



# ECONOMIC DIRECTIONS

A Publication of Saint Vincent College's Alex G. McKenna Economic Education Series

CENTER FOR ECONOMIC & POLICY EDUCATION, SAINT VINCENT COLLEGE, LATROBE PA VOL. 10 NO. 1 NOVEMBER 1999

## EARMARKS of a LENDER of LAST RESORT

Anna J. Schwartz

National Bureau of Economic  
Research



The following is a lecture delivered by Dr. Anna J. Schwartz, Research Associate at the National Bureau of Economic Research, Inc., at Saint Vincent College, Latrobe, Pennsylvania, on September 29, 1999 as the 46th lecturer in the Alex G. McKenna Economic Education Series.

Some observers of the financial distress of countries in Asia and Latin America in recent years have suggested that what the world needs is an international lender of last resort. The institution that could serve this purpose, it is claimed, is the International Monetary Fund (IMF), either as presently constituted, or perhaps with some minor adjustments of its mandate.

In the first part of this lecture, I define the role of a lender of last resort in a domestic setting, give the historical context of the origin of the institution and cite examples of a lender of last resort that performed well and examples of a lender of last resort that performed poorly. I then describe modifications in this century of the time-honored rules for a lender of last resort and sum up the discussion by listing the attributes of a lender of last resort in a domestic context. In the second part of the paper, I examine the changing role of the IMF since its creation in 1944. I then ask whether it is possible for an international institution like the IMF to possess the attributes of a lender of last resort. The answer, I believe, is negative. In the third part of the paper I conclude that world capital markets are prepared to hasten the recovery of countries in financial distress by lending to them on appropriate terms, putting in question the need for IMF lending.

### 1. The Domestic Context

#### *Definition of a Lender of Last Resort*

A responsibility of a central bank, the institution that occupies a central position within a country's financial system, is to serve as a lender of last

resort in order to maintain an unimpaired payments system. Let me first note what the term "payments system" refers to, and then how a payments system becomes impaired and what a lender of last resort does to prevent it from happening. A payments system refers to the procedures used to arrange transfers and advances of money between individuals and firms in an economy.

To answer the question about how a payments system becomes impaired, it is necessary to describe a modern banking system. It is a fractional reserve requirements banking system. In such a system, ordinary banks meet their reserve requirements — a fraction of the deposits on their books — by holding as vault cash the notes of the central bank and maintaining reserve balances with the central bank. Central banks control both the issue of bank notes and bank reserves — the sum of which is known as high-powered money.

One way a payments system may become impaired is when depositors fear for the safety of their deposits and run on banks. By withdrawing their deposits in cash, they squeeze the reserves of the banking system, threatening continued convertibility of deposits into cash. The fear that demands of depositors for cash cannot be met leads to a scramble for high-powered money. In a futile attempt to restore reserves, banks may call loans, refuse to roll over existing loans, or resort to selling assets. This is the sequence of events that impairs the payments system. It can also happen when fears prevail that funds are unavailable at any price to enable sound debtors to make payments that are due. The entire financial system is then at risk, as financial services are disrupted, and economic activity is reduced.

## Central Banks as Lenders of Last Resort

During the nineteenth century, central banks had to learn the role of lender of last resort. They learned initially to provide the banks with additional reserves to cut short a panic once it had begun, but eventually learned to act in advance to avert its occurrence. The traditional way to discharge the responsibility was to extend loans of high-powered money to all solvent banks and all solvent borrowers that were temporarily illiquid. The only institution that had the resources to provide such loans in a crisis was the central bank, which could create high-powered money without limit, and hence was the lender of last resort.

The prescription for the exercise of lender of last resort responsibility was developed by Henry Thornton in 1802 and by Walter Bagehot in 1873. They advised that eligibility for loans be limited to solvent banks, that the banks pay a penalty rate for the loan, that is, a rate higher than the prevailing market interest rate, and that the banks offer good collateral. The offer of good collateral was one indication that the bank requesting the loan was indeed solvent. It was also important for the central bank to give timely and predictable signals to



*Students welcome – (left to right): Richard Kessler, a junior economics major from Greensburg; Louise Cosacco, a senior economics and math major from Pittsburgh; Dr. Anna Schwartz; Nicholas Marquis, a senior economics major from Jeannette, and Nicholas Racculia, a senior economics major from Greensburg.*

market participants of institutional readiness to make available an augmented supply of funds. The signal in and of itself was often sufficient to allay alarm, so that the funds were never drawn on.

