PREVENTING ASIA TYPE CRISES: WHO, IF ANYONE, SHOULD HAVE JURISDICTION OVER INTERNATIONAL CAPITAL MOVEMENT?

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Thank you, Cynthia, for the opportunity to be on this very distinguished panel. I am presenting a view from the private sector of the proposals discussed by my colleagues. However, I should make clear from the outset that these are my own views and do not necessarily represent the views of Deutsche Bank or the Institute of International Finance.

These are interesting times. The capital markets are going through a phase of enormous disruption as a direct result of the financial crises in Asia and Russia. Net private capital flows to emerging markets have plummeted from a peak of $300 billion in 1996 to a projected $160 billion in 1998. The fundamental question before policy makers today is how best to respond to Asian/Russian style crises, maintaining both confidence and discipline in the market? The debate of who, if anyone, should have jurisdiction over capital flows has renewed in this context.

It is interesting that the issue is now framed as a question of whether an international entity (usually the IMF) should have the ability to assist or sanction a country's *imposition* of capital controls. Prior to the Asian crisis there seemed to be broad consensus that the elimination of capital controls in emerging market economies would be generally desirable. As recently as 1997, proponents of expanding the IMF's jurisdiction over capital flows argued it was necessary to promote *liberalization* of such flows. The Asia crisis has made it abundantly clear that even the best and brightest are still learning about the workings of the modern financial markets, a task not made easier by the rapid pace of change. We are now reconsidering our positions on whether such controls have a place in today's economic world; the debate is now when, and what type of capital controls are appropriate.

Without question, the issue is important. Private capital flows have been a major part of the engine for growth in emerging markets in the 1990's, replacing much of the financing formerly provided by official sources. Much of the flows have been to the private, rather than sovereign sector. A large component has continued to be in the form of portfolio (often short-term) investment, despite the concerns raised about this type of investment's volatility after the Mexican peso crisis of 1994 through 1995. Derivatives, particularly deliverable and non-deliverable currency

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forwards, have also become an important part of the equation. A very large and active secondary market developed both for bank debt and for securities. Technology has dramatically increased the speed with which these funds can be transferred out of a country perceived as troubled.

These changes, as you have heard, have given rise to a view in some circles that the old systems no longer work - that a new financial architecture is needed to promote resolution of crises. Feelings have been expressed that the private investors and lenders have not borne their fair share of the burden in debt restructurings, and that rapid uncontrolled capital flows have had a destabilizing influence on attempts to resolve recent crises. Certain officials, including Michel Camdessus, Managing Director of the IMF, have argued that the IMF needs authority over capital flows to provide a basis for moratoria, standstills and similar arrangements involving an element of involuntary deferral of performance of financial contracts. In this context, the G-7 statements call for greater private sector participation in resolution of debt crises, strengthening of the IMF and expansion of the IMF's policy of lending into arrears.

What exactly is meant by the G-7 statements is unclear. But the international financial community is concerned that certain proposals made after the 1994 through 1995 Mexican peso crisis may be resurfacing. A recurring theme is that an international organization or agency should have powers similar to a U.S. bankruptcy court. The IMF continues to be frequently mentioned as a potential repository of such powers. Government officials, in recent pronouncements, have referred to giving the IMF explicit power to impose a standstill. Expansion of the IMF's jurisdiction over capital flows - in particular expansion of the scope of Article VIII 2(b) to clarify that any contract in contravention of IMF approved capital controls will not be enforceable in member courts - has also been suggested as a means to achieve this result. Implicit in the proposals is the proposition that such a standstill or capital controls will have retroactive effect - i.e., that contracts in compliance with exchange controls at the time they were entered into will not be enforceable if IMF-imposed or -approved controls are subsequently adopted.

Given these recent proposals, my remarks tonight will focus upon the issues presented by expanding the IMF's jurisdiction over capital flows to more explicitly empower the IMF to implement or support a country in implementing stays, moratoria and other involuntary deferrals of performance of financial contracts. However, it should be stressed that vesting any other international organization with similar authority would raise many of the same issues (and perhaps even more so).

It should be noted that the IMF, in practice, has considerable influence over member countries' decisions to eliminate or impose capital controls. Perhaps most importantly, the IMF has significant leverage when a country seeks IMF support. Outside of a crisis, it also has influence over members' economic and financial policies in exercise of its powers of surveillance. It has also indirectly supported country decisions to defer payment to banks by lending into arrears.

