Week 6: International Finance. Sachs. 1995. "Do We Need an International Lender of Last Resort?"

Main question: Do we need an international lender of last resort (ILLR)?

Main answer: Yes, the world needs ILLR, under certain circumstances, but not centered in the IMF. Instead it should act like a bankruptcy court coordinating between creditors and debtors. It should also establish the international legal arrangements to promote The IMF should revise its policies and vision to keep pace with changing world financial system.

Explanation: Sachs argues that four major gaps in concept and practice of the IMF add unnecessarily to the instability in international capital markets.

1) The IMF, as established to act as a kind of ILLR, lacks the standards vis-à-vis this critical role. It violated internal rules by granting Mexico a standby loan equal to seven times its quota.
2) The structure of IMF-led debt restructurings has been woefully inadequate from the start of the crisis in 1982. It took seven years for the IMF to acknowledge the need for debt reduction from bank creditors.
3) The IMF has failed to define an adequate policy in its original area of core competence, exchange rate management. The IMF has tended to favor floating exchange rates over pegged exchange rates, despite the growing evidence that stabilization programs based on floating exchange rates are typically more contractionary.
4) Despite the growing importance of international capital flows, especially to the emerging countries, there are almost no international standards regarding data disclosure, capital controls, prudential standards for non-bank institutions, and the role of monitoring institutions, both public (such as the IMF) and private (such as the bond-rating agencies).

Sachs points out that there are two basic kinds of coordination problems in financial markets. The first is multiple equilibria in asset markets. The value of financial assets depends on market expectations, while market expectations depend on asset values. This circularity gives rise to many forms of self-fulfilling prophecies, with attendant instabilities and inefficiencies. There are three cases of multiple equilibria. The classic case is bank panic i.e. each depositor rationally races to withdraw funds ahead of the rest. The second is a general creditor panic against non-bank borrower. It comes if the size of the required loan is so large that it must be subscribed by a large number of creditors, each of whom may fear that other creditors will not subscribe to the loan. The third kind of multiple equilibria is a shift of asset demands away from domestic currency and into foreign currency, thereby pushing an economy into high inflation or keeping it stuck there. The possibility of a country to be hit by self-fulfilling prophecies then requires a role of ILLR, centered in an institution like the IMF.

The second problem is collective action problems. It is the case of a debtor in extreme financial distress that is unable to meet its debt obligations as they fall due, and that likely needs a partial cancellation of debts in the future. At each stage of a financial workout, collective action problems plague the readjustment of debt claims, to the detriment of the creditors as well as the debtor. Legal institutions have evolved in domestic economy to address these problems: bankruptcy laws. This collective action problem also applies to the international scene when the debtor is a government. In any case, Sachs argues that there should be bankruptcy law in order to strengthen the relief in order to maintain the political functions of the government. At the same time, the financial support should be designed to facilitate the rapid and deep restructuring of the state itself, including a retreat from the areas that brought on the state bankruptcy in the first place.

After all, the IMF lacks an adequate conceptual framework to fulfill all these roles required by coordination problems. In the multiple equilibria case, it only responds to bank panic, creditor panic, or currency crisis on an ad hoc basis. In the collective action case, there are no IMF procedures for automatic standstill, priority borrowing, or the negotiation of a comprehensive debt restructuring deal.

Sachs argues that the IMF should provide public goods not provided by the market. Most importantly, they should provide an international legal framework for overcoming problems of market failure. The international framework is currently inadequate all three cases: currency instability, creditor panic, and financial insolvency of sovereign borrowers. For currency stabilization, the IMF should selectively promote floating exchange rates. For most countries with low or moderate inflation, floating rates are prudent and effective, while fixed rates are difficult if not impossible to sustain when real exchange rates move out of line. On the other hand, for highly demonetized economies, there is a case for pegged rates to prevent a self-fulfilling flight from the currency, and to reduce the costs of stabilization. These countries, moreover, merit financial backing in the form of emergency stabilization funds at the outset of stabilization. Once stabilization and remonetization are achieved, however, the evidence points to the need for a gradual transition to a more flexible exchange rate to avoid currency overvaluation.

For creditor panic, the IMF should act like a bankruptcy court and thus dismiss its role as ILLR. As a bankruptcy court, it could supervise the extension of "administrative priority" for new private-market borrowing for a liquidity-strapped member government. The IMF still imposes traditional conditionalities on the priority borrowing. Also it should shift its practices to rely on private capital markets by playing a role instead as coordinator among the creditors. Countries would remain in contact with the private markets. If necessary, during the arrangements of these new market borrowings, the IMF would have the authority (in parallel with a bankruptcy court) to administer a temporary standstill on debt servicing. Moreover, by being a bankruptcy court, the IMF would shed its monopoly position as macroeconomic advisor to governments in distress and have the countries come up with their own economic adjustment plans.

In terms of debt workouts, the IMF does not adequately appreciate the linkages between reform and timely financial assistance. It has failed to provide financial assistances during three significant points of a debt workout: a debt service standstill at the outset of reforms; fresh working capital during the restructuring, so that critical governmental functions don't collapse; and (often) some debt reduction at the culmination of reforms, to help reestablish the government's solvency. In general, the IMF has shown remarkably little interest in coordinating the actions of the creditors to achieve efficient debt relief, whether a standstill, new loans, or debt reduction.

Again, failing to do its jobs, the IMF should revise its roles as established since the Bretton Woods and focuses more on the international legal systems. It should be a coordinator of funds from the private capital markets rather than lending its own money.