## The British Model of a Lender of Last Resort

The Bank of England was a slow learner of the need for lender of last resort assistance. A series of financial panics in 1825, 1847, 1857, and 1866 occurred before it developed the appropriate response to restore public confidence in the financial system. It was ineffective in quelling each of these four panics. It provided some assistance but not enough, and it did so hesitantly, so financial markets were not reassured. The panic of 1866, however, was the last one that the British experienced. After that date, the Bank of England was alert to the threat of panic and took actions that prevented the effects of individual bank failures from spreading to the entire financial system.

## Evolution of the Concept of the Lender of Last Resort in the U.S.

In this country the First Bank (1791-1811) and the Second Bank (1818-1836) of the United States were precursors of a central bank, but it was not until 1913 with the founding of the Federal Reserve System that the idea of a lender of last resort was given substance. The immediate cause for the implementation of the concept was the panic of 1907, the last of a series after the Civil War (1873, 1884, 1890, 1893) that had destabilized U.S. financial markets, though, as I have noted, there were no comparable British panics after 1866. This difference in the experience of panics in the two countries was explained in part by the unit banking system and undiversified asset portfolios of U.S. banks and the highly concentrated British banking system with well-diversified asset portfolios. Hence U.S. banks were more prone to fail than were British banks. The other

part of the explanation was the absence in this country of a lender of last resort comparable to the Bank of England.

The institution that had been corralled into service during panics before 1914 in the absence of a U.S. lender of last resort was the regional clearinghouse association of banks in selected cities (New York, St. Louis, New Orleans, Baltimore, and Atlanta). During panics, the clearinghouses issued loan certificates that banks used as if they were legal reserves. Loan certificates have been described as "quasi-high-powered money."

The most usual feature of a panic, when depositors sought to convert deposits into cash, was the decision by banks to restrict cash payments, that is, the banks restricted the amount a depositor could withdraw as cash, say, to \$10 a week, when the deposit account was a large multiple of that amount. The issue of loan certificates by the clearinghouses for which the banks were charged interest halted the impairment of the payments system. Clearinghouses during panic times enabled banks to continue lending without having to pay out their reserves, and firms and households had the means to pay their debts.

It was dissatisfaction with this ad hoc arrangement to cope with panics that led to the creation of the Federal Reserve System. During the 1920s many banks failed but no panic developed. The first test of the Federal Reserve as a lender of last resort came in November 1930, when a run started on a large investment banking firm in the South, and in December 1930, when a run on a large New York City bank led to panic conditions. The Federal Reserve failed that test as well as subsequent ones during panics in 1931, 1932, and 1933. The toll of bank failures and the one-third reduction in the quantity of money that it entailed over this period resulted in the adoption of deposit insurance, when an effective lender of last resort would have obviated the need for such an agency.

## Lenders of Last Resort Since the Great Depression

Neither the Bank of England nor the Federal Reserve has conducted lender of last resort operations in recent years according to the principles established by Thornton and Bagehot. The injunction to lend freely has been modified by involving other commercial institutions in addition to the central bank in rescuing troubled institutions. In the case of the Bank of England, this modification started as early as 1890, when the Bank arranged for



A Publication of Saint Vincent College's Alan G. McCormick Economic Education Series

### CO-EDITORS

Andrew R. Herr, Ph.D.

*Assistant Professor of Economics*

Gary M. Quinlivan, Ph.D.

*Professor of Economics*

### PROGRAM COORDINATOR

Rosey Doelling

### ASSISTANT EDITORS

Nicholas M. Racculia, C 00

Louise Cosacco, C 00

### STAFF

Donzell Brown, Jr., C 03

Marc Bilinski, C 02

Jeremy Dallettezz, C 02

Melissa Devich, C 00

Gretchen Dickson, C 00

Jennifer Farroux, C 01

Benjamin Goodwin, C 03

C.J. Jackson, C 03

Richard E. Kessler, C 01

Brandy Kovac, C 02

Nicholas Marquis, C 00

Maggie Martin, C 03

Mark Owens, C 01

Joseph Polka, C 00

Thomas Prokop, C 02

Rachael Rauch, C 03

Matthew Richardson, C 02

Karen Simmons, C 02

Gary Stofko, C 00

Robert Tallerico, C 02

other banks to join in the rescue of Baring Bros. This practice also occurs in France and Germany. In the U.S., the recent rescue of Long Term Capital Management was organized by the Federal Reserve Bank of New York in 1998, but only with private contributions.<sup>1</sup> In addition, banking problems are often resolved by the deposit insurance agency, not the central bank.