The perceived need to further expand IMF powers is based upon the changed structure of the market. In particular, there is a view that an international entity needs to have the authority to take quick action in a crisis to stop the bleeding and give the country breathing room. While banks in the 1980's generally observed effective standstills so long as good faith negotiations were taking place, concern exists that today's widely dispersed holders of debt may not have the same incentives - whether arising from relationships, contractual terms such as sharing clauses or political pressures - to participate in an organized debt restructuring. Consequently, the risk of the creditors attempting to seize assets, or of a rogue creditor, using strike suits and other means to hold a restructuring hostage to receive more than its fair share, is perceived to be greater. As mentioned above, many also believe that a mechanism should be in place to facilitate debt reduction instead of merely a stretch-out of existing principal and interest.

Not surprisingly, the private sector reaction to expanding IMF powers along these lines is one of nervousness. Such proposals give rise to fears that international respect for private contracts is being undermined and, particularly, those decisions as to enforceability of creditors rights will be made i) in fora where the creditors have a limited, if any, voice; and ii) by entities with conflicting interests and objectives. Giving an international entity explicit power to impose a standstill (unsettling enough to many lenders, particularly since it is unclear how long such a standstill will last) raises the specter that this power will lead to the next step, to the ability to effectively impose cram-down, or reduction of debt. The result is greater anxiety about returning to emerging markets at the very time that the official and private financial communities seek to rebuild confidence. Whispers about the use of other peoples' money to achieve international political objectives can be heard.

Proponents of giving the IMF or another international entity power to impose a standstill or otherwise modify creditor rights through imposition or sanctioning of capital controls draw an analogy to the United States bankruptcy system. They rightly point out that creditors continue to lend to United States companies even though creditors know that their rights may be compromised in a bankruptcy proceeding. However, there are fundamental issues presented in attempting to translate such concept into the international arena.

From the outset in the United States, there is a question, never fully resolved, as to whether the nullification or modification of United States contract rights as a result of an international treaty or IMF edict - particularly if *ex post facto* - could be challenged as an unconstitutional taking of property. United States bankruptcy law has its foundation in the United States Constitution. Even with this authority, bankruptcy proceedings attempt to strike a balance between property rights and the objectives to be achieved through the bankruptcy law. For example, stays are lifted if the court determines that the stay is unnecessary or that creditors are not being adequately protected. It also should be noted that the United States philosophies regarding debt relief underpinning Chapter 11 are not yet broadly accepted in other countries. Whether impediments will exist to according the IMF such powers under the laws of other jurisdictions is yet to be determined. Accordingly, there may be legal issues presented under United States and other laws by any attempt to grant the IMF bankruptcy-like powers. However, for today, we will put these interesting questions aside and focus upon the merits of these proposals.

The United States bankruptcy procedure generally involves a forum widely perceived to be impartial, focused largely upon maximizing the value of the estate for the creditors. Creditors participate in development of a plan, which is worked out between the debtor and representatives of the creditor groups (indeed, some commentators have referred to the role of the bankruptcy judge more as a referee than a decision maker). A party to the contracts, i.e., a significant creditor or the debtor, must initiate the proceeding. And, even in the United States, a bankruptcy filing is not a step lightly taken. The owners and management of the debtor are at risk of losing their equity and their jobs. Creditors fear losing control of the process.

Furthermore, in the context of private sector proceedings, stays are not imposed on a country-wide or industry-wide basis, but rather in the context of each individual debtor. As noted above, there is a balancing of the creditors' property rights and debtor relief objectives; exceptions to stays are accordingly granted taking into account the individual circumstances.

It will be very difficult for the IMF to provide a forum that creditors will view as impartial. The IMF is, by its nature, political. Its objectives, quite rightly, are not to maximize the debtor's estate for the benefit of private creditors. And, given that the IMF and its major shareholders are lenders themselves, the IMF has a conflict of interest not easily susceptible to remedy. It is likely to have a policy agenda that may preclude it from acting predominately as a referee, letting the debtors and creditors work things out as they see fit. It may even be the party directing the country to institute the proceedings. In this regard, it should be noted that neither the IMF nor the country will have the same disincentives as in a United States style bankruptcy to institute a stay or other proceeding - in fact, there may be incentives to take such action. Arguably in the case of the existing government, imposition of a stay would even strengthen its position; the IMF cannot be expected to have a bankruptcy court's power to force changes in management of the sovereign debtor. To the extent private sector debt is involved, the stay would shield debtor companies and their existing management from the consequences of their actions; furthermore, to the extent that they are doing business outside of their home jurisdiction, such companies would have protection not afforded to their competitors in such other jurisdictions.

