IMES DISCUSSION PAPER SERIES

New International Financial Arrangements

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Discussion Paper No. 2002-E-11

IMES

INSTITUTE FOR MONETARY AND ECONOMIC STUDIES

BANK OF JAPAN

C.P.O BOX 203 TOKYO

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IMES Discussion Paper Series 2002-E-11

August 2002

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Abstract

The paper addresses three related issues about monetary institutions. First, acting alone countries cannot achieve price and exchange rate stability. Large economies--the United States, Japan, the European Union--can provide the public good of price stability. Doing so would permit all countries that chose to do so to fix their exchange rates and achieve both benefits. In turn, the large economies would benefit from fixed exchange rates and domestic price stability. Second, to respond to the increased size of capital flows, the International Monetary Fund should be changed from a command and control institution into an institution that works to stabilize international financial markets by increasing incentives for stability. Third, recent discussion of international bankruptcy, collective action clauses, and debt rescheduling proposals suggests that reform of international financial institutions has attracted new attention. The paper discusses three proposals.

Key words: Price and Exchange Rate Stability, Role of the IMF, Debt Resolution, Collective Action Clause.

JEL classification: E5, E6, F3 and F4.

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This paper was prepared for the Bank of Japan's 10th International Conference, Tokyo, Japan, July 1-2, 2002. I am grateful to Adam Lerrick for many helpful comments.

New research, new policy proposals, new problems, and new policy officials have at last moved the organization of the international monetary system to the center of current attention. The Bank of Japan is to be congratulated for forecasting these developments when it chose exchange rate regimes as the topic when it first planned this conference 18 months ago. I have been asked by the organizers to broaden the topic to include the role of international institutions, itself a subject of recent interest to policymakers.

The paper begins by summarizing and extending comments I made at an earlier Bank of Japan conference and elsewhere proposing a policy rule for an open economy. Meltzer (1984, 1997) Then I discuss reform of the International Monetary Fund (IMF) and the recent proposals for debt default and restructuring. International financial institutions have moved a long way in the past three years from excessive concentration on large loans and conditional lending to structural reforms that reduce risk and improve market operations.

Exchange Rate Systems

Keynes (1923) set out the basic problem of international monetary arrangements. No country acting alone can achieve both price and exchange rate stability. Acting alone a country must choose one outcome or the other. If it fixes its currency to the currency of another country, it loses control of its price level and rate of inflation, and it may experience real costs of appreciation or depreciation as in Chile in the 1970s and early 1980s or in Argentina recently. If it chooses domestic price stability, the market sets its nominal exchange rate.

Some institutional arrangement or international agreement such as the gold standard resolves this problem by permitting countries to fix exchange rates and import low inflation. A metallic or fixed exchange rate standard, however, makes prices move procyclically.

Efforts to avoid either fully fixed or flexible exchange rates using some type of fixed but adjustable peg contributed to major crises. As Fischer (2001) noted, intermediate exchange rate systems -- those that are neither fixed permanently nor floating -- lost much of their appeal in the 1990s. At the end of the decade, only 34 percent of the countries reporting to the IMF had an intermediate system, down from 62 percent in 1991.[1] Some type of floating, usually a managed

[1] Fischer's data include an additional 26 countries in 1999, so the sample size changes. Fischer (2001, pp. 3-5) discusses classification problems.

float, is now the most common system.

Standard economic theory does not give explicit answer to the question: What is the optimal exchange rate system? It depends on country size, degree of openness, international capital mobility and other factors. Many recent policy discussions conclude that, with capital mobility, pegged exchange rates (including adjustable pegs and adjustable bands) are not durable. Breakdown has often occurred in a crisis, after large expenditure for defense of the peg, as in Mexico, Korea, Thailand, Indonesia, Russia and others.

Three important caveats are in order. First, the remaining choices of exchange rate systems are often described as corner solutions. That overstates the choice problem. Many countries that float intervene to adjust the exchange rate. Political pressures to do so are real, often strong and continuing, even if undesirable. Second, there are few freely floating currencies. Those that do are mainly currencies of large economies like the dollar and the Euro. Third, floating is not a fully specified policy until there is a rule for money growth such as inflation targeting, Taylor's rule, or some other restriction on the actions of the monetary authority.

