Reforming the International Financial System: Crisis Prevention and Response

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Forum on Debt and Development (FONDAD)

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Director: Jan Joost Teunissen

Reforming the International Financial System

Crisis Prevention and Response

Edited by
Jan Joost Teunissen

FONDAD
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Reforming the International Financial System: Crisis Prevention and Response

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Editor: Jan Joost Teunissen

The views expressed in this book do not necessarily represent those of the Forum on Debt and Development or any of the co-sponsors. The summaries of the floor discussions, following the papers, attempt to convey the sense and substance of what was discussed. They have not been reviewed by all of the participants.

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Abbreviations

ADB	Asian Development Bank
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
BCCI	Bank of Credit and Commerce International
BIS	Bank for International Settlements
CCFF	Compensatory and Contingency Financing Facility (of the IMF)
CCL	Contingent Credit Line (of the IMF)
CFF	Compensatory Financing Facility (of the IMF)
CGFS	Committee on the Global Financial System (of the BIS)
CMR	Capital Market Report (of the IMF)
DCs	developing countries
EAC	East African Cooperation
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN)
EFC	Economic and Financial Committee (of the EU)
EFF	Extended Fund Facility (of the IMF)
EMEs	emerging market economies
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism (of the EMS)
ESAF	Enhanced Structural Adjustment Facility (of the IMF)
EU	European Union
FDI	foreign direct investment
FSA	Financial Sector Assessment
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
FSSA	Financial Sector Stability Assessment
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
HIPC	Highly Indebted Poor Countries
HKMA	Hong Kong Monetary Authority
HLIs	highly leveraged institutions
IASC	International Accounting Standards Committee
IAIS	International Association of Insurance Supervisors
IDRC	International Development Research Centre
IFIs	international financial institutions
ILO	International Labour Organization

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IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (of the IMF)
IOSCO	International Organization of Securities Commissions
LOLR	Lender of Last Resort
LTCM	Long-Term Capital Management
MAC	Monetary Affairs Committee of the East African Cooperation
NAB	New Arrangements to Borrow (of the IMF)
NAFTA	North American Free Trade Agreement
NGO	non-governmental organisation
NPLs	non-performing loans
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
PRGF	Poverty Reduction and Growth Facility (of the IMF)
PRSP	Participatory Poverty Reduction Strategy Papers
ROSCs	Reports on the Observance of Standards and Codes (of the IMF)
S&P	Standard and Poor's
SBA	Stand-By Arrangement (of the IMF)
SDDS	Special Data Dissemination Standard (of the IMF)
SDR	special drawing right
SRF	Supplemental Reserve Facility (of the IMF)
UDROP	universal debt roll-over option with a penalty
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNU	United Nations University
URR	Unregulated Reserve Requirement
US	United States
WIDER	World Institute for Development Economics Research
WTO	World Trade Organization

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Preface

In the current debate on international financial reform, efforts at bringing together Northern and Southern perspectives are rare. In general, the way the international system works seems to give predominance to the views from advanced rather than developing countries. Therefore, I most heartily accepted the invitation of FONDAD and IDRC to be involved in an initiative to bring together Northern and Southern perspectives on international financial reform – the so-called Global Financial Governance Initiative (GFGI) – and act, together with Jan Joost Teunissen, as a co-chair of GFGI's working group on "Crisis Prevention and Response".

In recent years, there have been a lot of interesting new initiatives and a growing literature on the subject. However, the agenda continues to be restricted and most of the fora lack vigorous representation from developing countries. This is not only true for fora that do not include developing countries or just include them by invitation – which is a very partial way of being included – but there is also an unbalanced representation from developing countries among those that do include them, such as the IMF International Monetary and Financial Committee.

As a consequence, in these fora a number of issues have not yet received adequate attention. Let me mention a few of them. First, there is the issue of the coherence of macroeconomic policies of leading industrialised countries and the distortions that a system based on purely national institutions can generate in this regard. Second, there is the issue of the role of regional institutions in the developing countries – both in development finance and the field of crisis prevention and management. Third, there is the issue of maintaining national autonomy in certain areas, given the incomplete nature of the existing or proposed international arrangements. In developing countries, for instance, it is strongly believed that capital account regulations and the choice of an exchange rate regime are areas where national autonomy should be maintained.

It is useful to make a distinction between the real systemic and global macroeconomic issues versus what I would call "centre-periphery issues" (I use this term for historical reasons but also for the lack of an adequate alternative). Most of the literature takes the perspective of the classical discussion of the "lender of last resort" versus the "moral hazard" debate in banking regulations, which is basically a discussion about market versus policy failures in the financial sector. Although this discussion is certainly

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important, I would like to emphasise that the essence of centre-periphery issues is that there are basic asymmetries at the international level which are not captured in the ongoing debate.

First, shocks generally come from the centre in a context in which there is no such a thing as macroeconomic regulation and coordination at the world level. Moreover, when a crisis emerges, developing countries are supposed to respond in a pro-cyclical way, because "restoring confidence" generally implies the pursuance of pro-cyclical monetary and fiscal policies. Unfortunately, during boom periods the response is also likely to be pro-cyclical, because if authorities had to adjust during the crisis, they are unlikely to have any political support for applying anti-cyclical policies in order to save for the bad times that may come again.

Second, there is a large asymmetry in the development of domestic financial markets. Developing countries have to choose between currency and maturity mismatches. If they choose to not have foreign exchange risk and borrow nationally, they will have maturity mismatches because the domestic financial market normally lends on short-term maturities. If they choose instead to use international financial intermediation on a large scale, they will have foreign exchange mismatches. You may also prefer to eliminate those mismatches by adopting an international currency, but then you eliminate your macroeconomic flexibility as well. So you are trapped into having inefficient financial management of some sort. Solutions are always partial: you can solve one part of the problem, but you always keep another.

Third, there is an asymmetry in adjustment costs. Aside from the fact that developing countries usually have larger economic shocks as a proportion of GDP than industrial countries, their social safety nets are also less developed. As a result, economic and social shocks are larger in the periphery than in the centre.

An essential problem that we face in the developing world is the increase of risks that are incurred during periods of financial euphoria. These boom periods generally lead to risks that only later on, during a crisis, become apparent as a mix of debt crises, maturity mismatches and currency mismatches. The only way to address this problem is to go to the source of the distortion, which is international financial capital fluctuations.

Although a crucial part of the effort to reduce these fluctuations and prevent the outbreak of financial crisis lies in strengthening the global institutional framework – one of the important issues discussed in this book – developing countries also need to develop an adequate domestic policy response. The policy options available to them include: choosing an exchange rate regime that, together with capital account regulation, provides room for anti-cyclical monetary and financial policies; strengthening

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anti-cyclical prudential regulation and supervision; improving the debt profiles of both the private and the public sector; and applying adequate anti-cyclical fiscal policies.

The current "calm" phase in which emerging markets find themselves provides an excellent moment to examine ways to improve financial crisis prevention and management. It also offers the opportunity to broaden the reform agenda. In my view, the agenda should be broadened in at least three ways. First, it should go beyond the issues of financial crisis prevention and resolution to include those associated with development finance and the "ownership" of economic and, particularly, development policies. Second, it should consider not only the role of world institutions, but also of regional arrangements. Finally, developing countries, as major actors in the world economy and as frequent victims of crises, should play a larger role in the discussions about reforming the global financial system as well as in its governance.

José Antonio Ocampo

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Introduction

Discussion on reform of the international financial system is hardly unprecedented – for instance, it was a recurrent theme during the 1970s, and FONDAD has been engaged in examining such issues for many years. However, the scope of the debate is now broader than ever, as it includes a sweeping re-examination of the costs and benefits of global integration – spanning reform of the architecture of the financial system; the role and governance of key institutions such as the IMF and the multilateral development banks; the world trading system and the WTO; and other elements of an increasingly integrated and globalised system. Concerns about the negative consequences of globalisation were made evident in the recent demonstrations in Seattle, Bangkok, Washington and Prague. The concerns of the protestors reflect a number of real evils that the international system needs to confront.

The globalisation of international capital markets has substantially increased the volume and volatility of private capital movements and the consequent potential of such movements to contribute to sovereign liquidity crises, while complicating their resolution. As the movement of capital responds to sometimes abrupt shifts in market sentiment, countries' increased integration with international capital markets has augmented both the potential magnitude of financing requirements during periods of stress and the pace at which emerging pressures may develop into full-blown crises.

Developing country members of the IMF – especially those from emerging market economies – have increasingly complained during the past two years that decisionmaking in the Fund is dominated by a handful of advanced industrial countries, and that the voices and legitimate interests of developing countries are insufficiently heard.

The international community is absolutely seized, at the moment, with the topic of reforming the international monetary system in the context of a debate over the costs and benefits of globalisation and market-oriented policies. In a way, this is gratifying, because the conclusions of such a loud and visible debate are more likely to be acted upon.

The reflection above is not mine, but that of two prominent IMF officials, Jack Boorman and Mark Allen, made in various sections of their chapter in this volume. Their recognition that a "loud and visible debate" on reform of the global financial system is welcome confirms the need for such reform.

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This book consists of four parts. In the first chapter, in Part I, Stephany Griffith-Jones and José Antonio Ocampo argue that the reform agenda should be broadened to at least deal with two major problems of private capital flows to developing countries: volatility and concentration. To face the problem of volatility, first of all, action is needed by the major industrial countries. According to Griffith-Jones and Ocampo, these countries should take much more account of the "externalities" that their macroeconomic policies generate. But, at the same time, they should also become much more supportive of global regulation of capital flows, timely provision of adequate international liquidity with appropriate conditions when crises emerge, and international arrangements to facilitate orderly debt workouts. To face the problem of the concentration of private flows in a small number of developing countries, official development assistance should be strengthened to fill market gaps in countries and sectors which cannot access private flows. Griffith-Jones and Ocampo concentrate on some aspects of this broader reform agenda. They summarise the problems that the current system faces and use this as a background to analyse the regulatory agenda, both in source and recipient countries, and the issues that relate to the provision of international liquidity and development finance.

The thinking of policymakers in the advanced industrial countries has clearly been influenced by the recent financial turmoil, as the comment by Wouter Raab, a high-level official of the Dutch Ministry of Finance, illustrates: "Having once been an enthusiastic supporter of capital account liberalisation, recent developments have led me to believe that capital account convertibility is not automatically good for every country. In addition to the arguments put forward by Griffith-Jones and Ocampo (consistent and flexible macroeconomic management, adequate prudential regulation and supervision, and well-articulated liability management), I want to mention the size and the development of the domestic capital market. If this market is small in comparison to the size of capital inflows, it would be absolutely incapable of absorbing or dampening any shock from the inflow of foreign capital. It would make the country very vulnerable to the shock-waves coming from the volatile international capital markets. Any country in such a situation would do well to have mechanisms in place to control or regulate the inflow of foreign capital."

The second contribution in Part I comes from two outstanding Korean economists, Yung Chul Park and Yunjong Wang. They emphasise the lack of progress in reforming the international financial system, which they see as the major reason why some East Asian countries have begun to search for a regional defense mechanism. According to the authors, the establishment of a regional credit support mechanism, as proposed in the so-called

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Chiang Mai Initiative, might help prevent the recurrence of crises, and will be a more effective mechanism to manage future crises in East Asia. The group of thirteen East Asian countries of the Chiang Mai Initiative (involving the ten members of ASEAN and China, Japan and Korea) commands a large amount of foreign currency reserves estimated at more than $800 billion. "A mere ten percent of the total amount will be sufficient to provide first and second lines of defense against any speculative attack," write Park and Wang. "If the East Asian countries had been able to cooperate to use part of their reserves to supply short-term liquidity to Thailand in 1997, East Asia could have been spared the misery of recession and social dislocation."

Louis Kasekende, deputy governor of Uganda's central bank, also advocates regional cooperation. Although Africa was largely protected from the contagion problems associated with the East Asian crisis, Kasekende observes that African countries are not fully protected from volatility in international financial markets. The reasons are that many countries of the region are influenced by developments in South Africa – creating the likelihood of second-round effects on African countries – and that African financial systems are prone to volatility. "The markets are thin and lack sophistication and flexibility to effectively deal with minor changes in expectations and the switch in demand from domestic to foreign assets and vice versa," writes Kasekende. "There is, therefore, a strong case for monetary and financial cooperation among groups of countries in Africa."

Part II of the book looks at a new framework for private sector involvement in crisis prevention and management. Mark Allen and Jack Boorman examine this topic in the context of the broader effort to improve the functioning of the international financial system. First, they reflect on the globalisation debate and the lessons from recent international financial crises. Second, they review measures that help reduce the incidence and severity of crises, focusing in particular on the IMF's role. Third, they outline the role of the private sector in preventing crises and in contributing, along with the official sector, to crisis resolution. Finally, they consider related reforms of the IMF and other international institutions.

The ensuing floor discussion raises some interesting subjects. Reacting to a remark by Dutch banker Frans van Loon that there has been too little consultation between the public and private sectors, Allen reports on the setting up of a consultative capital markets group that would meet on a regular basis with the Fund management to discuss capital market issues. However, Allen sees a relationship with the private sector that is too close as problematic, because he is concerned that the Fund might look even more like "the pawns of Wall Street" than it already does. Roy Culpeper, president of the Canadian North-South Institute, insists on involving the

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private sector more in crisis *prevention*. He argues that one should make the private sector less risk prone now rather than waiting until after the crisis breaks out. Amar Bhattacharya, a high-level official of the World Bank, observes that there seems to be an emerging consensus on a number of *ex ante* measures to prevent a financial crisis. They include bankruptcy procedures, collective action clauses, the importance of creditor committees and investor relations, and the development of deep and strong domestic capital markets. Ariel Buira, a former deputy governor of Mexico's central bank, stresses that since crises are part of the essence of market economies, there is a clear need for international rules. Just as every country has *national* legislation for bankruptcies and suspension of payment, there should also be *international* rules to deal with the financial difficulties of troubled debtors.

Part III of the book discusses recent initiatives to improve the regulation and supervision of private capital flows. It includes two chapters, one by Bill White, the chief economist of the Bank for International Settlements in Basel, and another by Yilmaz Akyüz, director of the Division of Globalisation and Development Strategies at UNCTAD.

White reports that recent policy initiatives to regulate and supervise private capital flows have focused on the means to curb possible "excesses" while maintaining or moving carefully towards a regime of free capital flows. He places particular emphasis on evaluating recommendations made recently in various chapters by the Financial Stability Forum (FSF). Four sets of such initiatives are considered in his chapter: those that have to do with transparency (the need for better data, disclosure and indicators of vulnerability); those that have to do with the behaviour of creditors and debtors respectively; and how these recommendations might be implemented in practice.

Akyüz argues that because financial instability is global and systemic there is a need to establish global institutions and mechanisms to improve crisis prevention and management. In his view, the international community has not made much progress in setting up effective global arrangements, concentrating instead on marginal reform and incremental changes. Since the task of protecting themselves against systemic instability falls on developing countries, Akyüz argues that they should seek strategic rather than full integration into the global financial system. He stresses that IMF surveillance has been ineffectual in restraining destabilising influences originating from industrial countries, pointing to the US setting its monetary policy and interest rates regardless of their global impact as a major example.

In the ensuing floor discussion, Bill White agrees with Ariel Buira and Stephany Griffith-Jones that good policies in developing countries often

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lead to excessive capital inflows. As an example, he refers to Mexico where prior to the crisis of the mid-1990s there was a shift towards fiscal prudence, the signing of the NAFTA treaty and the privatisation of the banking system "along with many other welcome reforms." Another example White mentions is Southeast Asia, where a lot of structural changes were undertaken to open up and improve the economy. According to White, the dilemma for policymakers is how to identify the circumstances in which justifiable optimism turns into excessive optimism, and what to do about it.

Part IV of the book focuses on current proposals to reform the IMF to make it more effective, transparent and accountable. Aziz Ali Mohammed, advisor to the chairman of the G-24, addresses some of the issues that have arisen out of the recent worldwide debates on the future role of the IMF in the wake of its management of the Mexican, Asian, Russian and Brazilian financial crises. Mohammed is not interested in the arguments of people on either the far right or the far left end of the political spectrum who advocate the abolition of the IMF. His interest lies in reviewing the arguments of those who want the Fund to play a constructive role as an international credit cooperative serving its universal membership with impartial macroeconomic policy advice, technical assistance, and financing for countries facing temporary balance of payments problems. In this view, the issue is not how to reduce, but rather, how to enlarge the Fund's role in the global economy. This would, for instance, involve transforming the Fund into a genuine lender of last resort and a creator of international liquidity through its prototype SDR mechanism; an umpire in orderly debt negotiations between private and official creditors and their sovereign debtors; an international authority endowed with powers to declare a "standstill" on legal actions that private creditors might take to enforce their claims on sovereign debtors; and finally, an overseer of the international monetary system through the exercise of effective surveillance over the exchange rate policies of the major international currency countries.

In his comment, Ariel Buira adds another key issue: the far too small size of the Fund is the source of many of the problems that have emerged. One of Buira's main observations is that an international financial system based on the currency of a country that runs large and persistent external deficits, i.e. the US, is doomed to be inherently unstable.

In the final floor discussion, Yilmaz Akyüz argues that there is a need to get back to the drawing board to redefine the role of the Fund. He observes that the international financial system has become a kind of patchwork since the 1960s, creating and continually changing all kinds of mechanisms, facilities and functions in response to events in an *ad ho*c way. Other issues raised include: Should the level of economic and global governance be stepped up rather than down, as has been proposed by the

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Meltzer Commission? Should the Fund focus on systemic instability and macroeconomic policy or is the macroeconomic agenda now less important because it is increasingly difficult to narrowly compartmentalise the international agenda?

In the preface to this book, José Antonio Ocampo refers to the Global Financial Governance Initiative (GFGI) of which FONDAD is a part. Besides the GFGI's working group on "Crisis Prevention and Response", from whose first meeting this book results, there are two other working groups, one on "Development Finance" and another on "Institutional Reform". The following pages provide analyses and insights which intend to contribute to the improvement of crisis prevention and response, as well as to the reform of the global financial system.

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Part I
Positive and Negative Aspects of Recent Reform Proposals

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Facing the Volatility and Concentration of Capital Flows

Stephany Griffith-Jones and José Antonio Ocampo

I Introduction

The recent phase of financial turmoil in emerging markets generated a deep sense that fundamental reforms were required in the international financial architecture to prevent and improve the management of financial crises. The crisis led to the recognition that the potential benefits that globalisation offers is being seriously undermined by the high frequency of financial and currency crises. On the other hand, the expectation that rising private capital flows would substitute for decreasing official flows has not materialised. In particular, poor and small countries continue to have very restricted access to private capital markets.

The crisis has set in motion a number of positive responses: a special impetus to international efforts to strengthen standards of prudential regulation and supervision, as well as information; the drafting of codes and guidelines for macroeconomic management; a more preventive focus of IMF surveillance; the approval of new credit lines and the expansion of IMF resources; the recognition that financial liberalisation in the developing world generates risks and must thus be carefully sequenced; the partial acceptance by the IMF that fiscal overkill is inappropriate in adjustment programmes; the improvement of the Highly Indebted Poor Countries (HIPC) Initiative; and a greater emphasis given to the design of adequate social safety nets in developing countries.

Nonetheless, emphasis has been placed almost exclusively on domestic reforms in the capital recipient economies. Though useful, this asymmetrical approach wrongly implies that recent financial crises were largely caused by problems in the recipient economies. Most of the literature on these crises has argued, on the contrary, that imperfections in international capital markets were also a major – if not the main – cause of these crises. Moreover, to a significant extent, some of the domestic policies in recipient economies that led to crises – financial and capital-account liberalisation and pro-cyclical spending policies in the face of booming capital flows – were determined by pressure from private capital markets and even international financial institutions (IFIs). Therefore, significant complementary

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reforms in the source countries and in the approach of IFIs are required.

In some cases, responses during the recent crisis were insufficient or clearly inadequate: IMF conditionality was overextended; the issues associated with stable arrangements to guarantee the coherence of the macroeconomic policies of industrialised countries has not received sufficient scrutiny; strong unwarranted opposition to the 1997 proposal to create an Asian Monetary Fund led to its rapid dismissal, though it was revived in 2000 in the form of a swap arrangement among major Asian countries; more generally, the role which regional institutions can play in an appropriate international financial arrangement has not been given adequate attention; and no significant steps were taken to ensure a fair representation of developing countries in the discussion on reform or in a revised international architecture.

Even though international groups such as the G-22 and, more recently, the G-20 have been created in which some large developing countries participate, these groups are often only loosely related to the decisionmaking process. A major source of concern is that in the fora where important decisions on international reform are made (like the International Monetary and Financial Committee of the IMF), there is a significant underrepresentation of developing countries. Moreover, a very important and valuable new forum, the Financial Stability Forum (FSF), has no representatives from developing countries (for a very good review of these issues, see Culpeper, 2000).

The fairly rapid, though incomplete, normalisation of capital markets gave way to a sense of complacency that has slowed down the reform effort. Moreover, it could lead efforts in the wrong direction. One such step would be to give a new impetus to discussions on capital account convertibility. A negative road would be to follow recommendations (see, for example, Meltzer *et al.*, 2000) to significantly scale down lending – and several important functions and facilities – of the IMF and the World Bank. These recommendations are based on the incorrect diagnosis that government failures (both in developing countries and in the actions of IFIs) and, in particular, moral hazard played the key role in recent crises. On the contrary, as many analysts have stressed, recent crises have been caused, to an important extent, by imperfections in international capital markets linked to problems such as herding and multiple equilibria. Furthermore, private capital flows are still heavily concentrated and do not reach large parts and sectors of the developing world. Such recommendations are also based on the assumption that crises are intense but short, a fact that is contradicted by the fact that capital markets have not completely normalised more than three years after the onset of the Asian crisis.

This indicates that the reform effort in international finance should be

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broadened and deepened. Any relevant international financial reform should address the two major problems manifested by private capital flows to developing countries: *volatility* and *concentration*. To face the first problem, mechanisms need to be created or strengthened at an international level to guarantee macroeconomic and financial stability similar to the mechanisms that exist at the national level. These would include: (1) mechanisms to guarantee the coherence of macroeconomic policies worldwide and, particularly, to guarantee that macroeconomic policies in industrialised countries internalise the externalities that they generate; (2) a world financial regulatory authority; (3) an international lender of last resort that provides adequate liquidity to manage large capital account shocks, as well as emergency financing to manage more traditional shocks; and (4) international arrangements to facilitate debt work-outs. To face the second issue, official development assistance (ODA) should meet internationally agreed targets, and development finance should be strengthened to fill market gaps in countries and sectors which cannot access private flows as well as to catalyse additional private flows where feasible. Actions in these two areas should be complemented by the increasing participation of developing countries in international financial institutions and decisionmaking fora, and in the design of complementary regional and sub-regional mechanisms.

Though much of this agenda may be unrealistic in the short term, it is important that work continues to be done on a blueprint for such a future international financial order, as this type of vision is a valuable guide to current debates and efforts. Such a blueprint clearly argues, if anything, for an increased role of IFIs and other official resources, and for strong international as well as regional and sub-regional institutional arrangements.

This paper concentrates on some aspects of this broader reform agenda. Section II briefly summarises the problems that the current system faces. This serves as a background for analysis of the regulatory agenda, both in source (Section III) and recipient countries (Section IV), and on liquidity (Section V) and development finance (Section VI).

II The Nature of the Problems Facing the System

International capital flows to developing countries have exhibited four outstanding features since the 1990s.[1] First of all, official and private flows have followed opposite patterns: whereas the former have tended to

1 For a full evaluation of trends, see UNCTAD (1999), Chapters III and V, and World Bank (1999, 2000).

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decline, private capital flows have experienced rapid medium-term growth. Secondly, different private flows have exhibited striking differences in terms of stability. Thirdly, private flows have concentrated in middle-income countries, with official flows playing only a very partial redistributive role at a world level. Finally, the instability of private financial flows has required the design of major emergency rescue packages of unprecedented size which have concentrated funds in a few large emerging economies.

The first two patterns are shown in Table 1. Both foreign direct investment (FDI) and all types of private financial flows have experienced strong medium-term growth. However, these flows have exhibited striking differences in terms of stability: whereas FDI has been resilient in the face of crises, private financial flows have experienced strong volatility and "contagion" effects. Although access to markets has tended to be restored faster than in the past, conditions of such access – spreads, maturities and special options to reduce the risks of investors – have deteriorated. Significant instability in capital flows has been the rule since the eruption of the Asian crisis.

In contrast to the growth of private flows, official development finance and, particularly, its largest component, bilateral aid, has lagged behind. Indeed, bilateral aid has fallen in real terms so that in 1998 it reached 0.24 percent of the GDP of industrialised countries, a significant fall with respect to the 0.33 percent of GDP reached in the early-1990s.[2] The reduction in bilateral aid has been the most significant in the case of the largest industrialised countries. This trend has been partly offset, in terms of effective resource transfers, by the increasing share of grants in official development assistance. Contrary to private flows, official finance has been stable and some components of it – particularly balance of payments support and multilateral development finance – have displayed an anti-cyclical character.

The third pattern is shown in Table 2. Private flows have been strongly concentrated in middle-income countries. Low-income nations' share of private financing has been lower than their proportion of the total population of developing countries, a fact that may be expected, but it is also lower than their proportion of developing countries' GDP. This fact is particularly striking in bond financing, commercial banking and portfolio flows, if India is excluded in the latter case. In all these cases, private financing to poor countries is minimal. Low-income countries' share of FDI is also smaller than their contribution to developing countries' GDP. Moreover, a striking feature of FDI is its high concentration in China, which captures, on the contrary, a smaller proportion of financial flows. In

2 World Bank (2000), p. 58.

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Table 1 Net Long-Term Flows to Developing Countries, 1990-1999[a]
(in billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999[b]
Total	98.5	124.0	153.7	219.2	220.4	257.2	313.1	343.7	318.3	290.7
Official flows	55.9	62.3	54.0	53.4	45.9	53.9	31.0	39.9	50.6	52.0
Private flows	42.6	61.6	99.7	165.8	174.5	203.3	282.1	303.9	267.7	238.7
From international capital markets	18.5	26.4	52.2	99.8	85.7	98.3	151.3	133.6	96.8	46.7
Private debt flows	15.7	18.8	38.1	48.8	50.5	62.2	102.1	103.4	81.2	19.1
Commercial bank loans	3.2	5.0	16.4	3.5	8.8	30.4	37.5	51.6	44.6	-11.4
Bonds	1.2	10.9	11.1	36.6	38.2	30.8	62.4	48.9	39.7	25.0
Others	11.3	2.8	10.7	8.7	3.5	1.0	2.2	3.0	-3.1	5.5
Portfolio equity flows	2.8	7.6	14.1	51.0	35.2	36.1	49.2	30.2	15.6	27.6
Foreign direct investment	24.1	35.3	47.5	66.0	88.8	105.0	130.8	170.3	170.9	192.0

Notes:
[a] Net long-term resource flows are defined as net liability transactions of original maturity greater than one year. Although the Republic of Korea is a high-income country, it is included in the developing country aggregate since it is a borrower from the World Bank.
[b] Preliminary.

Source:
World Bank, *Global Development Finance 2000*, (http://www.worldbank.org/prospects/gdf2000/vol1.htm), April 4, 2000.

turn, the high concentration of the most volatile flows in middle-income countries, excluding China, has implied, that issues of financial volatility and contagion are particularly relevant to them.

Thus, low-income countries have been marginalised from private flows and have continued to depend on declining official sources of resource flows. Indeed, they have been strongly dependent on official development assistance, particularly grants, mostly coming in the form of bilateral aid. If we again exclude India, this becomes the only component of the net resource flows to developing countries that is highly progressive, because the share of low-income countries exceeds not only their share of developing countries' GDP but also their proportion of population. This is also marginally true of multilateral financing, excluding the IMF.

The volatility of private financial flows, on the one hand, and its strong concentration in middle-income countries, on the other, have jointly generated the need for exceptional official financing on an unprecedented scale concentrated in a few emerging countries. As a result, IMF (including ESAF) financing has exhibited both strong anti-cyclical behaviour, in relation to private flows, and concentration in a few countries. Both patterns are closely associated because cyclical borrowing by a few large countries is

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Table 2 Net Flow of Resources, 1992-1998
(Annual averages, in billions of dollars and percentages)

	Foreign direct investment		Portfolio equity flows		Grants		Bilateral financing	
	Amount	%	Amount	%	Amount	%	Amount	%
Developing countries	**109.4**	**100.0**	**33.0**	**100.0**	**28.0**	**100.0**	**2.3**	**100.0**
Excluding China	75.4	68.9	29.4	89.2	27.7	99.0	0.3	13.1
Low-income countries	**7.4**	**6.8**	**3.0**	**9.0**	**16.2**	**58.0**	**0.8**	**36.7**
India	1.8	1.6	2.2	6.6	0.5	2.0	-0.3	-11.2
Other countries	5.6	5.1	0.8	2.4	15.7	56.1	1.1	48.0
China[a]	**34.0**	**31.1**	**3.6**	**10.8**	**0.3**	**1.0**	**2.0**	**86.9**
Middle-income countries	**68.0**	**62.1**	**26.4**	**80.2**	**11.4**	**40.9**	**-0.5**	**-23.6**
Argentina	5.2	4.7	1.5	4.5	0.0	0.1	-0.2	-10.1
Brazil	9.8	8.9	3.6	10.9	0.1	0.2	-1.1	-49.6
Russian Federation	1.9	1.8	1.0	3.0	1.0	3.5	0.5	21.6
Indonesia	3.0	2.7	2.1	6.4	0.2	0.8	1.2	52.8
Republic of Koreab	2.0	1.9	3.5	10.5	0.0	0.0	0.1	3.1
Mexico	8.8	8.0	4.5	13.6	0.0	0.1	-0.7	-28.8
Other countries	37.3	34.1	10.3	31.3	10.1	36.2	-0.3	-12.6

Notes:
a The World Bank considered China as a low-income country until 1998. Since 1999, it has been classified as a middle-income country. In this table it is considered as a specific category.
b The World Bank classifies it as a high-income country, but it is included as a middle-income country in *Global Development Finance, 2000*.

the major determinant of the overall cyclical pattern. The latter feature has become even more marked in recent years. As a result, the share of IMF financing going to large borrowers has displayed a strong upward trend over the past two decades.[3]

The volatility exhibited by private capital flows is at the centre of recent debates and is certainly problematic. However, no less important problems are the marginalisation of the poorest countries from private capital flows and the decline in the bilateral aid on which they largely depend. International financial reforms must therefore also be focused on guaranteeing solutions to both of these problems.

3 Griffith-Jones and Ocampo (1999).

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Table 2 (continued)

Multilateral financing (excluding IMF)		Bonds		Commercial bank loans		Other loans		Total		Memo:	
Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	GDP	Population
15.3	**100.0**	**38.2**	**100.0**	**27.5**	**100.0**	**3.7**	**100.0**	**257.4**	**100.0**	**100.0**	**100.0**
13.1	86.0	36.6	95.7	26.7	97.0	0.3	8.7	209.5	81.4	89.3	74.8
5.8	**37.8**	**1.0**	**2.7**	**0.7**	**2.6**	**1.1**	**29.5**	**36.0**	**14.0**	**11.3**	**40.7**
1.0	6.4	0.9	2.4	0.5	1.6	0.2	5.9	6.8	2.6	5.3	19.4
4.8	31.5	0.1	0.3	0.3	0.9	0.9	23.5	29.2	11.4	6.0	21.3
2.1	**14.0**	**1.6**	**4.3**	**0.8**	**3.0**	**3.4**	**91.3**	**47.9**	**18.6**	**10.7**	**25.2**
7.4	**48.2**	**35.6**	**93.0**	**26.0**	**94.4**	**-0.8**	**-20.8**	**173.5**	**67.4**	**78.0**	**34.1**
1.0	6.5	5.9	15.4	1.2	4.5	0.0	-1.3	14.5	5.6	4.7	0.7
0.7	4.9	3.1	8.0	9.6	34.7	-0.5	-13.3	25.2	9.8	10.3	3.3
0.9	5.9	2.3	6.0	1.1	4.0	1.1	29.0	9.8	3.8	6.6	3.1
0.3	2.0	1.4	3.6	0.3	1.2	0.1	2.9	8.6	3.4	3.1	4.0
1.1	7.4	6.8	17.7	0.7	2.5	-0.4	-10.4	13.8	5.3	6.8	0.9
0.3	2.0	4.8	12.6	1.6	5.8	-0.4	-10.9	19.0	7.4	6.1	1.9
3.0	19.6	11.4	29.7	11.5	41.7	-0.6	-16.8	82.7	32.1	40.4	20.1

Sources:
World Bank, *Global Development Finance, 2000* (CD-ROM), (advance release), Washington, D.C., 2000.
World Bank, *World Economic Indicators 1999*, Washington, D.C., 1999 for GDP and population data.

III Financial Crisis Prevention: Regulation in Source Countries

The issues associated with financial crisis prevention have received extensive attention in recent discussions.[4] The most important area of agreement relates to the need to improve the institutional framework in which financial markets operate: to strengthen prudential regulation, supervision and accounting practices of financial systems worldwide, to adopt minimum international standards in these areas and sound principles of corporate governance, and to improve the information provided to financial markets.

4 See, among others, IMF (1998, 1999, 2000a and 2000b), G-7 (1998), UNCTAD (1998), Part One, Chapter IV, United Nations Task Force (1999), Council on Foreign Relations (1999), Miyazawa (1998), Rubin (1999), Summers (2000), Akyüz and Cornford (1999), Eatwell and Taylor (2000), Eichengreen (1999), Griffith-Jones (1998), Griffith-Jones and Ocampo (1999), Ocampo (2000a, 2000b), White (2000a, 2000b), and Wyplosz (1999).

