

The New International Financial Architecture: Bail-ins, Bail-outs, Bail-ups and Newspeak

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The term ‘bailing in the private sector’ is used to describe several quite different proposals with the common feature that they all seek to make private lenders to developing countries share in the costs of financial or currency crises in these countries. The International Monetary Fund (IMF) regards it as one of the main pillars of the ‘new international financial architecture’ — that is, the package of proposals for reforming the international financial system that is intended to reduce the frequency and severity of financial and currency crises in emerging markets. The other pillars of the IMF’s proposed package are transparency, prudential regulation of financial institutions, cautious liberalisation of international capital markets and the implementation of codes of international best practice for making and documenting economic policies.

There are three main groups of proposals for bailing in the private sector:

1. Governments or central banks in developing countries should explicitly purchase insurance against financial and currency crises from private financial institutions in international capital markets. There are already some examples of developing countries that have negotiated a contingent credit line (CCL) with major international banks that can be drawn down in specified circumstances. Alternatively, some bond contracts might contain clauses that would automatically trigger reduced repayment, or perhaps even increased new lending, in certain specified adverse circumstances for the borrower. The rarity of explicit insurance against financial and currency crises probably reflects the difficulty of defining such crises with enough precision to make insurance contracts legally enforceable. There is broad agreement in econometric studies that financial crises involve widespread bank failures, and currency crises involve both large increases in short-term interest rates and either large losses of foreign exchange reserves, or large exchange rate depreciation, or both. However, these circumstances depend either on subjective judgements, or on variables that could be readily manipulated by a central bank.
2. To make it easier for developing country governments to force private creditors to concede partial forgiveness of debts in a crisis, the IMF should sometimes ‘lend into arrears’ — that is, it should lend to countries that are in default on contracted debt service payments to banks or private bond holders. During the Latin American debt crisis of the 1980s, the IMF refrained from lending to

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countries in arrears to private creditors, but it began to do so in 1989, and further extended the conditions under which it was willing to do so in 1999.

3. The IMF and G-7 governments should promote the use of collective action clauses in sovereign bond contracts.¹ These clauses make it easier for a super-majority of bondholders to overrule objections from the remainder to a proposal by the debtor to reduce, or postpone, contracted debt service payments.

These proposals all seek to make foreign private lenders to emerging markets provide some form of insurance against financial and currency crises, but differ radically in the extent to which this insurance is explicitly contracted for in advance of a crisis. The first group of proposals seeks to encourage the development of market mechanisms that allow countries to buy insurance in advance of a crisis. In contrast, the second group seeks to force private foreign lenders to provide insurance pay-outs in the event of a crisis, despite never having explicitly contracted to do so in advance. The third group contains elements of both the previous ones.

It is argued here that proposals of the first type, which encourage countries to purchase insurance against financial and currency crises, are potentially sensible but are unlikely to achieve much. The effectiveness of such insurance is constrained by moral hazard and by the difficulty of designing contracts that unambiguously specify the event being insured against. There is little that governments or the IMF can do to ease these constraints. In contrast, proposals of the second type, which seek to force private lenders to provide insurance without having contracted to do so have nothing to recommend them. These are the proposals referred to here as 'bail-ups', since in the absence of explicit insurance contracts lenders will not willingly provide insurance. Once bail-ups are anticipated, foreign lenders will demand an interest rate premium for the implicit insurance services that they are being forced to bundle with their loans. The result will be increased borrowing costs for all developing countries and the crowding out of more efficient forms of insurance.

A minor theme of this article is that although the IMF and the other official financial architects regularly describe transparency as one of the main pillars of the new financial architecture, they apparently feel that in the case of their own transparency it is possible to have too much of a good thing. This article gives several examples of lack of transparency in IMF and other official attempts to help developing country governments to renege on private debts. 'Reneging' on a debt is used here to describe what happens when the terms of a loan contract are changed to the permanent disadvantage of the lender. It differs from 'default' only because the lenders may reluctantly agree to proposed contractual amendments if the expected gains from taking legal action to enforce the original contract are less than the expected costs.

