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Comment on

**“Towards a Statutory Approach to Sovereign Debt Restructuring:
Lessons from Corporate Bankruptcy Practice around the World,”
by Patrick Bolton**

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The first half of Patrick Bolton’s paper surveys corporate bankruptcy practices in various major countries. Then the remaining half attempts to draw lessons for the SDRM initiative currently being pursued at the IMF and for competing proposals of other ways to ease debt restructuring in emerging market crises. This well-written paper is a welcome contribution in two ways. In the first place, it is a very clear and concise exposition of these practices. Many writings on the subject are not user-friendly for non-specialists, because they toss around terms like debtor-in-possession and cramdown without defining them. There do exist a few other good papers that explain the basics. (Otherwise, I don’t think I could have figured out any of this literature over the last 15 years). But they tend to focus exclusively on American practice, or at most American plus British practice. So this comparative study would be useful even if it stopped at that. But there is a higher purpose.

SDRM: background

That is, in the second place, we need a lot of help in trying to figure out which of the competing proposals for some international version of bankruptcy procedures is preferable – a statutory approach such as the SDRM or a more market-based contracts approach such as debt exchanges and collective action clauses (CACs), or what combination of these. Even if one thinks he or she knows the answer to that question, there are still a lot of details to be filled in. It is natural to hope that a history and comparative analysis of how different countries do bankruptcy at the domestic corporate level can offer insights that may be useful for these ongoing decisions at the global sovereign level.

The biggest division is between bankruptcy practice in the United States and practice in the UK and elsewhere. At first, one might think that this issue of competing domestic standards is like many others: accounting standards, or regulations for issuing securities, or rules governing IPR, or drug testing/approval, or phytosanitary standards. In these cases, and many others, the US often tries to persuade multilateral fora to extend the approach that it follows domestically to the international level, either out of conviction that its way represents free-market virtue, or out of lazy ignorance of competing standards, or of conscious desire to give its firms a leg up. [A desire to advantage its firms could in turn arise because the domestic standard intrinsically suits its comparative advantage in some way, or just because its firms have already adapted to it and will thus be a step ahead of foreign firms who will have to adjust.] But the case of international bankruptcy procedures is not necessarily the same. The paper makes clear that the SDRM is rooted in the US tradition, seeking to extend it to the global sovereign

level. And yet the US Treasury was slow to come around to supporting Deputy Managing Director Anne Krueger's proposal first made in a speech in November 2001, in part due to opposition from the US investor community, which remains strongly opposed. The investment community, as represented for example by the Institute for International Finance, is now supporting instead the wider use of CACs. This would be an extension of the British system, as CACs currently thrive under London law, not New York law.

It is worth briefly reviewing the background, for anyone who may not have followed this issue.¹ Begin with what Jeff Sachs wrote in 1994 (and in his Princeton Essay published in 1995). Any well-trained economist, when confronting a problem like appropriate government intervention in debt crises of developing countries, will ask "where is the market failure?" Sachs' answer, which struck me as quite plausible, was that the root of the problem is the absence of any international bankruptcy court to perform for the case of international debt difficulties [especially on the part of sovereign governments] the restructuring function that Chapter 11 fulfills for domestic US corporate bankruptcy cases. Sachs proposed creating one.

As recently as one year ago, such proposals seemed hopelessly unrealistic. As an indicator of how unrealistic the proposal has been considered, consider a quote from Barry Eichengreen's 1999 book (p.92-93) that surveys proposals for reform. He lists what he sees as the substantive drawbacks of an international bankruptcy court, and then goes on:

¹ The subject has recently been surveyed by Rogoff and Zettlemeyer (2002). Roubini (2002) argues the case against any official new international bankruptcy procedure.

“Above all there is the political question of whether the creditor countries would be prepared to vest such formidable powers in the hands of an international tribunal of officials...Even the kind of limited scheme floated by the Canadian government...is patently unrealistic. And if it is unrealistic to think that the IMF or another international entity could be empowered to impose a standstill on payments, it is pure fantasy to suggest that the Fund could be given the power to impose settlement terms on debtors and creditors.”