A second modification has characterized the injunction to lend only to temporarily illiquid but solvent banks. The justification for this change is the allegation, first, that during a crisis, the lender of last resort cannot distinguish between an illiquid and an insolvent bank and, second, that it may be desirable to rescue an insolvent bank because of contagion effects on sound banks. Neither of these allegations is convincing to me.<sup>2</sup>

The practice of central banks, however, has been to prop up banks "too big to fail," and, if insolvent banks are shut, to do so only in the case of small banks. The Federal Reserve in 1989-90 gave discount window assistance to insolvent banks until the deposit insurance agency was in a position to resolve their future.<sup>3</sup>

Finally, the injunction to lend at penalty rates on good collateral has not been observed. Central banks have given assistance at market rates or below market rates. In addition, far from signaling in advance their intention to provide the financial markets with assistance, central banks have preferred to be ambiguous, so banks would not presume that they would be bailed out in case of difficulties. "Constructive ambiguity" supposedly constrains excessive risk taking by banks.

These modifications of the time-honored rules, it seems to me, replace them with discretion and, contrary to the briefs by central banks

<sup>1</sup> See Edwards (1999), who believes that "traditional lender-of-last-resort approach" would probably not have failed in the case of LTCM's collapse, it was "almost certainly not" "the most efficient way for the Federal Reserve to provide assistance."

<sup>2</sup> See Chari and Kehoe (1999), who explain: "The prospect of receiving funds from the lender of last resort, even if the bank is insolvent, reduces the extent to which interest rates on deposits vary with the riskiness of the bank's portfolio. Thus, the lender of last resort implicitly subsidizes the risk taking by banks. The subsidy leads banks to take on excessive risk and paradoxically can make financial panics more frequent and more severe when they occur. One way the lender of last resort could avoid moral hazard is to lend only to illiquid but solvent banks" (p.14).

<sup>3</sup> See Anna J. Schwartz, "The Misuse of the Fed's Discount Window," *Federal Reserve Bank of St. Louis Review* 74(5), September/October 1992, pp. 58-69. The FDIC Improvement Act of 1991 limits the use of the discount window for long-term loans to troubled banks. It also curtails the regulator's discretion regarding when to intervene in the case of an undercapitalized bank.



*Program participants – (left to right): Dr. Andrew Herr, Fellow in Economics and Policy, Center for Economic and Policy Education; Dr. Anna Schwartz; and Dr. Gary Quinlivan, Executive Director, Center for Economic and Policy Education.*

in their defense, invite forbearance on their part.

### *Lender of Last Resort Problem in an Emerging Market Country*

Central banks in emerging market countries can serve as lenders of last resort for domestic borrowers with domestic-currency-denominated liabilities. They can always print any amount of domestic currency to accommodate a sudden surge in demand. In emerging market countries, however, ordinary banks may borrow foreign currency and make domestic loans not only in domestic currency but also in foreign currency. If there is a surge in demand for foreign currencies, central banks can provide only the available foreign exchange reserves they hold; they cannot create more. I will mention a possible solution to this problem at a later point.

### *Summary of the Domestic Context*

A domestic lender of last resort can create high-powered money denominated in its own national currency. It can exercise its own discretion in allocating the resources it commands. Time-honored rules for the decisions it makes about how much to lend to which institutions on what conditions have been bent over the years since the rules were formulated. Nineteenth and twentieth century-type panics are no longer observed. Instead, lenders of last resort intervene whenever they believe there is a risk of contagion. I defer consideration of the validity of the idea of contagion until I deal with the claims of the IMF that it can serve as an international lender of last resort.