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The recent Working Group reports of the Financial Stability Forum have stressed the crucial role of stricter regulation and supervision of highly leveraged institutions and operations, controls on offshore centres, and the greater weight that should be given to the risks associated with operations with countries engaging in large-scale net borrowing, particularly of a short-term character, to discourage risky financing at the source. Although important progress has been made on defining these issues, far less progress has been made on implementation, particularly at the international level.

Nonetheless, some divergence of opinion remains. First, there is no consensus on institutional arrangements for international regulation. It is clear that the BIS should continue to play a leading role, but this would require an expansion of developing country membership in this organisation and, more broadly, in the definition of all sorts of international standards and codes of conduct. A crucial role will also be played by the Financial Stability Forum to coordinate regulation between countries and financial sectors but, as noted, this also requires that developing countries should participate in its decisionmaking process. Secondly, there are some differences of opinion as to what can be expected from enhanced prudential regulation and supervision, given their inherent limitations. Regulations will tend to lag behind financial innovations, supervisors are likely to face significant information problems, and macroeconomic events may overwhelm even well-regulated systems. Thirdly, traditional prudential regulation and supervision tend to have pro-cyclical macroeconomic effects: they may be unable to avoid excessive risk-taking during the booms and accelerate the credit crunch during crises, when bad loans become evident and the effects of provisioning standards are thus felt. Finally, there are disagreements on the best methodologies for regulation and in particular on how large a role should be given to market actors (e.g. rating agencies) themselves.

The Welfare-Enhancing Effects of Regulation

In spite of the limitations of international financial regulation, a very clear case can be made that strengthening it will be welfare enhancing. This is particularly true, if, as we discuss below, such regulation has explicit counter-cyclical elements to compensate for inherent pro-cyclical behaviour by financial actors, that can also partly characterise traditional financial regulation.

Indeed, there is growing support for the view that the welfare of both source and recipient countries can be increased by regulatory changes (through measures in source and/or recipient countries) that would reduce

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excessive lending and borrowing. It is noteworthy that Alan Greenspan proposed – for the case of interbank lending – that it could be appropriate for either borrowing or lending countries to impose reserve requirements to "deter aberrant borrowing: sovereigns could charge an explicit premium, or could impose reserve requirements, earning low or even zero interest rates, on interbank liabilities. Increasing the capital charge on lending banks, instead of on borrowing banks, might also be effective" (Greenspan, 1998).

There is growing recognition that it may often be desirable to regulate excessive surges of potentially reversible capital flows in recipient countries. An important part of the responsibility for discouraging such excessive reversible inflows, as well as managing them, lies with the recipient countries. However, the experience of the 1990s, with a very large scale of international funds – compared to the small size of developing country markets – leads to the question of whether measures to discourage excessive short-term flows by recipient countries are sufficient to deal with capital surges and the risk of their reversal.

Aizenman and Turnovsky (1999) have formalised such analysis by developing a rigorous model that considers the impact via externalities of reserve requirements on international loans (both in lending and recipient countries) on the welfare of both categories of countries. In particular, they evaluate the macroeconomic impact of reserve requirements in a second-best world where there is moral hazard due to likely bailouts on the lender's side and sovereign risk on the borrower's side; both generate large negative externalities on welfare. The general conclusion of their model is that the introduction of a reserve requirement in either the source or the recipient country reduces the risk of default and improves welfare in both countries.

Removing Distortions and Introducing Anti-Cyclical Provisions in Banking Regulation

There is broad agreement that the 1988 Basel Capital Accord was a major step forward in the design of minimum common standards for banking regulation. Nonetheless, it has also generated some distortions and, particularly, has maintained incentives for bank lending to behave in a pro-cyclical fashion. Due to significantly lower capital adequacy requirements for short-term lending than for long-term lending, it contributed to the build up of short-term bank lending and its reversal in East Asia and elsewhere. The new proposal published in June 1999 attempts to address this distortion by reducing somewhat (though perhaps not sufficiently) the differential between capital adequacy for short-term and other lending.

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The new Basel recommendations, though including many positive elements (see, for example, Cailloux and Griffith-Jones, 1999), also have suggestions that are widely seen as problematic. These include increasing the role of rating agencies to determine country weightings for capital adequacy, which could aggravate the pro-cyclical nature of bank lending, thus encouraging larger surges and larger reversals – clearly an undesirable outcome. There is significant evidence that rating agencies act in a pro-cyclical fashion. Indeed, as pointed out by various authors (see, for example, Turner, 2000; and Reisen, 1999), rating agencies failed to downgrade the East Asian countries before the crisis and then worsened it because they brought down the ratings as the crisis unfolded. Reisen and von Maltzan (1999) find that sovereign ratings lag rather than lead the market.

The major problem with current regulatory practices, including the Basel accord is, however, that they do not serve to moderate pro-cyclical market behaviour (Ocampo, 2000a, 2000b). Indeed, current rules do not seem adequate to internalise the rising risks which banks incur during booms. On the contrary, during crises, increased amounts of bad loans (which are usually not fully covered by provisions) will impact upon the lending bank's capital and can lead to a credit crunch if the bank is already facing a relatively low capital asset ratio, and – as is likely in a recession – is unable to raise new capital.

The answer thus may lie in the implementation of an explicit counter-cyclical mechanism which would, in boom periods, and in contrast to ratings, dampen excess bank lending. In periods of slowdown and of scarcity of finance, the new mechanism should not further accentuate the decline in lending but rather encourage it. Counter-cyclical elements can also be introduced in regulating other financial agents (see below, for mutual funds).

There would be two linked objectives for introducing counter-cyclical elements into regulation. One would be to help smooth capital flows and the other would be to smooth the impact of volatile capital flows on the domestic financial system and therefore on the real economy. Introducing counter-cyclical elements into regulation would help build a link between the more microeconomic risks on which regulators have traditionally tended to focus and the macroeconomic risks which are becoming increasingly important, both nationally and internationally. Counter-cyclical elements in regulation related to bank lending could be applied, either internationally, nationally or at both levels.

Several mechanisms could be used to introduce a counter-cyclical element into regulation of bank lending. One mechanism would be to require a higher capital asset ratio in times of boom, and to allow banks to use the additional cushion provided by the higher ratio so they could sustain lend-

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ing in times of recession at a lower capital asset ratio. Some practical difficulties may arise in implementing such a mechanism, of which the most serious one may be getting international agreement on a general formula for cyclically adjusted capital asset ratios.

A second mechanism for introducing counter-cyclical elements in bank lending regulation is to strengthen provisioning rules during booms, requiring, for example, banks to provision larger proportions of due loans or special provisions linked to the rapid increase in lending. Prudential supervision should certainly be strengthened for institutions experiencing a very rapid growth of lending. Also, generally precautionary provisioning could be encouraged or forced on intermediaries to cover normal cyclical risks (Turner, 2000). Any of these mechanisms would allow for provisions built up in good times to be used in bad times, without affecting reported capital. A problem that must be faced is the limited tax deductibility of precautionary provisioning. The large-scale application of this mechanism would require a change in tax laws, as indeed was done in the late-1980s in the UK.

A third mechanism, relevant particularly for domestic bank lending, is for regulators to place caps on the value of assets (such as real estate or stocks and shares) to be acceptable as collateral, when the value of such assets has risen sharply in a boom and is at risk of declining sharply in a recession. Rules could be used such as averaging values for the last five years, or accepting only 50 percent of current prices in the peak of a boom. The latter mechanism seems to have the least problems of implementation (it is already applied in some jurisdictions, e.g. Hong Kong).

A fourth possible counter-cyclical mechanism would be to limit or discourage lending for property, construction and personal consumption, as these items tend to increase substantially – and are often even a major factor – in booms (McKinnon and Pill, 1997). A possible implementation problem would be that it may be difficult to verify final use of credit, allowing such measures to be partially evaded.

Furthermore, regulators should be flexible in the downturn, particularly to allow banks to easily use cushions (e.g. of capital or of provisioning) in times of recession. It may even be advisable, if a recession is very serious, to allow capital asset ratios to fall below normally required levels, with the understanding that they will be rebuilt as soon as the economy starts recovering. A tension may arise here between the regulatory concerns about individual bank liquidity and solvency and the macroeconomic externalities of their actions, particularly in recessions.

Several issues require further scrutiny. What are the best mechanisms through which counter-cyclical measures should be introduced (e.g. flexible capital adequacy ratios, higher provisioning against losses, more

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"realistic" pricing of collateral)? How can the distinction between a temporary boom and a permanent increase in growth be best made? After what period of "boom" should regulatory changes be introduced? How large should such changes be? Should such measures be introduced for both international and domestic lending, or preferably for one of them? The previous remarks provide only initial thoughts on these important issues.

Filling Gaps

The broad welfare case for applying reserve requirements in both source and recipient countries can also be applied to institutional investors and, in particular, to mutual funds, which grew in relation to banks in the 1990s. This occurred both within the developed countries, and particularly within the US – where mutual funds receive more than 50 percent of total deposits in the financial system – and in capital flows from developed to developing countries (see d'Arista and Griffith-Jones, 2000). The narrowing of differences between banks and institutional investors, and the fact that securities markets and thus mutual funds also have access to the lender of last resort – nationally in the US but, more importantly, in our context also internationally, due to the frequent rescue packages put together by the IMF in recent serious currency crises – suggests the importance of improving prudential standards for institutional investors such as mutual funds.

As regards portfolio flows to emerging markets, there is an important regulatory gap, because there is presently no regulatory framework internationally for taking account of market or credit risks on flows originating in institutional investors, such as mutual funds (and, more broadly, for flows originating in non-bank institutions). This important regulatory gap needs to be filled, both to protect retail investors in developed countries and protect developing countries from the negative effects of excessively large and potentially reversible portfolio flows.

Given the very liquid nature of their investments, institutional investors can play an important role in contributing to developing country currency crises (for recent evidence, see Kaminsky, Schmukler and Lyons, 1999). It seems important, therefore, to introduce some counter-cyclical regulation to discourage excessive surges of portfolio flows. This could perhaps be best achieved by a variable risk-weighted cash requirement for institutional investors. These cash requirements would be placed as interest-bearing deposits in commercial banks. Introducing a dynamic risk-weighted cash requirement for mutual funds (and perhaps other institutional investors) is in the mainstream of current regulatory thinking and would require that standards be provided by relevant regulatory authorities and/or agreed

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upon internationally. The guidelines for macroeconomic risk, which would determine the cash requirement, would take into account vulnerability variables as defined by the IMF and BIS (for a more detailed discussion of this proposal, see Griffith-Jones, 2000).

The September 1998 Emerging Markets IOSCO Report (IOSCO, 1998) has in fact described in some detail and evaluated rather positively the above proposal. This report emphasised that "there appears to be scope – and an urgent need for further work. This is very likely to require a multilateral effort – i.e. by regulators from both source and recipient countries in collaboration with the industry."

As regards highly-leveraged institutions (HLIs), the corresponding FSF Working Group rightly focused on two problems: systemic risk linked to high leverage and reduction of market and economic impact of collapse of unregulated HLIs. Particular emphasis was placed on their activities in small- and medium-sized open economies where the potential damage that can be caused by large and concentrated positions can seriously amplify market pressures.

The Working Group considered the possibility of introducing formal direct regulation of currently unregulated institutions. This would include a licensing system, minimum capital and liquidity standards, large exposure limits, minimum standards for risk management, and even an enforcement regime with fines for transgressions. Such regulation was seen to have several very desirable effects, such as regular oversight and the reduction in the likelihood of disruptive market events. However, due to what were seen as both philosophical and practical problems, the Working Group did not recommend applying a system of direct regulation to currently unregulated HLIs at this stage, though it did not reject the possibility of establishing such a regime in the future. It emphasised that the failure to carry through their recommended measures would prompt such reconsideration (FSF, 2000a).

The philosophical objection relates to the fact that direct regulation would not be aimed at investor protection (as investors are sufficiently wealthy or sophisticated to do their own due diligence), but on the mitigation of systemic risk. Nonetheless, it can be argued that mitigation of systemic risk is also an increasingly valid regulatory aim. There are also practical objections, including how to avoid leakage through offshore centres. However, current efforts to improve and complete regulation in off-shore centres should help overcome those problems (see FSF, 2000b). Other practical technical issues are more valid, including the need to adapt capital adequacy and large exposure rules to the specific risk profile of HLIs. This should be done in ways that avoid the adverse effects that capital requirement could have on the efficiency and liquidity of markets in which HLIs

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are significant participants. This seems particularly important in a context when several large hedge funds have been wound down, which may diminish some of the negative impacts they had in recent crises, but could, according to some observers, deprive markets of contrarian actors, with some useful roles to play in financial markets.

The need to directly regulate HLIs may need to be revisited, partly in relation to the implementation (or not) of other measures recommended by the FSF Working Group and their perceived impact.

IV Capital Account and Prudential Regulations in Recipient Countries

Whatever international system is developed, it is clear that it will continue to be a very imperfect "financial safety net". Consequently, a degree of "self-insurance" by countries will continue to be essential to avoid financial crises, as well as to avoid "moral hazard" issues intrinsic to any support scheme. This raises issues as to the national policies necessary to guarantee financial stability and the areas where national autonomy should be maintained. At least in the developing countries, national autonomy should be maintained in two critical areas: the management of the capital account and the choice of the exchange rate regime. The choice of development strategies is obviously an additional, essential realm in which national autonomy should prevail.

The experience of developing countries indicates that the management of capital account volatility requires: (1) consistent and flexible macroeconomic management; (2) strong prudential regulation and supervision of domestic financial systems; and (3) equally strong "liability policies", aimed at inducing good public and private external and domestic debt profiles.[5] Despite the traditional emphasis on crisis management, the focus of the authorities should instead be on the management of booms, since it is in the periods of euphoria of capital inflows, trade expansion and terms-of-trade improvements that crises are incubated. Crisis prevention is thus, essentially, an issue of the adequate management of boom periods. Most of all, unsustainable expansion of spending and currency overvaluation, facilitated by extraordinary access to external financing or temporary export windfalls, should be avoided.

The regulation of capital inflows may be essential in open developing

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5 The literature on national policies is extensive. See, among recent contributions, ECLAC (2000, ch. 8); World Bank (1998), Chapter 3; Ffrench-Davis (2000); Helleiner (1997); and *Ocampo (2000c)*.

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economies as a mechanism for monetary and domestic credit restraint and for avoiding unsustainable exchange rate appreciation during booms. Although some appreciation may be inevitable and even an efficient way to absorb the increased supply of foreign exchange, an excessive revaluation may also generate irreversible "Dutch disease" effects. The macroeconomic effects of the regulation of inflows have, unfortunately, received much less attention in the past than the issue of the regulation of outflows during crises. Regulations governing outflows may also play a role as a way to avoid the overshooting of interest or exchange rates, which may have adverse macroeconomic effects, including the greater risk of domestic financial crises. Such regulations are also essential to put in place debt standstill and orderly debt workout procedures. They generate, nonetheless, credibility issues that should not be ignored by the authorities and they would be subject to considerable leakage if improvised during a crisis (see below). It is essential, of course, that any sort of capital account regulation be used as a complement and not a substitute for fundamental macroeconomic adjustment.

Simple rules are preferable to complex ones, particularly in underdeveloped regulatory systems. In this sense, quantitative controls (e.g. flat prohibitions on certain activities or operations) may actually be preferable to price-based signals. An interesting, simple price-based policy tool is reserve requirements on capital inflows, such as those used by Chile and Colombia in the 1990s. These requirements are a particular type of Tobin tax, but the equivalent tax rates (3 percent in the case of Chile for one-year loans and 10 percent or more in Colombia during the boom) are much higher than the percentage proposed for an international Tobin tax. The effects of this system on the magnitude of flows have been the subject of a heated controversy. In any case, since tax avoidance is costly and short- and long-term borrowing are not perfect substitutes, the magnitude of flows should also be affected.[6] A basic advantage of this instrument is that it is targeted at capital inflows and is thus a preventive policy tool. It also has other specific advantages: it is a non-discriminatory price instrument[7] and affects both financial and non-financial agents, thus avoiding arbitration between domestic and external borrowing.

Any mechanism in place must also meet an additional requirement: it must have adequate institutional backing. A *permanent* system of capital account regulations, which can be strengthened or loosened throughout

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6 Agosin (1998), Agosin and Ffrench-Davis (1999), Le Fort and Lehman (2000), Ocampo and Tovar (1999), and Villar and Rincón (2000).

7 Ocampo (2000a). Indeed, this instrument is similar to practices used by private agents, such as the sales fees imposed by mutual funds on investments held for a short period in order to discourage short-term holdings. See J. P. Morgan (1998), p. 23.

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the business cycles, is thus preferable to the alternation of free capital movements during booms and quantitative controls during crises. Indeed, the latter system may be totally ineffective if improvised during a crisis, simply because the administrative machinery to make it effective is not operative, and it may thus lead to massive evasion or avoidance of controls. Such a system is also pro-cyclical and leaves aside the most important lesson learned about crisis prevention: avoid overborrowing during booms and thus target primarily capital inflows rather than outflows.

From the point of view of borrowing economies, there is growing agreement that in domestic prudential regulation and supervision greater weight needs to be given to the accumulation of short-term liabilities in foreign currencies, to risks associated with the rapid growth of credit, and to currency mismatches of assets and liabilities. This implies that not only the micro- but also the macroeconomic risks typical of developing countries should be taken into account. In particular, due account should be taken of the links between domestic financial risk and changes in key macroeconomic policy instruments, notably exchange and interest rates. Moreover, given these macroeconomic links, prudential regulations should be strengthened during years of financial euphoria to address the increasing risks being incurred by financial intermediaries. These links also imply that the application of contractionary monetary or credit policies during booms (e.g. higher reserve requirements or ceilings on the growth of domestic credit) are strongly complementary to stricter prudential regulation and supervision.

Due to the important externalities which large non-financial firms can generate for the domestic financial sector, particularly in the context of exchange rate depreciation, the external liability exposure of these firms should also be subject to some regulation. Such exposure should be taken into account in risk evaluation, by requiring stricter rules on classification and provisioning standards for domestic lending to non-financial firms with high currency mismatches. Tax provisions (e.g. explicit taxation on external borrowing or exposure, or limits on the deductibility of exchange rate losses) and rules that force non-financial firms to disclose information on their external liabilities may also be relevant complements to such prudential rules. It is unclear, however, whether a system based on such tax and prudential rules is a substitute for direct capital account regulations. A basic advantage of this alternative is that it would facilitate financial integration. However, it would not tackle the direct source of the problem and would be more complex than a simple price-based instrument such as the Chilean-Colombian reserve requirement.

It should also be noted that, due to the strong link between financial and macroeconomic risks, prudential standards should probably be stricter in

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developing countries. This would be reflected, however, in higher spreads on domestic lending, generating strong incentives for non-financial firms to borrow directly abroad. This confirms that capital account regulations are complementary to stronger prudential regulation.

As the recent literature has emphasised and as the recent experience of many developing countries indicates, crises are associated not only with high debt ratios but also with inadequate debt profiles. The basic reason is that, under uncertain conditions, financial markets respond to gross – rather than only to net – financing requirements, or in other words, the rollover of short-term debts is not neutral in financial terms. This gives an essential role to "liability policies" aimed at improving debt profiles. Although improving the external debt profile should be the central role of such policies, there is a strong complementary relationship between good external and internal debt profiles. Hence, excessive short-term domestic borrowing may force a government that is trying to roll over debt during a crisis to raise interest rates in order to avoid capital flight by investors in government bonds. Also, excessively high short-term private liabilities increase the risks perceived by foreign lenders during crises, a fact that may induce a stronger contraction of external lending.

In the case of the public sector, direct controls by the Ministry of Finance are the appropriate instrument of a liability policy. Exchange rate flexibility may deter some short-term private flows and may thus partly operate as a "liability policy", but its effects are limited. Direct controls on inflows may also be an appropriate instrument to achieve a better private debt profile. A flat tax or reserve requirement on external borrowing has positive effects on the debt profile, as it induces longer-term borrowing, for which the tax can be spread over a longer time period, and is easier to administer. This effect has been subject to less controversy than the effect of such regulations on the magnitude of inflows.

The former analysis indicates that capital account regulations may be an essential instrument for crisis prevention and management in the face of strong volatility of capital flows and weak international financial safety nets. They may be complementary to other desirable policies in the macroeconomic and financial regulatory areas, and in some cases they may actually be preferable to the alternatives. The foregoing analysis argues, moreover, in favour of using capital account regulations as a *permanent* policy instrument. Of course, they are not foolproof, and some developing countries may prefer to use policy mixes that avoid their use (e.g. more active use of fiscal and exchange rate policies, as well as of prudential regulations) or may prefer a less interventionist environment even at the cost of greater GDP volatility. Thus, the most compelling argument is for maintaining the autonomy of developing countries to manage their capital accounts.

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There are actually no strong arguments in favour of moving towards capital account convertibility.[8] There is no evidence that capital mobility leads to an efficient smoothing of expenditures in developing countries through the business cycle. On the contrary, there is strong evidence that in these countries the volatility of capital flows is an additional source of instability. There is also no conclusive evidence of an association between capital account liberalisation and economic growth, and there are some indications that point in the opposite direction.[9] A simple way to pose the issue is to argue that, even if it were true that freer capital flows, through their effects on a more efficient savings-investment allocation process, have positive effects on growth, the additional volatility associated with freer capital markets has the opposite effect. Furthermore, the absence of an adequate international financial safety net is an equally important argument in this connection. Why should developing countries give up this degree of freedom if they do not have access to an adequate amount of contingency financing with well-defined conditionality rules, and no internationally agreed standstills and debt workout procedures?

V Emergency and Counter-Cyclical Financing

The enhanced provision of emergency financing during crises is another pillar of the system to prevent and manage financial crises. Although the direct focus of emergency financing is crisis management, it also has crisis prevention effects, as it plays an essential role in avoiding the destabilising expectations that are responsible for the deepening and spreading of crises (contagion) and, ultimately, for systemic failures. This has been, in fact, the essential defense for the role that central banks play at the national level as lenders of last resort. Current international arrangements are weaker in this regard. Indeed, the IMF provides "emergency financing" but certainly not *liquidity*, a fact that is reflected in the lack of automaticity in the availability of financing during crises.[10] Even though the Fund has the capacity to create fiat money, through the issue of Special Drawing Rights (SDRs), it has used this capacity only in the past and in a very limited way.

It is important to emphasise that emergency financing is not a substitute but a complement to strong regulation and debt workout procedures.

8 For a more extensive analysis of this subject, see United Nations Task Force (1999), UNCTAD (1998), Part One, Chapter IV, ECLAC (1998), Part III, Eichengreen (1999), Griffith-Jones (1998), Grilli and Milesi-Ferreti (1995), Krugman (1998a, 1998b), Ocampo (2000a) and Rodrik (1998).

9 See, in particular, Eatwell (1996), Rodrik (1998) and, for Latin America, Ocampo (1999).

10 This important distinction is made by Helleiner (1999). For a fuller discussion of this issue and its relation to IMF access to adequate resources, see Mohammed (1999).

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Regulatory changes help smooth capital flows to emerging markets. Together with private sector involvement in crisis resolution, through adequate debt workouts, they are essential to avoid moral hazard. However, the view that the appropriate way to combat moral hazard is by scaling down the role of the IMF in providing financial packages would make crises even more costly and/or lead to a sharp reduction in private flows to developing countries. In the current context of large and volatile private flows there may even be a case for significantly larger official emergency financing than currently exists. The great majority of recent reports support this view, with the major exception of the Meltzer Report (although the minority view in Meltzer also strongly values the broad role of the IMF).

The main lessons from recent crises are that: (1) as a preventive measure, wider use should be made of private contingency credit lines that are agreed during periods of adequate access to capital markets, following the (partly successful) pioneering experiences of some emerging economies; (2) large-scale funding may be required, though not all of it needs to be disbursed if support programmes rapidly restore market confidence; (3) funds should be made available *before* – rather than after – international reserves reach critically low levels; and (4) that, due to strong contagion effects, contingency financing may be required even by countries that do not exhibit fundamental disequilibria. Positive measures have been adopted in this area, including a significant expansion of IMF resources through a quota increase and the New Arrangements to Borrow, which finally entered into effect in late 1998; the launching of a new window in December 1997 to finance exceptional borrowing requirements during crises; and the creation of the Contingent Credit Line in April 1999 to provide financing to countries facing contagion and its redesign in September 2000.

The major controversies relate to inadequate funding, the design of some specific credit lines and the broadening scope of conditionality. With respect to the first issue, bilateral financing and contributions to the IMF will continue to be scarce during crises. This might reduce the stabilising effects of rescue packages, if the market deems that the intervening authorities (the IMF plus the major industrial countries) are unable or unwilling to supply funds in the quantities required. As bilateral financing and contributions to the IMF will continue to be scarce and unreliable in crises, the best solution may be to allow additional issues of SDRs during episodes of world financial stress; these funds could be destroyed once financial conditions normalise.[11] This procedure would create an anti-cyclical element

11 See United Nations Task Force (1999), Council on Foreign Relations (1999), Group of 24 (2000), Camdessus (2000).

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in world liquidity management and would give SDRs an enhanced role in world finance, a principle that developing countries have advocated in the past and should continue to endorse in the future. Second-best alternatives are to make a more active use of central bank swap arrangements under IMF or BIS leadership, and or to allow the IMF to raise the resources needed in the market.

It is useful to put the discussion of the second issue in the broader context of the functions that IMF facilities have to perform in today's world. There is, first of all, the traditional need for emergency financing to face balance of payments crises due to two sets of causes or a mixture of both: (a) inconsistent macroeconomic policies, and (b) traditional external shocks, such as a deterioration in the terms of trade, increased interest rates in developed countries, and/or a slow-down in developed countries' growth. The Stand-By Arrangement (SBA), the Extended Fund Facility (EFF) and the recently modified Compensatory Financing Facility (CFF) have for some time dealt with this traditional need.

There is, secondly, the new need for specific credit lines that are linked to "21st century-style" currency and financial crises, which are mainly caused by the interaction of volatile capital flows and domestic financial fragilities, and which can spread via contagion amongst countries (including those with fairly sound macroeconomic fundamentals). The challenges here are both improved crisis prevention and better crisis management if these crises do occur. Recent crises have led to the creation of the Supplemental Reserve Facility (SRF) and the above mentioned Contingent Credit Line (CCL). While these facilities reflect the clear new need for significantly enhanced public liquidity provision in a globalised world, where the risk of crises has significantly increased, they do not go as far as may be desirable and necessary in the provision of official liquidity financing.

There is, thirdly, the special need to provide credit lines to low-income countries, to strengthen in a sustainable way their balance of payments position, whilst supporting growth and poverty reduction. In 1999, the traditional facility in this area, ESAF was transformed into the Poverty Reduction and Growth Facility (PRGF).

This broad menu is essential to respond to the call by the G-24 for the Bretton Woods institutions to "maintain a range of instruments to address the needs of their diverse membership". It should be added that in the first two cases, but possibly also in the third, IMF lending should be perceived as "a bridge to and from private sector lending" (Summers, 2000).

Some IMF facilities seem to function fairly well, as regards the scale of financing they provide, and the circumstances under which they are used, although the nature and the scope of the conditionality applied should be

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narrower, as will be argued below. The facilities that function reasonably well to meet current needs are the stand-by arrangement (SBA), which will remain the Fund's main instrument, and the Extended Fund Facility (EFF). Some observers have challenged the value of the EFF, in spite of its importance to developing countries because it allows longer periods of adjustment to balance of payments disequilibria of a structural character. The simplified CFF can also perform a useful function in helping primary-producing countries cope with exogenously determined terms of trade shocks. However, the CFF should be expanded to cover the full extent of export shortfalls, and its conditionality reduced, given the fact that the cause of the problem is international. The fairly recently created Supplemental Reserve Facility (SRF), designed to provide exceptional financing during crises, has also worked well, even though resource limitations make it fall short of what would be desirable in today's world.

The CCL was created as "a precautionary line of defense readily available against future balance of payments problems that might arise from international financial contagion" (IMF, 1999). The philosophy of the IMF moving more strongly into precautionary lending – to reduce the chances of countries being caught by contagion, and give leverage to the IMF to encourage countries to pursue policies that would make crises less likely – is clearly the right one. However, the fact that the CCL has not been used since its creation in April 1999 reflects design problems that were only partly corrected in the recent redesign of this facility. These include: (a) the limited scale of the facility; (b) the lack of automatic triggering in the original design, which was partially corrected by making "activation" a fairly automatic process, though still requiring a "post-activation" review that would result in a conditional adjustment programme; (c) the "two-phase or double conditionality" that characterises such design; and (d) the fear of countries that private lenders and investors might see the use of the CCL as "the ambulance outside the door", which could contribute rather than deter a speculative attack or withdrawal of flows.

An active monitoring of the experience with the CCL is thus necessary to improve this clearly innovative facility. As pointed out above, if these and other new facilities (the SRF, in particular) are to be made more effective, they must be accompanied by better regulation to avoid problems of excessive moral hazard. Debt standstills and orderly debt workouts would also help reduce the excessive costs borne by debtor countries in crises under present arrangements (for detailed discussions, see UNCTAD, 1998, and United Nations Task Force, 1999). However, care must be taken in designing such measures so that they do not excessively discourage private flows to developing countries nor significantly increase their cost (Soros, 2000).

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As regards the issue of Fund conditionality, it is now accepted that it should be streamlined, refocusing on the IMF's central competencies (see IMF International Monetary and Financial Committee, 2000), thus reversing the trend towards increase in its areas and scope over the past two decades. Furthermore, while conditionality is clearly valuable when domestic policies are the source of macroeconomic diseliquibria that lead to balance of payments and financial difficulties, its relevance is unclear when difficulties are generated by external shocks such as contagion.

As Rodrik (1999) clearly warned in relation to the recent widening of conditionality, "An unappreciated irony is that conditionality on developing countries is being ratcheted up at precisely the moment when our comprehension of how the global economy works and what small countries need to do to prosper within it has been revealed to be strongly lacking (...) The reality is that our prescriptions often go considerably beyond what can be supported by careful theoretical reasoning or empirical demonstration". Conditionality should thus be carefully tailored to the specific circumstances of the particular balance of payments problem faced.

The Fund's core competence has traditionally been in macroeconomic policy and has rightly been expanding into financial vulnerabilities, as their interactions with the macroeconomy are strong. The new emphasis on growth and poverty reduction as a key aim for Fund programmes and of countries' macroeconomic policies, especially in low-income countries, is clearly welcome, as is its greater collaboration with the World Bank on these issues. However, it should not lead the Fund into involvement in detailed poverty-related conditionality. Similarly, great care must be taken that in both middle-income and low-income countries, the large number of standards and codes of conduct that have arisen after the Asian crisis, however useful they may be individually, do not collectively pose an excessive burden (via IMF conditionality) on countries' administration and policymaking. Indeed, it seems best if implementation of such standards remain voluntary. On the other hand, to ensure that Fund conditionality truly contributes to growth, automatic rules could be included in Fund agreements with countries to ease the restrictions of the adjustment programme, should evidence of overkill become clear.

Finally, but most importantly, the principle of ownership of policies should be respected, not just in rhetoric but in actual practice, and should cover all areas of policies, including short- and long-term macroeconomic policies and poverty-reduction strategies. This can only be possible if policy alternatives suggested by the authorities are actually discussed, even if they contradict the traditional preferences of IMF and World Bank programmes. Indeed, the principle of ownership can only be effectively pursued in the context of a broad policy discussion which goes beyond the nar-

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row range of alternatives that have been the focus of both macroeconomic and structural conditionality over the past two decades.

VI Development Finance

Private capital flows can and should play not only an important, but hopefully a growing role in international development finance. However, there are clear and important market gaps in private lending and investing in developing countries, which can only be filled by official development assistance and multilateral lending. There are also important circumstances where such aid and multilateral lending can help catalyse additional developmentally valuable private flows, which would otherwise not take place. Many private bankers and institutional investors are aware of such limitations and welcome official flows both to fill market gaps and to help catalyse new private flows.

The unwillingness of private lenders and investors to provide long-term financing is particularly critical for low-income countries (see Table 2). This is also true for smaller economies (even middle-income ones), given that entering these economies has high transaction costs. Therefore, the share of multilateral lending in total external lending tends to be far higher in smaller than in larger countries. Also, private lenders and investors are less willing to channel resources to activities where the social returns (such as education, health and sustainable development) may be higher than the private returns, especially in the short to medium term, or that are riskier but developmentally essential (such as lending to the financial sector in times of crises).

Official financing is provided on clearly advantageous terms and conditions as Table 3 indicates. Loans from both bilateral and multilateral sources have longer payback periods and lower interest rates than private credit. These characteristics are especially strong in new lending to the relatively less developed countries, but are equally valid for middle-income ones. Indeed, a very large proportion of bank lending to developing countries is very short term – less than one year. According to BIS data, in mid-1999, the proportion of short-term lending to total bank lending for all developing countries was 49.6 percent, a proportion that had been even higher in the previous years. As a result, any large shift from official to private sector borrowing would significantly decrease the average maturity of the debt of these countries, which would increase, in turn, the risk of volatility and *reversibility* of such flows.