To be sure, after the East Asia crisis hit, Treasury Secretary Rubin called for fundamental reform of the financial architecture, and Tony Blair even called for a “new Bretton Woods” (as would have President Clinton if his economic advisers hadn’t stopped him). Such language makes it sound as if very fundamental changes are in the offing. But the steps that were taken over the subsequent few years by the G-7, G-22, and other bodies really amounted to tinkering with the plumbing more than changing the entire architecture. Then in November of 2001, DMD Anne Krueger proposed that the IMF host a sovereign Chapter 11, now called a SDRM. And in April of 2002, she proposed a modified version. At the IMF Annual Meetings at the end of September, the major shareholders [i.e., the G-10] approved IMF plans to go ahead and draw up a detailed SDRM proposal, simultaneously with a more contract/market-oriented approach that envisions particularly wider use of CACs.

Personally, I find persuasive the argument that the absence of an international bankruptcy procedure is a central identifiable market failure. I realize that an SDRM, even if it had already been fully implemented, would have done little to help East Asia in 1997-98. But my own view is that the international financial community should either pursue this approach aggressively, to see whether it can be made to work or, if not,

should stop talking about reform of the financial architecture. I know of no other proposals that are simultaneously as sensible in conception and sufficiently ambitious to merit the title of “reform of the architecture.”

The US version of corporate bankruptcy law

Patrick Bolton identifies three key elements of corporate bankruptcy and reorganization institutions:

(1) a stay on individual debt-collection efforts and possible suspension of debt repayments (to solve the collective action problem of a “rush to the courthouse”),

(2) debtor-in-possession financing, which receives seniority over existing claimants, with the objective of keeping the firm operating in the interim if there is long-term value that might be lost by premature dismemberment of the firm, and

(3) delegation of negotiations to creditor committees, with ways of preventing a dissenting minority from blocking a settlement, though these ways are sharply limited in the US case. Each of these functions has possible analogues in international sovereign debt problems, but the fit is perhaps the closest in the case of the third. New York law requires that creditors give 100% support to restructuring proposals outside of bankruptcy court before they can go forward. Other countries’ systems are more concerned about the possibility of holdouts. International attempts to restructure in such cases as Russia and Peru are seen as having been hampered by a minority of holdout creditors, and a goal of any of the international proposals is to prevent that from happening.

I was interested to learn from the Bolton paper of the theory that the heavy reliance of US corporate finance today on bonds, as opposed to than bank loans, might be

attributable to their treatment in bankruptcy, particularly under the 1978 Bankruptcy Act. Bondholders are relatively well-protected: A reorganization plan must be approved, not just by a supermajority overall, but also by (a two-thirds majority by ownership) within each of the creditor classes. UK bankruptcy law, by contrast, gives greater protection to bank creditors.

Other countries' versions

In a final section of the paper, the author concludes that US corporate bankruptcy law and practice appears to be the most relevant for a comparison with sovereign debt restructuring.

The leading alternative to the US system of bankruptcy by statute is the UK bankruptcy-reorganization procedure, called “administrative receivership.” Relative to the US system, the British system tends to be creditor-controlled, to restructure debt more quickly, to lack debtor-in-possession financing, and to be biased in favor of liquidation, which makes bankruptcy less attractive to debtors. The UK system shares with the US a low level of court involvement, compared to other countries’. But I come away with the conclusion that the UK is less relevant as an alternative model of what an SDRM would look like than it is a reminder of the system under which CACs thrive – a market-oriented alternative to SDRM.

The paper also reviews systems in other countries, rich and poor. We learn, e.g., that Japan offers strong protection to secured creditors, and that Germany did as well, at least until recently. France and India provide strong protection for workers and other stakeholders.

Lessons for SDRM?

Three big questions are posed for an SDRM:

- (1) How much administrative involvement?²
- (2) How comprehensive should debt standstill be?
- (3) How much involvement of other stakeholders?

The paper has an historical discussion of political economy, which is very welcome as we economists too often skip the politics in trying to design a system, unless it is for the purpose of ruling some proposal out. Bankruptcy procedures were very controversial in US politics in the first half of the 19th century. The instinctive response to the SDRM, as with any ambitious proposal to reform the international financial architecture, is similar to Eichengreen's: "whatever its merits in theory, it will never be accepted in practice." So the history of how bankruptcy proceedings developed domestically seems a promising source of insight on the political barriers and how to overcome them.