## **2. The International Context** *The Changing Mission of the IMF*

I shall first describe the evolution of the IMF's mission from what it was originally con-

ceived to be. It was created in 1944 by the framers of the Bretton Woods Articles of Agreement. They believed that international capital flows had destabilized the 1930s, and that floating exchange rates had encouraged competitive devaluation of national currencies. Therefore, the Bretton Woods design for the postwar world permitted government controls to limit international capital flows and provided for exchange rates pegged in terms of the U.S. dollar or gold to achieve exchange rate stability.

In this setup, the IMF's role was to enforce the rules in the pegged exchange rate system about when fundamental disequilibrium justified changing the peg, and to provide temporary loans to countries with a balance-of-payments deficit. The source of IMF resources was initially \$8.8 billion in quotas that members contributed (25% in gold, 75% in currencies) — quotas that could be raised every five years — plus in 1961, up to \$6 billion in individual currencies that 10

industrial countries agreed to lend the Fund. A further addition to IMF resources was the creation of Special Drawing Rights by a 1967 amendment to the Articles of Agreement — so-called paper gold — and their first allocation in 1970. SDRs allowed the IMF to provide credit to member countries in excess of their quota subscriptions. Central banks, when allocated SDRs, can monetize them by issuing their equivalent value in national currencies.

The Bretton Woods system broke down in 1971, for reasons that do not need to be reviewed here. What is pertinent to this discussion is that the collapse destroyed the IMF's purpose. Floating exchange rates, the successor to the Bretton Woods pegged exchange rates, eliminated the IMF's exchange rate regulatory role and changed the character of balance-of-payments problems. Since 1971, the IMF has been seeking a redefinition of its role.

In the international context, one important change in the environment in which the IMF operated under the Bretton Woods system is that since its demise, a highly liquid international financial system has arisen, and the world capital market has become increasingly mobile. The significance of this change is the basis for the view that I present in the third part of this lecture.

During the 1970s and 1980s, the direction the IMF pursued for itself was the provision of advice and information to its members numbering over 180 countries. The Mexican bailout in 1995 that the Clinton administration engineered, however, pointed the IMF in a new direction. After some false starts, the administration orchestrated a \$50 billion rescue package — Mexico did not in fact obtain the full amount — to be provided by the Federal Reserve, the Treasury's Exchange Stabilization Fund, the IMF, and the Bank for International Settlements. This experience planted the idea that the IMF could function as an international lender of last resort.

## *Why the IMF Cannot Be a Lender Last Resort*

In a luncheon speech at the American Economic Association meeting on January 3, 1999, Stanley Fischer, the first deputy managing director of the IMF, argued the case that, in a reformed international financial system, for "an agency that will act as lender of last resort for countries facing a crisis." He asserted that there was a need for such an agency and "that the IMF is increasingly playing that role, and that changes in the international system now under consideration will make it possible for it to exercise that function more effectively."<sup>4</sup> The speech raises the question whether it is true that the IMF possesses the attributes of a lender of last resort.

I have shown that central banks have the capacity to serve as their banks' and, more generally, their financial system's lender of last resort. They can create high-powered base money in their own national currency, they can act quickly, and they need the consent of no other agency to act. The IMF lacks each of these attributes. It cannot create high-powered money in any national currency, so it cannot create international reserves. Fischer's answer is that the IMF "has access to a pool of resources, which it can lend to member countries." He notes that, if the IMF's resources bore the same size relative to output, to the quota formula, to the volume of world trade, as in 1945, its resources would be three, five, or more than nine times larger than they will be in 1999. Is there an implication that quota increases that have been sought every five years since the IMF's founding will in future be sought more often?

Fischer also counts on the IMF's use of authorization to create SDRs as a supplement to its resources as well as its ability to borrow. One major difference between a central bank lender of last resort and the IMF, to which Fischer does not allude, is that the IMF needs a vote of its Executive Board to take any action. It has no independent authority, such as a central bank has, even one subject to the consent of the minister of finance. The IMF cannot issue SDRs and cannot borrow except if authorized by vote of the member countries.

The IMF cannot act quickly. Before the IMF provides money to a borrowing country, it first engages in lengthy negotiations to introduce a reform program. If it abides by time-honored principles, a national lender of last resort rescues solvent banks temporarily short of liquidity. It does not rescue insolvent institutions. The IMF has no such inhibitions.

