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Argentina, once a foster child of the financial liberalization and development movement, defaulted last year on its public and private debt, and is now in deep economic and social chaos. What happened? Is Brazil, a country affected by the collapse of its trade relationship with Argentina and with similar institutions and problems , next, or will foreign investors feel reassured by the August 7, $30 billion IMF- and US Treasury loan package? Will these countries be able to regain the confidence of foreign investors? Is there a need for a new International Financial Architecture?

My goal in this article is more broadly to discuss emerging countries' access to capital. But let us step back a little. As of a few years ago a wide consensus had emerged among economists. Capital account liberalization – allowing capital to flow freely in and out of countries without restrictions – was unambiguously good. Good for the debtor countries, good for the world economy. The two-fold case for capital mobility is relatively straightforward: First, capital mobility creates superior insurance opportunities and promotes an efficient allocation of investment and consumption. Capital mobility allows households and firms to insure against country-specific shocks in world-wide markets; households can thereby smooth their consumption and firms better manage their risks. Business cycles are dampened, improved liquidity management boosts investment and promotes growth. Second, and besides insurance, capital mobility also permits the transfer of savings from low- to high-return countries. This transfer raises worldwide growth and further gives a chance to the labor force of low-income countries to live more decently. In these two respects, the increase in the flow of private capital from industrial to developing countries from $174 billion in the 1980's to $1.3 trillion during the 1990's should be considered good news.

That consensus has been shattered lately. A number of capital account liberalizations have been followed by spectacular foreign exchange and banking crises. The past twenty years have witnessed large scale crises such as those in Latin America (early 80s), Scandinavia (early 90s), Mexico (1994), Thailand, Indonesia and South Korea (1997), Russia (1998) , Brazil (1998-9; 2002) and Argentina (2001), as well as many smaller episodes. In retrospect, impact factors have ranged from quite minor (South Korea) to dramatic (Argentina);overall, the crises have imposed substantial welfare losses on hundreds of millions of people in those countries.

In the wake of recent twin currency-banking crises, experts in academia and the financial sector have expressed concern about a number of pervasive features in international lending: the strong debt bias, the liability dollarization, and the short maturities. A widespread consensus has developed in favor of encouraging equity portfolio and foreign direct investment and of discouraging short term capital inflows, and of promoting better country risk management by reducing emerging market countries' exposure to exchange rate risk.

Some of the concern about the "dangerous forms of debt" is well-taken. While currency depreciations usually hurt consumers by raising the price of imports and thus the cost of living, they further have dire consequences for the financial sector and industries, especially those in the non-tradable sector, whose liabilities increase without any offsetting effect on the asset side of the balance sheet. To top it all, during hard times, the short maturities allow foreign investors to scramble for exits out of the country, creating a situation akin to a bank run.

There is however more than meets the eye. When contracting short-term liabilities in foreign currency, a firm, bank or the Sovereign itself cannot be presumed to act irrationally. It is often said that they "have no choice" - understand : less dangerous forms of debt would just be too costly. The relevant policy question, though, is whether the private sector and the Sovereign should be encouraged or forced to rely more on foreign direct investment and long-term, domestic-currency - denominated debt.

One consideration to bear in mind is that investors' returns are often affected by the government's policies: for example, policies that may lead to a depreciation of the currency (depletion of international reserves, monetarization of deficits, policies encouraging the channeling of investments to the non-tradable sector, most commonly in real estate, failure to sink export promoting investments, for example investments in public infrastructure for tourism); and policies affecting investors' returns generally (e.g., change in corporate governance and bankruptcy laws, and in the resources affected to their enforcement, changes in tax, labor, and environmental laws.) .

This gives rise to what economists call a "moral hazard problem" , as the government has both the means (the policy instruments just alluded to) and the incentives not to fully internalize and protect the interests of foreign investors. Incentives to favor at the margin domestic constituencies over foreign investors are provided either by democratic accountability, that induces governments to pander to domestic political constituencies, or by conflicts of interest and capture, that induce politicians to favor specific domestic interest groups.

To be certain, governments do not derive any more utility from lowering the return of foreign investors than homeowners do from setting fire to their house once insured. They do not per se enjoy devaluing the claims of foreigners and mostly do not do it willingly. Rather, they are less cautious than they should at the margin; they will not take actions that reduce the probability of a crisis if these actions entail a substantial political cost.

Indirect evidence concerning the political incentive to under-internalize foreigners' stakes in the country is provided precisely by partial attempts at committing not to jeopardize these interests: for example, laws limiting fiscal deficits and public debt(or, in the trade area, membership in the WTO).Such commitment devices are highly imperfect. For example, commitments regarding fiscal deficits and public debt have little bite if local governments enjoy substantial fiscal and borrowing autonomy; and especially, the numbers are highly subject to accounting manipulations.

