

Globalization and Order VII : A New International Financial Architecture?

By Deepak Lal

The recent sovereign debt crises, have led many to argue that a new international financial architecture is needed. In this column, which concludes this series, I will examine if these arguments. The central question is whether these crises are endemic in a liberal order of capital flows, and whether public action can prevent or mitigate them or will necessarily exacerbate them.

The views of 'classical liberals' diverge from various 'dirigistes' on the issue. The major divide concerns the functioning of the macro-economy- both national and international. The classical liberals believe that, a competitive macro economy, without barriers erected by governments to adjustment, will be self-correcting. The dirigistes believe that the inherent instability of the macro-economy requires public intervention. The irony is that whereas most governments have now virtually accepted the classical liberal viewpoint as regards the domestic macro-economy by eschewing the Keynesian interventions commonly accepted in the two post war decades, various observers are recommending various dirigiste means to 'control' the international macro-economy.

This dirigisme reflects the continuing atavism concerning capital and credit markets. Economic historians consider the creation of the national public debt and the Bank of England soon after the English Glorious Revolution in the late 17th century, as an essential element in the rise in economic power and social status of the merchant and financier from the 16th to 18th centuries. This rise however posed severe problems for the existing 'Aristotelian' ethical beliefs of these societies. These concerned the ethical problem of ascribing virtue to the acquisition of wealth by the lending of money. This ban on interest was common to all the ethical systems of the pre-modern world. It was based on Aristotle's unequivocal statement: "Money was intended as a means of exchange, not to increase at interest".

This ban on interest was gradually lifted in the West. But, ethical worries about the 'unreality' of credit and of the socially unproductive nature of interest resurfaced with a vengeance in 18th century England following the Financial Revolution of 1694-96, which created a vastly expanded credit mechanism, leading to the rise of the rentier. This posed a severe problem for the traditional value system shared by both opponents and friends of the new goddess Credit. For the traditional ethical system, property in the form of land was the most real, and though the trader and the merchant's wealth was moveable, and hence not as reliable in inducing civic virtue as the landlord's, it at least consisted of real things. By contrast, the wealth of the stockholder and the stock-jobber created by the new system of public credit appeared to be unreal and fantastical. It traded pieces of paper which were mere "tokens of men's confidence in their rulers and one another" with their value dependent on "men's opinions of others' opinions of them". ((J.G.A.Pocock :in E.Kamemka, and R.S.Neale: (1975): Feudalism, Capitalism and Beyond")

This is a view of commerce and the speculation it necessarily engenders, which survives to our day in the outpourings of the various critics of global financial and capital markets. Lest it be thought to be the untutored prejudice of economic illiterates, one only has to remember Keynes' peroration on the stock market in his General Theory.

The same suspicion of international capital markets is shown by those who for instance want to "throw sand in its works" by imposing the so called Tobin tax on capital flows. There can be no justification for this, as consider the absurdity of imposing a similar tax on domestic stock market transactions to damp their volatility! Similarly, many of the current proposals to improve the so-called international financial architecture are misconceived.

Thus, the calls for the IMF to be converted into an international lender of last resort, by analogy with domestic banking systems, is not credible. There are two functions that a lender of last resort has to perform as set out in Bagheot's famous rules. First, it should be able to create high-powered money quickly to on-lend to solvent banks to prevent a liquidity crisis. Second, it must be able to distinguish between good and bad 'paper' and thus judge the soundness of the banks to which it is extending liquidity, with the insolvent banks being shut down. The IMF is incapable of doing either. The lender of last resort function for the money center banks involved in foreign lending must therefore continue to be provided by their parent central banks.

The IMF's recent proposal to oversee the orderly restructuring of sovereign debt, on the line of the US Chapter 11 provisions for domestic bankruptcy, appears to have some prima facie plausibility. As the Deputy managing director of the Fund, Anne Krueger explains, currently when a debtor country is unable to service its sovereign debt a minority of bond-holders can hold up the restructuring of the debt against the wishes of the majority. Moreover, the recent success of the 'vulture fund, Elliot Associates, in suing Peru for full repayment and interest on the \$20 million of government guaranteed commercial loans it had bought is as an example of the problem posed by the lack of an orderly mechanism for restructuring sovereign debt. Elliot Associates refused to accept the Brady bonds other creditors accepted, and instead obtained a judgment for \$56 million and an attachment order against Peruvian assets in the US. Elliot targeted the interest payments that Peru was due to pay to its Brady bond holders. Rather than be pushed into default, Peru settled. This contrasts with the outcome of the 1980's debt crisis when most of the syndicated bank loans, were restructured in an orderly way by a steering committee of 15 people holding about 85% of the debt. There was little incentive for holdout creditors to pursue claims through litigation, because they would have had to share any proceeds with fellow creditors. So a formal mechanism to restructure sovereign debt is needed.

The major flaw with this proposal is that, unlike a domestic bankruptcy court, where the debtor has to disclose all its assets, on which the creditors can be given a fair share of their claims, no such provision is included in the IMF proposal, and for a very good reason. Unlike domestic private debtors to whom Chapter 11 type bankruptcy provisions apply, sovereign debtors will be *unwilling* to pay their debtors well before they are

unable to do so. For only their assets in foreign jurisdictions can be legally attached by their foreign creditors when they default. In fact, the very example of Peru settling with Elliot Associates shows that it was able to pay! Similarly, the major 1990s debtors in crisis, Mexico and Indonesia, have large state owned oil companies whose assets would have covered their debt payments if they were willing to use them to pay off their debt. The IMF proposal will reduce the currently limited incentives for sovereigns not to over borrow, and will further curtail lending to these emerging markets. It is flawed by not recognizing that, unlike domestic bankruptcy procedures, it is the very invulnerability of a sovereign borrowers domestic assets from any claims by creditors, which makes any international sovereign bankruptcy scheme infeasible.

Does this mean that the volatility of international capital market, and the periodic 'bubbles' to which it is prone cannot be mitigated? As international capital markets are merely an extension of domestic stock markets, and just as there is no credible argument for volatile and bubble-prone domestic stock markets, to be shut down or have 'sand thrown' in their works, there is none for their international counterparts. Though volatile, and subject to bubbles, public intervention would only make matters worse. So I can only echo the sage advice of Lord Palmerston when faced by calls for public action in the face of spectacular defaults on foreign bonds when in a circular of 1848 eschewing any public action he wrote: "The British government has considered that the losses of imprudent men who have placed mistaken confidence in the good faith of foreign governments would provide a salutary warning to others".