It should be added that these problems are even more acute in domestic financing. In certain developed economies (e.g. Greece or Portugal), but

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Table 3 Developing Countries: Average Terms of New Commitments

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Average maturity (years)									
Official									
All Developing Countries	**22.2**	**20.9**	**21.1**	**21.4**	**22.1**	**19.2**	**21.2**	**20.1**	**18.5**
Income Groups									
Low Income	27.0	25.9	26.8	25.4	26.2	24.4	26.8	26.2	26.6
Middle Income	18.8	17.8	17.0	18.1	18.4	15.8	17.2	17.2	14.2
Private									
All Developing Countries	**13.9**	**10.2**	**10.0**	**9.4**	**8.9**	**7.4**	**8.3**	**10.0**	**8.8**
Income Groups									
Low Income	13.7	11.5	12.3	11.3	11.2	8.0	7.5	7.0	7.0
Middle Income	13.9	9.9	9.0	8.4	8.1	7.2	8.6	10.8	9.0
Average interest (%)									
Official									
All Developing Countries	**5.5**	**5.5**	**5.3**	**4.8**	**4.9**	**5.8**	**4.8**	**5.4**	**5.2**
Income Groups									
Low Income	4.0	4.5	3.8	3.8	3.9	4.5	3.9	4.2	3.7
Middle Income	6.6	6.1	6.4	5.6	5.8	6.7	5.6	6.0	6.0
Private									
All Developing Countries	**8.5**	**7.8**	**6.8**	**6.3**	**6.3**	**6.4**	**7.3**	**7.3**	**7.9**
Income Groups									
Low Income	7.9	7.5	6.7	6.0	5.7	6.4	6.6	6.4	6.9
Middle Income	8.8	7.8	6.9	6.4	6.5	6.4	7.5	7.5	8.0

Source:
World Bank, *Global Development Finance, 2000*, Washington, D.C., April.

more so in middle-income developing countries and even more in low-income developing countries, domestic capital and financial markets are relatively underdeveloped, especially for long-term maturities. Country risk is seen as relatively higher than elsewhere, which means that only shorter maturities are available.

Not only is multilateral lending more long term, it also tends to be counter-cyclical. During the debt crisis of the 1980s, World Bank lending increased significantly, thus helping to compensate the contractionary effects on the economy of the large falls in private lending. A similar pattern has been observed during the years of contraction in private flows to developing countries that was unleashed by the Asian crisis (see Griffith-Jones and Ocampo, 1999, Table 4). As we will see below, the role that development banks play in this regard is complementary to that of the IMF.

Not only does multilateral lending step in to fill important market gaps; also, of clear importance, is its catalytic role in encouraging additional private flows, especially to countries (e.g. poorer and smaller countries) or

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sectors (e.g. social and infrastructure) with limited access to private finance. It can also play a useful role in supporting the renewal of capital flows after crises. The preferential relations of development banks to countries are seen as the crucial factor in reducing the risks to private lenders or investors. It should be emphasised that the financial corporations associated to development banks play an essential role in this regard. Private lenders and investors clearly appreciate and value this catalytic role.

For low-income countries, the major issue is the reversal of trends in ODA flows, particularly those originating in the largest industrialised economies. ODA levels should meet the target of 0.7 percent of industrialised countries' GDP agreed upon in the framework of the United Nations. It is important that efforts to accelerate the Highly-Indebted Poor Countries (HIPC) Initiative should not crowd out new ODA financing in the budgetary processes of the industrialised countries. ODA should also provide additional resources to support the provision of global public goods, or those with strong international externalities, including peace processes, the global sustainable development agenda (climate change and conservation of biodiversity) and the fight against the worldwide drug problem. Recipient countries should obviously improve the efficiency and transparency with which resources are used.

Equally important, however, is the acceleration of the growth of multilateral lending. Multilateral lending should continue to play an essential role in at least four areas: (1) to channel funds to low-income countries; (2) to provide long-term financing to middle-income countries that do not have adequate access to private funds; (3) to act as a counter-cyclical balance to fluctuations in private capital market financing; and (4) to play a catalytic role for attracting additional private flows. To these we should add the traditional "value added" of multilateral financing: lending-associated technical assistance. Given the fact that old functions are still relevant and new ones (such as counter-cyclical lending) have been added, there is a case for additional resources.

The first of these functions underscores the central role that financing from IBRD-IDA and the regional and sub-regional development banks will continue to play in the immediate future with respect to low-income countries, as a complement to ODA flows. It has received widespread support in recent debates. The second and third functions emphasise the role that multilateral development financing will continue to play even for middle-income countries.[12]

12 Some authors reject, nonetheless, the validity of these arguments. The strongest argument in this regard is that of Meltzer *et al*. (2000) but a weaker version can be found in Gilbert, Powell and Vines (1999), who nonetheless argue that the World Bank should be allowed to lend to middle-income countries to improve its portfolio.

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The central role that multilateral banks play in the provision of counter-cyclical financing should be seen as a complement to balance of payments financing provided by the IMF. Financing from multilateral banks constitutes for many countries the only long-term financing that is available during crises. This type of funding is essential to smooth out necessary fiscal adjustments, averting the need to cut critical social programmes and making it possible to introduce social safety nets (see below). No less important, the support provided by multilateral banks, together with IMF financing, have acted, as major catalysts in shoring up or regaining confidence in countries at times of crises and hence in helping to restore private flows. In this regard, there have been some pioneering operations aimed at guaranteeing service on public debt in bond issues made at times of great uncertainty in capital markets.

The large-scale requirements for counter-cyclical financing to middle-income countries during crises may crowd out financing to poor countries. If multilateral development financing is not significantly expanded, its role as a counter-cyclical device will necessarily be very limited, and it would certainly be of secondary importance relative to its first two roles, particularly the provision of long-term development financing to poor countries. This is underscored by the data from Table 2, which indicate that multilateral financing in 1992-1998 represented only 15 percent of that provided by the private sector, excluding FDI, and only 8 percent in the case of middle-income countries. Thus, a useful counter-cyclical function would certainly require a significant increase in resources available to multilateral development banks or a more active use of co-financing and credit guarantees by these institutions.

The role of development banks in supporting social safety nets, which has received a correct emphasis in recent discussions, should be seen as part of the counter-cyclical role that multilateral institutions should play. Strong social safety nets are essential to manage the social repercussions of financial vulnerability in the developing world. The concept itself is subject to some confusion, as it has been used to refer both to the design of long-term social policies and to specific mechanisms to protect vulnerable groups during crises. The term should probably be used to refer specifically to the latter, although, as we will argue below, these arrangements should be part of stable mechanisms of social protection.

Multilateral banks have been involved in the former for a long time and have also accumulated some experience with the latter. However, the preferred mechanism since the late 1980s has been social emergency funds (later transformed in many countries into more stable social investment funds). Although they have introduced some innovations in social policy (e.g. competitive mechanisms to allocate resources and civil society partici-

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pation in social policies), their effects have been rather limited, their targeting has not always been effective and they may have crowded out resources from long-term social policies.[13] Other instruments have also been used in the past by developing countries, including some types of unemployment insurance (the major instrument of its kind in the industrialised world), emergency employment or emergency labour-intensive public works programmes, income-support schemes in conjunction with training, and some nutrition programmes. The recent crisis seems to have led to the design of new instruments: special subsidies to households with school-age children that are tied to school attendance, and various support programmes aimed at ensuring that families with an unemployed head of household do not lose their home during crises.

Recent analyses have come to some basic conclusions about these programmes. Firstly, safety nets must be part of *permanent* social protection schemes, as only a permanent scheme guarantees that the programme coverage will respond without lags to the demand for protection of vulnerable sectors during crises.[14] Secondly, given the heterogeneity of labour markets in developing countries, a combination of several programmes, with different target groups, is necessary. Thirdly, these programmes must be adequately financed and should not crowd out resources from long-term investment in human capital. This leads to a fourth conclusion: the effective functioning of social safety nets requires that public sector expenditure should include anti-cyclical components. This would be impossible – without generating inefficiencies in the rest of public sector expenditure – unless fiscal policy as a whole is counter-cyclical, a point that has not been sufficiently emphasised in current discussions. In the absence of this anti-cyclical fiscal pattern, external financing from development banks during crises will be unnecessary or, at best, illusory, as overall net fiscal financing requirements will actually decrease despite the increased spending associated with social safety nets.

Development banks and their associated financial corporations should also act as catalysts for private resources through three different mechanisms: guaranteeing timely payment of public debt, or the timely discharge of liabilities (in the form of guarantees or subsidies) assumed by the State in support of private projects; the direct financing or co-financing of innovative private projects, provided by the banking system directly or by the related financial corporation; and risk capital provided by the financial corporation to innovative firms. These mechanisms have been developed in a

13 See, in particular, Cornia (1999).

14 This issue is highlighted in the best available analysis of the subject (Cornia, 1999), which also emphasises the need for adequate financing.

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variety of ways by the development banks and their corporations, and have served particularly to boost private sector investments in infrastructure. One new mechanism could be to underwrite bond issues by countries that have not previously used this financing modality.

In all these cases, as well as in the guarantees offered on public sector bond issues at times of crisis, private investors value not only the solidity of multilateral institutions, but also their privileged relationships with governments, which gives added value to their support, beyond the funds they provide. Guarantee mechanisms need to be carefully designed, so that they only cover those risks which the markets themselves are unwilling on their own to cover, thus leading to additionality of flows. Both multilateral lending and guarantees should only be given when projects have been carefully evaluated and are economically viable. Naturally, the modalities used by the multilaterals to help catalyse private flows need to be reviewed and evaluated carefully, so that relevant modifications, improvements and updating can be introduced to maximise their development impact and minimise any problematic effects, not least of which are possible negative effects on the rating of multilateral banks.

The preferential relationship with developing countries as well as risk dispersion have resulted in multilateral development banks obtaining better risk-ratings than the countries or the regions they belong to, even when such institutions are entirely owned by developing countries (such as the Andean Development Bank – C*orporación Andina de Fomento*). This enables them to gain access to external funds at a lower cost than the countries can individually, thus performing useful intermediation activities. The overestimation of risk, typical of private capital markets, is another source of profitable intermediation by such institutions.

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Comment on “Facing the Volatility and Concentration of Capital Flows,” by Stephany Griffith-Jones and José Antonio Ocampo

Wouter Raab

Introduction

Stephany Griffith-Jones and José Antonio Ocampo have written a broad and wide-ranging paper that touches on almost every aspect of today’s discussion on the international financial architecture. In the short time that is allotted to me, I cannot do justice to the wealth of arguments they have put forward. It is not possible to state all the things that I agree with because they are too many. Let me therefore concentrate on a few issues where I have a divergent view and where I may have some additional observations to offer.

I would like to comment on the following subjects: (i) the role of the IMF and whether it should develop into an international lender of last resort (LOLR); (ii) regional cooperation and institutions; and (iii) national autonomy and current account convertibility. I will make these observations on a personal basis and not as a representative from the Ministry of Finance.

International Lender of Last Resort

Griffith-Jones and Ocampo say that one of the fundamental tasks of the international financial institutions (IFIs) is the provision of liquidity and that, as a result of recent capital account crises, the role of the IMF should further develop into that of an international lender of last resort. They are in good company (Stanley Fischer). I have my doubts:

- It would give the wrong signal to private lenders, since without significant changes to the framework under which private lenders operate, it would amount to bailing them out;
- Countries are not like banks: a country cannot be declared insolvent and bankrupt; you can’t close a country down, nor can you replace the management. Consequently, there is no exit strategy: once you started

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to provide emergency liquidity assistance, there is no choice but to continue, even if a country is not mending its ways;

- To enable the IMF to play a credible role of international lender of last resort it needs to have much more resources which are not going to be forthcoming: the worst thing is to have an international lender of last resort without sufficient resources. There are three ways to increase resources to the IMF which all face serious stumbling blocks: (a) a quota increase which the US Congress will block; (b) borrowing on the capital markets; and (c) SDR creation;
- The political realities under which an international LOLR operates would be totally different from a national LOLR: the provision of liquidity is driven more by political considerations than by economic and financial ones (e.g. large emerging markets have powerful allies; the IMF is just a pawn in the hands of the large countries). Although it is not a new issue, countries like the Netherlands are concerned about a further shift of the IMF into the political arena.

In the Netherlands, we have become very concerned about the very large size of the rescue packages to Korea, Brazil and Indonesia. The result has been a concentration of IFI resources in a small number of countries. Through the contribution of the multilateral development banks to these packages, our government guarantees were abused by providing balance of payments assistance to middle-income countries instead of financing development programmes.

In my view, the emphasis in the discussion is too much on the provision of large-scale emergency packages, which should be made available more upfront and more automatically with less conditionality, even beyond the present IMF Supplemental Reserve Facility (SRF) and Contingent Credit Line (CCL) as Griffith-Jones and Ocampo argue. The origin of the crisis and subsequent developments are characterised more by the imperfect functioning of capital markets (e.g. herd behaviour, lack of information or asymmetrical information, and the concentration in a small number of countries) and by unfortunate policies of the countries concerned. By and large, the response of the international community (i.e. IFIs and creditor countries) has been appropriate. Evidence to this fact is the relatively quick recovery of the countries concerned and the modest impact on the world economy as a whole.

It is fine to think about streamlining the provision of emergency assistance, because the process has been murky, *ad hoc* and time-consuming on occasion, but the emphasis should be much more on enhancing the IMF's role as a lender that catalyses private lending and involving the private sector more directly from the outset in the resolution of a liquidity crisis. No emphasis should be placed on automatic gap-filling by the IMF or any

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other public institution. It is more a question of balance than a black and white distinction of whether the IMF should or should not provide quick and large-scale liquidity assistance.

A New Framework for Private Sector Involvement

Much of the policy responses of the past couple of years have addressed the right issues. Financial sector regulation and frameworks for prudential supervision have been strengthened in emerging markets while governments have also been made more aware of the trade-offs in macroeconomic policies, such as between exchange rate policy and domestic monetary policy. There has also been more attention paid to asset and liability management, including the appropriate level of reserves against short-term foreign currency liabilities.

However, much less progress has been achieved with regard to the functioning of international capital markets. For example, risk is still not being factored in enough into lending decisions by private lenders. That can only be changed by changing the framework in which they operate. Prudential supervision and increasing the risk weightings and provisioning requirements for lending to emerging market countries are essential. But, in addition, we need to change the distribution of benefits and risks for private lenders in situations of liquidity crises.

There has been too little progress on private sector involvement. There is too little assurance that the next time around, which hopefully doesn't come, the private sector will be involved more directly from the outset. Therefore, in consultation with the private sector, we need to explore a framework for private sector involvement. This framework should not be rigid and could include a couple of principles that we can follow when a country is in a international liquidity crisis. This framework should be made public beforehand so that private lenders can factor it in into their lending decisions.

Contemporary liquidity crises originate in the volatility of foreign capital inflows and their large size relative to that of the domestic financial sector and capital markets. When a sudden decrease in capital inflows takes place in a crisis situation, the liquidity needs will almost certainly exceed standard IMF access limits.

Instead of immediate and automatic gap-filling through some kind of emergency facility by the IMF, the IMF should first determine the adjustment effort of the country concerned and determine the size of the financing gap. Subsequently, it would have to decide which part of the gap would have to be filled by the public sector and which part by the private sector (through roll-overs and new exposure). If private sector financing is not

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forthcoming, the country concerned could declare a temporary debt standstill during which an orderly debt work-out arrangement would be negotiated. As long as the country negotiates in good faith, the IMF and other official creditors could continue to lend to that country during these negotiations.

Such a framework would have to be made public beforehand, before any liquidity crisis takes place. The private sector would then know that there would be no more bailouts and that, in a liquidity crisis, it would have to roll over its exposure, and come forward with new loans or take losses. If this leads to higher spreads on loans to emerging markets reflecting the higher risk and lower loan volumes, it would be desirable because it would reflect the risks of lending to emerging markets.

Such a framework would bring private benefits and costs more in line with social costs. This approach would be more efficient than solutions which rely on an international lender of last resort creating a wide and probably increasing divergence between social and private returns from international lending. I am convinced that private agents should be confronted with the social costs of their actions and that pure contagion is a rarely observed phenomenon in emerging markets. This is not to deny the serious consequences of financial crises. However, they do not justify a remedy (an international LOLR) that allows policies to continue in which the benefits of international lending fall to the private sector and the costs are borne by the public sector.

In addition, an international lender of last resort is not able to prevent a crisis. By providing the wrong incentives, it would only make matters worse. As a tool of crisis management, I even doubt whether it would be able to achieve much. Given the political sensitivities involved, the activation of liquidity support would first require the occurrence of a negative shock. Most probably, it would be activated only after capital flight had occurred, and after the drying up of capital inflows would have already attacked the currency and stock market. Confidence would have already been shocked and, if contagion exists, it would already have done much harm to other debtor countries. Thus, most of the costs of an international liquidity crisis would have already been incurred. The only thing a lender of last resort would then do is transfer money from the public to the private sector. This would, in my view, only be justified if the social benefits exceed the costs, which I am not convinced would be the case in an international context.

Obviously, the case of a single private bank is different from a country. Because the general public's knowledge about an individual bank is much less than the knowledge of international banks about a country's economic situation, a lender of last resort can provide assistance to a private bank

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before the general public knows that there is a problem and before the confidence in the financial system is shaken. This is not the same for a borrowing country. Lending goes on too long and is rationalised by false arguments. A crisis is rarely invoked by the country concerned, but almost always by private lenders who finally realise that the debt build-up is unsustainable. As a result, the crisis occurs and the liquidity assistance from the LOLR comes too late to prevent it.

Regional Cooperation and Institutions

Griffith-Jones and Ocampo say many things about regional cooperation with which I agree. I represent a region which has far-reaching forms of cooperation. I do not belong to the group of people from industrialised countries that frown upon attempts at regional economic and financial cooperation. Of course, there is an issue about the relationship between regional cooperation and the IMF, but what is good for us in Europe can almost certainly not be wrong for other parts of the world.

Particularly in Asia, there are good reasons for exploring the possibilities for further economic and financial cooperation. There are some highly-developed financial centres in the region, and alongside the high-deficit countries there are some high-surplus countries. In short, there is money and expertise in the region. Financial stability can be enhanced by recycling Asian current account surpluses through Asian institutions and financial centres to countries with current account deficits. Currency and maturity mismatches could be diminished in this way.

At the same time, we need to be realistic as well. It will take some time before Asia will have developed well-functioning forms of regional economic and financial cooperation. There is no such thing in Asia as a Franco-German axis to provide balanced leadership. There is great cultural, political and economic diversity in Asia, making it more difficult to find forms of cooperation in which every country can participate on an equal footing. It will be essential to prevent the pitfalls that Europe experienced when providing balance of payments assistance to member countries. In Europe, Greece, for example, received financial assistance from the EU in the 1980s and early 1990s with hardly any conditionality. This seriously slowed down the necessary adjustment in Greece. In order to avoid these same traps in Asia, I believe it is essential to work closely together with the IMF on the terms and conditions when providing balance of payments support. As cooperation within Asia matures and intensifies, the link with the IMF can be gradually loosened. The stronger the economic integration in Asia becomes, the stronger the incentive to exert strong multilateral surveillance and peer pressure on participating country's economic policies.

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This is clearly demonstrated by developments in Europe. Economic policy coordination in Europe under e.g. the Stability and Growth pact, provides much stronger pressure on countries to change their fiscal policies than any IMF advice could ever have.

The role of the IMF for Europe is now to give an independent non-political expert's advice on a country's economic policy. But above all, the IMF now focuses on the appropriateness of the overall policy mix in the euro area and the interaction of EU policies with the rest of the world. So a division of labour between European institutions and the IMF is gradually developing which leads to better results for the region and the world as a whole. I subscribe to Griffith-Jones and Ocampo's views regarding the division of labour between regional institutions and the IMF. To the extent that it keeps the IMF on its toes and makes it more responsive to outside experts' views, it will also improve the functioning of the IMF.

Since it will take time to build up well-functioning and credible forms of regional cooperation, there is nothing to argue against starting with such forms in Asia or any other part of the world.

Current Account Convertibility

Having once been an enthusiastic supporter of capital account liberalisation, recent developments have led me to believe that capital account convertibility is not automatically good for every country. In addition to the arguments put forward by Griffith-Jones and Ocampo (consistent and flexible macroeconomic management, adequate prudential regulation and supervision, and well-articulated liability management), I want to mention the size and the development of the domestic capital market. If this market is small in comparison to the size of capital inflows, it would be absolutely incapable of absorbing or dampening any shock from the inflow of foreign capital. It would make the country very vulnerable to the shock-waves coming from the volatile international capital markets. Any country in such a situation would do well to have mechanisms in place to control or regulate the inflow of foreign capital. Simultaneously, such a country would need to develop both the depth and breadth of its capital markets before it could seriously consider a further dismantling of capital controls. Of course, such restrictions should not substitute for sound macroeconomic adjustment. Depending on the level of development and sophistication of the domestic capital market and financial sector, the liberalisation of capital flows should be sequenced in such a way as to take them into account.

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Reforming the International Financial System: Prospects for Regional Financial Cooperation in East Asia

Yung Chul Park and Yunjong Wang

I Introduction

The painful lessons learned from the emerging market crises since 1997 raise the question of the adequacy of the current global financial system, and has awoken interest in rethinking and redesigning the international financial architecture. Numerous proposals have been made by academics, policymakers and financial experts. They include the G-7 Finance Ministers' Report, the Meltzer Commission Report, the Task Force Report sponsored by the Council on Foreign Relations, and the Financial Stability Forum's recommendations. However, these proposals have been frequently criticised because emerging market views are not fully recognised and because they do not address emerging markets' vulnerability to global financial systemic risks.

These proposals begin with the premise that structural weaknesses and short-run macroeconomic imbalances in the East Asian countries were responsible for triggering and spreading the crisis through East Asia and beyond. As such, these proposals focus on structural reforms in these countries: strengthening the prudential regulatory system for banks; improving accounting practices and disclosure requirements for increased transparency; creating accountable and transparent corporate governance; and promoting greater flexibility in the labour market.

In a recent paper, Furman and Stiglitz (1998) suggest that these structural weaknesses were not necessarily the cause of the crisis, since structural reforms were not needed in gaining access to international capital markets. This does not mean that the crisis countries in East Asia do not have to carry out structural reforms. Such reforms will reduce the vulnerability of these countries to speculative attack. Be that as it may, a more balanced approach toward creating a new international financial architecture should be taken; it should address the problem of market failures that beset international capital markets and that often trigger financial panic and herd behaviour.

Frustrated by the lack of progress in reforming the international finan-

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cial system, East Asians have begun to search for a regional defense mechanism to complement the G-7 led reform efforts. They believe that the establishment of a regional credit support mechanism will help prevent the recurrence of crises, and will be a more effective mechanism to manage future crises.

Before the Asian financial crisis broke out in 1997, few would have argued for the creation of one or another form of regional arrangements in East Asia. East Asians did not have major incentives to encourage regional integration. According to Lawrence (1996), East Asians, or more broadly Asians, faced great obstacles to forming arrangements of their own that are patterned after those in Europe and North America. In contrast to the policy-led integration of Europe, a market-led process of integration was already taking place in East Asia. Given their history of enmity, competition and the uneven distribution of power, many neighbouring countries did not dream of creating a regional bloc. The East Asian countries had no impelling need to engage in any regional arrangements. They were also hardly prepared to make the structural adjustments and policy changes that a regional arrangement would require.

For these reasons, the achievements of ASEAN have fallen short of the initial expectations and much of the earlier skepticism that surrounded APEC still remains, as Lawrence has pointed out. Without a major breakdown in the global trading system, East Asia did not have any incentive to form a regional cooperative arrangement. However, the financial crisis that erupted in 1997 was a major financial breakdown that gave East Asians a strong impetus to search for a regional mechanism that could forestall future crises. This search is now gathering momentum, despite the fact that recovery has been much faster than expected.

Section II discusses a number of recent developments – both intra- and extra-regional – that have moved East Asians toward forming regional financial arrangements and the pros and cons of such arrangements in general. Section III examines the adoption and enforcement of global standards and codes of conduct proposed by a number of international financial institutions and other international organisations. In Section IV, the role of the IMF as a crisis manager and lender and its relevance to emerging market economies (EMEs) are considered. Concluding remarks are found in Section V.

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II Regional Financial Arrangements in East Asia

Arguments Against Regional Arrangements

The speed of recovery in East Asia since the middle of 1999 has been impressive. It is expected that recovery will continue in 2000 and help East Asia to return to the pre-crisis trend of growth. Despite the optimistic outlook for East Asian growth, there are widespread concerns that the current economic upswing in the crisis-hit countries does not necessarily mean that the region is out of the danger zone. In the eyes of many western investors, many of the vulnerabilities in East Asia that brought about the crisis have not disappeared. In the eyes of East Asians, few of the structural deficiencies of the international financial system that contributed to the crisis have been rectified.

For over two years, all of the East Asian crisis countries, except for Malaysia, have dutifully followed the IMF reform programmes to make their corporate and financial sectors more transparent, efficient and resilient to financial market instability. Although the reform processes in these countries are far from over, there is a growing concern that the economic reform they have embarked on, even if it is completed to the satisfaction of the IMF and western investors, may not necessarily safeguard them against future crises so long as the reform of the international financial system is deferred or pushed forward without consideration of the institutional and structural characteristics of emerging market economies (EMEs).

The reform effort, led by the G-7, has been losing steam and, from the point of view of East Asians, does not address the supply side problem of international financial markets. The small and medium-sized open economies in East Asia in particular may not be able to fend off speculative attacks on their own in the rapidly globalising and virtualising world economy. East Asians do not believe that the proposed domestic reforms, even if fully implemented, will help them secure their financial stability.

For these reasons, there has been increasing support in East Asia for developing a regional mechanism of defense in the form of financial cooperative arrangements. This support has culminated in the Chiang Mai Initiative of the ASEAN members and three other Asian countries to create currency swap arrangements.[1] The agreement is widely perceived as

1 Asia's three economic powerhouses – China, Japan and Korea – along with the 10 members of ASEAN, agreed during the Asian Development Bank (ADB) annual meeting in Chiang Mai, Thailand, to expand an existing network of arrangements designed to ward off a crisis similar to the one that rocked the region in 1997. The plan, dubbed the Chiang Mai Initiative, calls for a network of bilateral currency swap-and-repurchase arrangements and implies the establishment of a system of pooled reserves that central banks could draw upon to buy time when their currencies come under speculative attack.

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a major step toward strengthening financial cooperation among the East Asian countries.

After the crisis touched off in July 1997, Japan's proposal to create a regional monetary fund in East Asia received a positive response from a number of East Asian countries. The idea was, however, strongly opposed by the US, the European countries and, of course, the IMF for a number of reasons.

Eichengreen (1999) and others dismiss the contention that an East Asian regional fund may have a comparative advantage in diagnosing regional economic problems and prescribing appropriate solutions on the basis that it will increase competition in the market for ideas. A more serious argument is that East Asians are not ready for or capable of creating and managing an effective regional monetary fund. According to Eichengreen, East Asia lacks the tradition of *integrationist* thinking and the web of interlocking agreements that espouse monetary and financial cooperation in Europe.

For over a half century, European countries have worked very hard to develop a web of political and diplomatic agreements which encourage them to cooperate in monetary and financial matters. Such a web does not exist in East Asia. Furthermore, East Asians are not yet fully accustomed to or comfortable with negotiating an international treaty which includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly. This unwillingness would make it difficult for the regional fund to impose politically unpopular policies on the member countries and hence may pose a serious moral hazard problem.

Moral hazard is not a problem that will beset only regional arrangements. The IMF is also not immune to this problem and the task force report of the Council on Foreign Relations (1999) advises the Fund to adhere consistently to normal lending limits. The reasons why East Asian financial arrangements would suffer more from the moral hazard problem than the IMF, or any other regional institutions, have not been made clear. As Sakakibara (2000) puts it, if those countries unaffected by the East Asian crisis do not have any political incentive to contribute their own resources, they should say so instead of using the moral hazard argument as an excuse for opposing regional arrangements in East Asia.

Another controversial argument against regional financial arrangements is that there may be no need for regional funds and other arrangements in a global economy where much of the trade in goods and services is being conducted increasingly in cyberspace. The ongoing revolution in information and communication technology will accelerate globalisation and virtualisation. Therefore, what the world economy needs is a new system of global governance, which may include a global central bank and global regulatory authorities. In the case of financial markets and financial serv-

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ices industries, the scope of governance should be increased to the world level so as to realise scale economies and to accommodate the market forces driving financial globalisation. Public goods, such as the services of a lender of last resort and regulatory institutions, might be better provided at a global level.

While, in theory, the creation of a system of global governance may sound reasonable, in reality, it is politically unacceptable and must be dismissed as quixotic (Eichengreen, 1999). As a second-best alternative to the global governance system, global standards and codes of conduct on banking, corporate governance, management of monetary and fiscal policies and many others have been proposed. However, doubts were raised as to the effectiveness of international standards and the legitimacy of imposing them on EMEs.

As for East Asia's limited institutional capacity, Eichengreen (1999) has a point. If the European experience is any guide, East Asia may take many years to develop an effective cooperative arrangement for finance. However, it must also be noted that having suffered such a painful and costly financial crisis, the East Asian countries are prepared to set aside their differences and work together to develop a region-wide defense mechanism to help protect them from future crises. After three years of crisis management, East Asia has developed a large pool of skilled and experienced experts capable of managing regional financial cooperation among the countries of East Asia. Furthermore, the type of arrangements currently being discussed in East Asia does not necessarily require integrationist thinking or a web of interlocking agreements, as in Europe.

Rationales for Regional Arrangements

In this section, a number of arguments that support regional financial cooperative schemes in East Asia will be presented. Any argument for regional arrangements must begin with answering the most fundamental question of whether regional groupings, whatever forms they may take, are conducive to, or likely to interfere with multilateral free trade and the orderly globalisation of financial markets.

Despite many misgivings about the role of regional economic arrangements that have grown in number in recent years, experiences of the past decade suggest that they have been a complement and supplement to multilateral trade and financial liberalisation. That is, they have been building blocks rather than stumbling blocks for a more integrated world economy. There is no evidence suggesting that an East Asian financial arrangement would be oriented toward a withdrawal from the global economy and, hence, erect barriers to global financial integration.

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As Lawrence (1996) points out, the forces driving the current regionalism may differ fundamentally from those driving earlier moves in this century to regionalisation and the current initiatives represent efforts to facilitate their members' participation in the world economy rather than their withdrawal from it. Developing countries are motivated to join regional groupings because their participation might facilitate implementation of strategies to liberalise and open their economies. Since most of the East Asian EMEs are pursuing export-cum-foreign investment-led policies, they will gain very little by forming a regional arrangement that is designed to thwart globalisation.

There have been several other developments which encouraged the formation of a regional financial arrangement in East Asia. One development has been the slow progress of the reform of the international financial system. The urgency of reform in the G-7 countries has receded considerably with the rapid recovery of East Asia. The already slow progress has been further complicated by the perception that a new architecture, as it is now designed, may not be effective in sustaining global financial stability. Moreover, it would not safeguard financial stability in the EMEs. As long as the structural problems on the supply side of capital are not addressed, the East Asian countries will remain as vulnerable to future crises as they were before. Instead of waiting until the G-7 creates a new architecture, whose effectiveness would be at best questionable, it would be in the interest of East Asia to create its own system of defense through coordinated endeavours.

Many EMEs, in particular those which have experienced a financial crisis, are taking measures to build up their foreign currency reserves above the level regarded as adequate in terms of their import requirements. For instance, Korea is currently targeting a level of reserves equivalent to 20 percent of its GDP, largely because of the increased volume of its capital account transactions. By any measure, this level is excessive, and represents a clear case of resource misallocation. To reduce the amount of reserve holdings, at least some of the EMEs could enter into an arrangement for precautionary lines of credit with private financial institutions. They could also rely on the IMF as a quasi-lender of last resort, which could provide an additional issuance of SDRs.

There are other schemes for reducing the holdings of foreign currency reserves. For example, a group of countries, not necessarily from the same region, may decide to pool a certain percentage of their reserves to create new credit facilities for themselves. An individual country belonging to the arrangement can borrow from the credit facility and would not have to hold as much reserves as it otherwise would.

The group of thirteen East Asian countries of the Chiang Mai Initiative

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commands a large amount of foreign currency reserves estimated at more than $800 billion. Depending on how these reserves are pooled together and managed, a mere ten percent of the total amount will be sufficient to provide first and second lines of defense against any speculative attack. If the East Asian countries had been able to cooperate to use part of their reserves to supply short-term liquidity to Thailand in 1997, East Asia could have been spared the misery of recession and social dislocation.

There is also the argument that regional financial management could be structured and administered in a way complementary to the role of the IMF. For example, an East Asian regional fund could provide additional resources to the IMF while joining forces to work on matters related to the prevention and management of financial crises. An East Asian monetary fund could also support the work of the IMF by monitoring economic developments in the region and taking part in the IMF's surveillance activities. It could also be initially designed as a regional lender of last resort while the IMF assumes the role of prescribing macroeconomic policies to the member countries of the former.

Finally, East Asians must begin to examine the possibilities and desirability of cooperation and coordination in exchange rate policies, creation of a regional currency unit and eventually an East Asian common currency. Even though these monetary options are not feasible at this stage, an East Asian monetary fund could serve as a forum for such an examination.

III Standards and Enforcement

Most proposals for a new international financial architecture advocate establishing a set of international standards and encouraging countries to adopt them. Many standards already exist: the Basel capital adequacy accord, the IASC accounting standards, the IOSCO principles of securities regulation and the OECD standards of corporate governance. The IMF has developed Special Data Dissemination Standards (SDDS) and has prepared codes of good practices on fiscal, monetary and financial transparency. Since it may not be feasible, from a national sovereignty standpoint, to establish and enforce strict global rules or create global authorities such as a world central bank and a world regulatory authority, setting and enforcing international standards are recommended as a second-best solution.

Many agree that such standards are not a panacea. They are often too vague to mean very much. Even the major industrial countries cannot agree on specific standards for banking, corporate governance, disclosure, and accounting, because they understandably insist on standards that will serve their own interests. In most of the forums drawing up standards,

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emerging market economies and developing countries (DCs) are not included or are, at best, underrepresented.

Even if the G-7 and emerging market economies and other developing countries could come to an agreement on international accounting standards, banking and other regulatory issues, there still remains the question of enforcement. Some proposals suggest that cooperation and coordination between different supervisory organisations should be strengthened. Others argue that the IMF should be entrusted with the role of monitoring and supervising the compliance of its member countries with standards. Still others recommend that enforcement should rely more on incentives to induce countries to observe standards voluntarily.[2]

The IMF does not have either the manpower or the expertise to undertake the detailed international supervision of the financial and other standards of emerging market economies. This means that the IMF will have to create an incentive structure that directly links the amount of money a member country can borrow to its banking and other standards. Along with the IMF, it has also been suggested that the financial regulators of the advanced countries could help enforce standards by controlling the access of EMEs and DCs to international capital markets on the basis of their compliance record.