To complicate matters, a country may have a pre-announced inflation target but intervene in the exchange market to achieve the target. In what sense should these purchases or sales be described as managing the exchange rate? Does it matter that the central bank achieves the pre-announced target by purchasing foreign exchange instead of domestic securities? My answer is that if foreign exchange purchases do not change anticipated money growth or anticipated inflation, they should have no effect on relative prices including the exchange rate. These purchases are a way of achieving the designated monetary policy, the target interest rate, money growth, or inflation rate.

In relating exchange rate systems to policy rules, there are two lessons that have been noted for centuries but are often forgotten. First, exchange rate systems cannot achieve stability unless policies are stabilizing. Both fixed and floating exchange rates are sustainable if monetary and fiscal policies are disciplined. Neither works well if policies are destabilizing, but countries that inflate must have either floating or adjustable rates or exchange controls. Second, the choice of exchange rate system is a decision about the adjustment process. If the exchange rate is fixed, nominal prices and wages must adjust to restore equilibrium. Floating

the exchange rate is an alternative means of achieving the equilibrium real exchange rate.

My earlier statement of a monetary policy rule proposed that the major central banks or governments should supply a public good that would permit all other countries to have both reasonable price stability and a fixed exchange rate. If these currencies adopt and achieve a common, low rate of inflation--zero to two percent or minus one to plus one percent--countries that choose to fix their exchange rates to one of the major currencies (or to a basket containing all of them) would achieve both internal and external price stability. And, if many countries choose to fix their exchange rates, the major countries also get the benefit of more stable prices of traded goods and services. As an alternative, any country, small or large, could allow its currency to float and could adopt the common inflation target if it chose to do so.

Of course adopting either policy rule restricts budget deficits. There is a limit to the amount that countries can borrow. The limit is not a fixed amount or fixed percentage of GDP or exports. It depends on the saving rate, growth rate, export growth, and other factors that influence the country's real exchange rate. It depends also on the availability of loans from international financial institutions.

If major countries adopted the common inflation target and the market believed that each would achieve its target consistently, changes in real exchange rates would be the main source of exchange rate changes. Exchange rates would adjust to differences in productivity, tax rates, monopoly power, regulation, and other real events. For example, if innovation increases productivity in one country and tax rates and welfare state benefits reduce incentives to work in another, the real exchange rate would adjust. Countries with fixed exchange rates would experience price level changes to adjust their real exchange rates.

A tripartite agreement on a common rate of inflation for the dollar, the Euro and the yen would achieve a major benefit at modest cost. Central banks that follow my proposed rule, or a Taylor or McCallum rule, or set an inflation target would operate as before, substituting the agreed common rate of inflation into their rule. Small, open economies could adopt one of the principal currencies or establish a currency board to retain seigniorage. Other countries could choose a hard fixed rate or set an inflation target equal to the common inflation rate adopted by the principal currencies.

The common policy rule, if adopted by many countries, would reverse the early postwar

error of creating scores of central banks. Many former colonies wanted to create their own money as evidence of their independence. The benefit of having a central bank proved illusory and costly for countries that experienced high rates of inflation and enlarged public sectors financed by printing money. In many countries, a central bank was far more likely to create problems than to solve them.

Role of the International Monetary Fund

What role would remain for the IMF? Countries that adopted the common monetary system, either by fixing firmly to a major currency or adopting the common inflation target, would be more stable. They would have to discipline their fiscal policy to avoid excessive borrowing and to maintain the monetary rule, if the IMF does not provide loans to sustain budget deficits.

The International Financial Institution Advisory Commission, that reported to the United States Congress in March 2000, proposed major changes in international financial institutions. In the Commission's view, the IMF's two principal tasks would be providing the public good of increased economic and financial stability and greatly increasing the quantity, quality and timeliness of information about its member countries. The Commission concluded that most severe crises occurred in countries with weak banking systems and adjustable pegged exchange rates. There are many reasons for the weakness of banking systems in developing countries, but three are very common.