Fischer refers to a complaint that the Fund

<sup>4</sup> See Stanley Fischer, "On the Need for an International Lender of Last Resort," revised version of a paper delivered at the American Economic Association and the American Finance Association, New York, January 3, 1999. Available at: <http://www.imf.org/external/np/speeches/1999/010399.HTM>. Fischer is not the only one to propose a lender of last resort role for the IMF. See also Steven Radelet and Jeffrey Sachs (1997) and George Soros (1998).

is too slow in emergencies, but counters that the Emergency Financing Mechanism, introduced after the Mexican crisis, enables it to move very rapidly. Very rapidly means after weeks or months, while an agreement with the distressed country is produced. Lending with conditionality and providing money only in tranches do not meet the requirements for overcoming a shortage of liquidity. A national central bank can promptly provide liquidity to the money market without administrative complications.

The IMF, it is clear, is only a simulacrum of a lender of last resort. It is not the real thing. What will its function be? There will be changes in the international financial system that Fischer describes — a shift to floating exchange rates by emerging market countries, their holdings of international reserves will be larger, private sector institutions will be involved in rescues of countries in distress, and



those countries will adopt international standards — but he does not enumerate any changes in the way the IMF operates. It will still provide loans to pay off a country's foreign debts, although since 1998 no longer at subsidized interest rates, and will impose fiscal and monetary conditions and micromanage institutional behavior.

Fischer proposes that in the future the IMF will lend on Bagehot's rules through the Supplementary Reserve Facility. Given global capital markets that will be ready to lend to countries that are willing to pay a penalty rate of interest and to offer good collateral, is there a need for an IMF? Fischer parses lending freely as meaning "ready to lend early and in sufficient amounts to other countries that might be affected by contagion from the crisis." He nowhere defines contagion or justifies the assumption that it occurs.

## *The Myth of Contagion*

Will an individual country that has mismanaged its affairs precipitate an international financial crisis? One myth is that the loss of creditworthiness by the country in question has a tequila effect. The supposed tequila effect is that other countries without the problems of the troubled country are unfairly tarnished as also subject to those problems. In this way, it is said, contagion spreads the crisis from its initial source to other innocent victims. The second myth is that a bailout of the troubled country is essential. The rationale is again the idea of contagion. Failure to organize a bailout will create an international financial crisis by a domino effect. Rescuing the troubled country saves the rest of the world from unwarranted financial collapse.

Contagion, if the term is used accurately, occurs only in circumstances in which other countries are free of the problems of the country that first experienced trouble and yet suffered capital flight. It has become a dogma since the 1995 Mexican bailout that there was a tequila effect as a result of its distress. The evidence that has been offered since then is that the currencies and stock markets of countries (other than the original one to surface with problems) have declined. What is overlooked or deliberately omitted is that the countries said to be victims of contagion had the same problems as were present in the country that was supposedly the source of contagion.

Glib references to spillovers from disturbances that originate elsewhere are common in the current literature on international financial crises. The truth is that it is not necessary to invoke spillovers to account for multi-country financial disturbances. Capital flight from countries with similar unsustainable policies is not evidence of contagion. Proponents of the contagion dogma do not explain the absence of contagion from the New York stock market crash of 1987 nor from the 1990 Tokyo stock market and property bubble crashes.

It is ironic that the Mexican bailout of 1995 has inspired the model of what needs to be done. The emphasis by the IMF is on a standing procedure and faster access to funds. It thinks of itself as a financial panic lender. Lending by the IMF and the other rescuers, however, was not directed to the Mexican money market. The question that should be asked is, for whose benefit was the Mexican rescue arranged? Is there any doubt that the loan package was designed to pay dollars to Mexicans and nationals of other countries who invested in government tesobonos and cetes as well as dollar-denominated loans to Mexican nonfinancial firms? Is that the reason emergency loans are needed? To eliminate risk from investment in high-yielding foreign assets?

People in countries that pursue unsound economic policies pay a heavy price for those mistakes — slower if not negative growth, government austerity, and unemployment. But U.S.-backed bailouts protect investors who lent money to governments or private sector institu-

tions, not the people who suffer the consequences of unsound policies. In the absence of the IMF loans, investors would have taken a hit, but economic conditions in Mexico would have been no worse than they were with the loan, and Mexico would not have had the burden of repaying the loan.