Specifically, Bolton identifies as a possible guide the exemptions or opt-out provisions that were granted to states to reduce resistance to a federal system. It sounds promising at first; "states' rights" was the original strategy for getting all 13 former colonies to go along with the US federal constitution, and any attempts at global governance can be usefully informed by this precedent. But I fear the precedent may be less useful for an SDRM than might appear. In the first place, while farmers and other debtors were an important political constituency in 19th century America, developing

countries unfortunately have little vote in the design of the international financial architecture. I say this even though some large emerging market countries have finally been given a seat in groups like the International Monetary and Financial Committee (IMFC), the G-20, and the Financial Stability Forum (FSF), and even though I think that *on the trade side* developing countries collectively for the first time may have some real bargaining power in multilateral negotiations under the Doha Round. The greater obstacle that must be overcome as part of this, or any sensible reform, is more likely to be the US Congress, than debtor countries. The Congress is not for giving up any sovereignty, or approving any multilateral treaties of any sort these days. It is not likely to agree to amend the IMF Articles of Agreement in the way suggested, or to allow an international body to overrule US security laws and creditor protection. In the second place, perhaps the most obviously bad aspect of US bankruptcy law is precisely that some states retain provisions whereby residents declaring personal bankruptcy can keep such valuable property as expensive houses, and even racehorses. Currently top executives of Enron and other companies can engage in crash projects to build luxury houses in Texas or Florida, as a way of safeguarding their wealth if they have to file for personal bankruptcy.

One place where I think I disagree with this paper is the subject of corporate debtors shopping for the most friendly jurisdiction. Bolton suggests this may be a good feature of the US system, which could be usefully adopted at the global sovereign level:

“A form of jurisdiction shopping could be contemplated under an international bankruptcy procedure as well. To encourage courts to respond to the needs of the contracting parties, it may be desirable to allow for jurisdiction shopping, by say

² Should the decision be up to the debtor country and creditors [as under US law], or should the IMF or other body have to approve alone [as in Japan’s composition law and Chapter 9 of US law]? Should the debtor country remain in control (US) or appoint a receiver (as under French law)?

letting existing bankruptcy courts also handle cases of sovereign defaults. Thus, sovereigns and/or their creditors could file for bankruptcy protection in US bankruptcy courts (say New York or Delaware), or in an ad hoc sovereign debt restructuring body...”

When it comes to most kinds of standards, say for accounting or securities, a possible drawback of a system that allows jurisdiction-shopping is a “race to the bottom.” The “pro jurisdiction shopping” argument is that the competition will discipline those jurisdictions, so that they have an incentive to maintain standards that are user-friendly and low-cost. This is what the author has in mind. Perhaps this works for corporate bankruptcy law; perhaps Delaware is indeed the popular state in which to incorporate because the Delaware court delivers timely and efficient bankruptcy proceedings. But a court in any US state, whether Delaware or New York or Indiana, is likely to be heavily influenced by the economic interests of residents of the United States. If the other side in a dispute consists of residents of far-off countries, their interests may not receive a fair hearing, even in reality, let alone in terms of the perceptions of the citizens of those countries. Raffer (1990) proposed that the international bankruptcy court should be located in a neutral country, a Polonius-land that is neither an active lender or borrower. Marcus Miller (2002) considers that neutrality argues in favor of locating a Bond Restructuring Forum in any G-7 country other than the US and UK.

Differences between corporate and sovereign contexts

Bolton points out some differences between corporate bankruptcy and sovereign debt restructuring. The most important is that sovereign states are not liquidated and governments not replaced, at least not directly by creditors as part of default proceedings. Even though Walter Wriston’s famous statement that nations don’t go bankrupt is

generally cited as having been proven wrong (in 1982) soon after it was uttered, it is true that sovereigns do not go out of business, or at least have not since the time in the 19th century when Egypt was taken over by Britain and France for non-payment of the Suez Canal loans. As a footnote mentions, Chapter 9 for municipalities may be a more relevant precedent for sovereign restructuring. I wonder why Chapter 9 is not cited more often in the context of precedents for international procedures, and Chapter 11 less.

One would think that the knowledge that the debtor can't ultimately be put out of business would shift bargaining power from the creditor to the debtor, as Bolton notes. The standard countervailing aphorism to Wriston's is "If you owe your banker \$1 million, you have quite a problem; If you owe your banker \$1 billion, *he* has quite a problem." This doesn't seem to be the way it works in practice, however. The debtors in fact have the most to lose. For some reason, debtor countries almost never explicitly default, telling the world they have no intention of paying, despite what would seem to be advantages to doing so. Perhaps it is those on the creditor side of the table who in fact have the greater bargaining power. They are going to return to nice warm homes, whatever happens, while those on the debtor side may experience true economic hardship. (If the government ministers do not themselves experience poverty as do their constituents, they do run the risk of jail, in recent cases from Argentina to Korea to Indonesia.)