First, the banking or financial system is often used to support a development plan, a subsidy system, and social transfers by lending at below market interest rates to favored sectors or firms. China is currently an example, but there are many others such as Korea or Indonesia. Second, many developing countries are too small to offer local banks broadly diversified loan portfolios, if banks lend only to domestic borrowers. Korea is the world's eleventh largest economy, but its GDP is about the same size as the GDP of Los Angeles County. We know from theory and from the history of banking failures that insufficient diversification is a major reason for bank failures. Third, many developing countries permit their banks to borrow on short-term loans from money center banks in the developed countries. When several of these loans are not renewed, the banking system is forced to shrink and the exchange rate depreciates

and may collapse.

The Commission proposed four changes, a set of conditions that would permit countries to pre-qualify for assistance if there was a run on the currency or some other crisis. The IMF would monitor these conditions, as part of its Article IV process, and it would report its concerns or approval in much the same way that private rating agencies announce actual or possible future changes. The Article IV reports would be available to the public helping investors decide to invest or lend more or less to the government and the private sector. To reduce reliance on short-term loans, increase diversification of loan portfolios and strengthen the financial system, foreign banks would be permitted to enter the local market and compete to service the country's borrowers and depositors. These banks could balance their accounts with loans and deposits in local currency and diversify risk by entering many foreign markets. Several banks have done this where it is permitted, and the World Trade Organization has adopted a protocol requiring members to eliminate prohibitions against foreign banks. Several developing countries have made this adjustment. In the 1998 Brazilian crisis, foreign banks were a source of stability. Concerned depositors shifted their assets to foreign banks. The banking system did not collapse, so it helped to reduce the severity of the crisis.

Second, to strengthen financial systems the Commission majority called for recapitalization of local banks. The use of subordinated debentures is one way that the literature has discussed. The debentures would be held by a non-governmental agency. Third, the Commission's majority recommended improved standards for reporting the amount and timing of a country's foreign obligations.

The fourth recommendation called on the IMF to establish a standard for fiscal policy to assure that IMF resources "would not be used to sustain irresponsible budget policies." IFIAC (2000, p. 8)

The IMF welcomed the proposal for pre-conditions. It had earlier proposed a facility called the Contingent Credit Line or CCL. The design of the CCL and its failure to attract any members points up some of the problems in moving the IMF from a command and control

manager of many countries to a quasi-lender of last resort reducing global risk and instability.[2]

The IMF has not implemented the CCL. One reason is that the IMF staff has been unwilling to make the CCL automatic. They want to reserve the right to refuse assistance under the CCL if a member country contributed to the crisis. And they want to negotiate conditions for assistance. These departures from automaticity of assistance, if preconditions are met, increase costs for potential members and reduce the benefits. Prompt, automatic assistance reduces uncertainty and the size of the economy's downward adjustment. Absence of automatic support lowers the attractiveness relative to other IMF programs. The Commission majority viewed a CCL-type program as a way of replacing the IMF's command and control programs with an incentive system. Commitment by a country to a reform program, phased-in over a five-year period, and the IMF's approval of the program, would mark the country as qualifying for automatic assistance. Private lenders, who now supply most of the external capital for developing countries, would supply more capital to the country at lower cost reflecting lower risk. The country's government could propose reforms to its parliament as a means of obtaining additional foreign capital to support development. Instead of proposing reforms because the IMF required them, the country's administration could propose reforms believed to be beneficial to the country.

To strengthen incentives for reform, the majority proposed that countries that do not meet the standards for the CCL should not receive assistance from the IMF. If a crisis in one country threatened to cause a global or regional crisis, the IMF should lend to countries affected by contagion, including countries that did not meet prudential standards. It should not lend to the country that precipitated the crisis, unless it met the standards. A credible policy of this type would encourage reform.

Other proposals for reform include the use of penalty interest rates instead of the current practice of subsidizing borrowers and introduction of negative pledge clauses to prevent governments from subordinating existing creditors to obtain additional loans. The majority report mentions bankruptcy courts, collective action clauses, and other contractual changes in contracts, but it does not take a position. I return to these issues below.

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[2] A quasi-lender of last resort differs from a lender of last resort in that it cannot print money. The Commission majority proposed that the IMF would have the right to borrow in capital markets as part of its lender of last resort

These and other majority recommendations are based on several beliefs that should be made explicit. The principal role of the IMF and other public international financial institutions should be to improve the operation of markets, reduce risk, increase incentives for reform, and improve the quantity and reliability of information. Crisis prevention or mitigation without subsidizing risk or introducing moral hazard is one of its major duties. Reliance was on incentives both within the IMF and in the IMF's dealings with its clients.