Their lack of transparency indicates that the IMF and the other official architects are slightly ashamed of undermining loan contracts between developing

¹ The leaders of seven of the world's largest and richest countries – Canada, France, Germany, Italy, Japan, UK and USA – meet regularly as the Group of Seven (G-7) to try to coordinate economic policy making.

country governments and private foreign lenders. In order to gloss over the fact that they are doing so, IMF and other official reports use terms like ‘orderly restructuring of debts’, ‘rescheduling of debts’ and ‘temporary suspension of debt service payments’ to describe reneging by governments on their contracted debt service payments. It is logically possible to change the terms of a debt contract without disadvantaging the creditor. But in practice, restructuring, rescheduling and temporary suspension of debt service by countries hit by a financial or currency crisis almost always cause permanent losses to creditors. The reason is that the sovereign risk premiums that markets apply to new loans to such countries are far in excess of the interest rates offered by reneging countries. If the amendments proposed by the debtor were really sufficient to compensate the creditors for all the risks that they face, there would be no need for restructuring, rescheduling, or suspension of existing loans, since the debtor’s cash flow problems could be met by completely new borrowing.

‘Orderly restructuring’, ‘rescheduling of debts’ and ‘temporary suspension of debt service payments’, therefore, are all examples of Orwellian Newspeak. That is, they are jargon invented to camouflage reneging on debts by creating the false impression that lenders do not suffer permanent losses. The term ‘new international financial architecture’, is another example of Newspeak, since it creates the impression that the proposed plans are well designed and structurally sound.

Purchasing Insurance Against Financial and Currency Crises

A 1998 report of the Group of 22 (G-22)² proposed that sovereign bond issues should contain clauses requiring bondholders to accept reduced repayments, or even provide new loans, in specified adverse circumstances for the debtor country. In effect, such clauses would amount to the purchase of insurance by debtor governments from bondholders. This has the merit, relative to ‘bailing-up’ proposals, that the provision of insurance would be made explicit in the contract. Unfortunately, it is likely to be impracticable. Official bodies, like the G-22, can make the proposal, but since bond contracts are certainly not the least cost way of providing insurance, it is unlikely that private bondholders would be willing to offer such contracts at interest rates acceptable to the governments and central banks of debtor countries.

Another way in which a developing country can buy insurance against financial and currency crises is for its central bank to arrange a CCL from international banks that can be drawn down in specified circumstances. Argentina, Mexico and Indonesia have already done this, and Indonesia and Argentina have already made use of their credit lines. The obvious similarity between this and the G-22 proposal raises the question why some lines of credit have been arranged, whereas bond contracts providing for reduced repayments in certain circumstances have not. One possible answer is that a line of credit can provide insurance against crises without

² The G-22 consists of the G-7 plus Argentina, Australia, Brazil, China, Hong Kong, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand.

the need to explicitly define what constitutes a crisis. If the contract establishing the line of credit specifies an interest rate above that at which the country could borrow in normal circumstances, but below the almost prohibitive rates that a country experiencing a financial or currency crisis would have to offer to attract new lending, it will only be in the borrower's interest to make use of the credit line if a crisis occurs. A second possible answer is that the fact that only two countries have ever used CCLs indicates that they too do not work very well.

Transparency and Official Encouragement of Default

The Mexican and Asian crises demonstrated that the IMF has become an international lender of last resort. It performs this role in conjunction with the US government, the other members of the G-7 and the Paris Club of official creditors.³ The IMF is an agent of these richest countries, since they largely finance it and have a dominant influence on the Executive Board that controls its policies.

