Financial Crises and the Multilateral Response

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Barkbu, Mody, and **Eichengreen** review the modern history of financial crises, providing a context for analyses of the world's recent bout of financial instability. Their review highlights the heterogeneity of experience—to paraphrase *Anna Karenina*, every unhappy crisis is unhappy in its own way. But it also has revealed some common trends. The violence of financial reversals has tended to grow, mirroring the progress of financial liberalization, such as it is and the growth of international capital movements. One consequence has been that the financial requirements of international intervention have increased.

An explanation for this last trend is the absence of viable alternatives. Private lenders have an obvious interest in holding out for full payment, whether directly from the sovereign or indirectly through resources provided by international financial institutions. National officials have an interest in pushing into the future a difficult and politically embarrassing restructuring in the hope that good news will somehow turn up. Multilaterals find it hard to go against the wishes of those national officials and, being risk averse, fear restructuring as one of those "unknown unknowns." Recognizing that restructuring is difficult during a crisis, private investors have an incentive to lend at rates that are, in retrospect, too low. This implies that the next crisis has a larger capital outflow, increasing the size of the official financing needed to limit the damage.

These authors therefore explore how to automate the restructuring decision as a way of countering this bias. Automating the process has key advantages: it preserves

the integrity of the contract (which avoids the uncertainties involved in triggering CDS); it is predictable; and it can be priced. To this end, they explore the idea of adding to future government bond issues so-called sovereign cocos, contractual provisions that automatically lengthen maturities or reduce interest and amortization payments when a pre-specified debt/GDP ratio is reached.

At this point, sovereign cocos are an idea in search of a proposal. Adding them to future bond issues will require solving difficult technical issues. It would also require solving coordination problems—getting governments to move together. But, equally, not addressing the occurrence of ever-larger crises due to large inflows and subsequent large outflows of underpriced international capital is a story that cannot end well.