Improvements in the quantity, quality, and timeliness of information are another type of public good. Given the IMF's active role in surveillance and the competence of its staff, publication of its reports strengthens markets.

Crisis and Default Resolution

The third topic in the proposed revision of international financial arrangements is the resolution of financial crises and restructuring of defaulted sovereign debt. To facilitate the recycling of oil revenues in the 1970s, the United States Congress and the British Parliament passed sovereign immunities legislation that encouraged foreign governments to borrow using the contractual provisions of U.S. or British law. Among the provisions that have received current attention are the rights of creditors and debtors, particularly when there is a default. Bulow and Rogoff (1990)

For considerable time, discussion of these issues focussed on so-called "bailing in" of private lenders. Eventually, governments and international financial institutions recognized that if they did not lend into every crisis, banks and other private lenders could only sell their claims at a price that a buyer was willing to pay. Without the $250 billion in crisis loans to ten sovereign borrowers during the crises of the 1990s, lenders would have been bailed in. Argentina's default showed that lenders could sell only at a distressed price. The painful but necessary first step to relate risk and return on developing country debt is to end IMF bailouts of countries with unsustainable debt, overvalued real exchange rates, or insolvent banking systems.

The IMF appears to have learned part of this lesson. Discussion has now shifted to a different topic: what should be the role of the public and private sectors in resolving defaults? Anne Krueger (2001, 2002) gave great impetus to the discussion by reviving interest in a

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responsibilities.

procedure for international bankruptcy by sovereign debtors. Her proposal initially gave the IMF a major role in deciding the validity of a country's decision to stop payment of interest or principal. Krueger (2000a) responded to criticism by reducing the IMFs role.

A proposal by John Taylor at the U.S. Treasury relies mainly on debtors and creditors to resolve their problems. Taylor (2002) calls for revisions of debt contracts to include collective action clauses. These clauses permit a super-majority of creditors to bind all remaining creditors to the agreement on debt restructuring. Collective action clauses are recognized generally as desirable and often necessary to avoid holdouts and holdups. Both occur when an opportunistic investor (sometimes called a vulture) gains a blocking position in a single issue, refuses the debtor's settlement offer and insists on repayment in full. Opportunistic investors enforce their claim most effectively by seizing an asset such as a payment by the sovereign debtor in a third country. Collective action clauses would eliminate this problem if applied to all debt issues and all payments -- bonds, loans, commercial paper, and trade credit.[3]

Krueger's proposal relies on statutory provisions. She would have the IMF Articles of Agreement amended to include new provisions relating to a sovereign bankruptcy court. Any amendment of the IMF Articles is binding on all members once it is ratified, but some countries stipulate that amendments must be approved by the country's legislature. The United States is one of these. Several members of Congress have been skeptical of the IMF proposal, and the Joint Economic Committee of Congress issued a statement opposing the proposal.

Critics of the IMF proposal came from many quarters--from banks and investment funds, from economists and legal experts, from emerging nations and the US Treasury. One common feature of the protests was opposition to an expanded role for the IMF, whether by the institution itself or by the courts and committees it might control. And the critics claimed the proposal would increase the uncertainty that leads to volatility in markets and would result in less lending at higher costs for emerging economies.

Some feared that the policy objectives of dominant IMF members would influence decisions. Some anticipated a conflict of interest, since the IMF and other multilateral agencies are large creditors that may not be forever immune to sharing in losses when debt is restructured. Some opposed reliance on a rigid bureaucracy whose decisions are imposed by fiat and are

[3] Part of this section is taken from Lerrick and Meltzer (2002).

difficult to predict.

The IMF revised its proposal several times to develop the idea and meet some of the main criticisms. The most recent version, at the time this is written, argues that a principal advantage of the "statutory" approach is that it would bind all creditors in all countries and for all classes of debt--bank loans, bonds, trade credit, and other types of loans. Krueger (2000a) This is an advantage. If a rule of this kind became part of the IMF Articles of Agreement after ratification by its members, it would provide uniform treatment in all jurisdictions. Currently, debtors issue obligations in many different jurisdictions and subject to different laws. Krueger (ibid.,) argues that, without a uniform rule, different jurisdictions may have different interpretations of the same contract.