There are now several examples of last resort loans being made to countries that are in arrears to private creditors and even examples of official demands that debtor governments force private bondholders to accept 'rescheduling of debts' as a condition for last resort loans. The New York based Emerging Markets Traders Association (EMTA) states that in early 1999 'reports began to circulate that the IMF had requested Romania to roll over upcoming Eurobond payments' and that in February 1999, the Paris Club demanded that Pakistan reschedule its Eurobonds as a condition for a rescheduling of official debt (EMTA, 1999). Ukraine, while under an IMF program, rescheduled debt service obligations in a unilateral fashion in 1998 and 1999 before reaching agreement with private bondholders in 2000. According to the Financial Times (1999), 'Ecuador's recent default on its Eurobonds has been quietly welcomed in official circles'. Warburg Dillon Read (1999) commented that the timing of the announcement of Ecuador's default on its Eurobonds and Brady bonds, 'just a day before President Mahuad was due to announce an agreement with the IMF, raises the suspicion that the IMF was in fact requiring initiation of Brady restructuring as a pre-condition of the agreement. Warburg Dillon Read (1999) also stated that:

Ecuador's loud and frequent assertions that the country is acting with the full support of the IMF, the World Bank, the IDB, the US Treasury and President Clinton (but not so far, the Pope) has not met with any official denial, and is apparently true.

³ The Paris Club is the forum in which the G-7 governments, together with those of 12 of the next largest and richest countries, negotiate the rescheduling of the official debts of developing countries that are in imminent danger of defaulting. The group acts like a cartel because its principles of consensus and solidarity ensure that each member applies the terms agreed by the Club. Information on the Paris Club is available at: <http://www.clubdeparis.org>.

A recent IMF (2001) Issues Brief states that:

In some sense, the IMF already gives moral support to some standstills by agreeing to lend to countries that are in arrears to their private creditors, as long as they are negotiating with those creditors in good faith to reach a collaborative agreement.

It is disingenuous of the IMF to imply that its practice of lending to countries that are in arrears to private creditors gives only 'moral' support to debtors that unilaterally suspend contracted debt service payments. The difficulty of forcing debtor governments to honour their contracts used to be ameliorated by the IMF's refusal to lend into arrears; its new willingness to lend into arrears has therefore removed part of the underpinning of sovereign bond contracts. While the IMF cannot prevent private bondholders from taking legal actions to enforce contracts, it can exert enormous influence on a debtor's decision to renege on debts, or to repay them in full. The reason for this is that Paris Club agreements to reschedule debts are normally conditional on the debtor government satisfying the IMF that it is keeping to the terms of an IMF economic policy program. Whether the IMF approves or condemns a debtor government's policies on repayment of private debts is therefore crucial to obtaining the support of the Paris Club. This in turn is of vital importance to a debtor government, since the Paris Club's principles of consensus and solidarity make it a cartel of the world's largest and richest lenders.

A report for the Group of 10⁴ (1996) stated that IMF lending into arrears would 'improve the bargaining position of the debtor substantially' and would 'signal to the unpaid creditors that their interests are best served by quickly reaching an agreement with the debtor.' This report is itself disingenuous. It pays lip service to the view that 'it is essential to maintain the basic principles that the terms and conditions of all debt contracts are to be met in full and that market discipline must be preserved', but nevertheless supports IMF lending to countries in arrears to their private creditors, despite arguing that such lending substantially strengthens the bargaining position of the debtor in default.

Reports by the IMF and other official bodies treat transparency as a cardinal virtue. It is ironic, therefore, that the Financial Times should refer to Ecuador's default being 'quietly welcomed' in official circles, and that such major (and therefore presumably well informed) players as the (EMTA) and Warburg Dillon Read should have to use phrases like 'reports began to circulate' and 'is apparently true', to describe alleged IMF encouragement of Ecuador's default. The EMTA (2000) has complained that:

What is surprising to us after months of consultation between the private sector and official creditors is the comparatively little effort on

⁴ The Group of 10, which now has 11 members, consists of the G-7 plus Belgium, Netherlands, Sweden and Switzerland.

the part of official creditors to clarify the application of private burden sharing and the Paris Club principle of Comparability.

Like all virtues, transparency is easier to recommend to others than to apply to oneself.

Two potential justifications for official encouragement of renegeing by governments on private debts are sometimes offered:

1. that it helps to reduce moral hazard; and
2. that it helps to ensure comparability of treatment between private and official creditors.