Bolton lists as a further difference that sovereigns do not have to protect themselves against creditors racing to grab the debtor's assets. I have a question here. I remember that in the early 1980s a constant fear was that a miffed creditor would get a court order and "attach assets": a Brazilian ship in a US port, an Argentine plane at a US

airport, or Mexican oil in a US pipeline. The standard creditors' scramble for assets seemed a real danger, from what the lawyers told us. Indeed, such fears were listed as one of only several possible incentives that prevented countries from declaring outright default. And yet it never happened, neither in that debt crisis, nor those of the 1990s. Someone must know why, and I would like to hear the explanation.

Opponents of an SDRM

When considering a proposed major change in law, it is common to ask for testimony from those most affected. In the case of the SDRM, that would be the creditors and lenders. It is interesting that both groups are on record as opposed. Lenders of view it as a recipe for making default more common, at their expense. They also object to letting the IMF have seniority (which it de facto already has).³

While the immediate goal is to make restructuring run more quickly and more smoothly, I would say that the larger goal is to avoid the need for sharp recessions as part of the adjustment process and to do it without a large increase in the size of IMF loans – ideally with a decrease in the size of IMF loans relative to recent large packages -- for moral hazard and political reasons. If the IMF subsidy component were indeed reduced, it does not strike me as implausible that the net effect might be negative on the lenders, at least in the short run. If so, the IIF is only doing its job when it opposes the SDRM, representing the interests of the creditors.

A number of borrowing governments are also opposed, and this is a more interesting observation. The stated reason is that to make ex post restructuring easier, and

³ E.g., CSFB (2002).

make default more frequent, would reduce the ex ante availability of finance, in particular by raising the risk premium. I am not convinced by this line of argument.

I am not convinced that increasing the volume of lending should be a prime objective of public policy. True, the total amount of finance going from countries with high capital/labor ratios to countries with low ratios is currently already less than the first-best return-equating optimum, and in that sense a reduction in capital flows would have a first-order negative effect on global economic welfare. But given the severity of the recurrent crises, in terms of lost output, it seems to me that we have been living in a third-best world (or worse). I know that in the Mike Dooley (2000) view, recessions are the necessary device that assures creditors that debtors will not default for light cause, thus making international finance possible. But surely we can do better than gratuitous recessions as the disciplining device.

A reduction in the amount of debt may actually be desirable, a move from third best to second best, if it can be done in a way that is not too distortionary. I am not like some who favor an extraneous increase in exchange rate volatility to discourage foreign currency borrowing; and I think that capital controls are a complicated matter, more likely to be abused than to be used intelligently. Nevertheless, if a reduction in the volume of flows occurs as a side-effect of a plan that substitutes an orderly restructuring for the recession-mechanism, then I don't see this as a clear drawback. In other words, maybe a moderate reduction in capital availability is not such a bad outcome. The goal in architecture design should be to get some of the benefits of international capital markets, without the periodic collapses in real economic activity. Surely a system that depends on loss of reputation as a deterrent to default is better than a system that depends on

collapses in economic activity to accomplish the deterrent, and this is true whether the deterrent is triggered frequently or infrequently.

There are other counterarguments, such as political infeasibility or the fact that as currently envisioned, the SDRM applies only to governments defaulting on international obligations, which was not the main problem in most recent crises. But these arguments do not suggest that trying to launch an SDRM would do any harm.

Why, then, are borrowers opposed? Is it possible that if the question were posed to the borrowers collectively, they would be more supportive? When they speak as individual countries, they are afraid of the stigma that would come if they favored the SDRM. They fear the international community would think that they must think they will have to default. Do the emerging market groupings have any spokesmen in the international financial fora who are not first and foremost ministers or governors for particular countries? Such ministers need to worry that their views will come to haunt their home countries?

Lenders opposed, borrowers opposed... That would seem to be everyone involved. Is the IMF then wrong to propose SDRM, and G-10 governments wrong to support it? Lenders and borrowers does not exhaust the list of stakeholders. Citizens of borrowing countries (workers, taxpayers...) and of lending countries (exporters, taxpayers) are also on the list of stakeholders, and they stand to benefit a lot if a way can be found to resolve debt problems without collapses in the country's economic activity.