The East Asian countries and Brazil that were recipients of IMF loans are further examples of bailouts that limit wealth losses by investors in advanced countries, without benefit to the local populations.

Moreover, the Mexican bailout may well have fostered the belief among foreign investors in the East Asian countries that they were extending riskless loans because the IMF would provide the funds to pay them off. That in itself is enough reason to question the ground for the IMF's intervention. And there are surely other reasons related to the IMF's policy recommendations as conditions for its loans that could be challenged.

In my view, an emerging country that gets into trouble does not need the ministrations of the IMF to overcome its difficulties. Instead of bailouts that create conditions that promote the spread of financial crisis, the country can travel a different road to recovery.

### 3. Recovery Without the IMF

It is important to distinguish between a financial panic and a financial crisis. A financial panic occurs in the money market and is a threat to the economy's payments system. A panic can be quickly ended by a lender of last resort. The recent difficulties of emerging market countries have involved financial crises rather than financial panics. A financial crisis occurs when asset prices plunge — whether prices of equities, real estate, or commodities — when the exchange value of a national currency experiences substantial depreciation, when a large nonfinancial firm or a financial industry faces bankruptcy, or a sovereign debtor defaults. A financial crisis is a prolonged disturbance that is resolved by government agencies other than the lender of last resort, although at some stage it may provide liquidity to the market through the discount window or open market purchases.

In this country, the collapse of the savings and loan industry was an example of a financial crisis that initially involved the deposit insurance agency and subsequently a new agency — the Resolution Trust Corporation — to deal with the problem. Resolving the savings and loan crisis was not a lender of last resort responsibility.

The IMF thinks of itself not only as a financial panic lender but also as a crisis manager. It can fill neither role. Only the emerging market country can do so. If the banking system is short of liquidity, the domestic central bank, not the IMF, must create high-powered domestic money to calm depositor fears. If the problem is a shortage of foreign money, the answer again is not the IMF. Some emerging

market countries have devised schemes to deal with a sudden demand for foreign currency. The Argentine central bank has an option that cost it 33 basis points, under a repurchase agreement with 14 international banks to swap Argentine government securities for up to \$7 billion U.S. dollars, for which it will pay LIBOR plus 205 basis points. The length of the loan varies from two to five years, depending on the counterparty bank. Mexico has an arrangement with 31 commercial banks for a \$2.5 billion foreign currency credit line. These are emerging market country, not IMF initiatives.

Correction of the conditions that produced a financial crisis must fall on the troubled country, not the IMF. If the country cannot service or amortize its foreign borrowings, the country, not the IMF has to negotiate a workout with the foreign lenders. The same applies to firms or banks that cannot repay on due dates what they have borrowed. If individual banks, other financial institutions, corporate and non-financial businesses are insolvent, domestic agencies either exist or must be established to recapitalize them or shut them down.

Currency crises and severe banking problems have accompanied recent financial crises. Emerging market countries that peg the exchange rate of their currencies to the currency of a developed country are prone to currency crises. When foreign investors believe that the nominal parity of the currencies is inconsistent with economic fundamentals, they sell off the currencies. Efforts by the emerging market countries to support the pegged value by deploying foreign exchange reserves ultimately collapse, and they have no alternative but to allow the exchange value to float. Domestic entities with debts denominated in foreign currencies suffer. A depreciated exchange value of a national currency will recover when reformed internal policies signal to the market that the economy's health is improving.

Flaws in the operation of the banking systems of emerging market countries have been uncovered in the course of financial crises. Bad loans are a pervasive problem of their portfolios. The best hope to remedy a shortage of bank capital is for foreign banks to acquire an interest in the banks of emerging market countries.

Financial crises, unlike panics, are not quickly ended. They may require fiscal support, and the resolution may not be attained for months or years. Compensating for the loss of wealth that a financial crisis imposes may exact a reduction in personal consumption and increased national saving over an extended period. This is what troubled countries have to endure. The IMF does not spare them these bleak consequences. Every country that has been a recipient of IMF loans has suffered a severe decline in output, punishing high interest rates, and accelerating inflation, despite IMF loans.<sup>5</sup>

The IMF was established in 1944 to serve as a lender to countries when private interna-

tional capital markets were limited and repressed. IMF lending had a proper role in that regime but it no longer exists. In the 1990s, private international capital markets are deregulated and flush with funds. IMF lending in the regime that now exists is a carryover for which there is no proper role. Every day brings news of the success of emerging market countries in raising funds from pension, mutual, and hedge funds, even countries barely over a financial crisis. South Korea, five months after its crisis in November 1997, sold a bond offering of \$4 billion to international investors. Colombia sold \$500 million in bonds in March 1999, six months after its crisis. Thailand, Mexico, and Argentina in the past year also had similar success in raising funds. Peru sought a loan but rejected the offer because it was unwilling to pay the credit risk interest premium.