The next two sections demonstrate the inadequacy of these attempted justifications. A possible alternative explanation for the official community's desire to force private lenders to provide *ex post* crisis insurance to developing countries is that the revenue from this implicit tax on lending does not appear on the budgets of the G-7 governments. Rather, it automatically reduces the explicit cost to the IMF, and therefore to the G-7 governments, of financing bail-outs. If, instead, the full costs of such bail-outs were met only by the IMF, its resources would have to be supplemented by explicit transfers of on-budget revenue, which would have to come mainly from the G-7 countries. Persuading their governments, and in particular the US Congress, to further expand the funds available to the IMF by raising taxes or reducing other expenditures would be extremely difficult. This provides another example of official policy seeking to avoid being transparent.

Moral Hazard and Excessive Risk Taking

An argument that is frequently made in favour of making private bondholders share in the cost of financial crises is that doing so reduces excessive risk taking and moral hazard.⁵ The argument is that if bondholders are always repaid in full, they have no incentive to check on the borrower's ability to repay, and will lend to finance excessively risky projects. Of course, this is similar to the argument that can be made against government provision of guarantees or compulsory insurance of deposits in commercial banks. However, for a given readiness of official last resort lenders to provide bail-outs, it is likely that making it easier for a government to renege on its private debts would increase, rather than reduce, moral hazard and excessive risk taking.

Moral hazard and excessive risk taking might indeed be reduced if bailing-in the private sector were used to reduce the size of official bail-outs. However, this merely provides a justification for encouraging governments of developing countries

⁵ Moral hazard refers to the increase in the expected losses arising from an adverse outcome that occurs when a person buys insurance. The increase occurs because the purchase of insurance reduces incentives to take precautions that cannot easily be monitored by the insurance provider.

to find ways of insuring themselves against adverse events. It does not justify forcing lenders to provide an inefficient form of insurance that would tend to crowd out more efficient forms. Since loans are less likely to be repaid in full when a debtor is in financial difficulty, it is inevitable that lending and insurance are bundled to some extent. If the IMF and the G-7 governments undermine attempts by foreign private lenders to enforce the terms of contracts against governments that have been hit by financial or currency crises, they increase the extent to which all private lending must be bundled with de facto insurance (in the form of the borrower's ability to renege on its originally contracted repayments in adverse, but imprecisely specified circumstances). Because this form of insurance is opaque and can be manipulated by the borrower, it is likely to be much less efficient. Therefore, it is ultimately more costly for the borrower than negotiating a CCL or holding high foreign exchange reserves.

Comparability of Burden Sharing

The Paris Club tries to insist on the principle of comparability between private and official creditors in the sharing of the burden of partial default by debtor countries. This principle does not prevent loans by the IMF and World Bank, which are agents of the Paris Club governments, from being given precedence over the claims of private and other official lenders. For example, in writing about Ecuador's default on its Brady bonds, Warburg Dillon Read (1999) stated that 'we can be sure that the IMF and multilateral debt (roughly \$4.5 billion of the total [\$16 billion of public domestic and external debt]) will not be rescheduled in any way'.

The Paris Club governments do not apply the principle of comparability in the context of domestic last resort lending by their own central banks. Although such lending regularly involves them in large losses, central banks do not propose that other creditors of the banks receiving last resort loans must forgive part of what they are owed. Nor is the principle of comparability applied to IMF-financed bail-outs of depositors in failed commercial banks. In the Mexican and Asian crises, the IMF did not recommend that part of the bail-out costs should be met by discouraging other bank creditors from taking normal legal actions to recover what was owed to them. Quite to the contrary, the IMF has insisted on the benefits of reforming national bankruptcy laws to strengthen the ability of creditors to enforce loan contracts against recalcitrant debtors.