Many EMEs and DCs will find it difficult to accept these incentive-based proposals, because such schemes raise the issues of fairness and national sovereignty. If the incentive system is determined and administered by both the IMF and the regulatory authorities of the advanced countries, this would mean that advanced countries, in reality, can dictate the access of EMEs and DCs to world capital markets and IMF credit facilities. The most serious concern with regard to IMF conditionalities is that such standards may act as the wedge with which a broader set of institutional preferences – in favour of open capital account, deregulated labour markets, arms-length finance and Anglo-Saxon style corporate governance – will be imparted to the recipient countries (Rodrik, 2000).

It took the GATT member countries seven years (1986-1993) to negotiate an agreement on new rules for more open trade in goods and services and to create the WTO in the Uruguay Round. Standards are not rules, but if the member countries of the IMF cannot agree on setting and enforcing standards, then a negotiation process, à la the Uruguay Round, may be an alternative solution. This may be particularly necessary if the inter-

[2] The Financial Stability Forum (FSF) has recently published a paper on implementation issues of standards and codes — Issues Paper of the Task Force on Implementation of Standards. The paper recommends the provision of incentives for fostering implementation of standards, while it emphasizes country ownership in its process of implementing standards.

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ests of the advanced countries, on the one hand, and those of the EMEs and DCs, on the other, diverge.

The G-7 countries could take the initiative of starting a negotiation process among the IMF members towards introducing international standards. The negotiations may not take as many years as the Uruguay Round did, but they will have to go through an arduous and protracted process of settling the differences between the advanced countries and the EMEs and DCs. Such a negotiation process will be costly, but unless the IMF member countries come to an agreement on common standards, one cannot ensure the compliance of firms, banks and governments of the EMEs and DCs. In order to reduce the number of participants and make the negotiations more manageable, one possibility would be to limit participation in the initial stage to those EMEs and DCs with open trade and financial regimes. Without such a process, it is likely that there will be only two sets of competing standards supported by the US and EU respectively. Neither set of standards would, in that case, reflect the needs or wishes of EMEs and DCs. They would then either adopt the standards of one or the other, or remain outside both.

IV The IMF as a Crisis Manager and Crisis Lender

Fischer (1999) argues that the IMF can act as a crisis lender or as a crisis manager, although it does not have the power to create international reserves. As a crisis lender, it has access to a pool of resources contributed by its members which it can lend to member countries in need. Because it has the responsibility of negotiating with member countries in a crisis and arranging financial packages, it also serves as a crisis manager.

One might question whether the IMF will have enough resources at its disposal to serve as an effective crisis lender, but let us assume it could and would. Then, looking into the future, the IMF will mostly be lending to EMEs and DCs in emergency, and serve as their crisis manager. In this scenario, the IMF would seldom lend to the G-7 countries even in times of a crisis.

On paper, the IMF will continue to play the role of an international lender of last resort, but in practice that role will be taken over by a group of large countries which would directly administer the trust fund to combat systemic threats to the international financial system. For the purpose of constructive ambiguity, it would be desirable to make country eligibility, financing amounts, and the role of conditionality unknown *ex ante*. However, this constructive ambiguity may be interpreted as a lack of transparency and could become a source of confusion and arbitrary decisions.

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The Meltzer Commission (2000), suspicious of IMF management and the institution's principal shareholders alike, wants hard-and-fast rules for IMF lending. It recommends permitting the Fund to lend only to the countries that pre-qualify for assistance by building impeccably strong financial systems. However, rigid rules for IMF lending are patently unrealistic. Lending only to countries that pre-qualify for assistance would mean standing idly by when the weak, as well as the strong, are hit by systemic crises (Eichengreen, 2000).

Suppose a financial crisis breaks out in an EME. The trust fund will not be activated unless the crisis is believed to threaten the systemic stability of the international financial system. However, the crisis is likely to be contagious and spread to other countries and regions. At what point, then, should the trust fund be activated? One might ask why the G-7 countries should have the authority to make that decision and assume the role of international lender of the last resort.

The structure of the IMF is similar to that of a credit union. However, unlike a typical credit union, there is a clear demarcation between net depositors (lenders) and net borrowers. Advanced countries constitute the majority of lenders whereas EMEs and DCs make up practically all of the IMF's borrowers. A few rich industrial countries control the decisionmaking process as well as operations of the IMF. Given this dominance, one could legitimately raise the concern that the IMF may be "too responsive to its principal shareholders, which are high-income, international creditor countries whose interests do not necessarily coincide with those of the global society as a whole" (De Gregorio, Eichengreen and Wyplosz, 1999).

One might go one step further by saying that the IMF is constrained in reflecting the needs and wishes of EMEs and DCs. Even though international creditor countries are as much responsible for the East Asian crisis as East Asian countries themselves are, the IMF has been preoccupied with the structural reform of the EMEs and DCs, while not effectively rectifying the problems on the supply side of capital flows.

In order to redress the imbalance between advanced countries and EMEs in managing the IMF, the EMEs and DCs should be given the opportunity and be prepared to contribute more resources for the operation of the IMF. Commensurate with their enlarged contribution, the EMEs and DCs should be accorded greater representation both on the board of directors and in the management. Many EMEs are more willing and able to share the burden of financing various IMF credit facilities than ever before. This issue of representation will become more contentious in the future if the IMF is given a central role in the surveillance and enforcement of various standards.

One should, of course, recognise that the IMF is an international insti-

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tution providing the public good of international financial stability. Crisis management and prevention has externalities, and is not only the responsibility of EMEs and DCs, but also of advanced countries. Nevertheless, it is only natural and logical for EMEs and DCs to have a greater voice in managing the organisation that is primarily serving as their crisis lender as well as manager.

Advanced countries are likely to object to the idea of giving EMEs and DCs a larger representation in running the IMF. They may argue that without the dominant participation of the advanced countries, the IMF may suffer from leadership problems, deterioration in the quality of staff output and laxity in the enforcement of standards and loan conditions. Criticisms of the same type have been leveled against those who support the establishment of regional monetary funds.

If the decisionmaking process at the IMF is not politically neutral, and for this reason EMEs and DCs cannot expect more active participation in the IMF decisionmaking process, then the G-7 and the IMF should consider amending the IMF Articles of Agreement to strengthen the independence of the Executive Board and give the Fund financial independence (Gregorio, Eichengreen and Ito, 1999). Failing this, the G-7 and the IMF should be more positively disposed to the idea of creating regional monetary arrangements. Indeed, if one can argue that regional economic arrangements could serve as building blocks rather than stumbling blocks, then the same argument can be made for establishing regional monetary arrangements.

As noted in Section II, regional arrangements could be structured in a way that would complement, not substitute for, the role of the IMF. The Uruguay Round established the WTO with much-enhanced enforcement powers and gave birth to a large number of regional economic arrangements. In fact, more than 90 percent of all the contracting parties in the GATT are signatories to such arrangements.

In discussing the reform of the IMF, a consensus has emerged that it cannot be the sole locus of future financial liberalisation and stabilisation of international financial markets. Regional arrangements could complement and supplement IMF efforts to liberalise capital account transactions provided, of course, that such arrangements are subject to an outside discipline and do not become preoccupied with regional issues and initiatives.

Both multilateral and regional approaches can be effective and efficient in maintaining international financial stability. The reason is that financial crises tend to be regional mainly because trade is regional (Rose, 1998). With a large increase in intra-regional trade in recent years, financial crises are more likely to spread through trade linkages than before.

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V Concluding Remarks

There has been an emerging consensus in East Asia that East Asians must join forces to establish regional financial arrangements which will help them fend off speculative attacks and, in so doing, stabilise the East Asian financial markets. However, it is not altogether clear at this stage whether they will be able to successfully negotiate the creation of such arrangements, given the different interests of different countries in regional financial cooperation. Details of the swap arrangement among the ASEAN members and China, Japan and Korea (the Chiang Mai Initiative) will have to be worked out. At this stage, it is too early to tell whether ASEAN will be able to design a scheme acceptable not only to the ASEAN member states but also to China, Japan and Korea.

Now that China is about to join the WTO, Chinese policy makers realise that they may have to liberalise and open their financial markets and financial services industries sooner than expected. They also realise that as the country with the largest market, they must contribute to, and cooperate with other countries, to sustain financial stability in East Asia. However, China will find it very difficult to support any regional arrangements dominated by Japan.

In promoting regional cooperation in East Asia, Japan has a very important role to play as the second largest economy in the world and as a member of the G-7. While Japan and the other East Asian countries cannot, and should not, ignore the wishes of the US and the European Union, the East Asian countries must decide whether a regional cooperative mechanism will help restore the dynamism and vitality the region was accustomed to before the crisis.

During the Asian crisis, Japan was less active and forthcoming than it could have been in articulating the predicament of, and extending financial support to, the crisis-hit countries. To many East Asians, Japan was watching the demise of the East Asian countries, one by one, on the sidelines. As Sakakibara (2000) puts it, however, no one can criticise Japan, or the US for that matter, for their failure to come to the rescue of the East Asian crisis countries, including Korea, because both superpowers were also acting in their own national interest. In recent months, nevertheless, Japan has become more active in advocating the creation of East Asian monetary and financial arrangements, at least informally.

Japan must spell out to the other East Asian countries what its' national interests are and what it is prepared to do to support the establishment of East Asian financial arrangements. Japan must find ways in which it could collaborate with China on resolving regional economic issues.

East Asia has a long way to go before formalising and putting the

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Chiang Mai Initiative into effect and launching other types of cooperative mechanisms. In this respect, Japan should be able to provide leadership in accomodating the differences among the East Asian countries that are likely to surface in the negotiation process and, most of all, be prepared to provide a large share of the resources needed to facilitate regional financial cooperation without dominating the other countries. It will be a deciding challenge for Japan to redefine its status in the region.

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Comment on "Reforming the International Financial System: Prospects for Regional Financial Cooperation in East Asia," by Yung Chul Park and Yunjong Wang

Louis A. Kasekende

Introduction

Africa and, in particular, the East African region has a lot to learn from the East Asian crisis. Over the past two decades, economies of East Africa have followed more market-based policies. The reform programmes have focused on macroeconomic stability, liberalisation of foreign exchange, trade and marketing, improving incentive structures to promote both savings and investments, and rehabilitating the economic, social and institutional infrastructure.

In conjunction with these domestic developments, the world economy has experienced fundamental changes on account of increased globalisation of financial markets and issues relating to the movement of capital between countries have become central in the international monetary system. There are questions of whether African countries should promote capital account convertibility to take advantage of increased capital movements. Related to this are the risks Africa would be exposed to in case of market failure in either the domestic or international financial markets and how these risks would be mitigated.

Africa, in general, unlike East Asia, is not strongly integrated into the international capital markets. Capital flows to countries in Africa are small relative to flows to other regions, but large relative to the size of the economies and, at times, compare favourably with flows to other regions. Due to its limited integration into the international capital markets, Africa was largely protected from the contagion problems associated with the East Asian crisis. But this is not to say that Africa is fully protected from any dangers related to market failures in international financial markets. A large number of countries of the region are associated with and influenced by developments in South Africa. The South African private sector has

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increased its exposure in Eastern and Southern Africa. To the extent that South Africa is integrated into the international capital markets, there is a greater likelihood of second-round effects on African countries. In addition, African financial systems are prone to volatility. The markets are thin and lack sophistication and flexibility to effectively deal with minor changes in expectations and the switch in demand from domestic to foreign assets and vice versa.

In particular, a number of countries depend on one or two major export products subject to seasonality and commodity price shocks. The markets lack instruments to smooth out market behaviour during booms and busts, placing most of the burden on the monetary authorities. Unfortunately, the challenges to macroeconomic management and possibilities of market failure in a liberalised environment in Africa are unlikely to attract international response and concern since there is no systemic risk to the international financial system.

The solutions to the problems faced in Africa are therefore, primarily, domestic. Africa has to promote a sound financial system, develop and deepen markets, close regulatory and legal gaps and strengthen the supervision of the financial system. Without a doubt, progress in these above areas will reduce the probability of volatility in the financial sector but is unlikely to guard against future asset price bubbles, self-financing panics and bank runs. Uganda, in the recent past, suffered from instability in the foreign exchange market triggered by events in the Congo and a terms of trade shock. Similarly, Kenya, Malawi and South Africa have had to deal with volatility in their foreign exchange markets which can be traced to developments in Zimbabwe leading up to parliamentary elections in that country. On several recent occasions, private sector investors in Kenya have shifted savings and investments to neighbouring countries, especially Uganda and Tanzania as uncertainties heightened. The recent regional banking crisis problems affected cross-border interests of the banks and required coordination by the regulatory authorities.

There is, therefore, a strong case for monetary and financial cooperation among groups of countries in Africa. As a first step, countries belonging to a group need to agree on:

- codes and practices;
- sharing of information; and
- harmonisation of policies.

Policies at the Regional Level to Prevent Financial Crises

An effort at monetary and financial cooperation is already underway in East Africa. Uganda and its East African neighbours are currently develop-

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ing financial crisis prevention measures through the Monetary Affairs Committee (MAC) of the East African Cooperation (EAC). The MAC comprised of the Governors of the three East African central banks is undertaking the following programmes for coordinating and harmonising common approaches to stem the contagion effects of financial crisis:

- *Licensing Banks:* This would ensure that uniform criteria are applied by all the three central banks in the licensing of new banks, especially with respect to entry requirements. In the MAC's view, banks should have adequate unimpaired minimum capital and the region should guard against malpractices infiltrating the system.
- *Supervision and Regulation:* All acts and statutes are being reviewed and harmonised to strengthen the regulatory and supervisory capacities of the three central banks. Joint on-site inspection of banks with cross-border branches are currently being conducted.
- *Harmonising the Payments System:* This is meant to reduce risks (such as fraud) and enhance efficiency in the payments system. The countries have agreed to a uniform cheque standard.
- *Information Sharing:* The MAC meets once a year to review resolutions of previous decisions and harmonise approaches to common problems in the financial system. The sub-committees on Supervision, Monetary, Information Technology and Payment Systems follow up the decisions and prepare the groundwork for future MAC meetings.
- *Currency Convertibility:* The MAC has also agreed on convertibility of the three East African currencies to enhance payments and funds transfers. Although they have yet to agree on harmonisation of fiscal, monetary and exchange rate policies, the EAC countries have adopted the principle of a single currency. They have not yet set up a regional emergency fund to bail out a member in case of financial turmoil not associated with macroeconomic imbalances. Such a fund would give the countries of the region the capacity to quickly respond to problems as they emerge.

Challenges

Credibility

There are serious doubts that cooperation and harmonisation will be binding on all the members given a history of weak implementation of regional agreements and a lack of appetite to enter regional blocs. Unlike East Asia, Africa has not yet gone through a painful and costly financial crisis which could be used to motivate strong regional financial cooperation. Apart from South Africa, Africa lacks a powerful and financially sound country to

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take the leadership role in promoting such cooperation. It is highly doubtful that Kenya or Zimbabwe, in their current state, can offer the required leadership role. At the moment, South Africa is best positioned to take that role but it begs the question of whether South Africa's national interests stretch to the whole of Eastern and Southern Africa.

Lock-In Mechanisms

Some researchers have proposed that it may be in the best interests of regions like East Africa to negotiate a financial cooperation arrangement with the European Union. This would introduce the required credibility and penalties for non-compliance. In addition, the IMF could play a critical role in facilitating financial agreements with the region and providing a line of credit that can be used in case of financial turmoil.

Rationalisation of Groupings

Politics have tended to dictate the formation of regional groupings in Africa. This explains the setting up of overlapping organisations with little economic rationality. There is a need for a rationalisation of these groupings guided by economic interests. It would help greatly if domestic institutions such as central banks are strengthened and given the necessary autonomy to deal with issues and forces that stretch beyond national borders.

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Floor Discussion of "Positive and Negative Aspects of Recent Reform Proposals"

Regional Versus Global Arrangements

On the issue of regional versus global arrangements, Mark Allen suggested distinguishing between three different aspects of regional arrangements: regional swap arrangements, regional surveillance and regional standards. He believed that there could be a role for regional swap arrangements but the issue would be when to use them and under what conditions? "One problem with regional swap arrangements is that countries in a region tend to be affected simultaneously, because there is little diversity in the suppliers of funds. Another question, which applies when the financing needs to be supplied conditionally, is whether the region is better placed than the multilateral to apply such conditionality. The US has a network of swap arrangements with Canada and Mexico. However, when the Mexican crisis happened in 1994-95, the swap arrangement turned out to be of little use in those circumstances."

Allen also believed there would be scope for regional surveillance. "Countries can get together and give each other more candid and better focused policy advice than a multilateral can. After all, the G-7 goes through its own form of surveillance so that its members can potentially put peer pressure on each other, which they wouldn't want to do in a broader setting. There is scope for regional surveillance, for example, amongst the ASEAN countries or amongst the Central European countries where the actions of one country affects the reputation of the other countries in the region because they are seen as a group from the outside. However, in practice, it can be very difficult to apply that sort of candid pressure in a meeting of finance ministers inside the region. There is a tendency to just be nice to each other and spend all their time blaming outsiders rather than focusing on what one member could do to make life easier for the other members of the group."

Allen did not see any role for regional standards and codes. "These codes and standards are what the globalised international capital markets are looking for. But, since the capital markets themselves are globalised, there aren't any reasons why these codes and standards should be regionalised."

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Amar Bhattacharya suggested that it would also be useful to distinguish between dealing with "short-run" volatility versus dealing with systemic crisis. "The Chiang Mai swap arrangement is a perfectly reasonable arrangement to deal with short-run volatility. The difficulty arises in dealing with systemic crises, both because the covariance risk is higher in a regional context and because of the globalisation of financial markets."

Bhattacharya observed that in the absence of a true international lender of last resort and an arbiter of financial markets one has to deal with three questions. "First, do regional arrangements help in augmenting the overall envelope? I would argue that, especially in East Asia, we might actually have a true second line of defense (as opposed to a phantom second line of defense) if we have regional arrangements. So, in a resource envelope sense, regional arrangements could actually play a very useful role, especially in East Asia. Second, what do you do if you want to bail in the private sector? How is that going to work and who is going to be the arbiter? I would argue that the IMF needs to be the arbiter. Whatever regional institution is put in place, it has to play under the overall umbrella of the Fund. Third, regarding the issue of conditionality, there cannot be two types of country conditionality or, worse still, a regional institution undermining IMF conditionality. You would need to have complementarity between the institutions in a similar way to the regional peer surveillance that Mark Allen mentioned."

Yilmaz Akyüz made yet another distinction: between the existing regional institutions such as the UN regional economic commissions and the development banks, on the one hand, and new forms of regionalism that are developed as a response to the failure of global arrangements, on the other. "The regional financial cooperation that Yung Chul Park is suggesting falls in the second category. The Asian swap arrangement emerges from the failure of global arrangements and should be seen as a second-best option. Therefore, I don't see the logic of incorporating this into the discussion of global architecture. It departs from the idea that the global arrangement is not working."

Ariel Buira dwelled on the holding of international reserves as a way for a country to insure itself against financial crises. "Holding reserves is the most primitive sort of insurance, namely self-insurance. The next step is group insurance, which is certainly better, if still very costly. Thus, regional arrangements make economic sense vis-à-vis self-insurance. The best approach would be to take insurance to the global level. However, the global system is not prepared to give prompt and sufficient financial support. So in the face of the failure of the global system one has to fall back on regional systems, not because they are the most desirable arrangement, but because the IMF has failed to adjust to changing circumstances."

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Buira said that the chances of success of monetary cooperation were higher in Asia than in Latin America. "In Latin America, we made some attempts at monetary cooperation but they have not been very successful for one very strong objective reason: most of the countries are permanently in deficit on the current account. This is a major difference with Asia. A group of countries with large surpluses have a much better chance of success than if they were all borrowers. Also, regional surveillance and conditionality are much more difficult when you are all borrowers. You need both surplus and deficit countries to have a reasonable balance of conditions and policies to be followed."

Bill White added that the crucial factor for regional swaps would be the willingness of surplus countries to lend to deficit countries. "The real question is whether the creditor countries, let us say Japan or China, are prepared to take the credit risk on their books by lending money to countries that are running deficits. That is a significantly greater committment than the willingness to do swap for good collateral. The jury still seems to be out on that issue."

José Antonio Ocampo stressed that the rationale for regional cooperation is not the failure of global institutions, but the significant complementary role that regional institutions have to play. He gave three reasons for this complementarity. "First, there are services that cannot be provided at the international level. For example, the coordination of macroeconomic policies, such as between Argentina and Brazil, cannot be done by the IMF; it has to be done at the regional level. Second, it is good to have competitive development finance systems. It is excellent for a country, particularly a small country, in Latin America for instance, to have access to the World Bank and, at the same time, to the Inter-American Development Bank and a sub-regional development bank. It is particularly good for the small players. Third, since the IMF is controlled by advanced countries and the world is made up of many small countries, it is good for those small countries to have regional and sub-regional institutions in which they have a real voice. Voice gives a sense of belonging which cannot be substituted by any other means."

Ocampo said that he was aware of the limitations of a regional response to financial crisis – "a crisis of Mexico or Brazil cannot be managed by a regional reserve fund, though a crisis of Central America could be managed at the regional level" – but observed that its role should not be underestimated.

"I come from one of the few regions of the world, the Andean region, which developed a reserve fund and a development bank at the very start of its integration process in the 1960s. During the crisis of the 1980s, we lent to all the member countries at different times, and thus played a useful role

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in a very severe time of crisis. Of course, it wasn't sufficient because the size of the fund was relatively small compared to the crisis, which was of a global order, but, it was useful."

Yung Chul Park disagreed with Mark Allen's rejection of regional variations in standards and codes. "Whether you like it or not we are living with different standards in different regions. Look at the accounting standards. The Europeans and Americans are never going to agree to a single standard when it comes to details. Flexibility in regional standards is important to allow the firms and banks in different regions to trade, transact, borrow and lend across different regions. Instead of trying to develop a single worldwide set of standards, we need a regional variation in standards."

Howard Brown was very surprised that representatives of some emerging markets have argued that the Basel Core Principles are a problem for them. "If I were in the finance industry or the central bank of an emerging market, the Basel Core Principles would be something I would want to implement quickly. It's not the case that it's a 'one size fits all' that forces you into a straight jacket: it doesn't. Canada and the US have as different regulatory regimes as you could possibly find; they are completely different in terms of philosophy and approach. Yet, Canada is substantially compliant with the Basel Core Principles as, I assume, the US also is. One standard allows a lot of variation in terms of institutions and methods of implementation."

Park agreed with Amar Bhattacharya on the distinction between short-run crises and systemic crises. "Amar is 100 percent right that the regional swap and other arrangements we are thinking about are basically designed to deal with short-run crises. However, we still do not have an answer for the systemic problem we suffered from, an answer that will determine the success and failure of the regional arrangements."

Park supported Ocampo's view that regional arrangements should not be seen as a response to the failure of the global system. "Regional arrangements should be viewed as building blocks towards a completely free multilateral and global system. In other words, we are trying to move towards an idealistic state and in order to get there we have to go through intermediate stages. Regional arrangements are one of those intermediate stages."

Lender of Last Resort and Standstills

Yilmaz Akyüz distinguished between financing for current account purposes and financing for capital account purposes. He observed a contradiction in the paper by Griffith-Jones and Ocampo regarding the need to have both a lender of last resort and capital controls. "On financing for current account purposes, let's take the example of a country that has run

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out of reserves and is unable to finance its imports. This is very much like 'debtor-in-possession' financing in Chapter 11. The other form of financing is to provide money in order to maintain an open capital account and to meet the demands of the creditors; this is the lender of last resort. By definition, a lender of last resort assumes that under crisis conditions we have open capital accounts, no standstills and no exchange controls. I am not sure what kind of capital control José Antonio and Stephany have in mind, but there is a degree of contradiction in this argument that we need both a lender of last resort and capital controls. Certainly, this was not the case under the Bretton Woods System."

José Antonio Ocampo felt that it was unclear whether the rules for an emergency financier like the IMF are exactly the same as those for a true lender of last resort. "There is the issue of lending to countries rather than banks. In order to have a truly international lender of last resort, you would have to lend to banks. I agree with Yilmaz that you would have to have perfect convertibility of capital account because otherwise it doesn't make sense. Although I doubt that we will have a lender of last resort in the visible future for political reasons, there are at least two important issues on the international table.

First, do you want to generate new mechanisms with more onerous credit conditions? There is a choice between shorter-term and higher interest rates together with conditionality, or the older philosophy of the lender of last resort, that is, to have lending of some type but with no conditionality. In some credit lines, it would be better to move in the latter direction to have a faster disbursing mechanism.

The second issue is: do you want to have pre-qualifications? I differ with Stephany on this point. I don't like pre-qualifications by the IMF because it would generate a new function of the IMF as a credit rating agency and I don't think that is the function of the IMF. I prefer some mechanism that has no conditionality but higher costs."

Stephany Griffith-Jones explained her view on pre-qualification. "As for the point of pre-qualification, the British Treasury suggested that there could be a short-term CCL, of six or even three months, both of which would be automatically activated. That would be more interesting because there would be no additional conditionality.

I disagree with José Antonio on the point of pre-qualification. If you are in favour of managing booms and an individual country doesn't want to do this, you have to deal with it at the international level. In that case, there is the issue of how you increase leverage for the Fund or another institution to influence policy in times of boom. I find pre-qualification quite attractive. But, of course, it has to be pre-qualification and there should not be another take on conditionality once a crisis comes."

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Yilmaz Akyüz agreed with Ocampo that there are problems with an international lender of last resort. “Typically, a lender of last resort is supposed to support the currency and the country, not just meet the demands of the creditors, watch the currencies collapse and then come in and give them money. The latter is how it happened in Asia.”

He then illustrated, with the Brazilian case, that pre-qualification is not going to avoid the kinds of conditionalities Griffith-Jones and Ocampo are criticising. “The Brazilian case was perhaps the first attempt at a genuine lender of last resort. There was an agreement between Brazil and the IMF to put together a package of $40 billion dollars contingent on the Brazilians making some fiscal adjustments and some gradual depreciation of the real by 6 percent. After the Russian crisis, Brazil came under attack and the IMF stood by and watched until the real went from 116 to 200 to the dollar. In the end, it sat down with Brazil to impose additional conditions and made one tranche of some $8 billion available. From this case, it seems clear that pre-qualification is not going to avoid the kinds of conditionalities you are criticising because you have to monitor it constantly after a country passed the test. In the meantime, various events take place that are subject to interpretation. You always have to sit down and talk about the conditions. So pre-qualification does not work as long as there is a lag between the time of qualification, Article IV Consultation for instance, and the provision of money.

Since the 1980s’ debt crisis, UNCTAD has argued very strongly for temporary standstills, perhaps combined with Article VIII.2b of the IMF, as the most viable solution to provide some global framework. I see many countries in the Interim Committee – now the IMFC – thinking in this way, but facing opposition from the United States. I see Canada’s six point plan and some other European countries advocating temporary standstills.”

Ariel Buira suggested that the role of the lender of last resort, capital controls and standstills come in at different moments. “A change in market sentiments and a loss of confidence provokes a sudden interruption in capital flows. It would be very nice if you had already established a lender of last resort beforehand which could reassure the market that you will not become insolvent and unable to pay your bills, thus avoiding a panic. Another way to prevent this insolvency is to have capital controls on inflows so that you discourage capital inflows beyond a certain level, such as a certain proportion of your market, etc. Once you are faced with a crisis, standstills, Chapter 11 and restructuring come in. At this point, it would be very helpful for the Fund to have amended Article VIII.2b in order to be able to do all these things. The rationale of the system should require that you have a lender of last resort to give confidence to the market and avoid

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a crisis. In contrast, the way it works now is that you run into a crisis and then you try and pull the country out of it. This is contrary to the stipulation in the Articles of Agreement that the Fund should try to prevent measures that are destructive of national and international prosperity."

Aziz Ali Mohammed suggested that, from a political perspective, the CCL is not going to work. "We are forgetting the political angle. The Fund may have negotiated a CCL with one government, but when a crisis approaches during an electoral cycle, the government might change. At this point, the Fund may not be sure if the new government, which might be coming in on a totally anti-IMF platform, would repay the debt. Things like the CCL simply won't work given the reality of political electoral cycles."

Capital Controls

Amar Bhattacharya argued that the emphasis in the balance between international and domestic action should lie on domestic actions. "If Hong Kong Bank lends one percent of its equity to an Indonesian conglomerate, it won't represent a systemic risk to Hong Kong but a systemic risk to Indonesia. That is why the balance of actions must lie on the national side."

He stressed that domestic action should not be limited to the imposing of Chilean type of controls. "Much of the domestic actions, whether they are macro- or microeconomic, take time and institutional underpinnings. Because of that, José Antonio Ocampo emphasises regulation and, in particular, Chilean type of controls. But, important as Chilean types of controls may be, I think it is vital not to put your eggs all in one basket because financial systems are crucial and have a cross-border aspect. Good banking sector regulations such as better capital adequacy, having regulations on net foreign assets, and making leverage, for example, a criteria to determine risk rates in banking systems, are equally important. Similarly, there are regulatory options on the corporate side. Joe Stiglitz and I wrote a proposal linking tax deductibility of corporations to disclosure and tilt it against incentives for foreign borrowing. You could, for example, make a registry of foreign transactions as a criteria of eligibility for domestic bankruptcy procedures. There is a whole menu of things you can do which makes good sense for risk management, corporations, banks and for the entire economy, before you come to a Chilean type of control."

Mark Allen stressed the need to distinguish between controls on capital inflows and outflows. "Controls on inflows or outflows are a totally different set of problems. The control of inflows, such as the Chilean type, is a question of countries being wise at boom times and turning capital down

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which would otherwise be coming in and resist domestic demands to finance itself this way. This is probably something that ministers of finance and central bank governors should do but it is very difficult to achieve. It implies that when people are offering you the money, you should be applying a self-denying ordinance.

On the other hand, controls on outflows involve a very different set of costs and benefits. One of the reasons there has been so much liberalisation on the outflow side is not that the IMF and the industrial world have been putting pressure on countries to liberalise – although there has been an element of that – but that the costs of capital controls in everyday business life are indeed very high in middle-income countries. The main advantage of the controls is that you may actually need them to prevent capital outflows when a crisis comes. Whether they are effective is another story."

On capital inflow regulations, Guillermo Le Fort commented that he liked the pragmatic approach taken by José Antonio Ocampo and Stephany Griffith-Jones as opposed to the ideological kind of discussion that tends to separate two possible worlds: one with and one without capital controls. "I think of these regulations as instruments of macro-policy that have advantages and disadvantages, generating benefits and risks. It is important to note that these regulations cannot be used in isolation of other elements of a coherent macroeconomic policy in order to be effective and they should not be overextended because their effectiveness has some limitations."

He then distinguished between price-based and quantitative regulations of capital inflows. "I think that the price-based mechanisms are much more flexible and can be used counter-cyclically while the quantitative tend to generate no type of environment that allows graduated use. In addition, price-based regulations can be used in a non-discriminatory way while the quantitative tend to generate, if not discrimination, then what we could call 'discontinuities', by affecting some people or operations while not affecting others, which can have damaging effects.

However, a price-based mechanism like the unregulated reserve requirement does have leakage problems and only provides incomplete coverage of the system. The larger the leaks, the lower the macroeconomic effectiveness of the mechanism. At the same time, the existence of leaks and incomplete coverage implies larger macroeconomic costs because the generated distortions are larger when financing costs are differentiated between sectors or operations of the economy. Moreover, I agree with José Antonio that the price-based mechanism cannot compensate for expected jumps in the exchange rates. One way to misuse it is to try to avoid the appreciation of the exchange rate through it. If there is an expected appre-

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ciation of the rate, the potential gains of that appreciation cannot be absorbed by the costs of the unregulated reserve requirement which tends to be 200 or 300 basis points. These costs are not enough to compensate for the gains that could be made by a jump in the exchange rate in a very short period of time.

Nonetheless, quantitative capital inflow regulations tend to have much more important shortcomings and problems. Two such regulations were used in Chile. One was the withholding period for investment that was set at one year; investments coming in had to stay in the country for one year before being repatriated. The other was the authorisation to issue instruments, such as bonds and equity, in public markets abroad. Both of these had important problems. They tended to be more easily circumvented as markets developed. First, local market development was hampered by this type of quantitative restriction because the withholding period makes it very difficult to attract portfolio investments and develop the domestic financial – bond and equity – markets. At the same time, other problems like the discontinuity and discrimination in access to the external market is much more evident when some companies with a certain level of risk are authorised to issue in the international market and others are not. When this happens, you generate a discontinuity in the costs of and access to external financing that creates problems and distortions.

Not only do quantitative regulations generate important macroeconomic costs, as compared to the price-based regulations, they are also more easily circumvented through financial innovations. The authorisation to issue abroad was circumvented very early by the development of the private issue. The one-year withholding period was circumvented more recently a few years ago with the development of the offshore forward market for foreign exchange, the so-called non-delivery forward markets. The unregulated reserve requirement is not affected by either of these two innovations."

Equal Rules in North and South

Mark Allen was struck reading in Griffith-Jones and Ocampo's paper that a lot of work has been done on trying to improve standards at the emerging market level while very little has been done at the level of industrial countries. He explained why he found this quite normal: "Why is there a set of problems related to access to capital markets for emerging markets which don't seem to relate to industrial countries? Since finance to emerging markets is a very small tail on a rather large international capital markets dog, it is somewhat unrealistic to expect industrial countries to make major changes which would affect the entire international capital markets purely to deal with the problem of emerging markets."