This is a useful point. The IMF proposal next considers how to respond to a member country's decision to default. I cannot see why the IMF should make this decision instead of leaving it to the debtors, creditors, and the market.

Markets have an exceptional ability to evolve and adapt. Postwar experience, especially in the 1990s, is dominated by IMF bailouts of creditors claims. When the easy fix of bailouts was an option, both borrowers and lenders rationally placed obstacles in the path of restructuring to force a stream of subsidized funds from the industrialized world that made good capital market losses and glossed over country policy errors. With bailouts ruled out or reduced in size, scope, and frequency, the private sector is confronted with a choice: accept regulation or find its own solution to make restructuring work.

For over a century, financial contract law has sought to contain what Francis Palmer, the English jurist, called "the tyranny of the minority." Many bonds now require 100% agreement to reduce borrower debt burdens. Opportunistic investors, who seek to hold the restructuring process hostage and enrich themselves at the expense of the remaining bondholders, still remain the stumbling block in an orderly resolution of debt claims.

When Under Secretary of Treasury John Taylor opted for a decentralized market-oriented approach, Taylor (2002), he proposed a simple answer: a package of protective clauses would be built into all sovereign bonds going forward, as has been the practice for corporate debt under United Kingdom law for the past century.

Majority action clauses by which a super-majority of creditors can impose an

amendment to the payment terms of debt instruments on a dissenting minority can resolve the difficulties posed by holdout or opportunistic investors. To be truly effective, these clauses should not be applied issue by issue but across all debt of the same priority rank. Otherwise, a vulture investor, who accumulates a blocking minority position in a single small issue, can attempt to hold hostage the entire restructuring process. The voting provision should be based upon a super-majority of all creditors of the same priority, regardless of the instrument held--bond, loan or trade credit--as long as the treatment of all individual groups of claims is non-discriminatory.

The protections provided by a sovereign bankruptcy court can be easily replicated in debt contracts. Protections include automatic stay of individual creditor litigation through the use of a trust indenture, where the trustee controls all action against the debtor on behalf of all bondholders; and targeted subordination of outstanding claims to interim lenders, the equivalent of debtor-in-possession financing, can continue debt service in a liquidity crisis. These and other desired elements can be integrated into new bond issues. Again, voting should be across all creditors of the same rank regardless of the instrument held. All other debt instruments, such as bank loans and trade credits, would be amended to match the new bond provisions.

The outstanding stock of old debt remains vulnerable to predators. Complex in its variety of issues, distributed among many investors and lacking the protective provisions, existence of this stock is now the chief argument for an official bankruptcy court. The claim is that, without a formal procedure, an orderly framework for debt restructuring must await the maturity of all bonds--as long as 30 years. One way to resolve this problem is to exchange all existing debt for new debt that contains the collective action clause, as Taylor proposes. The IMF proposal for a uniform rule, binding on all sovereign debt, seems more effective.

Nothing in Taylor's proposal is new. Perhaps by chance both New York and London used the wording in corporate bond contracts when emerging market bonds reappeared in the 1970s. London contracts required 75 percent of holders to alter the contract; New York required 100 percent. By law, these percentages apply to corporations, not to sovereigns. Borrowers and lenders have the option of writing their contracts in London, where collective action clauses are standard. Why have they not done so? Why do they not rewrite all contracts based on New York (or other) law, so that all contracts have London rules, including

collective action clauses? One possible explanation is that debtors and creditors relied on IMF-led bailouts, so there was no reason for concern. It would be helpful to know if this is true. No less important, borrowers could only gain approval of the Securities and Exchange Commission to sell bonds in the U.S. if they operated under U.S. (effectively New York) law.

Some critics suggest that voluntary arrangements cannot work because debtors in sound financial condition have no motivation to embrace change where costs are incurred up front and benefits seem remote, perhaps at a time when another Minister of Finance is in office. But there are immediate benefits. Converted instruments would trade at narrower spreads in the market reflecting the predictability of an orderly restructuring if crisis should occur. Lower costs of financing on new borrowing and greater access to funds would result. The weaker the credit, the greater the immediate gain.

After a small group of countries initiates the process and gains a relative advantage in financing, the rest would likely follow. If many borrowers execute conversions in unison, no stigma of imminent trouble can be attached to the reform and markets would not penalize the debtor's cost of funds.