What is the secret of access to capital markets? Countries that need to borrow abroad can count on finding private sector lenders if they will pay a penalty rate and offer good collateral. These are the terms, according to Fischer, on which the IMF in the future will lend. Does the IMF see itself as a lender in competition with capital markets?

Some countries that cannot meet the conditions for borrowing that the private market sets may require financial aid. Outright gifts to them from an international agency may be the right solution. A case can be made for such gifts to countries that have endured earthquakes, hurricanes, monsoons, or plagues.

For economic development, however, emerging market countries that are reforming their banking structures, creating the proper mix of regulation, oversight, and market discipline to enforce acceptable rules of conduct in lending and investing, pursuing sound monetary and fiscal policies, and encouraging open capital markets will be well on the way to recovery from recent financial crises.

### Concluding Comments

To create a more stable international financial system, each country should have in place a lender of last resort. A lender of last resort can forestall threats to the payments system associated with bank runs and stock market crashes. Despite references to the IMF as an international lender of last resort, it lacks the attributes of such an authority either in a domestic or global setting.

Financial crises differ from financial panics. Crises require the involvement of domestic agencies other than the lender of last resort. The IMF is no substitute for these crisis resolvers.

Crises and panics differ from currency crises, depreciation of the exchange value of a national currency as the result of a loss of confidence by investors in the currency of a coun-

<sup>5</sup> Thus far, Brazil has not experienced high inflation in the aftermath of its financial crisis. The delinking of wages and the exchange rate before the onset of crisis conditions appears to be the explanation for this result.

try pursuing unsustainable policies, encompassing large current account deficits, excessive credit growth and misallocation of investment funds, excessive monetary expansion, and fiscal laxness. Currency crises occur when the nominal exchange rates at which countries peg their currencies are inconsistent with the economic fundamentals.

The widening and deepening of world capital markets in recent decades have established them as providers of loans to creditworthy countries, putting in question the need for IMF lending.

#### References

- Bagehot, Walter (1873). *Lombard Street: A description of the money market*, London: Henry S. King and Company.
- Chari, V.V. and Patrick J. Kehoe (1999). "Asking the Right Questions About the IMF," *The Region* 13 (May); 2-26. Federal Reserve Bank of Minneapolis.
- Edwards, Franklin R. (1999). "Hedge Funds and the Collapse of Long-Term Capital Management." *Journal of Economic Perspectives* 13(2) Spring: 189-210.
- Fischer, Stanley (1999). "On the Need for an International Lender of Last Resort." Available at: <http://www.imf.org/external/np/speeches/1999/010399.HTM>.
- Radelet, Steven and Jeffrey Sachs (1997). "What Have We Learned, So Far, from the Asian Financial Crisis?" mimeo, Harvard Institute for International Development. Available at: [www.hiid.harvard.edu](http://www.hiid.harvard.edu).
- Schwartz, Anna J. (1992). "The Misuse of the Fed's Discount Window," *Federal Reserve Bank of St. Louis Review* 74(5): September/October, pp. 58-69.
- Soros, George (1998). "The Crisis of Global Capitalism," *Wall Street Journal*, September 15, 1998.

Thornton, Henry (1802[1965]), *An inquiry into the nature and effects of the paper credit of Great Britain*. Edited with an Introduction by F.A. Hayek. New York: Augustus M. Kelley.

## CENTER ANNOUNCEMENTS

All lectures listed below will be, unless otherwise indicated, at 7:30 pm in the SVC Science Center Amphitheatre.

**January 26, 2000 (Alex G. McKenna Series)**  
**Dr. Walter C. Labys**, Professor and Benedum Distinguished Scholar at West Virginia University, "Can World Market Volatility Upset the U.S. Economy?"