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Stephany Griffith-Jones recognised this "tail wagging the dog" problem when it comes to the international regulation of capital flows, but stressed that such regulation would also be in the interest of industrial countries. "International regulation is desirable if developing countries are allowed to participate in the discussion. There are a number of possible regulations in the industrial countries. One regulation might be tax changes, changes in incentives for actors so they don't hurt someone else. But, there is still the problem as to why the developed countries should do it. Why would the UK or the US want to do this if it doesn't affect them? The only argument we can give is the risk of spill-overs. These crises happen in very strange ways that can jump across borders. The US and the world economy were lucky that the Long-Term Capital Management (LTCM) crisis was contained, but the fact that it came from the emerging markets should be a cause for concern."

Griffith-Jones added that the distinction Mark Allen made between industrial and emerging markets should not be overplayed because developed countries have also used very tight controls for a long time. "I think the Chilean reserve requirement was exactly copied from Spain's because about ten years ago, just as they were joining the EU, Spain had a 20 percent reserve requirement."

Roy Culpeper underscored Stephany Griffith-Jones' point that one of the developments since the Asia crisis with which we should be most concerned is the asymmetry in the world system between rules for the North and the South. He illustrated this with the example of the Basel capital adequacy standards. "A manifestation of this so-called two-tiered system that is emerging is what is coming out of the new Basel capital adequacy standards. These new standards create one system for the big money centre banks, a sort of self-regulatory requirements through their own risk management systems, and another system for everyone else. This puts banks and financial institutions in the South at a competitive disadvantage."

Mark Allen pleaded for caution with respect to a two-tiered system. "We tend to create one set of rules for the industrial countries, one set of rules for the emerging markets and perhaps another set of rules for the other developing countries which haven't yet reached emerging market status. We have to be very cautious about doing this. There are a number of problems with setting up this sort of group approach. One is the 'Groucho Marx problem', especially for the emerging market group, meaning that countries don't really want to belong to clubs that have people like them as members. One of the great aims of the more advanced emerging markets is to prove in their actions, deeds and statements that they are not really emerging markets but industrial countries. Therefore, they believe that the rules which apply to the emerging market group shouldn't

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apply to them and that they should have the freedom of action that is given to industrial countries. I sympathise very much with that, but its dangers must also be brought out. We need to be much more clear about what the objective conditions are, in terms of the economic structures of countries, which permit them to gradually move into the universe where the freedoms of the industrial countries apply. We need a better sense of the objective conditions and the sequencing of policies to be able to bring this out, rather than grouping countries and saying 'this set of rules applies to this group', and 'this set of rules applies to that group'."

Allen added that such caution, with respect to a group approach, also applies to capital controls. "We have been arguing here that the Chilean type of controls on inflows is probably a pretty good thing and that countries should be encouraged to have them. That means that we would suggest that a particular group of countries apply such controls whereas we would not suggest this to another group, including such countries as the United Kingdom. I am not saying that this is not a good idea, but we need to be objective about what distinguishes these groups of countries from one another."

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Part II

A New Framework for Private Sector Involvement in Crisis Prevention and Crisis Management

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A New Framework for Private Sector Involvement in Crisis Prevention and Crisis Management

Jack Boorman and Mark Allen

It is a pleasure to have the opportunity to participate in this year's FONDAD conference on the reform of the international financial architecture. We have always found these discussions useful, challenging and timely.

This session of the conference deals with a new framework for private sector involvement in crisis prevention and crisis management. We would like to discuss this topic in the context of the broader effort to improve the functioning of the international financial system. Accordingly, this paper begins in its first two sections with some reflections on the debate about the benefits of globalisation and lessons from recent international financial crises. In the third and fourth sections it reflects on the discussions that are underway on steps to help reduce the incidence and severity of crises, focusing in particular on the IMF's role. In the fifth section, the role of the private sector in preventing crises and in contributing, along with the official sector, to crisis resolution is outlined. A final section considers related reforms of the IMF and other international institutions.

I The Debate Over Globalisation

After coming to the IMF in early May 2000, the new Managing Director, Mr. Köhler, announced that he would make the articulation of a personal vision of the priorities for reform one of his first orders of business. He thus started consulting widely with member governments, other international organisations and fora, and the private sector. In the process he has already visited Asia and Latin America, and will hold discussions with governments in Africa and Europe in July 2000. The results of these consultations, recommendations from other groups, and further consideration in the IMF Executive Board will become evident shortly as this vision is articulated and embodied in strategic directions and initiatives.

Discussion on reform of the international financial system is hardly unprecedented – for instance, it was a recurrent theme during the 1970s,

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and FONDAD has been engaged in examining such issues for many years. However, the scope of the debate is now broader than ever, as it includes a sweeping re-examination of the costs and benefits of integration – spanning reform of the architecture of the financial system; the role and governance of key institutions such as the IMF and the multilateral development banks; the world trading system and the WTO; and other elements of an increasingly integrated and globalised system.

Concerns about the negative consequences of globalisation were made evident in the recent demonstrations in Seattle, Bangkok and Washington, perhaps to be repeated in Prague. It is possible to identify a number of specific concerns in the slogans of the protestors:

- The exploitation of child labour in some developing countries and failure to observe labour standards;
- The dislocation and unemployment following factory closures caused by international competition;
- Environmental damage caused by economic development;
- The violation of the rights of indigenous peoples in development projects;
- The disproportionate social costs that adjustment programmes put on the poor and the workers;
- The homogenisation of production techniques and consumption internationally;
- The imbalance between the influence of people and corporations in global decisionmaking;
- The impact of external indebtedness in causing poverty in poor countries; and
- The growing absolute gap between the incomes of rich and poor.

The demonstrators have attacked the multilateral institutions at the centre of global economic governance, the IMF, the World Bank, and the WTO, although not the UN or the ILO. The protestors have identified globalisation, and its management through these institutions, as the direct cause of the evils they list. The institutions are accused of being undemocratic and serving the interests of multinational corporations rather than those of the world's peoples. This is a view shared by few of those working in the institutions concerned, or by few of the governments that constitute their members.

The criticisms of globalisation have emerged just at the time when the advantages of liberal capitalism have become received wisdom throughout the world. Alternative systems of economic organisation have shown themselves to be bankrupt and have collapsed. The general view is that the economic liberalisation that has taken place since the Second World War under the aegis of the multilateral organisations, and the technological

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innovations, especially in the areas of information technology and telecommunications, have brought more prosperity to more people than at any time in human history.

Among the demonstrated benefits of the liberal capitalist world system are:

- Economies with open, outward-oriented policies generally grow faster than those with inward-looking, protectionist policies – and have the capacity to increase living standards for all. This is true because such policies enable countries to exploit their comparative advantages in production, provide opportunities for greater economies of scale, and result in a structure of relative prices that improves the allocation of resources. This was a major reason for the contrast between economic performance in Asia and that of parts of Latin America and Africa in the 1970s and 1980s;
- Liberalised financial systems help to promote growth through financial intermediation and efficient allocation of capital for investment;
- Private capital flows – both direct foreign investment and portfolio flows – have generally helped increase investment and growth in developing economies; and
- Investor opportunities expand with globalisation – not only for multilateral corporations, but also for pension funds, other forms of institutional investment, and individuals.

Nevertheless, the concerns of the protestors reflect a number of real evils that the international system needs to confront. However, the solutions are not going to be found in throwing out the system that has delivered so much over the last fifty years. The issues raised by the protestors are not susceptible to simple solutions. Both sides must be open to debate and discuss honestly and without demagoguery the roots of the problems and the advantages and disadvantages of alternative solutions.

This informed debate is vital if political support is to be retained for the liberal multilateral system. The personalised stories of hardship that stem from the system and dislocation are more vivid and dramatic than the steady and broad-based growth in prosperity for so many. The political system needs to mobilise support for the policies that bring general prosperity, while tackling the evils intelligently. It is particularly important that the debate in the industrial countries does not lead to the adoption of solutions that inadvertently cut off the people of the developing countries from following the path of prosperity.

The IMF's involvement in globalisation is, of course, mostly in the area of trade and financial markets. As the focal point for international cooperation on monetary issues, the IMF has a responsibility for helping to ensure the smooth functioning of the international monetary system – not the

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least as a means to promote growth in member countries – by helping them to become more fully integrated into the global trading and financial systems. Although the work of the IMF deals most typically with fiscal and monetary policy, exchange rate arrangements, and financial systems, in the pursuit of its responsibilities, it touches upon many other factors as well. This cannot be avoided, since our membership is diverse and there is not one unique model of an open market economy. There are many choices for countries to make – on tax policy, social spending and many other issues – and it is important to find specific solutions that take factors that are unique to a country, such as its level of development and its social and cultural traditions, into account.

II Lessons from Recent Financial Crises

Just as globalisation can be an enormously positive force for economic growth and for raising living standards generally, it can also pose risks. These risks materialised in dramatic ways in Mexico (1994/95), Asia (1997/98), Russia (1998), and Brazil (1998/99). Such experiences have led to a search for answers as to what caused these crises, what aggravated them once they began, and what can be done to prevent them or, if they occur, to manage them better and limit the costs they can impose.

A central feature of each of these crises was a rapid reversal of previous capital inflows, which in turn forced a large and abrupt adjustment in the current account with widespread consequences throughout the economy. The exact sources of the change in market sentiment that lay behind the crisis varied from country to country, as did the ways in which the authorities, private creditors, and official lenders responded. The results underscored weaknesses in the actions of all these participants. For example:

- In Thailand, signs of policy weaknesses and external vulnerability were detected prior to the crisis. When exchange market pressures began, the authorities chose to defend the exchange rate without changing the policy mix by using reserves and forward intervention, but in ways that few could detect owing to a lack of transparency in these operations. This choice, in combination with an asset price bubble and weak financial system, significantly increased the vulnerability of the Thai economy, further weakened investor confidence, and ultimately limited the options available to the authorities in designing an appropriate policy response.
- In Korea, it was more difficult to foresee the nature and extent of the underlying problems because they were mainly associated with banks and non-financial enterprises, rather than public debt or macroeconom-

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ic imbalances. The government was largely unaware of the size of the short-term external debt of these sectors. This short-term debt had arisen in part because of perverse incentives caused by the sequencing of capital account liberalisation, in which short-term capital inflows were relatively easy to obtain while foreign equity investments and longer-term borrowing were discouraged.

- In Indonesia, the proximate source of external vulnerability was, as in Korea, in the external debt of the private sector. However, its severity was compounded by problems of governance in corporations and banks, the absence of effective bankruptcy procedures and other legal and institutional preconditions for an orderly workout of private sector debt, and the consequent assignment of the losses of insolvent banks and corporations to the government.

A common denominator in the Asian cases was the lack of information for markets – and often, even for policymakers – which weakened decision-making about the degree of external vulnerability until the problems had become so large that there were no longer good options for dealing with them. A complicating factor was that in some cases sources of vulnerability were mainly in the private sector, where timely and reliable data were particularly hard to come by.

The Asian cases also raised questions regarding other broad issues:

- Exchange rate regimes: do pegged rates necessarily increase risks?
- Banking and financial sector supervision: were the institutions in these countries ready to confront the risks present in global financial markets? Should there have been a different sequencing of structural reforms and capital market liberalisation?
- Adequacy of bankruptcy regimes to permit an orderly workout of domestic debt and prompt reorganisation of the financial sector.

In Mexico, a risky public debt management strategy contributed to the onset of the crisis, while the situation in Brazil was largely precipitated by classic problems of fiscal sustainability and public debt dynamics. Russia faced fiscal and exchange rate problems, but in addition there were major issues regarding governance, weaknesses in the banking system, and other structural problems.

These experiences also raised questions about the functioning of markets and the role of the IMF. For the IMF:

- Could it have done a better job of detecting signs of vulnerability to crises? And, in cases where it did see problems on the horizon, could the IMF have done more to convince country authorities to address them? Indeed, should the IMF have spoken more publicly about the dangers?
- Could the IMF have moved more quickly when the crises struck?
- Was it right for the IMF and the international community, more gener-

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ally, to provide the large financing packages that were put together? Or should the private financial sector – banks, bondholders, and others – have been asked to play a bigger role?

- Was the IMF's policy advice correct, not only on the macroeconomic policy side, but also in the diverse areas of structural reform in which changes in policy were sought?

For markets, questions raised include:

- Are there ways to reduce herd behaviour?
- Do financial firms have biases toward excessive risk-taking in the risk/reward system of dealmakers? How can risk analysis be given a greater voice within financial institutions?
- Can supervisors do a better job of building systems that permit the failure of individual banks and corporations, rather than permitting problems to grow and spread into system-wide crises?
- Should financial institutions that engage in large international transactions, such as hedge funds and investment banks, be required to disclose more detailed and frequent information on their activities?
- Is it possible to develop instruments to help facilitate restructuring of private sector claims, including claims on sovereigns?

These and other related questions have been taken up in a number of recent reports on international financial reform emanating from intergovernmental fora such as the G-22 and the Commonwealth Secretariat; from parliaments; from US-based groups like the Meltzer Commission, the Overseas Development Council, the Committee on Economic Development, and the Council of Foreign Relations; and from similar organisations in Europe, such as the "Geneva Group". Each of these reports focuses, to a considerable extent, on questions about the role that the IMF should play in a globalised financial system, how the IMF can help its members identify and contain risks, and ways to improve the functioning of international financial markets.

III The IMF's Role in Preventive Surveillance

Probably the most important theme running through the proposals to reform the international financial architecture is the need for better identification of sources of vulnerability and measures to prevent the emergence of crises. For the IMF, this translates into a search for ways to increase the effectiveness of surveillance.

One of the basic responsibilities of the IMF is to exercise surveillance over the policies of its members, in order to promote growth, low inflation, and sustainable balance of payments positions. Surveillance is thus

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our first line of defense against financial crises. The obligation of members to cooperate in this surveillance is set out in Article IV of the IMF Articles of Agreement. In order to fulfil its responsibility, the IMF must constantly adapt to the changing economic environment, including the challenges posed by the global integration of capital markets. This process of adaptation led the IMF, some years ago, to look increasingly beyond fiscal, monetary and exchange rate issues in order to find ways of detecting and reducing internal strains on the financial sector that can lead to economy-wide instability. With the continued evolution of financial markets, surveillance of those markets is becoming ever more complex. The recent crises underscored the potential for problems in the enterprise sector to push the banking sector to the brink. There is also a need to be aware of possible regional or even global spill-overs from a country's policies. In addition, the Fund has a special responsibility for multilateral surveillance of the global economy and international financial markets, so that it can identify overarching trends that need to be taken into account in formulating country policies and, if necessary, to suggest improvements in the system.

The speed and virulence of recent financial crises, spreading through the capital account and disrupting the domestic economy of crisis-hit countries, has underscored a number of areas which require more intense scrutiny under IMF surveillance:

- The adequacy of economic data to detect signs of vulnerability;
- The quality of official supervision of banks and other financial institutions;
- The adequacy of the legal and institutional underpinnings of the financial sector, including accounting and auditing standards, bankruptcy regimes and corporate governance;
- Transparency by governments in their dealings with their citizens and their creditors;
- Appropriate sequencing of capital account liberalisation, particularly in relation to the capacity for financial supervision; and
- Consistency between a country's exchange regime, its macroeconomic and institutional framework, and the exposure to potentially volatile international capital movements.

These are all controversial issues. For instance, the topic of capital account liberalisation is sometimes perceived as a tug-of-war between proponents of rapid liberalisation and those in favour of maintaining highly restrictive regimes, based mainly upon theoretical arguments and *a priori* logic. I think it helps to focus this debate to couch the discussion in terms of costs and benefits of capital controls for any particular country and, especially, the proper sequencing of reforms of the domestic financial system and supervisory regime that are necessary pre-conditions for taking

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full advantage of linkages to global financial markets. In the area of exchange rate policy, countries have tended to move away from pegged rates in the wake of the recent financial crises, and toward either much more flexible exchange systems or rigidly fixed ones, such as currency boards or dollarisation. But it would be going too far to say that this represents an international consensus, or that the choice of regime in itself resolves the underlying problem of ensuring consistency with the country's economic situation and policies.

A number of initiatives to increase the availability of information on possible sources of vulnerability have been taken during the past two years by, or under the leadership of, the IMF. Among the most important have been the efforts to develop internationally agreed upon methodological standards for compiling data on foreign exchange reserves and short-term debt. These standards grapple with conceptual issues such as the recording of repos and various kinds of derivative transactions, as well as difficult practical problems of extending the coverage of debt data to include the private sector. The new methodologies are already being used in conjunction with the Fund's voluntary system of data dissemination standards and the Executive Board will discuss in June 2000 their possible application to data reported to the Fund for surveillance purposes.[1]

In addition, the IMF is continuing its research on empirical models of financial crises and ways to use these models to develop macroeconomic and micro-prudential indicators and early warning systems that can be utilised in surveillance. Using these and other techniques, we are seeking to promote greater continuity in surveillance and the associated dialogue with member countries. Of crucial importance is that we are trying to develop better ways of ensuring that this research and the work on methodologies is informed by, and helps to inform, our day-to-day work with member countries. In addition, related work is underway in the IMF and World Bank to summarise lessons from the experience with public debt management and capital market development in member countries, and to distil these into best practices in public debt management.

The IMF is also intensifying its efforts to identify possible sources of vulnerability in members' domestic financial systems. The IMF and World Bank are cooperating closely in an experimental Financial Sector Assessment Program (FSAP), under which they carry out comprehensive and cross-disciplinary examinations of financial systems, including their legal and institutional arrangements, the adequacy of supervisory regimes, and the current situation of banks and non-bank financial institutions, such as

1 Public Information Notice, No. 00/59.

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securities firms and insurance companies. In order to cover such diverse issues, the FSAP draws upon specialised expertise from other institutions and member governments. The joint FSAP provides the basis for special assessments in the Fund and Bank. In the IMF, a Financial Sector Stability Assessment (FSSA) is prepared, focusing on risks to macroeconomic stability stemming from the financial sector and feeding into Article IV surveillance, technical assistance and programme design. In the Bank, a Financial Sector Assessment (FSA) is prepared, which provides inputs to Country Assistance Strategy Papers, technical assistance and sectoral lending operations. A pilot programme of FSAPs covering 12 countries will be completed later this year and a further 24 assessments are to be undertaken in 2001.

Another major focus of the IMF in recent years has been the development of standards and codes on matters that are essential to the proper functioning of domestic and international financial markets. One of the first of these was the Basel capital adequacy standard, adopted in 1988 by a group working under the auspices of the G-10 central bank governors. The Basel capital adequacy standards served for many years as an essential guidepost for countries seeking to strengthen their domestic financial systems. However, a number of issues arose in their application over time – such as the appropriateness of incentives arising from the risk weights attached to various types of assets, implications of growing complexity and substitutability in financial instruments, and pro-cyclicality (e.g. when economic downturns led to reduced asset quality, a need to moderate asset growth – or reduce assets – to restore capital-asset ratios arose, which contributed to a further weakening of economic activity). The capital adequacy standards are now being updated to take into account subsequent innovation in international financial markets as well as the interests of a broader group of countries.

A second wave of work on standards, which began in the late 1990s, has been oriented both toward providing guidance for efforts to strengthen domestic institutions and encouraging the release of information by governments to their citizens and to financial markets. The principle behind this "transparency" objective is that the release of information to the public will tend to improve both policy formulation and the functioning of financial markets, by permitting voters and lenders to make more informed decisions, strengthening accountability, and facilitating market discipline. The approach of formulating common standards for all countries is based on practices believed to be consistent with good governance and the stable and efficient functioning of financial markets. It is designed to provide a basis for assessing the adequacy of the current legal and institutional frameworks and priorities for further development, and also to ensure that

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information disseminated on these matters is based on a clear and consistent framework. The IMF has led the way toward the approval of internationally agreed upon standards in the areas of data dissemination, fiscal transparency, and transparency in monetary and financial policies, and has participated in the elaboration of standards in the areas of banking supervision and payments systems. Other institutions have led the way in the development of standards in related areas such as securities, investment funds, insurance, accounting, auditing, and corporate governance.

It is clear that the existence of such standards provides a powerful tool for improving the specificity of the IMF's policy advice. In addition, the existence of the IMF's surveillance responsibility, under which it maintains a policy dialogue with each of its 182 member countries, provides a logical vehicle for bringing together the results of assessing the observation of these standards. However, many issues have arisen in the application of this principle, including:

- Whether the IMF has the expertise to assess the observance of standards in many of these areas, and – where this is not the case – whether any other body exists which can do this for the entire Fund membership;
- Whether an attempt to use surveillance as the focal point for assessing the observance of standards risks blurs the IMF's focus on macroeconomic and financial sustainability and mires the process in a morass of detail;
- Whether standards, the observance of which is voluntary, are appropriate topics for IMF surveillance, which is an obligation of Fund members; and
- Whether IMF surveillance is the appropriate way to ensure dissemination of information on the observance of standards to financial markets and the broader public.

Owing to the need to mobilise expert resources for assessing the observance of the various standards and the time that it takes to prepare each one, the preparation of assessments for IMF member countries is being carried out in a phased manner. In that context, the IMF has begun a pilot programme of Reports on the Observance of Standards and Codes (ROSCs), under which reports are prepared on a standard-by-standard and country-by-country basis, at the initiative of individual Fund members. The accumulated information for a given country is used as background for Article IV consultation discussions, as well as in guiding technical assistance. This "modular" approach has the advantage of staggering the workload on national authorities and staff and making it easier to coordinate with the World Bank and other institutions that are also participating in the assessments.

The benefits to the system as a whole of the widespread use and observ-

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ance of internationally agreed standards are clear – they provide a framework for the dissemination of information in areas that are crucial to the functioning of financial markets, as well as assurances that the information will be understandable and roughly comparable across countries. But the willingness of individual countries to adhere to such standards and codes, or to agree to be measured against them, depends on their perception that this may have tangible benefits for them. This will only be the case if market participants make use of the information, and if it is seen to lead to differentiation in spreads and other lending terms.

Countries that have asked for assessments to be performed would always have the option of publicising the results, and we anticipate that this will be done in many cases. However, this does not entirely get around the question of how incorporating the results into IMF surveillance might also contribute to widespread dissemination of the results. This possibility arises mainly as a result of recent initiatives to increase the transparency of the IMF's own activities.

Under its transparency initiatives, the IMF has increasingly begun to release a wide range of information on its activities, including documents underlying policy discussions in its Executive Board, letters of intent for IMF-supported programmes, and its Article IV surveillance reports and the summings up. While summings up are now available in the vast majority of cases, the Article IV reports are publicised only with the prior consent of the member under an experimental pilot programme. The experience under this pilot programme will be reviewed by the Executive Board in August 2000, and we would expect the review to focus mainly on two related issues:

- First, whether the prospect that Article IV reports will be published reduces their candour and usefulness; and
- Second, more generally, whether increased IMF transparency tends to undermine its role as a confidential advisor to governments.

The modification of IMF surveillance to take into account the evolution of international financial markets has led many observers, both inside and outside the institution, to question whether the IMF is becoming involved in areas that are beyond its competence and mandate. They see this trend as potentially harmful to the IMF's credibility, reducing its ability to do adequate work on its core topics, and contributing to overlap and the possibility of conflict with other organisations, including the World Bank. Earlier this year, the Executive Board agreed that the Fund's involvement in issues outside of its core areas, in the context of surveillance, should be guided by a "macroeconomic relevance" test. Since then, the staff has been exploring ways to take fuller advantage of the possibilities for complementarity in the activities of the IMF, World Bank, and other international

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institutions in member countries. We are sure that there will be strong possibilities for joint efforts in our work on low-income countries, financial sector surveillance, and the assessment of standards, and have put coordinating bodies in place to help ensure good inter-institutional collaboration in these areas. We are also seeking further ways of refining the division of labour – and of coordinating activities with other institutions in areas where overlap is inevitable and desirable.

IV The Financial Facilities of the IMF

Another issue that has featured prominently in discussions of the international financial architecture is the role of the IMF's financial operations. Among the issues raised regarding the IMF's financial facilities have been:

- Whether the Fund's large-scale assistance during financial crises creates moral hazard by bailing out private investors;
- Whether more traditional Fund financing permits countries to unduly delay adjustment or substitutes for more costly market borrowing or both; and
- Whether the Fund's financing operations are unnecessarily complex.

Many observers see the complexity of the IMF's financing operations as confusing to members and the general public and as tending to undermine the transparency of the IMF. A first stage of simplification of the financing facilities was completed in early 2000 when four facilities were eliminated and it was agreed that a fifth would be streamlined.[2] Further discussions are planned for summer 2000.

There is a widely-shared opinion that the Fund should not only play a central role in preventing financial crises, but also in managing them when they do occur. The Fund successfully introduced the Supplemental Reserve Facility in late 1997 to provide very large-scale support for relatively short periods to members undergoing capital account driven crises. In such large financing operations it is necessary to both protect Fund resources and minimise moral hazard, and to find the right balance between Fund financing and private sector involvement. We will return to this topic in the next section.

We have also been experimenting with ways in which IMF financing

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2 In March 2000, the Executive Board abolished the Buffer Stock Financing Facility, the contingency element of the Compensatory and Contingency Financing Facility, and the policies on Currency Stabilization Funds and support for commercial bank Debt and Debt Service Reduction operations. At the same time, it agreed to simplify the remaining (Compensatory) element of the Compensatory and Contingency Financing Facility. The Y2K facility expired, as planned, on March 31, 2000.

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facilities could encourage stronger policies by members that do not have immediate balance of payments difficulties and, in that way, further help to prevent crises. With this objective in mind, the IMF created its Contingent Credit Line (CCL) in 1999. This decision introduced an element of prequalification for Fund financing because a country must have established a solid track record on policies and progress toward observance of certain standards before it can qualify for a CCL. No member has requested a CCL to date, suggesting that it may, in fact, be less attractive than the IMF's ordinary financing facilities. Consequently, there is broad agreement on the desirability of modifying it to increase incentives for its use. One possible area for modification is reducing the disparity between rates of charge on the CCL and other facilities. However, there is also concern that the CCL suffers from some fundamental problems (particularly regarding the conditions for its activation and the implications of exiting the facility once it has gone into operation) that may be harder to address.[3]

A number of outside observers have focused on the possibility that IMF financing might simply substitute for financing from other sources or, if it is additional, might actually delay needed adjustment. Both of these are complex issues, relating to the nature of the IMF policy dialogue with members, conditionality, and the catalytic role of IMF arrangements. A number of changes in the financial terms of IMF financing facilities are being considered to address these concerns, including the possibility of shortening the maturities of some of the facilities, introducing an expectation of early repurchase, as well as escalating charges with length and/or the magnitude of outstanding obligations.

V Private Sector Involvement in the Prevention and Resolution of Crisis

Notwithstanding the heightened attention given to prevention, crises will occur and members are likely to approach the Fund and official creditors more generally, for financial resources in support of their adjustment programmes. The globalisation of international capital markets has substantially increased the volume and volatility of private capital movements and the consequent potential of such movements to contribute to sovereign liquidity crises, while complicating their resolution. As the movement of capital responds to sometimes abrupt shifts in market sentiment, countries' increased integration with international capital markets has augmented both the potential magnitude of financing requirements during periods of

3 Discussions of these issues are confirmed for September 2000.

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stress and the pace at which emerging pressures may develop into full-blown crises.

The potential magnitude of such crises and potential moral hazard arising from large-scale official financing packages suggest the desirability of private sector involvement in their resolution. As noted in the International Monetary and Financial Committee (IMFC) Communiqué of April 2000, "in some cases, emphasis should be placed on encouraging voluntary approaches, as needed, to resolve creditor coordination problems."[4] In other cases, a more concerted approach may be required, involving a certain degree of encouragement or pressure from the official sector. It will be important, in such cases, to strike an appropriate balance between limiting moral hazard, on the one hand, and the effect of concerted measures on the prospects of the member concerned for regaining spontaneous capital market access and on the efficient operation of capital markets more generally, on the other.

The magnitude of financing requirements may, in some cases, dwarf the volume of balance of payments financing traditionally available from official sources (consisting primarily of normal levels of access to Fund resources in support of appropriate adjustment policies, programme lending by the World Bank and other multilateral development banks, and debt relief from the Paris Club and other official bilateral creditors). Moreover, in a world of highly mobile capital, estimated financing requirements may be subject to a high degree of uncertainty, as estimates depend critically on assumptions about the pace at which confidence will recover and the associated behaviour of private capital. Ensuring that Fund-supported programmes with countries that are deeply integrated into international capital markets and are facing pressures in the capital account are fully financed will often require difficult judgements concerning whether or not the involvement of the private sector should be concerted.

- It is possible that, in most cases, it will be sufficient to rely on the Fund's traditional catalytic role. That is to say, programme financing would continue to be based on the assumption that the combination of official financing and the implementation of appropriate policies will allow confidence to build and a spontaneous resumption of capital market access to emerge.[5] It is recognised that, under this approach, there are uncer-

4 Communiqué of the IMFC of the Board of Governors of the International Monetary Fund, April 16, 2000 (www.imf.org/external/np/sec/pr/2000/pr0031.htm).

5 Countries that enjoy spontaneous access to capital markets would be able to mobilise new borrowing, and may also be able to arrange voluntary debt exchanges that smooth payment humps. Several members with outstanding Brady Bonds have been able to arrange voluntary debt exchanges that allow the collateral to be released to the member. Such exchanges would not be possible after a member has lost spontaneous access to markets.

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tainties at the start of a programme about the pace and magnitude of capital outflows and, therefore, about the drawdown of official financing before private capital is stabilised and starts to flow back.

- In other cases, in which the prospects for a spontaneous return of private capital are less propitious, a more concerted means of securing private sector involvement may be required in order to provide reasonable assurances that programmes will be adequately financed.

At the start of Fund-supported adjustment programmes, the official community will need to decide whether: (i) to make available official resources in the expectation that the catalytic approach in support of credible adjustment policies (possibly complemented by some gentle encouragement to help overcome collective action problems)[6] will lead to a spontaneous return of private capital; or (ii) to condition the use of Fund resources on more concerted means of securing continued private sector involvement. Fund staff have suggested a preliminary framework for coming to a choice between these two options in individual country circumstances.[7] This framework seeks to build on the principles, considerations, and tools articulated by the G-7 Finance Ministers in their report to the Cologne Economic Summit.[8] It is generally agreed that the Fund's approach to individual cases would need to be flexible and would require considerable judgement on some complex issues.

Under the suggested framework, private sector involvement could be ensured primarily through reliance on the Fund's traditional catalytic approach if the country's financing requirements are moderate, or if the country has good prospects for rapidly regaining market access on appropriate terms, even if the financing requirements are large. More concerted forms of private sector involvement could be required if the financing requirement is large and the country has poor prospects for regaining market access in the near future, or has an unsustainable medium-term debt burden. While the suggested framework may provide a useful approach to the issue, making it operational requires a number of difficult analytical judgements.

There are divergent views regarding whether or not it would be desirable to establish a presumption concerning the particular circumstances under

6 Gentle encouragement to overcome collective action problems could include an intensification of the dialogue between the member and its creditors, and the dissemination of data to help provide creditors with the comfort that their forbearance was not being used to allow others to exit.

7 Statement by the Acting Chairman to the IMFC on Progress in Reforming the IMF and Strengthening the Architecture of the International Financial System, April 12, 2000 (www.imf.org/external/np/omd/2000/state.htm).

8 Report of the G-7 Finance Ministers to the Cologne Economic Summit; June 18-20, 1999 (www.library.utoronto.ca/ca/g7/finance/fm061999.htm).

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which concerted private sector involvement would be required. Specifically, some favour establishing a presumption (but not necessarily a requirement) that, if access to Fund resources exceeded a specified percentage of quota, concerted means of securing private sector involvement would be required (figures such as annual access rates of 100 percent of quota or cumulative access of 300 percent of quota have been mentioned). Others consider that individual cases would still need to be considered on their merits, within the framework of principles articulated by the G-7 Ministers of Finance. Those sharing this view believe that moving toward a more mechanical system for determining the circumstances in which concerted efforts would be used to secure private sector involvement would be problematic, because of the difficulty of framing rules appropriate to future cases of an undefined nature.

The choice between establishing a quantitative approach to defining the circumstances in which the Fund would condition its support on concerted private sector involvement, and retaining the flexibility to consider each case on its merits, involves an assessment of the costs and benefits of the two approaches. In brief:

- The primary benefits of establishing a presumption regarding the conditions under which the Fund would require concerted private sector involvement would appear to be: (i) the relative predictability of a rules-based framework, with the associated implications for the incentives facing markets to assess and manage risks; and (ii) limiting the risk that large-scale official financing could be used to allow the private sector to exit during programmes if an expected spontaneous return of private capital does not materialise within the programme period, thereby exposing official financing to excessive risk and, possibly, creating moral hazard.
- The principal costs of establishing a presumption regarding the conditions in which the Fund would require concerted private sector involvement could take two forms: (i) an adverse effect on prospects for a resumption of spontaneous market access by the country concerned in circumstances in which there may be good prospects that the catalytic role would be effective; and (ii) adverse effects on the efficient operation of international capital markets, more generally.

Finding an appropriate balance between the costs and benefits of these approaches involves two main issues:

- First, the ability to estimate the likely effectiveness of the catalytic approach at the start of a programme – in other words, the associated prospects for a prompt and spontaneous resumption of capital market access within the programme period; and
- Second, the availability of instruments for securing concerted private

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sector involvement and the effects of their use on the country concerned and on capital markets, more generally.