Paris Club rescheduling of the debts of governments that experience crises is a form of last resort lending. It is also influenced by political considerations and is clearly not a normal commercial transaction. The fact that the official community may decide to bail out developing country governments whose survival is important to G-7 governments, or to extend last resort loans that are intended to preserve the stability of the international financial system, rather than to be profitable in narrowly commercial terms, is therefore not a valid reason for weakening the enforceability of normal commercial contracts. In the unlikely event that they can be justified at all, the costs of bail-outs undertaken by governments for strategic reasons, and of

official last resort lending designed to prevent systemic financial failures, should be met out of general tax revenue and paid for by small increases in all taxes, rather than by trying to finance most of it by the extremely inefficient method of undermining contractual rights.

Collective Action Clauses

Collective action clauses, which make it possible for the borrower to change the amounts to be repaid if 75 per cent or 90 per cent of bondholders agree to the proposal, have been advocated as being in the interest of most bondholders, as well as the borrower.⁶ This argument is often based on an analogy to Chapter 11 of the US Bankruptcy Code — once a firm is in financial difficulty, it may well be in the interest of individual creditors to seize its assets at the earliest opportunity, even if doing so can be expected to reduce the total repayments made to all creditors as a group. Chapter 11 provisions can be used to prevent such a creditor grab. In the absence of an international bankruptcy court, the advocates of collective action clauses argue that they are needed ‘to discourage maverick investors from resorting to lawsuits and other ways of obstructing settlements beneficial to the debtor and the majority of creditors’ (Eichengreen and Mody, 2000).

From the point of view of most bondholders, the actions of the maverick investors are indeed harmful if they so exacerbate the debtor’s situation that total repayments are reduced. There is however, a second collective action problem facing private bondholders — the problem of coordinating resistance to attempts by borrowers to obtain partial debt forgiveness in circumstances in which full repayment is possible. A majority of bondholders may be willing to accept partial debt forgiveness if each believes that legal action is costly and unlikely to succeed. But, even if a few firms are ready to take legal action if not repaid in full, the borrower may be deterred from ever attempting to obtain partial forgiveness. By making it harder for a few bondholders to resist an attempt by the borrower to obtain partial debt forgiveness in adverse circumstances, collective action clauses may exacerbate this second collective action problem.

Eichengreen and Mody have investigated the effects of collective action clauses on the cost of borrowing by comparing the yields on bonds issued under US governing law that requires unanimous agreement of bondholders to any proposal for altering the terms of a bond to extend the repayment period, or to reduce the amount to be repaid, with those issued under British governing law that sometimes include collective action clauses. After controlling for factors that might affect the likelihood that a borrower will default, Eichengreen and Mody divide their sample into two roughly equal halves, according to the borrower’s credit rating. They

⁶ Sharing clauses have also been proposed. These would require a creditor that brought a successful legal action against the debtor to share the proceeds with all other creditors. Sharing clauses have little to recommend them since they would create massive free rider problems of their own, and greatly increase the scope for debtors to avoid their contractual obligations.

estimate that sovereign borrowers with poor credit ratings have to pay a premium of about 130 basis points (1.3 percent per year) if they issue bonds containing collective action clauses, but that those with relatively good credit ratings can reduce the interest rate that they have to pay by about 50 basis points (0.5 percent per year) by including collective action clauses.

Eichengreen and Mody interpret their results as implying that the prevention of creditor grabs does indeed increase the total amounts that bondholders are likely to recover in the event that full repayment of debts is impossible. They suggest that this is the dominant effect in the case of bonds issued by borrowers with relatively high credit ratings. But in the case of investors with relatively poor credit ratings, the dominant effect is 'the moral hazard and default risk associated with renegotiation-friendly loan provisions' (Eichengreen and Mody, 2000:3). They do not explain what type of moral hazard they have in mind. However, since they argue that the inclusion of collective action clauses raises the interest rate demanded by lenders to such countries, it must reduce the total amount that bondholders expect to be repaid. Their rationale must presumably be something very like the second type of collective action problem described above; namely, that the ease of preventing litigation by some disgruntled bondholders makes it easier for a borrower, perhaps encouraged by the IMF and the Paris Club, to force all bondholders to accept partial forgiveness of debts even if full repayment would have been possible.