Debtors can be encouraged by the IMF to convert their existing bonds by making the new provisions a precondition for access to official financing. The "no bailout" policy should be firmly reiterated to underscore that subsidized official intervention is no longer forthcoming. The IMF could also consider subsidizing the cost of conversion for debtors as a global public good. Financing could be generated through adjustments to the Fund's rate of remuneration on credit balances and rate of charge on loans as has been done in the past for special programs.

A likely effect of debt restructuring, whether under IMF rules or not, is that the price of the debt falls far below its price prior to the default. Many institutional investors must sell the bonds once default occurs. These sales and any panic selling drive down bond prices and may influence the restructuring negotiations and the perceived risk in sovereign debt. Other reasons for selling include debt that is held on margin and investment funds that sell to pay off customers. A small volume of sales in an illiquid market can cause a large price change.

This problem can be avoided if, at the time of default, the government announces (1) a minimum restructured value (or maximum write down) at which it offers to restructure its debt and (2) that the IMF has agreed to purchase for cash all debt offered during the restructuring

period at a price equal to 80 or 85 percent of the minimum restructured value. The IMF's offer expires when the restructuring ends. Lerrick and Meltzer (2002a, p. 4)

The IMF's announcement would have two benefits. It would put a floor under the price to which the debt would fall and, more importantly, it would increase the demand for defaulted debt. The reason is that, given the IMF's guarantee of a floor, the bonds become the highest grade collateral for a loan at 90 or 95 percent of the guarantee. Speculators could earn attractive annualized returns by buying the bonds, using them as collateral for a bank loan and exchanging them for the restructed debt.[4]

The two principal objections to the proposed floor price are (1) the difficulty of deciding on the minimum restructured value at a time of default and (2) the risk of adverse or irresponsible behavior by the debtor, or political instability, once the IMF issues its guarantee. Both events would require the IMF to purchase debt. IMF (2002)

The second risk cannot be excluded because the possibility of political upheaval is always present. The debtor country may act to reduce the bonds' price to the floor guarantee. This is a costly long-run tactic that arises only if a country plays a one-time game.

In a default, the IMF must always project the growth rate, inflation rate, interest rate, and other determinants of the minimum restructured value. It does not lend without projecting, formally or informally, the possibility that the program will fail. The IMF is perhaps at lower risk if a program fails, because it pays out the loan in a series of steps (tranches) and can stop payment. In fact, it usually resumes payment after several months.

Concluding Remarks

In April 2002, the G-7 nations agreed to encourage countries to amend contracts to include provision for a standstill in payments and collective action clauses, by which a super-majority could bind all debt holders to accept a revision in contractual terms. The IMF can continue to develop its bankruptcy plan for possible adoption in the future.

The new arrangements for dealing with default and for assisting countries in default are important steps away from the policies of the 1990s. Incentives for reform and market action

[4] In Lerrick and Meltzer (2002, p. 5), we estimate annualized returns as high as 40% depending on the market price of the bonds and the time to restructuring.

and discipline have a much larger role; command and control by the IMF now has a smaller role.

More remains to be done to reduce financial risk. IMF loans to Turkey and debt forgiveness for Pakistan show that political considerations remain powerful. Perhaps evidence of increased stability will in future encourage greater use of incentives and fewer bailouts even in politically sensitive countries.

One task for the future is to learn about the general equilibrium effects of the new arrangements. New contractual terms, fewer bailouts, and greater reliance on incentives will affect the market's functioning. Risk on sovereign debt will increase in the short-term if IMF bailouts end or are much less common. Countries will have more incentive to reform by establishing the rule of law, opening the economy, securing property rights, and avoiding macroeconomic imbalances. Such changes will change the amount, duration, and form of capital transfer to developing countries.

Finally, markets work best when relevant information becomes available promptly. The quantity of information has increased greatly. The quality of information has lagged behind. One can cite as an example loan losses on bank balance sheets in Korea, China, and many other countries. Or, one can cite the amount of hard currency reserves available at the Argentine and some other central banks. The IMF still has much work to do to help markets function, to rely on incentives instead of command and control, and to reduce risk to the minimum required by nature and trading arrangements.

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