With regard to the first of these issues, it is difficult to predict the evolution of countries' access to capital markets, particularly during the recovery from crises and periods of global turbulence. Market sentiment toward particular countries can shift abruptly. Moreover, more general developments in international capital markets, which are difficult to anticipate, can introduce significant swings in the availability of capital flows to emerging markets as a whole. These factors compound the twin (and related) difficulties of projecting both the availability of private financing and the magnitude of the financing requirement. Nevertheless, although it is not possible to specify a quantitative model for predicting capital market access for a particular country, a range of factors are likely to have a bearing on the prospects for spontaneous capital market access. Some of the major factors involved can be grouped under the following headings:

1. *Characteristics of the economy.* Market perceptions of key characteristics of an economy that have a bearing on its ability to service additional external debt can be found in the reports of credit rating agencies and other readily available market commentaries. The consistent availability of credible data about the country is also likely to have a bearing on investors' decisions.
2. *Previous levels of market access and market indicators.* Market indicators, including, in particular, secondary market yields on outstanding debt instruments and measures of liquidity, provide important indicators of the prospects for regaining market access. Countries with an established presence in capital markets may find it relatively straightforward to return to capital markets after a hiatus associated with a liquidity crisis. In contrast, those without an established presence (or with only a limited presence) in capital markets may find it difficult to place new instruments as they emerge from crisis or near crisis. This suggests that the effectiveness of the Fund's catalytic approach is limited in such cases. Market access will also depend on the general state of financial markets.
3. *Strength of the macroeconomic and structural policy framework.* A market perception of this strength is likely to be a critical element of decisions as to whether or not to restore spontaneous access.
4. *Authorities' commitment to sustain the implementation of the reform programme.* Investors are likely to be particularly concerned about the ability of governments to muster the will and political consensus required to maintain sound macroeconomic and structural policies.
5. *Level of reserves and availability of financing.* The availability of substantial resources (whether in the form of undisbursed loans to build official reserves or fully credible lines of credit and similar instruments provided

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by the private sector and the official community) can have important implications for spontaneous market access, particularly with regard to creditors' willingness to maintain short-term credit lines and residents' decisions regarding capital flight.

6. *Stage of crisis and experience with creditor-debtor relations.* It is likely that the Fund's catalytic approach will be most effective at the early stage of a liquidity crisis. Over time, when the crisis deepens, and the associated damage to the quality of balance sheets of domestic financial institutions and the corporate sector becomes extensive, the spontaneous return of private capital is likely to be delayed. Government access to capital markets may progressively worsen as fiscal costs associated with resolving financial sector difficulties and the erosion of the tax base increase. Moreover, an interruption of normal creditor-debtor relations, as a result of default, is likely to delay the spontaneous return of private capital.
7. *Portfolio disequilibria.* Finally, the prospects for a spontaneous abatement of outflows and the return of capital may be affected by the extent to which the maintenance and rebuilding of such exposure is viewed as consistent with the maintenance of creditors' and debtors' portfolio equilibrium. At one extreme, capital outflows associated with a financial panic may be reversed rapidly by the catalytic effect of Fund and other official involvement. At the other extreme, if maintaining or rebuilding exposure is seen as being associated with portfolio disequilibria, the catalytic approach could be weakened. One example of such a disequilibrium could arise if a shift toward a floating exchange rate results in a permanent reduction in the attractiveness of domestic currency assets to foreign investors that had hoped to benefit from high domestic interest rates.

The record of predicting the effectiveness of the Fund's catalytic role is uneven but, on balance, favourable. In several cases, projections concerning maintaining or regaining market access within the programme period have been broadly validated (Argentina, Colombia and Turkey). In a few other cases, however, expectations about the effectiveness of the catalytic approach were not borne out by experience. In particular, there is a question whether, with the benefit of hindsight, the Fund should have attempted a concerted rollover of interbank debt at an earlier stage in the case of Korea and Thailand. The decision to proceed with the extended arrangement with Russia in July 1998 was taken in the absence of full information regarding Russian banks balance sheets and without a complete understanding of the inter-linkages between the markets for Russian domestic and international debt instruments. Lessons learned from these episodes can be expected to strengthen the ability to predict the effectiveness of the Fund's catalytic role in future cases.

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In recent years, some experience has also been gained with the use of concerted techniques to secure private sector involvement in the resolution of financial crises. In the case of Brazil, outflows of interbank and trade-related credits continued after the programme was initially approved in early December 1998. In early 1999, however, the policy framework was strengthened and a "light touch" applied to help resolve problems associated with collective action among commercial bank creditors through the dissemination of data and peer pressure, and without the application of moral suasion by the official sector. By applying a steadying hand during a period of turbulence, it was possible to secure a voluntary agreement on the maintenance of exposure to interbank and trade-related credits. This cooperative solution was successful in securing agreement among a large number of creditor banks. As policies were strengthened and took hold, and confidence was rebuilt, there was a spontaneous increase in the extension of such types of credit. Two critical factors that enabled a light touch to be effective in coordinating commercial banks were: (i) banks' interest in maintaining their long-term commercial involvement with Brazil; and (ii) the unwinding of leveraged positions of foreign investors following the Asian and LTCM crises, thereby limiting the scale of capital outflows through other channels. It is unlikely that similar efforts to apply a light touch could be successful in cases in which banks – or other relevant groups of creditors – did not have an interest in preserving a long-term commercial relationship, and in which there is potential for a more broad-based outflow of capital.

In other cases, a more forceful approach was employed, though in some instances only following the demonstrated failure of the earlier purely catalytic approach. In the case of Korea, the roll-over and restructuring of interbank debt was achieved with moral suasion from supervisory authorities and the extension of a sovereign guarantee. Even in this instance, however, the earlier unwinding of exposure probably made the remaining creditors more receptive to requests to maintain exposure, as did the recognition by all the players that a concerted roll-over had become the only feasible alternative to a default as the crisis progressed. But there are questions regarding the general applicability of this type of approach. Central monetary authorities may not be willing to exert moral suasion in all cases in which concerted action might be indicated. Moreover, to the extent that banks are required to maintain exposure to one country, there is a risk that payments pressures will be exported to other countries as banks actively manage their portfolios. Finally, there is a concern that banks may cut credit lines at an early stage of discussions between a country and the Fund because they expect to be corralled into supporting Fund arrangements through concerted roll-over operations, thus further exacerbating balance of payments pressures.

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Taking the concerted approach beyond bank credit lines and trade credits, the limited recent experience with the restructuring of international sovereign bonds has some encouraging elements: both Pakistan and the Ukraine were able to reach voluntary agreements with bondholders over new instruments featuring relatively long repayment periods and moderate coupons, thus moving these countries toward medium-term viability. Moreover, the experience so far with Ecuador's sustained default on Brady and Eurobonds, and subsequent bond exchange, suggests that creditor litigation may not be as serious a problem as some had once feared.

Important questions also arise in cases where a unilateral restructuring of domestic debt or the temporary imposition of comprehensive exchange controls need to be considered as a means of arresting capital outflows in a more general way. In both cases, there could be immediate concerns about the spill-over effects resulting from the need for leveraged investors to generate liquidity for margin calls by liquidating investments in other markets (as occurred in the aftermath of the August 1998 Russian crisis). It is also likely that investors' concerns regarding transfer risk, following either a unilateral restructuring or the use of exchange controls, could have an adverse medium-term impact on a member's ability to attract private capital from non-resident investors and persuade residents to reverse capital flight and hold an increasing proportion of their financial assets at home.

If allowed to run its course, a financial crisis is immensely destructive of both the country's prosperity and the value of creditors' claims. A cooperative solution that prevents this outcome can clearly be in the interest of everyone involved. Nevertheless, while some success has been achieved in securing concerted private sector involvement in specific cases, it has become increasingly clear that the international community does not have at its disposal a full range of tools to assure a reasonably orderly involvement of the private sector. In some cases, depending upon the specific circumstances, it may be possible to use concerted techniques in a fashion that prevents private investors from exiting in the midst of a crisis but avoids serious spill-over effects and substantial medium-term damage to the member's prospects for regaining spontaneous market access. In other cases, however, the available tools may be blunt, and it may not be possible to stop capital outflows without substantial unwelcome side-effects.

Private capital is the engine of economic growth for a large number of countries. Accordingly, there is a critical need to adopt preventative measures that encourage the productive use of private capital without generating vulnerability to crises. This requires a combination of appropriate policies, efforts to strengthen financial systems and debt management policies, and concrete steps to improve the environment for private sector decisiontaking. It is also important for countries to take the opportunity

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presented by periods of relative calm to put in place mechanisms that could be helpful in managing crises and near-crises. Examples include the establishment and maintenance of debt monitoring systems, the collection and timely provision of data, establishing constructive dialogue with creditors, and the use of collective action clauses in bond documentation.

It is clear that the Fund's policy concerning the involvement of the private sector in the resolution of financial crises remains one of the most difficult issues facing the Fund in the context of the policies governing the use of its resources. Erring in the direction of providing too much official financing – even if feasible – could create moral hazard, and could thereby risk increasing the frequency and severity of future crises. At the same time, erring by too frequently reaching for concerted means of securing private sector involvement is likely to have a detrimental effect on the private sector's willingness to channel resources to emerging and developing countries, thereby placing the prospects for sustained rapid economic growth in jeopardy. Finding an appropriate way for the Fund to navigate these shoals is important to the institution's ability to find an effective means to resolve financial crises in a world of global capital markets. And the difficulty of finding an appropriate balance again underscores the critical need for effective crisis prevention.

VI Governance and Institutional Issues

An issue which frequently arises in the public debate on globalisation is the appropriate division of responsibility and mode of interaction among international institutions, governments, and other groups in dealing with issues of common concern. Clearly this topic is not going to go away, and everyone involved needs to give greater thought to procedures for how such groups should interact. This affects decisionmaking on broad, multilateral issues such as debt relief, labour standards and trade liberalisation. But it also has a bearing on the IMF's relations with individual member countries, including the process through which groups within a country, in addition to the central government, may become involved in discussions of Fund-supported programmes.

Closer to home, the topic of governance in the IMF is already high on the agenda. Developing country members – especially those from emerging market economies – have increasingly complained during the past two years that decisionmaking in the Fund is dominated by a handful of advanced industrial countries, and that the voices and legitimate interests of developing countries are insufficiently heard. Some of the phenomena that have led to this perception are understandable. The main contributors to

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the large-scale financing packages which the IMF has provided when called upon to intervene in crises in emerging market countries have had a great deal to say about the conditions under which they would be extended and how IMF policies and procedures should be modified for this purpose. Moreover, because the G-10 countries, working through the BIS, have long played a key role in the development of techniques and standards for bank supervision, it was natural to turn to the BIS and the Fund for help in improving the understanding of recent financial sector problems and possible tools for dealing with them.

At the same time, however, there has been a proliferation of *ad hoc* groups, generally with participation that was unrepresentative of the IMF's broad membership, seeking to lead the international dialogue on issues in the reform of the system. Inevitably, the work of these groups has drawn heavily on input from the IMF staff, the recommendations have focused on the policies and activities of the IMF, and the positions reached in such groups have been echoed by major shareholders in IMF Executive Board discussions.

The problem with proceeding too far along these lines is that the IMF can succeed only if it is seen as legitimate and broadly representative; an institution that serves the interests of only a few members has no future as an international institution, nor should it. Against this background, the development of architecture-related initiatives in recent months has included very broad processes of consultation with the membership, in addition to the usual process of consideration by the Executive Board. In addition, we think it is fair to say that the developing and emerging market countries are now making greater use of opportunities to ask that such initiatives be reconsidered or further refined in the course of Executive Board discussions.

Preparations are now underway for the next review of members' voting power in the IMF in order to examine whether their quota shares appropriately reflect their relative importance in the global economy. A revision would likely tend to increase the voting power of a few countries, including some emerging market countries. However, the issue is not that simple because mechanically applying many types of formulas for determining quotas would tend to further reduce the quota shares of developing countries and increase the collective quota share of advanced industrial countries. It is, therefore, likely that the consideration of this issue will take some time.

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VII Conclusion

While it is difficult to summarise such a broad range of issues in a few words, it may be useful to try to recapitulate some important themes. The international community is absolutely seized, at the moment, with the topic of reforming the international monetary system in the context of a debate over the costs and benefits of globalisation and market-oriented policies. In a way, this is gratifying, because the conclusions of such a loud and visible debate are more likely to be acted upon.

We at the IMF have a responsibility to rise to the challenge of explaining, and making more widely known, the immense potential of an open system of international trade and capital markets to contribute to growth and the improvement of living standards around the world. At the same time, recent experience underscores the necessity of doing a better job of ensuring that these potential benefits are accessible to all and that the potential risks arising from integration are minimised through appropriate systemic reforms and prudent policy management by individual countries.

There are many difficult, unresolved issues ranging from the sequencing of structural reforms and capital market liberalisation, ways to reduce the likelihood of herd behaviour in markets, and the balance between contractual rights and risks to the financial system from uncoordinated creditor actions, to issues of governance at the corporate, country and international levels. We will need to make the most of the energies and ideas of all who want to deal with these issues in order to improve the functioning of the international financial system and preserve broad public support for a system that has brought so many benefits to so many people.

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Comment on "A New Framework for Private Sector Involvement in Crisis Prevention and Crisis Management," by Jack Boorman and Mark Allen

Maria Ramos

We have been talking about private sector involvement for some time now. I remember when this discussion first arose in the G-22, the group on private sector involvement did not have too many initial volunteers but it did get off the ground. The issues are incredibly complex and difficult and the fact that we still don't have a clear choice between setting out specific rules of the game versus a more pragmatic *ad hoc* country-by-country approach attests to that.

There are two ways in which one can look at the problem. One is that you can look at it with an *ex ante* kind of approach: what can we do now that we are no longer in the midst of a crisis as we were in 1998? We have an opportunity to think about the issues and the architecture that is required to enhance crisis prevention. What kinds of things does one deal with at a time like this? I think that situation has to be distinguished from an environment where you are in the midst of a crisis, where there has been some form of contagion, where you are unable to roll over your short-term debt, and where there is a crisis that will result in some kind of a debt standstill. Then you are in a very different set of circumstances requiring a different approach.

There are a number of issues in Jack and Mark's paper that the IMF attempts to deal with such as the issues around financial stability, i.e. the bigger structural issues. In a way, those are related to what one does to prevent a crisis, which are the *ex ante* issues. Certainly in the G-22 and, I think now in the G-20, the focus is on getting the economic environment right and the financial system and the countries involved on both the supply and the demand side. The focus is on improving the financial systems in countries and on the macroeconomic stability of the borrowers, which is an important set of issues that should not be forgotten. But we've all also come to understand that macroeconomic stability is just part of the story. It is a necessary but not sufficient condition to prevent a crisis. Stability has to be underpinned by a set of structural "good governance" issues. Much

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has been said in the case of the East Asian countries about the structure of the financial sector, the regulation and supervision of financial markets, and the quality of the regulation.

One of the things we talk about, but do not spend enough time thinking through, is the nature of capital markets in the emerging economies. What are the rules of the game in the domestic capital markets, what does the balance sheet of the government and the maturity structure of the debt look like? For me, these are very important issues. If one invests time outside of a crisis environment to get these kinds of structural issues right, then we can go a long way to preventing crises and creating an environment where the private sector understands the rules of the game more clearly.

During the 1998 crisis, South Africa was in Europe trying to do a Eurobond issue that we walked away from because we didn't need to borrow the money in that market. We were in the fortunate position where it didn't make any difference to us whether we financed the billion dollars worth of bonds in the Euromarket or not, since we could raise the money domestically because our domestic capital markets are deep and broad enough. We walked away because Russia was in the market at the same time only three days away from a crisis and the banks were lending Russia money for which they were charging a very high premium. When I spoke to the banks' representatives, who were trying to get a bit of our business too, they told us that "Russia is too big, it is too important strategically". These banks knew that the IMF and the US were going to back Russia, so they could potentially walk away from that kind of situation if things went wrong. Nevertheless, they still charged a high risk premium. My point is: if you get all the structural issues right on both the supply and on the demand side you can start addressing some of the issues of private sector involvement.

Another point is that borrowers and lenders have to have a good relationship. It should not be a relationship that occurs only when you are about to default on your debt. In our case, to give a very practical example, we spend a lot of time, even though we are nowhere near a financial crisis (our debt-to-GDP ratio at this moment is somewhere in the order of 45 percent), talking to the investors and the people who buy our bonds and we encourage our private sector to do exactly the same. You need to have these kinds of relationships in place before you get into trouble. I can't think of just going to speak to your bank manager when you need money.

What happens when you are in a crisis? When you get into a crisis you need to start thinking about the private sector's involvement in crisis resolution and you have to find ways of dealing with the fact that you are no longer able to roll over your debts. Does it help to have a pre-defined set

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of rules? Should we continue going down the route we are on at the moment of following the framework apparently accepted by the IMF and the US, in particular, and by many of the developing countries? The attitude of some developing countries changed in the middle of the G-22 meetings, incidentally. I remember at the beginning of the G-22 discussion in this particular task group on private sector involvement there was a strong feeling that we needed some rules of the game. I think Brazil was the first to change its mind when it had to go into negotiations. I was very sympathetic to this because it becomes a very different environment when you have to negotiate a debt standstill or a change in your debt structure with your creditors. We in South Africa still don't have any fixed ideas about whether it's better to have rules, which create transparency but may be a bit costly up front. The other side of that argument is that if you go through a debt standstill it will be costly. Your spreads are going to widen for a very long time after you have declared a debt standstill; i.e. there are costs on both sides of the equation.

There is an argument for having some rules of the game. A part of the rules of the game, the *ex ante* rules, is certainly the collective action clauses. We, from the developing world, made a big deal about the G-7 and G-8, in this case, being the first to put in collective action clauses. We have to acknowledge, however, that this is a bit of a red herring. If you are a country like the US, UK or Canada, having collective action clauses is hardly going to affect your cost of borrowing, but the real test is what the costs will be if a developing country introduces collective action clauses.

In South Africa, we asked some lawyers and bankers to start thinking about collective action clauses and what they would mean in terms of the costs of borrowing. I don't know if there are any shortcuts in the middle of the crisis. You can go down the route which I think Jack and Mark call "catalytic" in their paper and try to get as much private sector "buy-in" as you can and try to prevent the banks from rushing for the exit. However, in an extreme crisis situation default will have to be part of the equation. In that case, the only way in which you are going to prevent a short-term outflow of capital is through some pretty tough exchange control measures. I don't know if there are too many options available. In 1985, during the Apartheid era, South Africa unilaterally declared a debt standstill and re-imposed very draconian exchange control measures. However, it's not something one would like to advocate. There were a whole range of political factors which complicated that particular debt workout and now, 15 years later, we are still in the last phase of that debt rescheduling, so it has taken a long time to resolve this.

There are times when one needs a set of clear rules about what happens if there is a massive capital outflow and an attempt to get the private sector

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involved. Although some of those rules are obviously going to increase the spreads, it might be a price worth paying to complete the cleaning up so that everyone understands what the rules of the game are. One issue is the trade-off between having those rules and paying that price up front or not having rules and finding yourself having to pay that price in the resolution of the debt crisis.

Nevertheless, I also see the need for a catalytic approach to try to get as much private sector buy-in as possible. If South Africa went into default mode, which one would I prefer? I guess my gut reaction would be that I would take my chances trying to negotiate this out with the creditors by using the catalytic approach. Although this would probably be the preferred choice, it may not be the most rational. In the emerging market context, particularly for those countries that are systemically important, if there is an opportunity to get some of the *ex ante* measures in place, it would be important to do so.

This still leaves out quite a lot of the supply side, in other words, the creditors and what they do. Because there is a lot of work taking place in this area it is worth continuing to sort out the rules of the game on the supply side: what does the international regulatory environment look like, what is the role of the BIS in Basel, what do the new codes mean, what does "capital adequacy" mean, what are the reporting requirements, and how do we share more and better information about our own financial sector? That side of the equation remains important and probably an area where not enough work has actually been done and not enough agreements have been achieved.

I have a point about the Contingency Credit Line (CCL) facility because this was one of the responses of the G-22 to the crisis. It was a great idea at the time, but the problem is: what is the nature of the facility, how is the facility perceived by the financial markets, how is it priced, and who's going to be in the group that has access to this facility? If some countries that have sound, sustainable macroeconomic policies are put apart from those that don't, who are those countries and if they are so good why do they need the facility? For South Africa, there is also the question of what conditionality means in relation to the CCL. Because the CCL is an idea with enormous potential, maybe the crucial question is why it hasn't worked out.

In conclusion, I do not really have any wonderful answers for improving private sector involvement except to say that this is one area where a lot of the answer lies in a country's ability to structure relationships with its creditors and to get its own financial markets working. If it can do that, it will not be as dependent on international capital markets and flows as many emerging countries that have no other option but to go into those markets.

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Floor Discussion of “A New Framework for Private Sector Involvement in Crisis Prevention and Crisis Management”

Consultation Between the Private and Public Sectors

Dutch banker Frans van Loon started the debate by arguing that, in his view, there is too little contact between the public and private sectors. “It is very difficult to have a meaningful exchange of views with the public sector on financial crises and most of the discussions take place between public officials and academics. In the Netherlands, we have a deep belief in public-private contact and a lot of discussions and it has worked well. As bankers, we believe there is no other way out than to talk and find a model of cooperation. Certainly, there is a very carefully described ‘set of arrangements’, according to which the rules are generally painted with constructive ambiguity left in. But within that set of arrangements you have to have parties who know each other, have contact and invest in that relationship not just in times of crises. In our view, that is not happening now.”

Mark Allen responded that the IMF actually talks a lot to the private sector. “We have had a series of meetings in the past and the annual Capital Market Report (CMR) systematically surveys the views of market participants. In the next CMR there will be quite a large section on this. More recently, the Managing Director, Mr. Köhler, has announced that the Fund is setting up a Capital Markets Consultative Group which will meet on a regular basis with the Fund management to discuss capital market issues. The Managing Director has also announced that he wants to see a ‘constructive engagement with the private sector’. A lot of thought is being given to the issue of relations with the private sector.

I am a bit concerned, however, that we in the Fund shouldn’t look even more like the pawns of Wall Street than we do already. That is certainly an argument that was made on the streets in Washington in April and will doubtlessly be made on the streets of Prague in September. There are obstacles to a partnership with the private sector because our basic concerns are with our members. Our relationship with the private sector has to be seen clearly within the framework of serving the membership of the institution. There is a parallel here between how the domestic monetary authorities of a country deal with their financial sector. Indeed, they have to talk, understand what’s going on and take their views into account, but a

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finance minister who's in the pocket of the banking system is going to be in trouble politically. He has a much bigger constituency."

Bill White agreed with Frans van Loon that in the past there had been too little consultation between the private and public sectors. "Nevertheless, at a recent meeting of the G-10 Deputies it was suggested that the Deputies repeat a recent meeting with the private sector that had taken taken place in London. However, it emerged in the course of the discussion that in addition to the G-10, the Financial Stability Forum, the G-20, the BIS and the IMF were all independently engaged, in various ways, in seeking enhanced cooperation and information sharing with the private sector. So, while there has been a shortage of activity in this area in the past, this problem looks as if it is being redressed.

I should note that I have a problem with the wording 'private sector involvement'. Personally, I thought right from the beginning that the public sector made a significant error in the context of of the otherwise excellent work of the Willard Group in emphasising the need to get the private sector involved. Of course, the private sector is involved. It is their money that has been lent. The real question that ought to have been emphasised was: Where is the market failure that demands the involvement of the public sector? That issue needs to be articulated more clearly."

Mark Allen elaborated on this "real" question. "It is useful to ask: what is the market failure that requires the public sector to be involved at all in resolving crises? Furthermore, what is the market failure that requires the IMF to exist? More specifically, markets operate in a legal and institutional framework where such matters as what to do when contracts can't be implemented get resolved. This is part of trying to put together an international institutional framework which exists on the national, but not the international level. The second reason for public sector involvement is that there are considerable externalities with excessive domestic adjustment, both to the countries involved and contagion to others, and, generally, reduced world prosperity. One could certainly imagine how the world might operate when countries and their creditors just resolve things without any interference from the international public sector. But the world has changed in the last 200 years. References to the history of 19th and 20th century indicate that the powerful countries in the system, the UK, France and the US have always had a great interest in getting these issues resolved and haven't been prepared to just let a country and its creditors solve things."

Howard Brown supported White's view that the wrong question was asked. "The right question is: what should the role of the official sector be in all this? We should presume that the private sector is going to be involved in debt workouts. It seems to me that the role of the official sector is to

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provide a framework for debtors and creditors to cooperatively resolve their problems. In that context, a standstill can be seen as a mechanism for enhancing cooperation. A standstill is not something you want to impose in every single case, you have to use it as sparingly as possible. There is a very strong argument for using it in cases where you have a clear coordination failure among creditors, as you had in Korea."

Maria Ramos, who participated in the Willard Group (G-22), also agreed that the wrong question was raised. "The private sector is involved – it's part and parcel of the global economy. The point is how the public sector responds and whether governance issues exist on both sides. Even through the crisis of the 1970s and 80s, it has always been about the rules of the game and how the public and private sectors respond to different crises."

Ariel Buira observed that in the present system there seems to be the desire on the part of some players to retain an element of discussionality. "This element of discussionality is used in two ways. One is to keep the debtors a little bit uncertain as to the terrible things that will happen to them if they fail to meet their debts. It is a sort of moralistic element, that you ought to be good otherwise terrible things will happen to you. On the other side is the discussionality of: 'I will help those who are my friends, who are important to me. I am not bound by any rules, so I will not help those I don't like, they can go to hell.' A framework that will protect the debtors is not envisioned because the purpose is to preserve the value of the assets of the creditors. However, a debtor country has a much greater ability to pay if there is a framework that deals with the financial difficulties of troubled debtors. This is the essence of the problem and one should face it very squarely."

Ngaire Woods stressed that one of the problems is that the Institute for International Finance and the private sector are prone to come to the table and simply say that anything that will cost them money won't work. "I think the private sector has been rather unhelpful in trying to formulate good public sector policy in this field. Perhaps we shouldn't expect the private sector to be more helpful than that, afterall, they do have a clearly defined set of interests with which we shouldn't expect them to bat. The logical conclusion is that the public sector should stay separate from the private sector in formulating its positions. In other words, the whole reason why we need public sector involvement comes from the need to represent a very different set of interests, not just taxpayers', but systemic interests, which the banks simply cannot see. I am interested in how the private sector could be encouraged to play a more constructive role in thinking through the implementation of public sector policies. Unfortunately, all I've heard from the private sector is simply a constant restatement of 'that

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won't work, that won't work, that won't work.' In their view, only their interests, pursued in a particular way, will ever work."

Private Sector Involvement in Crisis Prevention and Crisis Management

Roy Culpeper insisted on the importance of involving the private sector in crisis *prevention*. "Much of the analysis on private sector involvement in Jack and Mark's paper and the comments so far has to do with crisis management. In other words, after the crisis has broken out, how do you get the private sector to share the burden? What this seems to leave out of the discussion is crisis prevention. How do you address the question of the riskiness of the private sector? How do you make the private sector less risk prone now rather than waiting until after the crisis breaks out to then figure out how to bring them in and resolve it?

Two issues are relevant here. First, we are seeing this movement to bigger and bigger banks and financial institutions through mergers all over the world. The question is: does this make for safer or riskier banks? Why don't we have a world competition policy in the financial sector? Which global institution should take on that role?"

Amar Bhattacharya observed that there seems to be consensus on a number of *ex ante* measures to prevent a financial crisis. "Four points were raised in the discussion that I want to underscore. The first is the central importance of bankruptcy, not just international bankruptcy, but domestic bankruptcy because domestic bankruptcy prevents private sector problems from becoming public sector ones. Second, there is an emerging consensus on collective action clauses. Third, creditor committees and investor relations are important. Finally, the development of deep and strong domestic capital markets are centrally important.

The difficulty is on crisis involvement. Jack and Mark's paper actually sets out a decision tree that highlights and flags the differences. The first point is whether the involvement is catalytic or concerted. The reason you have a difference is that you never get a pure private or public response. Secondly, if it is concerted, the other distinction to make is whether it is voluntary or involuntary. If you decide to make these choices you then face the choices of *how*, *when* and *who*.

By *how* we mean, is the approach going to be generic, rules-based or specific case-based? I wish to amplify a distinction, already made by Maria, between the rule of whether you are going to get engaged in a standstill or exchange restriction and a code of behaviour that would apply to you if you decide to get engaged. The two are different. The first is that there are rules by which you would be allowed to put a standstill in place and the

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second is what kind of codes of behaviour would apply to you so that they are non-discriminatory. I think there is more consensus on the latter than the former.

Secondly, *when* do you apply this? When the water is already gone, there is no point in closing the floodgates.

Third, *who* would this apply to? The relationship between creditors and debtors has become much more complex, so the *who* is no longer a simple issue of dealing with interbank credit lines. This makes the case much more complex. Do you distinguish between new and old creditors? While there is a clear case for penalising creditors for the original sin, I don't think bringing in new creditors on the basis of burden sharing with the private sector necessarily makes sense because the person who often ends up paying the burden is the taxpayer in the borrowing country. It is worth making that distinction when you are talking about the *who*."

Yilmaz Akyüz argued that it is important to make a distinction between involving the private sector in stopping the panic and sharing the burden. "To stop the panic, you should include everybody: the domestic private sector, unhedged borrowers going after dollars such as in Indonesia, and currency speculators such as in Malaysia. Involving the private sector in this way to prevent the collapse of the currency will include not simply standstills but certainly exchange controls of some kind. That point could be particularly important in the kind of crisis we saw in Asia.

The concern that was expressed in the Asian crisis is that the private sector would be more involved if the IMF was involved less. Would the private sector have behaved differently if the IMF had been involved less and there had been a real threat of default? The pure market mechanism, which includes standstills, may be more desirable. Standstills are part of the market mechanism and if we leave it to such mechanisms the debtors might be better off than by involving the IMF in the debt negotiations process.

Who is going to declare a standstill and how is it going to work out are very complex issues. Nevertheless, we are discussing, for instance, access to a lender of last resort or emergency financing on a pre-qualification basis. Why can't we apply pre-qualification to standstills? Or introduce mandatory clauses for automatic rollover under certain conditions into international debt contracts?"

Yung Chul Park gave a brief description of Korea's experience dealing with the private sector. "First of all, we have to consider what we mean by the 'private sector'. In our negotiations with creditor banks in January 1998, the private sector meant about ten major international money centre banks represented by Citibank. Most of these were smaller European and North American banks which delegated their authority to negotiate to

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these ten major banks. We seem to presume that international financial markets, especially the intermediation market, are rather competitive, but I don't think so. We will even see an increasing concentration of power if the current trend of mergers and consolidations continues in the future. Within ten years, it wouldn't be surprising if we end up with five or six major banks and five or six investment banks. So we have to be careful about what we mean by the private sector and the 'catalytic' or 'concerted' approach.

In our negotiations with the creditor banks, Korea had absolutely no leverage. The creditor banks got everything they wanted: they got 300 basis points more than they would get from the international markets at that time. In this negotiation process we set a very bad precedent by simply giving in. We just accepted every concessional term that they demanded. The negotiations had two stages. In the first, up until Christmas Eve 1997, Larry Summers organised numerous conference calls with the G-7 deputy finance ministers to get them to agree to persuade the large banks to negotiate. The British Deputy Minister talked to HSBC, Larry Summers talked to US banks and the Japanese representative talked to Japanese banks, etc. Before Christmas Eve, these G-7 countries were able to persuade these major investment banks to come to the negotiation table in New York at the end of January of 1998. The second stage of negotiations took place between Citibank and the Korean authorities. Korea had absolutely no leverage whatsoever. On many occasions we went to the IMF and the US Treasury to ask them to intervene in our favour but they were very reluctant to do so. In order to stabilise international financial markets, the most important thing they were concerned with at that time was to make sure that the major international banks came back to East Asia. So the key players were willing to accommodate the wishes of these major international banks. We thought at the time that this was setting a very bad precedent. Bailing in the private sector would be very difficult once you set that kind of precedent.

Before the crisis hit, the Korean banks and institutions had developed very good working relationships with all of these major institutions. In East Asia, relationship banking is very important. The first thing you try to do is develop a relationship with other banks. So we thought we had some sort of implicit contract with them to continue rolling over these short-term loans as long as we were not making too many mistakes, until they suddenly changed the rules of the game in November 1997.

Our problem originated from short-term borrowing in the interbank market. Surprisingly, two years after the crisis started we are again borrowing from that short-end of the market. This is what they offer us; there are not many other facilities. No East Asian country can issue bonds in the

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international financial markets because they cannot obtain any kind of rating. As a result, our borrowing from the short-end of the market is increasing substantially. I don't know what to do about this. I wish the BIS or some other institution would somehow step in, look into this interbank market more closely, and monitor and tell us what is happening, and what the right amount of borrowing would be? At the same time, the suppliers need to be told to be careful about excessive lending to these countries.

Another question is whether it is a good thing that financial intermediation services have been concentrated in the hands of a few major international institutions. Who is going to provide the countervailing forces to negotiate with these institutions in the future? Bailing in the private sector means that the official sector is going to negotiate with these very powerful financial institutions. The G-7 seems to be the only entity which could provide some kind of countervailing force."

Maria Ramos wondered whether concentration in the international banking system is increasing systemic risk. "Is there greater safety in having larger banks or are we building up to another major crisis? The problem with these big banks is that they are almost too big to fail. I do not think that we are facing up this problem from an international regulation, liquidity and risk point of view. A systemic risk issue is going to emerge due to the fact that there is a lack of competition particularly at the top and in certain parts of the business. Maybe this is not the case in retail banking, but it certainly is in the investment banking side of this business with which we, most of us who borrow, have to deal. I have the cynical view that there is an enormous amount of money being made by investment bankers who are going to advise on both sides of these transactions."

Frans van Loon shared Ramos', Park's and the others' concerns about the concentration of the banking system. "My company is also expanding and merging and buying companies all over the world because, for the moment, that is the smartest thing to do; it makes sense and adds shareholders value. I hasten to add that ING is an integrated financial services company that can add value precisely by combining insurance, pension fund management and all those types of things, with banking, commercial, retail and investment banking. However, it is also clear to many of us that this cannot go on forever.