**February 9, 2000 (Government and Political Education Series)**  
**Mr. Stephen J. Entin**, Executive Director and Chief Economist, Institute for Research on the Economics of Taxation, "The Political Economy of the U.S. Tax System."

**February 23, 2000 (Government and Political Education Series)**  
**Dr. Randy T. Simmons**, Professor of Political Science at Utah State University "Liberty and the Environment"

**March 8, 2000 (Alex G. McKenna Series)**  
**Dr. Vernon L. Smith**, McClelland Professor of Economics at the University of Arizona, "Personal vs. Impersonal Exchange."

**March 22, 2000**  
 Environmental Economics Conference: "Green Politics: An Analysis of Al Gore's *Earth in the Balance*" (Speakers and lecture titles to be announced)

**April 5, 2000 (Government and Political Education Series)**  
**Dr. Herman Belz**, Professor of History at the University of Maryland, "Affirmative Action and American Equality."

**May 16, 2000 (Government and Political Education Series)** Lecture/Luncheon at the Duquesne Club, **Paul Gigot**, Columnist/Editorial Page, Wall Street Journal (lecture title to be announced)

**September 27, 2000 (The 50<sup>th</sup> Lecture in the Alex G. McKenna Series)**  
**Dr. Jagdish Bhagwati**, Arthur Lehman Professor of Economics at Columbia University (lecture title to be announced)

**November 1, 2000 (Alex G. McKenna Series)**  
**Dr. Hal Varian**, Dean of the School of Information Management and Systems at UC Berkeley, (lecture title to be announced)

## BOOKS BY THE CENTER'S STAFF

**T. William Boxx and Gary Quinlivan's** newest edited collection, *Toward the Renewal of Civilization: Political Order and Culture*, Eerdmans, ISBN: 0-8028-4534-7. Contributors include: Hilton Kramer, Claus Ryn, Joyce Little, Charles R. Kesler, William B. Allen, Stephen J. Tonsor, III, Elizabeth Fox-Genovese, Robert P. George, Hadley Arkes, Martha Bayles, Dinesh D'Souza, and Ralph McInerney.

**Gary M. Quinlivan and Brian Surkan**, *For Freedom and Prosperity: Philip M. McKenna and the Gold Standard League*, Center for Economic and Policy Education and the Saint Vincent College Center for Northern Appalachian Studies, ISBN: 1-885851-14-6

**Bradley C.S. Watson**, *Civil Rights and the Paradox of Liberal Democracy*, Lexington Books, ISBN: 0-7391-0038-6

*Congratulations to the Center staff that graduated May 1999. Those pursuing advanced degrees include: Cecilia R. Dickson, presently at Harvard Law School; Anthony T. Kovalchick, presently at Duquesne Law School; and also congratulations to staff member William G. Karaszia, C'98 on his acceptance to the masters program of the London School of Economics.*



A Publication of Saint Vincent College's Alex G. McKenna Economic Education Series

SAINT VINCENT COLLEGE

300 Fraser Purchase Road, Latrobe, Pennsylvania 15650-2690

### ABOUT THE SERIES

The Alex G. McKenna Economic Education Series is presented by the Center for Economic and Policy Education at Saint Vincent College. These periodic lectures are open to the general public. The purpose of the series is to explore the role of free markets in solving many of the social problems confronting the United States and the World today. Dr. Gary M. Quinlivan, professor of economics at Saint Vincent, directs the series. Up to date information about the Center can be obtained on the web at [www.stvincent.edu/cepe](http://www.stvincent.edu/cepe)

The Alex G. McKenna Economic Education Series is made possible by a grant from the Phillip M. McKenna Foundation.

Saint Vincent College subscribes to a policy of equal opportunity in accordance with federal, state and local laws. In so doing, Saint Vincent does not discriminate against any individual on the basis of race, color, sex, religion, national origin, age, veteran status or disability in any of its programs, activities, admission or employment decisions. The Director of Personnel, Saint Vincent College, Latrobe, Pennsylvania 15650-2690 is the college officer with responsibility for overseeing the implementation of this equal opportunity policy and the affirmative action plan. 3122-10m-11/99



NON-PROFIT  
 ORGANIZATION  
 U.S. POSTAGE  
 PAID  
 PERMIT NO. 110