be unable to stem the contagion effects of other emerging market countries. With regard to moral hazard, the G-10 reported that market participants believe that these covenants might increase moral hazard on the part of the borrower and consequently reduce the financial instrument's attractiveness for the investor community. Other experts say that bond covenants would not create or enhance incentive for countries to default on their bonds since no country wants to risk the possibility of losing access to international capital markets.

Bond Covenants Could Improve Burden Sharing, but Could Also Raise Costs for Sovereign Borrowers

Bond covenants that specify debt-servicing problem or default workout procedures to resolve potential liquidity crises may foster cooperation between creditors and debtors. In addition, bond covenants could provide for appropriate burden sharing between debtors and creditors because conditions could be agreed upon to ensure that creditors are treated and paid in a fair and equitable manner. Market participants who were critical of this proposal told us that bond covenants might raise the costs for sovereign borrowers because investors are likely to demand a higher premium as compensation for the inclusion of covenants in bond contracts. Some said that, if this happened, debtor countries might resist including these covenants in their bonds. Moreover, the G-10 reported that market participants believed that such covenants could reduce the attractiveness of emerging market bonds, which are usually viewed as simple securities that are easily transferable, unencumbered, and easily sold at any time the investor chooses. In addition, these bond covenants could pose unique administrative challenges because market participants believe it might be difficult to agree on the terms and conditions to be included in such covenants. For instance, market participants reported that they would be unlikely to agree to conditions that allow nonunanimous decisions by bondholders to change the schedule of debt payments. They also rejected that idea of majority voting clauses because they are viewed as infringements on creditor rights.

Our Conceptual Framework for Analyzing Initiatives and Proposals to Resolve Sovereign Financial Crises

We developed a 10-point conceptual framework to guide us in identifying the advantages and disadvantages of initiatives and proposals to resolve future sovereign financial crises. As part of our analysis of the initiatives and proposals, we sought to determine whether and how each could

(1) limit contagion and systemic risk to the international financial system, including responding to a crisis with sufficient speed and quantity of resources;

(2) affect moral hazard;

(3) induce appropriate country economic and financial policies;

(4) address the cost-effectiveness associated with development and implementation;

(5) share burdens between parties in a sovereign financial crisis;

(6) facilitate coordination and communication between parties in a crisis;

(7) be flexible enough to deal with various types of financial crises;

(8) apply principles consistently to countries in similar financial distress;

(9) address the legal requirements needed for development and implementation; and

(10) apportion the administrative burden of development and implementation.

In developing the framework, we drew insight from the following: interviews with public and private sector officials, the list of desirable features that resolution strategies should have as developed by a G-10 Working Party, and our past work.[1] We then informally circulated a draft of our framework to obtain comments from officials representing our congressional requester; Treasury, the Federal Reserve; private capital market participants (commercial banks, investment banks, and mutual fund managers); academia; and one private research organization. Almost all of the officials generally agreed with the elements of the framework. However, in a few instances, some officials made suggestions to clarify some points within individual elements. Where appropriate, we

[1] Farm Bill Export Options (GAO/GGD-96-39R, Dec. 15, 1995).

incorporated these comments to finalize the conceptual framework that we used in our analysis.

As agreed with our congressional requester, we used our framework to identify advantages and disadvantages of initiatives and proposals to resolve future financial crises as they related to the U.S. government; U.S. private sector creditors; and, to the extent possible, debtor countries. We assessed information obtained from published reports and studies and from interviews with U.S. and international public and private sector officials.

In our analysis, we highlighted the framework elements that were most important to the initiative or proposal being discussed, and we then divided our analysis into two sections. First, we assessed the trade-offs between two issues that were relevant to almost all of the initiatives and proposals: (1) the impact on contagion to other countries and systemic risk and (2) the impact on moral hazard. Second, we evaluated the other criteria as relevant to each initiative and proposal. For example, one initiative involved doubling GAB, which are lines of credit that G-10 countries maintain through IMF, to $47.6 billion.[2] Our discussion of this initiative's advantages and disadvantages to the United States focused on the three most salient framework elements: how the initiative responded to contagion effects, how the initiative addressed moral hazard, and how the initiative could spread the burdens for resolving crises. In this case, our analysis of GAB did not focus on, to name two, the administrative or legal requirements elements because neither were major issues or major obstacles to implementation of this initiative.

We did not use the framework to endorse any particular initiative or proposal. Furthermore, the relative importance of each element in our framework is a matter of perspective.

[2]See chapter 4 for more information on this initiative and our analysis.