I am particularly concerned about the increasingly similar methodologies of risk management. We are all using highly sophisticated econometric-type risk management systems which have a strong Anglo-Saxon flavour to them. They are excellent and they are beautiful but they all start to become the same. It is rather scary to me, and I think several others of us in the financial world, that we all use the same system, because in the totality of world events it is difficult to imagine that the best financial inter-

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mediation happens along one particular model. Particularly in the context of Europe, there is still much to be done in the financial sector such as the integration of, not just the capital markets, but all the other elements of the financial sector; a number of other mergers and events still have to take place. But, on the global scale, it is obviously not going to last forever, and as Mr. Park said, it cannot be right that you have a limited number of big players. I share the concern about the relatively limited numbers of big players that seems to be emerging."

Risky Investments Contribute to Systemic Risk

Bill White emphasised that pressures exist for funds to make risky investments. "On the private sector side, what one has observed as interest rates have gone down is that there has been a growing tendency for investors to say that these rates of return are simply not acceptable. In turn, this attitude has led investors to take greater risks in order to raise the rate of return. This problem has been compounded by the growing emphasis on shareholder value and sharply increased competition in the financial services industry. In sum, at the very moment when it has become harder and harder to make a decent rate of return, the shareholders have become even more demanding. The presence of significant safety nets has been another factor encouraging investors to take on greater risks, particularly in emerging markets. What we have observed in emerging markets may indeed be symptomatic of a rather deeper and more systemic set of problems affecting both emerging and industrial countries with implications for both the public and private sectors."

Frans van Loon responded that fund managers are not all like-minded in their investment strategies. "In the private sector there are very different players including a number who truly have a long-term interest in staying in business in various countries. They have a longer-term wish to play the game and their horizon is a bit longer than the next quarterly earnings figures. Moreover, one should recognise that fund managers are just one sector of the financial arena. There are many others who have a longer-term interest.

Now, why do the banks keep hawking short-term lending when they know it's a risky thing? I can only assure you that in my bank and in many banks under the supervision of our central bank it is happening a lot less now because the penalties for and supervision of that are a lot more severe. To what extent are risk management systems improving internationally? I think every banker worth their soul knows that short-term interbank lending to countries with ongoing systemic problems is one of the more riskier things you can do. If bankers continue to do that, it's partially as you say,

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because it's easy, because the incentives are the wrong way around, and it's easier to lend short-term to a Korean bank than to buy their shares, for instance. But on the bank's side, the lender's side, I can reassure you that the BIS rules are certainly constraining this much more than in the past."

Collective Action Clauses

Stephany Griffith-Jones elaborated on Maria Ramos' comment on collective action clauses. "There have been quite a few studies on this, the implication of most of them being that there is very little difference in the spreads between those bonds that have and don't have collective action clauses. Even before the discussion started internationally, I think investors really hadn't noticed the difference. Countries like Argentina, which have both kinds of bonds, say that there is no difference."

Bill White commented on this further. "At the BIS, we have done a limited amount of statistical work on the effects of collective action clauses and we estimate that the inclusion of such clauses may have raised the costs of financing by somewhere between forty and fifty basis points. Nevertheless, certain qualifications are required. On the one hand, it should be noted that these differences are not statistically significant. On the other hand, it may be the case that investors in the past have not been as careful in interpreting the implications of such clauses as they may become in the future."

Ariel Buira thought that it would be in the interest of the international community to generally apply collective action clauses. "We should introduce regulation in all of the OECD and any other countries to simply say that whoever wishes to issue bonds in my market will have to include a collective action clause. This will apply similarly for the Canadian government in their domestic markets as for the Mexicans who go to the Canadian market. I do not think that such legislation would result in much larger spreads."

International Authority Needed to Resolve Crisis

José Antonio Ocampo reflected on the history of the financial crises and said that debtor governments, in general, value their relationship with creditors so highly that they go too far keeping debt service payments current. "Having studied the crisis of the 1930s in Latin America, it is very clear that countries were trying to avoid stopping their payments on the debt, as they also were in the 1980s. A rationalisation for that is that liquidity and solvency problems have very blurry limits and that everybody tries to justify a crisis as a liquidity crisis even when it is clearly a solvency crisis.

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I do not think this problem has any solution before a crisis hits. A standstill is probably the only solution. Even if the national authorities call it too late, declaring a standstill has to be a strictly national decision in today's world.

Once the crisis hits and the countries are negotiating with the IMF and the creditors, it seems less clear to me that countries should have such a high degree of autonomy. Precisely because they value their relations with creditors so highly they are likely to interpret the situation too optimistically and agree with the creditors' assumption that the situation is much better than it, in fact, is. This may continue to be true even after crises has struck, leading to repeated renegotiations of the debt, as the experience of the 1980s indicates. Alternatively, this may reflect a significant difference in perception between lenders and borrowers. This is why, once the crisis has struck, there is a role for an international authority, which should at least play the role of a voluntary arbiter and possibly determine future debt service conditions."

Ariel Buira stressed that since crises are part of the essence of market economies there is a need for international rules. "Countries, at some point, will not be able to meet payments on time, either because of policy mistakes or of exogenous factors. Every country has legislation for bankruptcies and suspension of payment, whether it is called 'Chapter 11' or something else. The real question is: why do we not have an international set of rules to deal with this? Why don't we have a predictable legal framework to deal with the financial difficulties of troubled debtors?"

Howard Brown argued that the official sector needs to provide jurisprudence or 'soft law' on debt workouts. "The distinction between using a rules-based and a case-by-case approach is maybe exaggerated. Case-by-case works quite comfortably with the rules. This is certainly the case at the Paris Club where there is a body of soft law and jurisprudence in a hierarchy of claims. Nonetheless, the first rule is that you treat countries on a case-by-case basis and are flexible in order to solve the problems you're facing."

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Part III

Recent Initiatives to Improve the Regulation and Supervision of Private Capital Flows

Recent Initiatives to Improve the Regulation and Supervision of Private Capital Flows

William R. White

I Changing Attitudes to International Capital Flows

Before turning to how official attitudes to private capital flows have changed over time, it is useful to just look at the facts.[1] Prior to World War I, net capital flows were proportionally as large as today although the complexity and volume of the interactions (gross) was then much less. Most of the flows in the earlier period were in the form of long-term bonds, with governments, railways, mining and other commodity extraction enterprises being the primary beneficiaries. Since, in large part, governments were building infrastructure at the time, it could be contended that most of these loans were in some way linked to exports and the means to service debt. Nevertheless, there were many crises even if crises after 1972 have been both more frequent and more severe.

Following the events of the 1930s, there was a collapse in international capital flows (as well as trade) and only a very gradual recovery after World War II. Beginning in the 1960s, and constantly accelerating subsequently, there has been a sharp revival of international capital flows although their composition now differs markedly from that seen prior to World War I. As to maturity, loans tend to be of rather shorter duration. Moreover, the reliance on bond financing is less today, with both purchases of equity and foreign direct investment playing a much more important role. Bordo (2000) ascribes this change, to a large extent, to modern communications, which allow more direct oversight and therefore raise the comfort zone insofar as risk-taking, at a distance, is concerned. Recurrent foreign exchange and banking crises have been experienced in emerging markets over the last two decades, with new concerns about maturity mismatches (as in Korea in 1997) adding to traditional credit and market risk as catalysts for crises.

Official attitudes to international capital flows have also changed greatly

[1] For a useful survey of both the facts pertaining to the globalisation of international financial markets and related policy issues, see Bordo (2000).

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over the years. However, what has not changed is the underlying reality of the so-called "impossible trinity". A country cannot have unhampered international capital flows, a fixed exchange rate system and its own independent monetary policy all at the same time.[2] Different and changing views as to which of the three should be given up have been at the heart of the century-long debate over the merits of international capital flows.

Under the gold standard, the desirability of open capital flows was never called into question. Nor, generally speaking, was the desirability of a fixed, global exchange rate system debated. While it was recognised that this regime meant the absence of a domestically orientated monetary policy, many looked upon this as a favourable attribute since politicians were commonly regarded as less disciplined with respect to the public purse than they ought to be. Under the Bretton Woods system, fixed exchange rates were considered essential to avoid the competitive devaluations and the drying-up of trade which had characterised the 1930s. The retention of a domestic policy capability was also seen as important even if the Great Depression had called into question the efficacy of monetary policy in such extreme circumstances. In light of these exigencies, capital flows were generally discouraged by the official community and various forms of exchange controls were maintained in many developed countries well into the 1980s.

However, with time, capital flows gradually increased as Euromarkets, offshore centres and advancing technology allowed old restraints to be circumvented. By 1972, the Bretton Woods system had collapsed and the main industrial countries reverted to a floating exchange rate regime. While it took another 25 years, a similar result has been observed in many emerging markets, most recently in Asia and in Latin America. Interestingly, these latest developments took place against the backdrop of a debate as to whether the Articles of the IMF Charter should be altered to allow the Fund to actively encourage capital account liberalisation. While it is not clear that the motivation for this was linked to the impossible trinity problem, the reality of freer capital flows certainly had implications for this issue.

Today, the conventional wisdom is that there should, in principle, be no further reimposition of direct controls over capital flows. However, the removal of existing controls should be done carefully and at a pace consistent with the evolving capacity of the domestic financial system to withstand associated shocks. Countries should also follow one or other of two possible exchange rate regimes. They should either float "freely" and con-

2 This is one of the principal insights for which Robert Mundell recently received the Nobel prize. See Mundell (1963).

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duct an independent monetary policy, or they should try to link their currency "irrevocably" to some other currency and eschew domestically oriented monetary policy altogether. Of course, both of these choices are somewhat of a caricature. No currency floats entirely freely, since the domestic monetary authority must always have some views as to the implications of exchange rate movements.[3] Moreover, no fix is irrevocable since the domestic pain implied by currency board arrangements may prove unbearable.[4] Indeed, even currency unions (and variants on "dollarisation") can be abrogated.

During the postwar period, there has been a considerable evolution in thinking with respect to exchange rate regimes and international capital flows. This has perhaps made the inevitability of more mobile capital flows a trifle more palatable. First, the Bretton Woods system assumed that fixed exchange rates were needed to ensure an open trading system. Clearly the explosive growth of trade in recent decades, spurred as well by the development of financial markets to hedge foreign exchange exposure, has reduced the force of this argument. Secondly, it has become increasingly obvious that direct capital controls invite evasion and become porous with time, and that new technological advances are constantly compressing the period for which controls remain effective. In contrast, the positive implications for international resource allocation of international capital flows are becoming increasingly appreciated. As for the capacity of such international capital flows to incite domestic crises, it is also increasingly accepted that such flows are often more a catalyst than a cause.[5] In many recent crises, the underlying problems were essentially linked to domestic credit expansion: in Mexico in 1994 due to excessive consumption, and in Asia due to excessive (i.e. unproductive) investment. Nevertheless, for many, the temptation to shoot the messenger has proved irresistible.

It must be readily admitted that international capital flows also have their downsides. They can clearly exacerbate domestic excesses, in effect allowing postponement of needed policies and thereby demanding still larger policy adjustments later. Moreover, the suddenness of the reversal of these flows may make it all but impossible to avoid the policy adjustment becoming disorderly. Internationally integrated financial markets also mean that financial markets in emerging market countries are vulnerable to interest rate increases in industrial countries. As well, there is growing

3 For a recent discussion of this, see White (1999).
4 Neither the Hong Kong Monetary Authority nor its Argentine counterpart act as pure currency boards. In both cases, the authorities take measures to ensure some cushioning of effects of reserve changes on the interest rate due to exogenous capital flows and the trade account.
5 See White (1998).

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evidence that equity markets in developing countries are more correlated with those of industrial countries than would seem consistent with the underlying fundamentals.[6] While the adoption of floating exchange rate regimes significantly mitigates these dangers, it by no means wholly eliminates them.

In the light of these insights, recent policy initiatives to regulate and supervise private capital flows have focused on means to curb possible "excesses" while essentially maintaining or moving carefully towards a regime of free capital flows. While a whole host of bodies have been involved in formulating such recommendations over the last few years, particular emphasis will be placed here on evaluating recommendations made recently in various papers published by the Financial Stability Forum (FSF).[7] In the various sections that follow, four sets of such initiatives are considered. Section II examines those recommendations that have to do with transparency: the need for better data, disclosure and indicators of vulnerability. Sections III and IV look at those sets of recommendations that have to do with the behaviour of creditors and debtors respectively. Section V deals with how these recommendations might be implemented in practice. As always, actions speak louder than words. However, actions also demand considerably greater efforts on the part of all the parties concerned.

II Measures to Improve Data, Disclosure and Indicators of Vulnerability

A presumption underlying recent recommendations in this area is that "excessive" capital flows will be less likely if the disclosure of various kinds of information is improved. An underlying but not always clearly specified question is whose welfare is best promoted by such transparency. On the one hand, we might have the recipient country, and, more specifically, the particular borrowers, who are receiving the money. On the other hand, we have the lenders providing international capital. With respect to the former, "excessive" generally means inflows with the potential to do macroeconomic damage, whether on the way in (say rapid credit expansion, inflation and asset price bubbles), or on the way out (banking and foreign exchange rate crises and associated recession). This was the principal source of concern during the recent Mexican and Asian crises. With respect to

6 See BIS (2000b), Chapter V.

7 See FSF (2000a, b, c, d and e). These papers were, of course, drafted in full knowledge of earlier proposals.

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creditors, “excessive” would mean flows of such a magnitude as to call into question the solvency of the lending institution or, ultimately, a whole set of financial institutions. This was the principal concern in the debt crisis of the early 1980s, at least viewed from the perspective of the creditors.

Without wishing to diminish the importance of transparency, its limitations must also be clearly recognised. Insofar as transparency about the economic circumstances of recipient countries is concerned, how lenders use such information is also crucial. For example, as far back as 1996, the BIS international banking statistics clearly indicated a dangerous build-up of foreign short-term liabilities by many Asian countries.[8] This was not sufficient to stop the boom in international lending. As for transparency contributing to the improved health of institutions undertaking international lending, the problem is that there are no clear criteria for determining when such lending threatens to undermine their health, either individually or collectively. When things are going well, all loans look creditworthy, and vice versa. Moreover, at the micro level, the exposure of one financial institution to a sector/country might seem appropriate. However, if all financial institutions in a country were exposed to the same degree to that same sector/country, the overall exposure of the creditors' financial system could become dangerous. Problems of this sort will be a recurring theme in considering the merits of the various recommendations being assessed in this paper.

This having been said, a number of sensible suggestions for increasing transparency, and in turn market functioning, have been made recently. A first set, with clear implications for the work of the BIS, has to do with providing better data on international debt exposure. The second set of suggestions has to do with enhanced disclosure about short-term position-taking with respect to the currencies of emerging market economies. And the third set of recommendations concerns the provision of better indicators of potential vulnerability in emerging market economies to crises of various kinds.

Improving the International Financial Statistics

Those concerned with the exposure of emerging market economies to potential capital outflows and liquidity problems would welcome comprehensive statistics indicating the external liabilities and assets of individual countries. The FSF Capital Flows Report recommends certain enhancements in this regard.

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8 See BIS (1996).

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In principle, it would be best to collect comprehensive debt statistics from the debtor countries themselves, but such statistics are generally unavailable, and then, only with long lags. The IMF is pursuing improvements in this area (to be incorporated into the IMF's Special Data Dissemination Standard (SDDS)) but, for the moment, the much more timely creditor-based statistics remain at the heart of the external debt statistics. Data collected from banks active in international lending are reported to the BIS and are aggregated to gain an indication of the exposure of borrowers resident in individual countries. These data are then supplemented with statistics indicating funds raised through securities issues in international markets (also collected by the BIS), statistics on official trade credit (OECD) and debtor-side data concerning such issues as Brady bonds (IMF and World Bank). Recently, these statistics have been re-evaluated and improved and they are now available on a regularly updated basis on the Internet.[9]

For some countries, there exist quite comprehensive debtor-side statistics, and it is not uncommon that they differ from the creditor-side statistics just referred to. A study is now under way at the BIS, consistent with another recommendation from the FSF Capital Flows Report, to establish why these differences occur. Indeed, some explanations are already available. It is clear that the creditor-side data, as currently constructed, fail to incorporate domestically issued debt securities purchased by foreigners as well as the effects of internationally issued debt securities purchased by domestic buyers. The FSF has, in fact, recommended that efforts be undertaken to collect such numbers with a view to improving the current creditor-side statistics.

In assessing the external vulnerability of individual countries, information about assets is a useful complement to information about liabilities. In view of the misperceptions about official reserve levels generated by "unorthodox" operations carried out by the Bank of Thailand and the Bank of Korea in the recent Asian crisis,[10] the Committee on the Global Financial System (CGFS), in cooperation with the IMF, devised a template for proper disclosure in this area. The IMF subsequently adopted these standards, which are now also part of the SDDS. The G-10 countries agreed to apply the template to themselves ("*pour encourager les autres*") and are now in the process of doing so. Progress on the part of the emerging market economies remains very mixed to date.

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9 See www.bis.org for the joint BIS-IMF-OECD-World Bank statistics on external debt.

10 In the former case, forward exchange rate intervention had been heavily used in the former case. In the latter case, some of the reserves had been invested with Korean banks, which had used them to pay down liabilities of Korean companies which had borrowed abroad. In both cases, the true level of available reserves was lower than official estimates.

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A further shortcoming of the current data is conceptual rather than empirical. In assessing a country's vulnerability to capital outflows, net exposure to foreigners may matter, but gross exposure may matter as well. Private assets held abroad by residents generate revenues which may ease the national burden of external debt service, but only if those revenues eventually find their way back home. In any event, such private assets cannot be seized and used to provide liquidity support in times of stress. Moreover, if the capital account is free of controls it may be a serious misconception to suppose that foreigners are the principal problem. Any domestic asset can be sold for foreign currency in a crisis and it is very common to find domestic asset holders leading the rush for the exits.

A second set of concerns relates to the health of the financial institutions which have lent money to emerging markets. In this case, creditor-side data can be collected on a consolidated basis (i.e. the worldwide exposure of an individual institution) and then aggregated to determine the exposure of a set of institutions (e.g. French banks) to individual countries. Although this has been done since the early 1980s, a number of recent improvements have been implemented through the efforts of the CGFS and the BIS. First, the consolidated statistics will shortly be available on a quarterly rather than a semi-annual basis. Second, the reporting lag before publication will be significantly reduced. Third, banks resident in 17 additional countries will begin reporting to the BIS. Fourth, and probably the most important improvement, data will shortly be available on an ultimate risk basis. That is to say, loans made to Japanese banks in Hong Kong, for example, will now be classified as an exposure to the former rather than the latter. These new attributes will also be helpful in improving estimates of debtors' exposure based on the use of these creditor statistics.

Consistent with recommendations made by the FSF Capital Flows group, further improvements have recently been suggested by a Working Group of the CGFS.[11] In particular, the statistics should include exposure in the form of such off-balance sheet items as derivatives, guarantees (given by the banks as well as those given to the banks) and also undrawn contingent credit facilities. Mindful of the reporting burden this puts on banks, the Working Group (as well as the FSF Capital Flows group) recommended that these changes be phased in by 2004 and that they rely as much as possible on reporting systems developed for the banks' own internal risk management processes. In this sense, these recommendations parallel the market-compatible and market-friendly approach increasingly being followed by the Basel Committee on Banking Supervision (BCBS).

11 See BIS: CGFS (2000).

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Improving Disclosure with Respect to Position- and Risk-Taking

At the height of the Asian crisis, there were repeated allegations that highly leveraged institutions (HLIs), in particular hedge funds, were speculating against certain currencies. More broadly, concerns were raised that portfolio shifts and associated capital flows were exacerbating currency volatility.[12] In response to these events, the CGFS examined whether firm-level information about position-taking in foreign exchange markets could be collected, aggregated to ensure anonymity, and then published on a regular basis. Preliminary investigations soon indicated that such information would not be provided on a voluntary basis. Many of the firms contacted felt that they had better insights than others about market positioning, and that this proprietary information could be used by them to generate profits. As for the possibility of making mandatory the provision of such information, several authorities felt it would be politically impossible to ensure the needed legislation and the project had thus to be considered impractical.[13]

While not specifically directed to international capital flows and position-taking with respect to currencies, a number of other initiatives are under way aimed at improving disclosure with respect to risk-taking more generally. The broadest of these is the Multidisciplinary Working Group on Enhanced Disclosure,[14] which is currently organising a pilot study into the feasibility and the usefulness of enhanced disclosure with respect to risk and exposure data. A panel of firms representing a broad cross section of financial market participants and activities are participating and a pilot study disclosure template has been extensively discussed and revised. The first set of results (some quantitative and some qualitative) will be submit-

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12 In the case of Hong Kong and South Africa, it was alleged that HLIs were conducting twin operations that bordered on the unethical. In the Hong Kong case, funds were said to have sold the Hong Kong dollar short while at the same time shorting the equity market. If the Hong Kong Monetary Authority (HKMA) were to raise rates to support the currency, profits would be made as equity prices fell. If interest rates were not raised, profits would be made as the currency fell. In the event, the HKMA defended itself by intervening vigorously in the equity market, making very significant profits in the process.

13 The degree of disappointment generated in the official community varied sharply across countries. Most disappointed were those who felt industry disclosure was a *quid pro quo* for the decision of the official community to regularly publish a full account of their foreign exchange reserves and associated intervention.

14 This Group is chaired by Peter Fisher of the Federal Reserve Bank of New York and includes representatives of the BCBS, CGFS, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and a number of hedge funds and other financial institutions. This initiative is sometimes referred to as Fisher II since Fisher was also the Chairman of an earlier working group, sponsored by the predecessor of the CGFS, encouraging better disclosure by financial institutions of their activities in derivative markets.

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ted to national regulators and then analysed as to their usefulness (relative to collection costs) by the Working Group itself.

It should also be noted that the Basel Committee on Banking Supervision (BCBS), in the light of the events surrounding the difficulties of Long-Term Capital Management in autumn 1998, has suggested that banks pay much closer attention to the investment practices (especially the use of leverage) of those to whom they lend.[15] More recently, the FSF Working Group on Highly Leveraged Institutions suggested that higher capital charges might be imposed when required information of this sort was not forthcoming. Finally, legislation is pending in the United States that will require compulsory disclosure by HLIs above a certain size. At the most recent meeting of the FSF, there was widespread support for this initiative and a suggestion that it might usefully be imitated elsewhere.

Just as better data provide no panacea, greater transparency may also have shortcomings alongside its obvious benefits. One possibility is that greater openness will lead to more emulation and herd-like behaviour, exacerbating sudden shifts in capital flows and market prices. A second complication is that all this information will be collected only periodically. Given the ease with which positions can be altered in modern financial markets, anything short of real-time disclosure may give a very misleading indication of what is really going on.

Improving Indicators of Vulnerability in Emerging Market Economies

The FSF Working Group on Capital Flows also recommended that greater efforts be made to collect data and construct indicators of the potential vulnerability of emerging market economies to exchange rate crises and banking crises. There is now a vast literature on such issues[16] which, broadly put, concludes that indicators of potential exchange rate crises seem more reliable than those used to predict banking crises. While this might just be the nature of the beast, data shortcomings in the case of bank exposure may also be an important explanatory factor.[17] It should also be noted that these indicators often fail to predict actual crises. Perhaps worse, they often predict crises which fail to happen. Public disclosure of such predictions might then conceivably cause crises which might otherwise never have happened. As with the other measures recommended above to

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15 See BIS: BCBS (1999b) and the follow-up document (BIS: BCBS, 2000).

16 The forthcoming BIS Working Paper (Hawkins and Klau, 2000) provides a useful overview of the current state of knowledge.

17 The IMF has recently embarked upon a major exercise to improve data and contribute to the construction of better vulnerability indicators. See IMF (2000b).

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improve transparency and enhance rational decisionmaking, there can be a downside to these efforts.

For the last two years, the CGFS has been regularly reviewing crisis indicators for emerging market economies which have been constructed by the staff of the BIS. In association with other statistics germane to assessing the future prospects of individual countries, qualitative assessments are made of where problems with systematic implications might arise. This exercise is conducted within the framework of a broader assessment of changing risks and vulnerabilities in the international financial system. The results of the Committee's deliberations are subsequently transmitted orally to the G-10 Governors by the Chairman of the CGFS and are an important input to similar discussions which take place regularly (with a broader group of participants) at the FSF.

III Policy Responses Directed to Creditors

Various kinds of lenders are responsible for international capital flows: banks, securities firms, insurance companies, funds of various sorts, and investors who purchase directly market instruments (e.g. bonds, equities, notes, etc.) issued by borrowers in emerging market economies. The question then arises as to how each might be induced to behave more prudently, so as to avoid "excessively" large or volatile swings in international capital flows. Three sets of incentives can be suggested: better internal governance by lenders, more market discipline and better external regulation and supervision.[18]

Contrary to popular opinion, and in spite of the continuing existence of various safety nets, many lenders have lost money in recent financial crises in emerging markets. This should make lenders more cautious in the future. Moreover, the ongoing discussions about "private sector involvement" in the management and resolution of crises make it clear that creditors may suffer in future crises even more than in the recent past. There is a growing consensus that official funding of the size observed in the Mexican (1994) and East Asian crises, which helped limit private sector losses, should not be the norm in the future. As suggested in the G-7 communiqué, issued in Cologne (20 June 1999) and translated into practice in the

18 For a fuller discussion of the analytical framework within which to discuss crisis prevention measures in the international financial system, see BIS (2000b), pp. 148-9. Reference is made there to the "three Ps", namely: three problems (short-term volatility, medium-term misalignments and contagion), three pillars (sectors, markets and infrastructure) and three prescriptions (internal governance, market discipline and supervision).

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context of a number of sovereign debt restructurings since, bonded debt will no longer enjoy the effective seniority which it had during the 1980s.

Nevertheless, there remain significant reasons to fear that internal governance constraints may prove inadequate to prevent future capital flows from discomforting emerging market economies. The financial industry is becoming increasingly competitive. At the same time, shareholders are increasingly demanding greater shareholder value. This combination may bias investment in the direction of those classes of assets which provide higher rates of return, which include investments in emerging market economies, even though they are inherently riskier. Moreover, even if the exposure of any single investor to a single country remains rather small (relative to capital), the cumulative effect on the country's capital account could well prove hazardous to the recipients.[19]

Given that the financial viability of the lenders has not been significantly affected by recent losses in emerging markets, effective market discipline of the traditional type also seems unlikely. Indeed, markets collectively are as likely to be as influenced by excessive "animal spirits" as are individual institutions. Nevertheless, some moderation of the collective movement into particular countries might be achieved through ongoing consultations between committees of lenders and representatives of borrowers. The sharing of views in such a forum about potential vulnerabilities might well prove useful. This suggestion has been made repeatedly[20] in the context of discussions as to how the private sector might become more directly involved in both crisis prevention and crisis management. A further force for collective moderation would be for lenders and rating agencies to pay greater attention to whether individual countries meet agreed upon international standards with respect to financial stability.[21] However, a recent survey of market participants by a working group of the Financial Stability Forum indicated widespread ignorance of the existence of such standards.[22] Clearly, a significant marketing effort will be required before countries are made to pay an appropriate market price for non-conformance in this area.

This brings us to the third set of incentives to more prudent behaviour: those provided by the supervisors. The first issue to be addressed is

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19 In the 1980s' emerging market crisis, debt bonds were a very small part of total debt and their restructuring was judged to be more trouble than it was worth. Partly in consequence, bond issues subsequently became much more common and the outstanding stock of such debt can no longer be ignored.

20 For a recent example, see EFC (2000).

21 There are currently around 50 sets of such standards on the website of the Financial Stability Forum (www.fsforum.org).

22 See FSF (2000e).

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whether the detailed provisions of the Basel Capital Accord encouraged an excessive inflow of capital into emerging market economies in the form of short-term, and particularly interbank, liabilities. *Prima facie*, the 20 percent risk weighting for less-than-one-year interbank lending to banks[23] in non-OECD countries might have been expected to have such undesirable systemic effects. This is the case even if, at the level of an individual firm, it makes good sense to treat a short-term loan as less risky than one that is locked in for a longer period.[24]

This question of risk weights was raised in the context of the recent review of the Basel Capital Accord. A working group concluded that "Lack of data and observations meant that the working group could not establish firm evidence one way or the other on the question of distortions induced by the risk weights, but some of the tests offered the possibility of the maturity of lending being affected".[25] A similar investigation by the CGFS also concluded that the risk weights might have had some influence, but that other factors were likely to be more important in explaining both the volume and maturity of lending by internationally active banks. Safety net provisions, which banks seemed to feel alleviated credit risk, market risk and liquidity risk, were noted in particular.

Although the new Basel Capital Accord has yet to be finalised, it seems clear that major banks and many others will use the internal ratings-based approach and thus will be categorising the individual credit risk of counterparties more carefully. To this extent, some of the criticisms of bias implicit in the old Accord may no longer apply. However, under the proposed standardised approach, likely to be used by many less sophisticated banks, similar issues of bias could arise depending on the final design of the system. However, at the moment, it seems very likely that the risk weighting applied to lower-quality borrowers will be higher using the new system than the old one.

A second issue having to do with the supervisory regime relates to the possible pro-cyclicality of capital requirements. The most obvious example of this in the old Capital Accord was the possibility for Japanese banks to factor in 45 percent of unrealised capital gains on investments into their measured Tier 2 capital. Since international capital flows also tend to

23 The risk weight for maturities of one year or more is 100 percent, five times as high.

24 Fallacies of composition of this sort are receiving increased attention. For example, were all banks to find themselves hitting against minimum capital provisions at the same time, their collective efforts to cut loans to strengthen their capital base might induce an economic slowdown that actually made their capital position worse (given higher loan losses) rather than better. The best known example of such a fallacy of composition in the macroeconomic literature is the "fallacy of savings" pointed out by Keynes.

25 See BIS: BCBS (1999a), p. 28.

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respond to shifts in the level of available capital, such pro-cyclical tendencies could have effects on such flows as well.

Under the proposed new Capital Accord, the increased reliance on internal credit ratings by lending banks may have the effect of exacerbating these tendencies. This could happen if internal ratings were themselves inherently subject to waves of rising and falling confidence, and if market discipline fails because it is also subject to the same tendencies. In this situation, the reliance on the supervisors (Pillar II of the new Capital Accord) to moderate such tendencies will be all the more important. Unfortunately, when it comes to efforts specifically directed towards moderating international capital flows, supervisory oversight will generally suffer from the same problem as reliance on internal governance and market discipline. Viewed from the perspective of an individual creditor, the sums involved are generally not large enough to merit great concern on the part of the supervisors.

IV Policy Responses Directed to Debtors

In the absence of other viable alternatives, the onus falls back on the recipients of international capital flows to protect themselves as best they can. The FSF Capital Flows Report first recommends that emerging market countries should identify any biases that may exist within their own jurisdictions towards shorter-term capital flows and should try to remove them. The Report falls short, however, of recommending Chilean-style capital controls to actively induce longer-term lending by penalising flows which remain in the recipient country for less than a specified time period.[26] Nor does the Report note the widespread practice of forbidding domestic banks to have open positions in foreign currency, at different maturity positions and in aggregate. This might help remove at least one source of potential difficulties.

The FSF Capital Flows Report emphasises the need for countries to monitor and assess their vulnerability to a sudden withdrawal of foreign currency funding. Further, the Report suggests that the sovereign should be concerned not only about the government's own vulnerability, but also about that of the nation as a whole since, in a crisis, the foreign currency requirement of others (banks in particular) could well fall back on the sovereign. As a further practical step in this direction, the Report concludes that the IMF and World Bank should be asked to draw up "guidelines" of best practice in the area of national/sovereign external debt

26 For a fuller discussion of such controls and many related issues, see BIS (2000a).

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management.[27] In effect, governments should try to maintain higher levels of foreign exchange reserves depending on the level of shorter-term liabilities that might suddenly be withdrawn.[28]

While governments must clearly try to monitor their vulnerability to international capital flows, the concept of focusing on the national balance sheet has a number of shortcomings.[29] First, in assessing the national external position, data will be required on corporate foreign exchange exposure. This was a major source of trouble in both the Mexican and the East Asian crises. Unfortunately, in most countries such data are not available even for on-balance sheet items, much less off-balance sheet exposure. Second, for governments to focus on, and implicitly take responsibility for, the potential vulnerabilities of private sector entities could risk engendering a significant degree of moral hazard. This tendency could of course be offset by a determined effort on the part of governments to force the private sector to protect itself against prospective movements in the exchange rate.

A third problem, already alluded to above, is that it is not at all clear that measures of short-term liabilities to foreigners accurately measure the extent of the potential foreign exchange problem. Domestic residents can also sell domestic assets and purchase foreign ones. Moreover, the longer-term assets of foreigners, including foreign direct investment, can still be a source of exchange rate pressure if they can be covered in other markets.[30] Put succinctly, the more developed the financial markets of the emerging market economy, the less likely are simple guidelines for prudent portfolio behaviour to be useful. Nonetheless, regulations, such as those prohibiting the lending of domestic currency assets to foreigners who might wish to sell them, might still be useful under some circumstances.

A final suggestion arising from the FSF Capital Flows Report is that

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27 In fact, the Fund and the World Bank are already well advanced in such an endeavour. This parallels other work the Fund is carrying out on best practice for internal debt management as well as the management of foreign exchange reserves. See footnote 34 below.

28 This might be thought a variation on the so-called "Guidotti rule", which recommended that countries' foreign exchange reserves (including contingent credit lines) should cover debt service and repayments due within the next year. This approach has shortcomings in that it implicitly assumes a balanced trade account and no other capital flows. Given the tendency for capital flight on the part of the domestic as well as foreign residents in crisis situations, these shortcomings must be thought serious.

29 These issues were actively discussed at a meeting of senior central bankers from emerging market economies which took place last November at the BIS. See BIS (2000a).

30 A number of commentators on recent capital inflows into emerging markets have expressed satisfaction that the inflows are increasingly in the form of foreign direct investment. One might be reminded of the once fashionable "Lawson doctrine", which said that current account deficits were not a problem if they were the by-product of private sector decisions and not government excess.