Eichengreen and Mody's econometric evidence is itself open to question. Since debt rescheduling is very rare for sovereign borrowers with relatively high credit ratings, it is hard to believe that collective action clauses, which can only be relevant in the event of rescheduling, can really reduce interest rates by 50 basis points. This is larger than most estimates of the entire country risk premium for the Australian government relative to the World Bank or the US Treasury. A communiqué of the G-10 (2000) states that in January 2000, the UK included a majority-action clause in its euro-denominated treasury note program and that this had no discernible effect on price or liquidity. A study by Becker, Richards and Thaicharoen (2000) controls for a wider range of variables than that used by Eichengreen and Mody and concludes that collective action clauses have little or no discernible effects on bond yields in secondary markets.

If, as seems to be the case, collective action clauses have little or no effect on the interest rates, then their widespread adoption would do little either to raise or to lower efficiency. Alternatively, if Eichengreen and Mody's econometric results are correct, the implication is that borrowers with relatively good credit ratings should adopt these clauses, but that moral hazard would be exacerbated if they were adopted by relatively high-risk borrowers. For obvious reasons, the borrowers with the best credit ratings pose few problems for the international financial system. Proposals to strengthen it, therefore, have focused on reducing the likelihood of default by high-risk borrowers. It follows that their results, even if they were correct, would not justify their Panglossian conclusion that collective action clauses are 'an important element in the campaign to strengthen the international financial architecture' (Eichengreen and Mody, 2000:abstract).

Conclusion

Proposals that governments of developing countries should insure against financial crises by arranging CCLs from major international banks is sensible enough, but somewhat empty. So far, only two countries have ever used CCLs from international banks. If they are such a good idea, why are such credit lines so rarely used, and what is to be done if more countries do not take out such insurance? In part, the apparent lack of interest in credit lines may reflect the fact that they are a close substitute for the foreign currency reserves that all central banks hold in the form of money at call in the major international financial centres. In part, it may also be that the willingness of the IMF and the G-7 governments to bail out governments facing financial crises reduces the incentives for these countries either to hold large reserves, or to negotiate insurance contracts that are close substitutes for them. This possibility is supported by the fact that the two governments with the largest ratio of reserves to GDP are those of Hong Kong and Taiwan, which are not members of the IMF. The G-22 Report's proposal for clauses in bond contracts to provide for reduced repayments in specified circumstances is similar in aim to the proposal for CCLs from international banks, but would be even harder to implement in practice.

There are two main objections to bailing up private lenders by having the IMF, or G-7 governments, provide support to governments that suspend debt service payments to private bondholders. First, the real conditions that govern bond contracts, as opposed to the nominal conditions, become obscured and ambiguous. Second, negotiating CCLs with international banks appears to be a less inefficient way for governments to buy insurance than issuing bonds containing explicit, let alone implicit and ambiguous, conditions for reduced debt service payments in adverse circumstances.

The IMF and G-7 governments could answer both the above objections to bailing in by proposing a new form of bond contract, which would specify that debt service payments would be suspended for the duration of a 'declared financial crisis', and that the maturity of the bonds would be extended by the duration of the crisis. The IMF would be the arbiter of when a crisis started and when it ended. It would be easy to design more elaborate contracts that provided for different adjustments in response to the intensity of the crisis, as judged by the IMF. This proposal would offer a more efficient form of insurance than the current proposals for bailing in private bondholders by lending into arrears because the contracts would be relatively unambiguous and transparent. Of course, such contracts might never be used. Even though they would dominate the existing IMF bailing in proposals in terms of efficiency and transparency, the interest rate premium demanded by lenders for the insurance provided would probably be so high that few, if any, borrowers would be willing to pay it. Proposals to bail up private bondholders avoid this potential embarrassment for the new architects by forcing all bond contracts into a mould that is even less efficient than one that would probably be rejected by almost all borrowers and lenders if they were allowed to choose.

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