A little thinking about this moral hazard problem points at the flip side of risk exposure: dangerous forms of debt are also "policy resistant"; by reducing the foreigners' claims' sensitivity to policy, they make the government more accountable, ultimately to the benefit of the country. To see this, return to our vulnerability trilogy .First, encouraging foreign direct and equity portfolio investment and promoting international diversification by encouraging residents to invest abroad does not foster accountability. Some match between stakeholders (investors , here) and political constituencies (those whom the government is most eager to please) must be achieved. Debt financing and small frictions inducing a home bias therefore should not be the object of widespread opprobrium.

Similarly, short-term maturities tend to keep countries' governments on their toes. The threat of capital flight that would result from government misbehavior does (although not always) act as a deterrent. The third member of the vulnerability trilogy, foreign-currency denominated liabilities is subject to a similar conclusion: If foreigners hold pesos, they bear part of the cost of a depreciation; by contrast, they incur smaller losses if their claim is in dollars. And so the country bears a higher fraction of the cost of policies that may result in a depreciation, which increases accountability.

To be certain, this view abstracts from a number of other relevant considerations, such as the possibility that borrowing countries' governments serve powerful interest groups rather than the population's general interest , or the risk of panic driven by poor lender coordination. But the basic point remains: regulating dangerous forms of debt as is most often proposed may not give weak countries access to better forms of financing, but rather shut them off from international capital markets.

The analysis above partly explains why the United States, in which the government has limited control rights and key political constituencies' interests are aligned with investors' interests (e.g., through the pension fund system), can borrow so much; and why many poor African countries, which have a much more pressing need for foreign capital but whose wealth (often appropriated by a small group) is invested abroad and whose leaders have substantial control over economic life, have almost no access to the international capital market.

Argentina is another case in point. Government moral hazard is illustrated by the failure to suppress tax evasion and corruption , by the unwillingness to reform dysfunctional institutions, to tame the battle between provinces and Buenos Aires, and to reestablish a social pact , and by the insistence on maintaining (and gambling on) an a priori unsustainable exchange rate peg (see box) . Investments by rich Argentinians abroad (a textbook case of international diversification!) did not contribute to align the interests of stakeholders and political constituencies. Argentina’s unsustainable fixed peso-dollar exchange rate regime led to yet another instance of moral hazard: the default on private and Sovereign debt.

What about the IMF in all this? My own view is that the IMF is meant to solve a particular market failure. Namely, it is there to help borrowing countries to attract foreign investment by offering a specific governance mechanism, acting as a delegated monitor on behalf of investors.

An analogy will help grasp this point. Banking and insurance regulators act as delegated monitors for retail depositors and insurees, who have little individual incentive to monitor their financial institution and, in case of trouble, to exercise the normal prerogatives of creditors. Similarly, the IMF can represent investors in the tasks of prevention and crisis resolution (the often decried ex ante surveillance and ex post conditionality). To be certain, foreign investors are much more sophisticated and better informed about countries they lend to than retail depositors and insurees are about their financial institution; but in either case lenders' dispersion gives rise to free riding and a lack of coordination. Hence the need for a delegated monitor [Delegated monitoring is also a prevalent feature in financial markets: think of general partners or takeover artists acting on behalf of limited partners in venture capital or leveraged buyout deals, or lead investment banks in investment banking. Prudential supervisors and the IMF perform a somewhat similar role with respect to financial institutions and borrowing countries, although their incentives to monitor are only partly monetary –the deposit insurance fund and the loans' exposure,respectively-, and also reflect public interest considerations].

Two important points, though: First, the IMF, by representing foreign investors, really acts to the benefit of the borrowing countries, in the same way prudential supervision enables banks with average capital ratios to gain access to retail depositors: for, foreign investors ,finding the country more attractive, ex ante compete away the benefits from improved governance and offer better terms to borrowers. Thus, by helping countries to achieve some commitment, the IMF can fulfill its overarching mission, which ,in my view, is not to benefit foreign investors, but rather to help countries finance their development. Second, the IMF's legitimacy ultimately relies on a reputation for taking the population's interests at heart. But it ought to act tough when crises result from poor government, especially when the bad policies benefited the government's buddies .