G-10 includes the Bush Administration. A footnote in the paper says "Interestingly, the SDRM is a political issue where Republicans are siding with 'main street' against 'Wall Street'." But I don't think it is clear what the position of the Bush

Administration is. Their rhetoric has been quite variable in the area of international finance. John Taylor has been ambivalent, and was apparently opposed at first. And even in October 2002, a few days after the Annual Meetings, Glen Hubbard, Chairman of the Council of Economic Advisers, said the SDRM might not be necessary if market players could construct their own private debt rescheduling forum, a remark that was interpreted as encouraging Wall Street opposition. But if the private market has not moved substantially in the direction of CACs, after ten years of proselytizing, what reason is there to think it could on its own achieve a debt-rescheduling forum, which is a harder enterprise?

The alternative: market mechanisms

I think everyone agrees that some improvement on the regime as it stood ten years ago has been necessary. The paper discusses two private sector approaches: exchange offers (Roubini...), which work under New York law, or CACs (Eichengreen...), which to date have only worked under London law.

It is often argued that bonds, the dominant financing vehicle of the 1990s, cannot be restructured as easily as loans, the dominant vehicle of the preceding cycle, because there are so many disparate bondholders. But people forget how many banks there actually were in the 1982 debt crisis, how heterogeneous they were, and how difficult it was to keep them all on board with packages that required them to “voluntarily” roll over their loans.⁴ There were more similarities between the two cycles than most people realize. If the resolution of the debt crisis in the 1980s had been speedy or without large

⁴ Also, while the crises of Mexico 1994-95 and Thailand 1997 were primarily related to securities, banks were still key in Korea 1997, Turkey 2000, and Brazil 2002.

economic losses, then the shift in lender composition might have been a key point to explore. As it is, the 1980s resolution never worked very well if judged by the ultimate test: the decade of lost growth. The goal should not be to address bondholders alone, on the theory that bank loans are easy to deal with. But any reforms that made restructuring work better would be desirable.

The proponents of exchange offers (Roubini, including in a recent paper of which I am co-author) argue that they have been used effectively in some recent cases: Ukraine, Pakistan and Ecuador. They argue, further, that CACs could have been used, as the instruments allowed for them, but when the time for negotiation came, an exchange offer was preferred, indicating a revealed preference for this approach.⁵ Bolton argues that the explanation is that these were small countries for whom “the IMF’s stated policy, that it would not consider any bailouts without some concessions from other creditors and bondholders, may well have been credible.” The threat of default was very real, so the creditors had to bargain. By way of contrast, an exchange offer failed in Russia in 1998, precipitating the full-fledged Russian default/devaluation. Bolton infers that Russia for geopolitical reasons was the quintessential moral hazard play, that investors thought they could do better than the exchange offer because the IMF would have to bail out nuclear-armed Russia. But Ukraine and Pakistan were also potentially-nuclear countries of some geopolitical importance. Furthermore, if the problem in the Russian case was indeed acute moral hazard arising from a belief that it would always be bailed out no matter what, then the fact that the IMF and G-7 did ultimately pull the plug in August 1998 must have had a salutary effect on future investor calculations of this sort. It seems clear that

⁵ (p.32) and Frankel and Roubini II.b4.

we should not be satisfied with the way the current system is working, for any of these countries.

The proposal to expand the use of CACs (the contractual approach), as an important reform in the international financial architecture, has been around for quite awhile. Eichengreen and Portes (1995) and the Rey Report were underway even before the Mexican peso crisis of December 1994. Debtors have been described as reluctant to ask for CACs, for the same reason as their reluctance to support an SDRM: the stigma. For quite awhile, the recommendation was that G-7 governments should take the lead and issue bonds with such contracts, to remove the stigma, and that only their refusal was holding things up. But both Canadian and UK governments have now issued bonds with CACs; apparently it has done little to promote enthusiasm in emerging markets.

Bolton gives four drawbacks to contractual or market approaches. (1) What happens to any other bonds and claims, beyond the specific bonds covered by CACs and exchange offers, (2) enforcement of priority, (3) DiP financing, and (4) the high debt burden that remains even after restructuring. Fischer (2002, p. 31-35) lists drawbacks with the current system of market-based PSI, including difficulty of enforcing “voluntary” restructuring, and finds that the most profound difficulty is the absence of an accepted framework like the proposed SDRM, wherein a debtor, in extreme circumstances, can impose a payments suspension while working to restore viability.

To my mind the appropriate strategy at this point is to pursue SDRM *simultaneously* with market alternatives such as CACs. Three points:

- (1) They are not incompatible. Ultimately, both could be in effect simultaneously.
- (2) CACs are thought to be easier to put in place, so why not start with them.

- (3) Having deliberations for the SDRM in progress creates an incentive for the private financial community to pursue CACs (or other alternatives) which recent history suggests they are otherwise unlikely to do.

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