As a result, accountability and pressure for reform will be further reduced. Creditors will be effectively defanged to the extent their contract rights become unenforceable. They will retain little or no leverage to force a recalcitrant country or company to the negotiating table (other than a refusal to lend further money). Furthermore, in the private context, the international stays would most likely be imposed across the board There would be no consideration of the merits of individual cases, industries or companies or, if there were to be, the decisions would most likely be made by either the IMF or the country affected (with the endorsement/encouragement of the IMF). In short, the IMF would wield a very powerful, but blunt instrument. Creditors would have little, if any, input or control.

Many major private sector participants consequently are not convinced that expanding the IMF's jurisdiction over capital flows to give it enhanced power to impose or support standstills or moratoria is either necessary or desirable at this time. Historically, at times of crises, stays effectively have been implemented through creditor cooperation with a country. Litigation has not been a major factor where the country has been negotiating in good faith. Whether litigation becomes more of a problem in today's environment remains to be seen. However, there are still factors (in addition to expense and time) which discourage creditors from engaging in an unseemly rush to the courthouse.

Generally, sovereign debtors have few assets outside of their home country that can be relied upon. This is often true of private debtors as well. There are special defenses to suit or attachment that must be overcome, based upon sovereign immunity, act of state, and comity. Courts can be hostile to a creditor that they do not believe is acting in good faith and with commercial reasonableness. In a recent decision, *Elliott Associates, L.P. v. the Republic of Peru*, the Southern District of New York refused to enforce a claim against Peru invoking the medieval defense of champerty, providing a warning to those who buy claims strictly for the purpose of bringing strike suits. Countries have long memories of those who take legal action against them. Among other things, financial institutions who sue may find themselves locked out of lucrative business opportunities for many years to come.

Leading creditors who have negotiated debt restructuring packages in the context of the London Club have never had the authority to bind those not at the table. As a result, they have been extremely cognizant of negotiating a package that other creditors would be willing to accept - ensuring at least some level of fairness. Bondholders, protection councils, and similar groups have performed similar functions for securities holders in the past. The secondary market also, frankly, creates certain opportunities for sovereign and other debtors. Although certainly not endorsed by the international financial community, debt reduction has been achieved by some countries, most notably Peru and Nigeria, who have arranged for buy-backs of their debt in the open markets after it began trading at a deep discount. Where perceived as necessary, moratoria have also been imposed by governments, albeit at a steep price in later ability to access capital markets. Although this has unsettled markets, this may not be a bad thing - particularly if markets can learn to differentiate among different debtors. It is not a step taken lightly.

Even using the United States model for a stay in bankruptcy does not achieve all, perhaps, desired. One question is how long should the standstill last? Debt restructurings have taken as much as 14 years to conclude. What happens when the standstill is taken off? If the country's fundamentals have not improved, the capital outflow situation may be even worse than before. Also, what should be done with derivatives? United States law exempts many such contracts from the automatic stay, recognizing that time is of the essence in these transactions due both to their nature and the intricate network of hedges institutions use.

A brief mention of lending into arrears. Statements have been made implying that this may be the way to indirectly give the IMF power to sanction a deferral of payment to creditors and even a reduction in debt. To the extent that this is the case, it presents the problems discussed above and consequently risks further unsettling the markets rather than building confidence. Any decision to expand the IMF's policy in this regard should be carefully evaluated for its potential impact on the markets.

The private sector recognizes that the current situation is not perfect. When we look at the system today and the mechanisms available for risk management, we can see that the markets do look different than the 1970s - but many of the changes are positive. The markets are more liquid, more diversified, more open. New methods of quantifying and managing risk have been developed in response to these changes and it can be expected that, as the markets continue to change and new problems arise, there will be further development.

This evolution is taking place in the context of the issues discussed today. Private sector groups such as The Institute of International Finance are actively promoting practical, private-sector based, approaches to debt crises, including greater public-private sector dialogue and cooperation. For example, private circles are currently debating whether introduction of contractual provisions to facilitate private debt restructurings (such as *collective representation* clauses) would be desirable. Plans, such as the Jakarta Initiative, are being developed and implemented to promote organized out of court workouts of troubled private sector companies. Steps are being taken to strengthen local bankruptcy systems, and international protocols and concordats for recognition of foreign bankruptcy proceedings (including court-imposed stays) are being developed, to provide relief in the case of private sector companies. The IMF and the world financial system may well be better served by the IMF supporting these measures rather than trying to substitute for them.

The desire for a more orderly and theoretically tidy process is understandable. However, the temptation to resort to a quick fix, especially with respect to complex and dynamic markets, should be resisted. Some humility may be appropriate when we think that, only in 1997, the desired objective was to promote the elimination of capital controls in emerging markets. Before implementing radical solutions, we should proceed cautiously and ask hard questions about their overall impact on private capital flows creatures that have proved to be extremely fickle over the last year.