IMF's Special Data Dissemination Standard

IMF'S SPECIAL DATA DISSEMINATION STANDARD

Coverage				
Prescribed		Encouraged categories and/or components	Periodicity	Timeliness
Category	Components			
Real sector				
National accounts: nominal, real, and associated prices	Gross domestic product by major expenditure category and/or by productive sector	Saving, gross national income	Q	Q
Production index/indices	Industrial, primary commodity, or sector, as relevant		M (or as relevant)	6W (M encouraged, or as relevant)
		Forward-looking indicator(s), e.g., qualitative business surveys, orders, composite leading indicators index	M or Q	M or Q
Labor market	Employment, unemployment, and wages/earnings, as relevant		Q	Q
Price indices	Consumer prices and producer or wholesale prices		M	M
Fiscal sector				
General government or public sector operations, as relevant	Revenue, expenditure, balance, and domestic (bank and nonbank) and foreign financing	Interest payments	A	2Q
Central government operations	Budgetary accounts: revenue, expenditure, balance, and domestic (bank and nonbank) and foreign financing	Interest payments	M	M
Central government debt	Domestic and foreign, as relevant, with a breakdown by currency (including indexed), as relevant, and a breakdown by maturity; debt guaranteed by central government, as relevant	Debt service projections: interest and amortization on medium and long-term debt (Q for next 4 quarters and then A) and amortization on short-term debt (Q)	Q	Q
Financial sector				
Analytical accounts of the banking sector	Money aggregates, domestic credit by public and private sector, external position		M	M
Analytical accounts of the central bank	Reserve money, domestic claims on public and private sector, external position		M (W encouraged)	2W (W encouraged)
Interest rates	Short-term and long-term government security rates, policy variable rate	Range of representative deposit and lending rates	D	[a]
Stock market	Share price index, as relevant		D	[a]
External sector				
Balance of payments	Goods and services, net income flows, net current transfers, selected capital (or capital and financial) account items (including reserves)	Foreign direct investment and portfolio investment	Q	Q

Coverage			Periodicity	Timeliness
Prescribed		Encouraged categories and/or components		
Category	Components			
International reserves	Gross official reserves (gold, foreign exchange, SDRs, and Fund position) denominated in U.S. dollars	Reserve-related liabilities, as relevant	M (W encouraged)	W
Merchandise trade	Exports and imports	Major commodity breakdowns with longer time lapse	M	8W (4-6W encouraged)
International investment position	[b]		A (Q encouraged)	2Q (Q encouraged)
Exchange rates	Spot rates and 3- and 6-month forward market rates, as relevant		D	[a]
Addendum: Population		Key distributions, e.g., by age and sex	A	...

Note 1: D means daily. W means weekly or with a lapse of not more than one week after the reference date or close of the reference week. M means monthly or with a lapse of not more than one month. Q means quarterly or with a lapse of not more than one quarter. A means annually.

[a]Given that data are widely available from private sources, dissemination of official producers may be less time-sensitive. Although dissemination by recorded telephone messages or fax services is encouraged, dissemination of these data can be made part of other (preferably high-frequency) dissemination products.

[b]The Special Data Dissemination Standard prescribes data on the international investment position on an annual basis to be disseminated within two quarters of the end of the reference year. The Standard calls for countries to work toward the development, as appropriate and feasible, of the international investment position following the component detail specified in the fifth edition of IMF's Balance of Payments Manual. Assets and liabilities should be classified according to the following breakdown: direct investment; portfolio investment, including debt and equity; other investments; and reserves (assets only).

Source: IMF.

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 3, 1997

Mr. Thomas J. McCool
Associate Director, Financial Institutions and Markets Issues
General Accounting Office
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for your letter regarding the draft report International Financial Crises: Efforts to Anticipate, Avoid, and Resolve Sovereign Crises (GAO Job Code: 233492). We appreciated the opportunity to review and comment on the draft. Treasury staff welcomed the substantive and cooperative meetings they had with the individuals preparing the report.

The study addressed a number of very important issues. We believe that the draft report covers these issues in a thorough fashion and will contribute constructively to their comprehension and analysis.

Senior Deputy Assistant Secretary Timothy Geithner is providing to you, under separate cover, a number of substantive and technical comments for your consideration.

Sincerely,

Robert E. Rubin

Comments From the Board of Governors of the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

May 6, 1997

Mr. Thomas J. McCool
Associate Director
Financial Institutions and
Markets Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

Thank you for your draft report, *International Financial Crises: Efforts to Anticipate, Avoid, and Resolve Sovereign Crises.* In general, the Board believes that the report is a constructive and reasonably comprehensive analysis of current arrangements and certain recent initiatives and proposed procedures related to this very complex and important set of issues.

Federal Reserve staff have a number of technical comments on the draft report, which will be sent to you under separate cover for your information and consideration for the final version of the report.

Sincerely,

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