Last, the IMF 's role as a lender of last resort (LOLR) should be approached cautiously. This role is usually motivated by a vague analogy with the central banks' role of LOLR. But there is a key difference. The rationale for a central bank's provision of liquidity is the existence of macroeconomic shocks affecting the country. Liquidity provision can be seen as an insurance scheme in which the current and future generations of consumers stabilize the economy in bad times . Such shocks are much smaller at the world level. Indeed, a country could in principle obtain insurance against its own fluctuations by buying insurance from large international financial institutions (for example, through foreign exchange swaps or domestic-stock-market indexed securities) or by letting the private sector diversify into foreign stock markets and the like. The reason why countries do so only to a very limited extent (cf., for example the relatively small credit lines secured from banking consortia by Argentina, Mexico and South Africa in the 1990s) is deeply related to the moral hazard considerations discussed above. Foreign exchange swaps, domestic-stock-market -indexed securities or foreign lines of credit all shift the cost of bad policies to foreigners and reduce accountability, ultimately to the detriment of the borrowing countries.

To sum up, a country's level and quality of access to international capital does not depend solely on its international collateral ,but also on a variety of institutional features such as the level of domestic savings, their location at home or abroad),the set of policy choices available to the political authorities, and the interests of dominant political forces. They also hinge on the alignment of investors and domestic interests. These simple considerations question the current consensus against dangerous forms of debt.

Box:Argentina and Brazil

In 1991,Argentina adopted a currency board so as to stabilize its exchange rate. Under the so-called Convertibility Plan, pesos could be exchanged one-for-one with US dollars. With inflation under control, the country grew rapidly at a rate exceeding 6 percent per year until 1997.But ,hit among other things by the Russian and Brazilian crises in 1998-1999 and by a strong dollar which ,due to the peg, reduced the economy’s international competitiveness, Argentina then entered a protracted recession (GDP fell by 4 percent between 1998 and 2000). It came to the IMF for help in late 2000, and received a $40 billion package (including $14 billion from the IMF).

While such a rescue package looks enormous , it really was not in view of the size of capital flows in a crisis situation. IMF packages ,which recently have grown substantially, per se are unable to stop the worst crises. And ,indeed, facing a deep crisis, unable to meet fiscal deficit targets and to restructure its Sovereign debt (it had 88 different bond issues under 5 different legal juridictions!), Argentina, as we know, ended up defaulting by abandoning the peg and by “pesifying” foreign-currency denominated debt.

What went wrong? A couple of things. First, an unstainable fiscal deficit, aggravated by the fiscal irresponsibility of provinces, for which the constitution forces the central government to take responsibility. The ratio of public debt to GDP rose from 29 percent in 1993 to 41 percent in 1998 and 50 percent in 2000.Apparently nothing to worry about in view of the 60 percent ratio set by the Maastricht Treaty and the numbers reached by some European countries. Yet there were reasons to be concerned. First, the 1993-1998 increase occurred during a boom and a privatization program; one would have expected public finances to improve, not to regress. Second, to keep debt under control, Argentina has a lower ability to raise revenues from taxes than European countries. Its tax revenue is about 20 percent of GDP, not 50 percent.

Third, Argentina’s natural vulnerability to external shocks was much exacerbated by the peg to the dollar. A drawback common to all pegs is that if the country needs to depreciate its currency or just is unable to maintain the peg, the private and Sovereign debts ,which are mainly denominated in foreign currency, blow up, creating serious problems for the public and private sectors. In the meantime, the country will have lost money in the attempt to maintain the peg. [One would think that there is a straightforward solution to this problem:encourage or force debtors to borrow in local currency. However,and for the accountability reason discussed in the article, a move toward domestic-currency denomination of debts would have costs as well.]Thus,the peg was unsustainable and played an important role in the Argentinian debacle.

The stand-by agreement negotiated in 2001 did not suffice. The situation had become too messy, and the human cost too high to make IMF conditionality (conditions that ,if implemented, would help restore investor confidence in the country) credible. The rest is history, as they say..

Brazil might be next, although noone really knows . Hurt by the Argentinian crisis, with a public debt of 62 percent of GDP (up from 30 percent in 1994), Brazil is in trouble. The real has lost a quarter of its value this year. And , despite the $ 30 billion IMF package ($24 billion of which for 2003, conditional on meeting economic targets),foreign investors ,such as Citigroup, are pulling out ,for example by cutting export credit lines, loans and other commitments. The private and public sectors are exposed to rising debt liabilities as the depreciation of the real increases the cost of their foreign-denominated reimbursements.

To be certain, Brazil is not Argentina. Its currency floats, which removes a source of vulnerability , that of a sudden and drastic devaluation and of the loss of foreign reserves in a vain attempt to defend the currency .But the exposure to foreign exchange risk remains. Public employment is smaller too:7 percent in the late 90s as opposed to 12,5 percent in Argentina(a figure more similar to that of some European countries with much better fiscal capability). Yet, its vulnerability is undeniable.