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emerging market economies might wish to develop domestic bond markets for issues in domestic currency. This would in principle allow investors to tap domestic savings rather than have recourse to foreign bond markets, and would help avoid a dangerous degree of foreign exchange exposure. Indeed, if foreigners were to buy such bonds denominated in domestic currency, then access to foreign savings would also be maintained but with foreigners taking on the exchange rate exposure. Clearly, there is merit in this suggestion, particularly since well developed local bond markets would provide more diversified sources of finance in good times as well as bad.

Nevertheless, some outstanding questions still need to be answered. First, if there were to be less net borrowing abroad, this would imply a smaller current account deficit and some process of internal macroeconomic adjustment (higher savings or lower investment). Depending on how it occurred, this might be more or less welcome.[31] Second, the infrastructure required to set up a properly functioning bond market is not cheap. This raises the question of the minimum size required for a country to have its own domestic financial markets. A more effective alternative might be to issue bonds denominated in a domestic currency in some well-developed overseas markets; perhaps of a regional nature, as recently suggested by the Hong Kong authorities. Third, and this applies to issues in both domestic and foreign markets, there is the broader question of how to generate demand for longer-term bond issues denominated in currencies with a sometimes dreadful track record. This issue of "original sin"[32] may be the most difficult one to deal with.

V Implementing Policy Recommendations in Practice

The FSF has sent out to each of the international financial institutions a list of all the policy recommendations, generated by its Task Forces, which apply specifically to that institution. Most of the recommendations noted in Sections II and III above fall into this category. Presumably these institutions will respond appropriately and the FSF will monitor their compliance. As for recommendations which apply to the national authorities in the industrial world, it is envisaged that the national representatives in the FSF would do the monitoring and follow up in the first instance. How compliance might be enforced, were problems of non-compliance to

31 A higher savings rate would have been most welcome in Mexico in the early 1990s. Conversely, a lower investment ratio would have been the preferred outcome in East Asia in the second half of the 1990s.

32 This term was originally coined by Ricardo Hausmann. See Hausmann (2000).

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emerge, remains moot. In the final analysis, none of these recommendations have the force of international law.[33]

However, even greater problems with implementation seem likely to arise at the level of the emerging market economies themselves. This would pertain to the recommendations made in Section IV above, and indeed to the much broader range of suggestions that have been made regarding crisis prevention in the financial markets of emerging market economies. Even when it is clear what needs to be done, mustering the political will to do it in the face of entrenched interests will prove difficult. Shortages of required resources, especially of skilled and motivated government employees, pose further challenges. Support from the international community will be necessary, but not necessarily sufficient.

Providing the proper incentives for action will be essential. One aspect of this could be ongoing assessment of compliance by the IMF and World Bank. The Financial Sector Assessment programme, currently being undertaken on a test basis in the context of Article IV surveillance, is an example of the genre. The problem with this approach is that there is simply too much for the IFIs to do. The web site of the FSF currently lists over 50 sets of international standards of best practice. Twelve of these are designated as being of particularly high priority. Moreover, as universal institutions, the IFIs should, in principle, treat each of their 180 member countries equally with respect to whatever programmes of ongoing assessment are put in place. Subject to this latter stipulation, the need to set priorities with respect to subject matter becomes all the more important.[34]

Even supposing a proper assessment of compliance could be made in the area of international capital flows, how might enforcement be assured? One possibility is the withdrawal of funding for non-complying countries, but this presumes they were receiving money from the IFIs in the first place. Another possibility which might be envisaged is that non-compliance might be brought to the attention of the FSF or some other international body or grouping. In this case, some variant on the "name and shame" approach seemingly favoured by the Financial Action Task Force might or might not be deemed appropriate.[35] Another possibility is that the

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33 For an interesting and comprehensive overview of such issues, see Giovanoli (2000).

34 The Fund has recently begun to draft some standards of best practice with respect to domestic debt management and the proper management of foreign exchange rate reserves. (See IMF, 2000a and IMF, 2000c). However, a number of commentators have expressed the view that these items should not be high on the list of the Fund's priorities given other urgent measures required to support crisis prevention.

35 The Financial Action Task Force is concerned with international money laundering. It has recently published a list of jurisdictions (mainly offshore financial centres) graded according to their degree of willingness to cooperate with international authorities concerned about money laundering. Similar initiatives have also been taken by the OECD with respect

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FSF might bring these results to the attention of the G-7 or the G-20. Ministers and Governors who are members of these groups might then try to apply peer pressure to improve behaviour. Ultimately, these groups might even apply collective sanctions to non-performers, though the track record in this regard is not very promising.

Indeed, collective action would seem all the less probable given that the individual country receiving the capital inflows would be the most likely to be directly hurt in consequence. If the country itself did not care enough to properly protect itself, why should other countries collectively wish to force it to do so? In practice then, peer pressure might most effectively be applied by drawing attention to what seems to be in the recipient countries' own best interests. Recognition of this self-interest seems likely to be the best spur to effective action.

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to the somewhat different issue of jurisdictions considered to be tax havens. The FSF Working Group on Offshore Financial Centres (OFC) recently classified all such centres into three categories based on assessments (by other banking supervisors) of the quality of their banking supervision. This assessment included the willingness of the OFC supervisors to share information with banking supervisors in other jurisdictions. The FSF Working Group was at pains to note that their classification was not based on some idea of unacceptable behaviour. Rather, it was a simple recording of above average, average and below average assessments. It is expected that future on site IMF assessments will not only refine the work done to date but also lead to more clarity as to what should be done with the results.

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Comments on "Recent Initiatives to Improve the Regulation and Supervision of Private Capital Flows," by William White

Guillermo Le Fort

Bill White's review of the subject is very comprehensive and well organised, and I am in general agreement with its content. In my comment, I want to focus on the controversial issues and on my discrepant views, although I understand that by doing so, I risk lacking a framework and thus my comment may seem choppy.

The Impossible Trinity and the Capital Account of Today

Despite the fact that international capital flows of sizable proportions were also present in previous periods of history, in recent decades financial crises have been more frequent and severe, and have had ample international repercussions. Each crisis has had its own special characteristics and each time different explanations have been given to account for what went wrong. However, since there appears to be no clear remedy, we will most likely see more of them.

Globalisation, contagion and financial interdependence are contemporary characteristics of an economic environment that is not only more prone to financial instability, but also more restrictive for macroeconomic policy. The impossible trinity problem has become more acute because, in effect, the capital account has become more open and capital flows have been more responsive to changes in perceptions about macroeconomic conditions in each country. As a result of the restriction on the macroeconomic policy mix, something will have to give. Either the independent monetary policy has to be abandoned by adopting a currency conversion mechanism that permanently fixes the exchange rate, or the currency is allowed to float, abandoning concerns about "exchange rate misalignments". Or, the third option would be that restrictions to capital flows should be imposed to pursue an independent monetary policy and defend an intermediate exchange rate system in the hope that it corrects the misalignments.

Following Bill's paper, the third and last alternative is not relevant. If, as

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he states, direct capital controls become porous over time, are distortionary, and invite corruption, it seems rather unwise to use them. I agree that their effectiveness becomes increasingly limited over time, and that some, like quantitative restrictions, can be especially damaging for financial sector development. However, I think that there is a role for capital controls to play at certain periods of time, particularly in intermediate stages of development, and during stressful conditions. Under conditions of severe capital inflow shocks of an exogenous nature, it seems almost impossible to avoid using restrictions given the lack of alternative policy instruments. In this case, there are no domestic policy inconsistencies and the use of a flexible fiscal-tax policy, although conceptually correct, appears to be politically impossible.

Among regulations for capital inflows, it is possible to distinguish between price-based regulations and quantitative restrictions. Price-based regulations can be defined in such a way that they are non-discriminatory, transparent, and can be used as a counter-cyclical device with similar effectiveness as other macroeconomic policy instruments. Quantitative restrictions are, in general, more distortionary, generate discontinuities, and could even be used in a discriminatory way and, potentially, for private benefit. I must say, however, that prudential regulation on banking can be subject to similar concerns.

The Lack of Instruments

I agree with Bill that capital flows are not the cause of the problem, but they are the vehicle through which risky positions are first built and then undone with very complicated macroeconomic consequences. What caused the increase in real private domestic expenditure that fueled crisis in Mexico and Asia in the 1990s and in Chile in the 1980s? It is hard to say, but in any of these cases the spending expansion would not have materialised without the ample availability of external financing through massive capital inflows.

How could the excessive spending expansions have been avoided? Theoretically, fiscal policy instruments could have been effectively used for this purpose, but they were not available. Alternatively, generalised prudential regulations that limit the exposure to exchange rate risk of different agents could also have been effective, but it is not possible to regulate and limit the financial risk of every agent. On the other hand, price-based regulations on capital flows could have been introduced, but their effectiveness is limited. Unfortunately, we lack the adequate instruments to avoid conditions that may develop into financial crisis.

Price-based restrictions on inflows can be used to mitigate the effect of

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large capital inflows, but its effectiveness depends critically on its broad-based application. The political resistance and the limitations of the legal authorities to impose them can significantly affect their use. Even general price-based restrictions do not isolate the economy from capital flows. In particular, the defense of a pegged exchange rate or of an exchange rate band can be impossible in the case of a surge in capital flows, even with price-based restrictions.

Under the expectation of a sudden currency appreciation, the protection given by priced-based regulations on capital inflows would not be sufficient to defend a particular level of the exchange rate. Then, large capital inflows leading to significant expenditure expansions would take place despite the imposition of a restriction like the Unregulated Reserve Requirement. In this case, the effectiveness of monetary policy is seriously hampered as long as the expectation of currency appreciation is still in place and the flows continue to come in.

The abandonment of the intermediate or pegged exchange rate system is a natural response for a country attempting to regain control over its macroeconomic environment in the presence of strong capital flows and insufficient conditions to effectively control them. Allowing the currency to float permits the recovery of monetary policy as an effective instrument. However, floating not only implies renouncing the exchange rate target and the "misalignment correction", it also implies higher financial risks for domestic firms and financial institutions.

Floating requires the preparation of the financial system for higher exchange rate volatility. In principle, this can be done establishing limits to currency risk for the different sectors in the economy and developing a market for coverage against exchange rate risk. The Financial Stability Forum's *Report of the Working Group on Capital Flows*[1] recommends limiting the exchange risk taken by the government and the regulated financial system. As for the non-bank private sector, the report suggests including in the regulations a special concern for the exchange risk in the positions of bank clients. Issuing foreign debt in domestic currency or developing local or regional bond markets in domestic currency are also ways to facilitate the coverage against exchange rate risk. The problem of original sin that hampers the development of long-term bond markets in domestic currency could be confronted through indexing.

Transparency Is Not Enough

I am in full agreement with the efforts directed at transparency. Risks

1 Available at www.fsforum.org/Reports/Home.html.

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should be disclosed, and this is valid not only for the government and the banking system, but also for the non-bank private sector. But I doubt that transparency is going to solve the problem. Several times, vulnerability indicators have not been a deterrence to risk taking either because they are interpreted lightly, or because of the teenager syndrome: “it won’t happen to me”. Investment decisions are influenced by this perception of being sheltered from risks.

A careful look at the origins of excessive external financing is needed. There could be elements of incomplete information causing herd behaviour, or the perception of government guarantees that generate moral hazard. Transparency does not help much if investors are not looking at the data and just follow the leader, although you can expect that the leader will eventually consider the facts. Transparency is useless if investors believe they are somehow sheltered from risk, because they can get out in time, or if they believe in some implicit insurance for the exchange rate or credit risk through some form of government-sponsored rescue. The government must therefore avoid messages that could be identified as investment guarantees.

Simple indicators of vulnerability are not always representative. Foreign debt and vulnerability are not synonymous anymore; particularly a high ratio of foreign debt to GDP does not imply higher difficulties to repay in the future. Financial development and asset diversification implies the joint accumulation of foreign assets and of foreign liabilities. Therefore, vulnerability indicators should consider the level of assets and liabilities and the open risk positions in order to measure or asses vulnerability.

The BIS-IMF-OECD-World Bank data on external debt statistics tend to be biased to show higher vulnerability. In the case of Chile, at one point, they used the BIS statistics defined for residual maturities to represent short-term debt, while for medium- and long-term debt they used the Central Bank of Chile statistics, which were defined on original maturities, resulting in a double counting of amortisation due. A similar problem results from the purchase by foreign commercial banks of securities issued by Chilean corporations abroad to the extent that they are classified as short-term bank assets. Besides, the BIS creditors’ statistics were designed to measure bank exposure in different countries and cannot simply be used as an indicator of external debt. However, in the case of Chile, the BIS has now accepted that domestic liabilities in foreign currency should not be included as part of external debt.

I think we need to follow a different road by putting emphasis on the development of asset and liabilities data in each country. Countries are the ones most interested in limiting their own risk and generating a vulnerability indicator that presents the whole risk profile and avoids the debt bias.

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In my country, Chile, in particular, we have been making a very serious effort to develop an information system of foreign liabilities for which we have a mandatory registration system that allows us to follow positions of private corporations.

Let me conclude by saying that I consider Bill's paper not only very interesting and motivating, but also a very useful instrument for policy discussions on the subject. Despite all my comments and observations, I am in broad agreement with its contents and prescriptions.

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On Financial Instability and Control

*Yilmaz Akyüz**

I Introduction

The increasing frequency and virulence of international currency and financial market crises, also affecting countries with a record of good governance and macroeconomic discipline, suggests that financial instability is global and systemic. For a number of reasons, the potential threat posed by inherently unstable capital flows is much greater for debtor developing countries with close integration into the global financial system. Because their national policy efforts will not be sufficient to deal with the problem, there is a need to establish institutions and mechanisms at the global level in order to reduce the likelihood of such crises and to manage them better when they do occur. However, so far, the international community has been unable to achieve significant progress in setting up effective global arrangements in these areas, concentrating instead on marginal reform and incremental changes. Under these conditions, the task of protecting themselves against systemic instability falls on governments in developing countries. Once fully integrated through the liberalisation of the capital account, however, the scope for national policy to prevent instability remains highly constrained. Therefore, developing countries need to seek strategic rather than full integration into the international financial system. This can be achieved by establishing mechanisms designed to regulate and control international capital flows in order to reduce instability while tapping international financial markets for trade and investment. Regional arrangements between developing countries can also play an important role in this process by providing collective defense mechanisms against systemic instability and contagion.

Types of Instability

It is not always clear what is meant by "financial instability". It will be useful to make a distinction among the following types of financial instability, since the probability of their occurrence and their effects differ between developed and developing countries:

* The opinions expressed and the designations and terminology employed in this paper are those of the author and do not necessarily reflect the view of UNCTAD.

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1. Currency instability: one should distinguish between currency volatility, gyrations and misalignments, which are all related to instability of capital flows. While volatility refers to short-term, daily or weekly changes in exchange rates, gyrations describe sharp declines or increases which often move the exchange rate from one level to another. Misalignments, on the other hand, refer to persistence of exchange rates at levels unrelated to longer-term fundamentals. Gyrations often come after long periods of misalignments.
2. Financial crises refer to sharp declines in prices of financial assets including bonds and stocks, defaults by debtors, sharply increased non-performing loans, and difficulties in the banking system in meeting the demand of its depositors.
3. International debt crises describe defaults on international obligations by sovereign or private debtors.

Differences Between Industrial and Developing Country Crises

Experience shows that in developing countries reversal of external capital flows and sharp declines in the currency often threaten domestic financial stability leading to increased defaults and non-performing loans. Similarly, domestic financial crises in developing countries often translate into currency turmoil, payments difficulties and even external debt crises.

By contrast, currency turmoil in industrial countries does not usually spill over into their domestic financial markets. The EMS crisis of 1992-93 is a good example. Another example is the sharp movements in the exchange rate of the dollar vis-à-vis other major currencies we have seen in recent years. For instance, last year, the dollar-yen rate changed by more than 20 percent within a week. Such swings are comparable to those experienced in East Asia in 1997-98, but they did not lead to widespread defaults and bankruptcies in the financial system. Similarly, crises in the domestic banking system, or stock and bond markets in the United States and Japan during the past two decades rarely triggered currency crises and external payments difficulties (although pressures on the dollar were a major reason for the stock market collapse in 1987).

II Why Are Developing Countries More Vulnerable?

The Role of Domestic Policies

Financial and currency crises in emerging markets have occurred under varying macroeconomic and regulatory conditions, implying that differen-

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ces in domestic policies cannot solely be used as explanatory factors. Differences in national conditions include:

- *external deficits:* financial crises occurred when current account deficits were large and unsustainable (Mexico and Thailand), but also when such deficits were relatively small (Indonesia and Russia).
- *currency overvaluation:* although significant overvaluation has often been characteristic of countries experiencing currency turmoil (Mexico, Russia and Brazil), this has not always been the case; in most East Asian countries the appreciation of the currency was moderate or negligible.
- *budget deficits:* while in some cases crises were associated with large budget deficits (Russia and Brazil), in others the budget was balanced or in surplus (Mexico and East Asia).
- *consumption or investment:* crises occurred when capital flows were accompanied by a boom in private consumption (Mexico) as well as in private investment (East Asia).
- *public or private debt:* crises occurred when external debt was owed primarily by the public sector (Brazil and Russia) as well as by the private sector (East Asia). However, the vulnerability of the domestic financial system is greater when external debt is owed by the private sector rather than by sovereign governments, since private debt establishes closer linkages between currency and financial markets. This can clearly be seen from a comparison between the Brazilian and East Asian crises. Since external debt is increasingly privatised in developing countries, their vulnerability is accordingly increased.
- *financial regulation:* crises occurred in countries with relatively well-developed regulatory arrangements, including for Basel capital requirements (Malaysia) as well as in those without such arrangements (Thailand).

The common characteristic of all these crisis countries has not been their similarity in domestic policies, but their openness to international capital flows.

The Role of Structural Factors

A number of structural factors determine developing countries' vulnerability:

- *Net foreign indebtedness and the currency denomination* of external debt play a crucial role in vulnerability. The vulnerability of developing countries is greater because of their typically higher net external indebtedness and higher shares of their external debt denominated in foreign currencies.
- *Dollarisation* further adds to vulnerability since it effectively eliminates the difference between residents and non-residents in the determination of the profitability of their investments and their ease of access to

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foreign assets. Certainly, in developing countries this is much more important than in industrial countries. In many such countries, foreign exchange deposits by residents exceed deposits in domestic currency.

- *The size of developing country financial markets* is small, so that entry or exit of even medium-size investors from industrial countries is capable of causing considerable price fluctuations even though their placements in these markets account for a small percentage of their total portfolios. In relative terms, the presence of foreign investors in developing country equity markets is much greater, reaching at least 25 percent of the market, compared to less than 10 percent in the stock exchanges of Tokyo and New York.

External Shocks

Developing countries are more vulnerable to external shocks and contagion from other emerging markets. Trade shocks played a crucial role in the debt crisis of the 1980s as well as the more recent crisis in East Asia. In the former case, the collapse of commodity prices, brought about by the deflationary policies in the US, was an important factor in the deterioration of current accounts of many highly-indebted countries. In the Asian crisis, declines in terms of trade and export earnings of a number of manufacturers were important factors in the weakening of balance of payments and the loss of investor confidence.

Destabilising financial impulses from industrial countries have been even more damaging. Currency and financial crises in emerging markets are often connected with major shifts in macroeconomic policies, interest rates and exchange rates in the industrial countries. The sharp rise in US interest rates and the appreciation of the dollar was a major factor in the debt crisis. Likewise, both the surge in capital inflows and the subsequent outflows associated with the East Asian crisis were strongly influenced by swings in exchange rates and monetary conditions in the major industrial countries. Shifts in monetary conditions in the US have also played a large role in the fluctuations in private external financing for Latin American countries.

Instability of G-3 exchange rates pose serious difficulties for developing countries which typical link their exchange rates to major reserve currencies. It is open to question whether emerging markets can attain exchange rate stability when the currencies of the major industrial countries are subject to large gyrations. Indeed, many observers (including Paul Volcker and George Soros) have suggested that the global economy will not achieve greater systemic stability without some reform of the G-3 exchange rate regime, and that emerging markets remain vulnerable to currency and

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financial crises as long as major reserve currencies remain highly unstable.

Contagion across emerging markets is another source of vulnerability. While there is also contagion across stock or bond markets of industrial countries at times of relatively sharp declines as, for instance, was the case during the 1987 stock market collapse, such cross-border transmission of instability is generally limited compared to contagion among developing countries. Contagion is particularly powerful within regions, as was seen in the 1980s, and, again, more recently in East Asia and Latin America. Many observers argued, for instance, that if Brazil had been in Asia, it would not have suffered from the cutback in bank lending in 1982. Similarly, regional linkages were important in the contagion in East Asia, which hit almost every country with close integration into global financial markets. Nowadays, there is even a tendency of global contagion across emerging markets as financial markets tend to lump third world borrowers into the same class. Almost every emerging market experienced a sharp increase in its spreads during the recent bouts of crisis.

IMF surveillance has so far been ineffective in preventing crises in emerging markets, let alone providing a multilateral discipline over monetary and financial policies in industrial countries with significant impact on international capital flows. In bilateral surveillance of emerging markets, the IMF tends to be pro-cyclical. It is unwilling to advise countries to impose control over capital inflows, even when they are clearly unsustainable, or to impose standstills or exchange controls even when capital outflows are extremely damaging.

Furthermore, IMF surveillance is totally ineffectual in restraining destabilising influences originating from industrial countries. The US is seen to be benignly neglecting the dollar's exchange rate and the Fed sets its monetary policy and interest rates regardless of their global impact (except perhaps once, in the aftermath of the Russian default). Major countries no longer enjoy such freedom in setting their tariffs and trade policies, and it is difficult to understand why they should continue to keep this freedom with regard to macroeconomic and financial policies since financial shocks tend be much more damaging than trade shocks. Although this asymmetry between the trading and financial systems must still be resolved, little attention has been given to it in the recent reform initiatives.

Timely provision of liquidity to protect countries against contagion has not been the international policy response to prevent currency crises in developing countries. Rather, assistance coordinated by the IMF has usually come after the collapse of the currency, in the form of bailouts designed to meet the demands of creditors, to maintain capital account convertibility, and to prevent default. The 1999 Brazilian package was the first exception to this rule: it was intended to protect the economy against contagion.

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Approval of the package was subject to a stringent fiscal adjustment and a gradual depreciation of the real throughout 1999. After a political struggle the Brazilian government succeeded in passing the legislation needed to meet the fiscal target. However, when the attack started, the currency was allowed to collapse. As a result, the Fund required additional and more stringent conditions regarding the fiscal balance in order to release the second tranche of the package.

III Reforming the International Financial Architecture: What Reform?

After the recent bouts of turbulence and instability in emerging markets, a consensus seemed to emerge that because instability was global and systemic, national efforts would not be sufficient, and that there was a need to reconstruct the global financial architecture. A number of proposals have been made and some of these proposals have been discussed in fora such as the IMF, BIS and the Financial Stability Forum. However, efforts have so far concentrated on marginal reform and incremental changes rather than on the encompassing and more challenging ideas that emerged in the wake of the East Asian financial crisis. With a stronger-than-expected recovery in East Asia, the containment of the damage in Russia and Brazil and the rebound of western stock markets, emphasis has increasingly shifted towards costly self-defense mechanisms and greater financial discipline in debtor countries. Developing countries are urged to adopt measures such as tight national prudential regulations to manage debt, higher stocks of international reserves and contingent credit lines as safeguards against speculative attacks, and tight monetary and fiscal policies to secure market confidence, while maintaining open capital account and convertibility. Proposals for appropriate global regulation of capital flows, timely provision of adequate international liquidity with appropriate conditions, and internationally sanctioned arrangements for orderly debt workouts have not found favour among the powerful.

Political constraints and conflict of interest, rather than conceptual and technical difficulties, appear to be the main reason why the international community has not been able to achieve even modest progress in setting up effective global arrangements for the prevention and management of financial crises. Political disagreements do not occur only between industrial and developing countries. There have also been considerable differences among the G-7 members regarding the nature and direction of reforms. A number of proposals made by some G-7 countries for regulation, control and intervention in the financial and currency markets have

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not enjoyed consensus, in large part because of the opposition of the United States. By contrast, agreement within G-7 has been much easier to attain in areas aiming at disciplining the developing countries.

A rules-based global financial system, with explicit responsibilities of creditors and debtors and well-defined roles for the public and private sectors, seems to be opposed by some major industrial powers. Instead, they continue to favour a case-by-case approach because, inter alia, such an approach gives them considerable discretionary power due to their leverage in international financial institutions. Moreover, even if it were adopted, it is not clear if such a system would be desirable from the point of view of developing countries, since it is not realistic to envisage that a rules-based global financial system could be established on the basis of a distribution of power markedly different from that of existing multilateral financial institutions. It is much more likely that it would continue to reflect the interests of larger and richer countries, rather than redressing the imbalance between developing and industrial countries. Such biases against developing countries exist even in the so-called rules-based trading system where the North-South relation is a great deal more symmetrical than in the sphere of finance.

IV The Basel Capital Accord and New Proposals[1]

Even before the East Asian financial crisis, it became apparent that the standards of the 1988 Basel Capital Accord were increasingly divorced from the credit risks actually faced by many banks, and distorting incentives for banks regarding the capital maintained for a given level of risk. There were problems in three main areas:

1. Low weight to claims on banks (for those outside the OECD area with a residual maturity of up to one year, and for all claims on banks incorporated in the OECD area) is considered a serious problem since it encourages short-term interbank lending driven by interest-rate arbitrage, which was a major factor in excessive exposure to short-term debt in the Asian crisis. Moreover, this treatment implies that all banks (including those such as BCCI) have lower credit-risk weights than blue-chip corporates.
2. Failure to distinguish among risks of loans to different private borrowers: the same capital charge is assessed against a loan to a company with

1 For a detailed examination of these proposals see A. Cornford, *The Basle Committee's Proposals for Revised Capital Standards: Rationale, Design and Possible Incidence*, G-24 Discussion Paper No. 3, May 2000, UNCTAD-Center for International Development, Harvard University.

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an investment-grade rating as to a company with a junk-bond one, thereby providing incentives for so-called "regulatory capital arbitrage".

3. Failure to distinguish between the differences in creditworthiness of different sovereign borrowers, except between OECD and non-OECD countries.

The new capital adequacy proposals are designed to respond to the above shortcomings and they rest on three pillars:

1. Minimum capital requirements with a finer calibration of private and sovereign risks. In determining such requirements two approaches are proposed: (a) the standardised approach based on the rating of an external rating agency (e.g. S&P); and (b) banks' internal rating approach, which is considered as an option only for big international banks.
2. Supervisory review of capital adequacy in accordance with specified qualitative principles, enabling supervisors to require banks to hold capital above the minimum requirement, and to review internal risk assessment systems.
3. Market discipline is expected to be ensured by the provision of reliable and timely information by banks to allow their counterparts to make a sound risk assessment.

However, not only do the new proposed capital rules fail to resolve some of the old problems associated with the 1988 Accord, but also they bring about new problems:

- *Big international banks will become rating agencies:* this could be problematic since it would explicitly allow regulatory capital arbitrage, particularly when the profitability of a bank is threatened by competition from other banks and non-bank financial institutions.
- *External rating is problematic:* this will lead to pro-cyclicality, as the record of the rating agencies shows.
- The proposed system does not eliminate the problems associated with short-term interbank lending. Two possible approaches to *weights for interbank exposures* are proposed, one linking them to the sovereign risk for the country where the bank is incorporated, and the other based directly on the internal ratings of banks themselves. Under the second approach, short-term interbank claims might still receive more favourable treatment than those with longer maturities.

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V The limits of Prudential Regulations[2]

Effectiveness in Preventing Financial and Banking Crises

The continuing incidences of financial instability and crises in industrial countries suggest that regulatory and supervisory reform is unlikely to provide fail-safe protection in this area. If this statement is true for even industrial countries with state-of-the-art financial regulation and supervision, it is likely to apply *a fortiori* to most developing and transition economies. These limits to the effectiveness of regulation and supervision have various sources.

Financial regulation is constantly struggling to keep up with *financial innovation*, and it is not always successful. There is a continuing danger that new practices or transactions not yet adequately covered by the regulatory framework may prove to be a source of financial instability. There are also growing difficulties regarding the transparency required for regulation and supervision. The balance sheets and other returns of many financial firms have an increasingly chameleon-like quality which reduces their value to regulators. One can envisage a tightening of regulation sufficiently drastic to come close to eliminating the dangers due to innovation, but such tightening would probably stifle innovation too much to be politically acceptable in any country valuing dynamism of its financial sector.

Perhaps the most fundamental determinant of the limits of regulation and supervision is the *susceptibility of most of the bank's assets to changes in their quality resulting from changes in economic conditions*. No private sector loan or other asset on a bank's balance sheet should be generically classified as "good". Changes in the market value of a bank's assets can create serious problems not only for the profitability of the bank but, more fundamentally, also for its solvency, particularly when such changes are too large for a bank's capital to provide adequate safeguard. However reasonable the original decision to make a loan and however justified its initial classification may be, the loan remains vulnerable to the possibility of an eventual deterioration in its status. This is closely linked to the "endogenous fragility problem" discussed by Hyman Minsky. So long as cycles of financial boom and bust are features of the economic system, there will always be unforeseeable deteriorations in the status of many bank assets. During such cycles, risks take time to build up and become widely evident. For a while, indeed, the quality of loans can actually be enhanced by the very financing boom of which they are a part. Eventually, however, the

2 This section draws on Y. Akyüz and A. Cornford, *Capital Flows to Developing Countries and the Reform of the International Financial System*, UNCTAD Discussion Paper No. 143, November 1999.

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excess capacity generated by the boom and the over-extended position of financial firms are likely to lead to a reversal, again subject to a similar bandwagon effect.

Consequences of such boom-bust cycles can be described in terms of the concept "latent concentration risk", as used in the literature on credit risk. Concentration risk is traditionally handled in the context of banking regulation and supervision through limits on the size of exposures to particular borrowers. For this purpose, "borrower" is typically defined to include groups of counterparties characterised by links due to common ownership, common directors, cross-guarantees or forms of short-term commercial interdependency. But boom-bust cycles bring into focus risks that are due to latent concentration as they lead to a deterioration in the economic positions of counterparties *apparently unconnected* in other, more normal periods. Indeed, a common feature of the boom-bust cycle appears to be an exacerbation of the risk of latent concentration as lenders move into an area or sector *en masse* prior to attempts to exit together.

To some extent, the risks of latent concentration can be handled through banks' loan-loss provisions and through higher prudential capital requirements for credit risk. But the financing associated with booms in the value of property, equities and other assets is difficult for supervisors to restrain with the measures at their disposal owing to the size of increases in expected income growth or capital gains which are frequently involved. The limited crisis-preventing potential of financial regulation is generally recognised by specialists in the field. Its primary objectives have more to do with reducing liquidity and solvency problems of financial firms in order to protect depositors, and thus prevent or mitigate systemic risks due to contagion, rather than with preventing the outbreak of financial crisis.

Preventing Currency Crises

Prudential regulations are even less effective in preventing currency and external debt crises. Again, gyrations in reserve currencies and currency crises are common among countries with state-of-the-art regulation and supervision systems. This was seen in the large gyrations of the dollar in the 1980s and the EMS crisis in the early 1990s. There are now massive inflows of capital into the US which many consider unsustainable. Certainly, a sudden reversal of capital flows to the US can have serious repercussions for the financial system, just as happened with the stock market crisis of October 1987.

Thus, prudential regulations cannot prevent destabilising spill-overs from currency markets to financial markets, nationally or internationally. When banks pass the currency risk onto borrowers they simply turn it into

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a credit risk, unless borrowers also hedge against it. However, a debtor country cannot hedge against currency declines, except at very high costs resulting from additional credit lines, reserves, etc.

Preventing Emerging Market Crises

Basel standards are designed to protect the international banking system, not the developing debtor countries. Regulating exposure of creditors does not protect debtors when the same exposure means different risks for borrowers and lenders because of differences in size.

Reducing exposure does not prevent rapid exit. There is an asymmetry in regulations; by regulating exposure, entry is, in a sense, restricted. But there is no regulation restricting exit, such as a standstill, which could benefit both creditors and debtors.

Effective prudential standards in emerging markets do not necessarily protect them against currency and financial instability. The Malaysian example is highly illuminating and deserves close examination.[3] On the eve of the crisis in 1997, Malaysian non-performing loans (NPLs) were 2.2 percent of the total, the Basel ratio was 12 percent, and the ratio of provisions to NPL was nearly 100 percent. The short-term debt of the economy was more than adequately covered by international reserves. Even after the crisis broke out, there was no substantial capital outflow, as in Korea and Thailand. Despite all that, the ringgit lost 30 percent of its value, equity prices collapsed, NPLs rose to 12 percent and the economy went into a deep recession. Why? The initial policy response was orthodox, involving a hike in interest rates without relieving the pressure on the exchange rate. A reversal of policy towards expansion of credit and low interest rates faced serious difficulties due to speculation on the ringgit – much of the increased liquidity went abroad in dollars, primarily through the market in Singapore and also through bank speculation in Malaysia. Thus the controls came about in September 1998 in order to allow monetary policy to support recovery rather than the speculation against the currency.

VI Policy Autonomy and Scope in Developing Countries

In view of the lack of global mechanisms to prevent financial crises, and the need to manage them better when they occur, the question is: to what extent could emerging markets establish effective mechanisms to reduce the likelihood of crisis and the resulting damage.

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3 For a brief account see UNCTAD, *Trade and Development Report 2000*, chapter 4.

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Exchange Rate Regimes

Since the recent bouts of crises, exchange rate policies in emerging markets have been widely criticised for encouraging excessive borrowing abroad and for giving one-way bets to speculators. Accordingly, they are now advised to fix the rates forever or to allow them to float freely to avoid build-up of fragility.

However, under free capital mobility, no exchange rate regime will guarantee stable and competitive rates. Currency crises are as likely to occur under flexible as under fixed exchange rates; flexible exchange rates provide no more guarantee against real appreciation than fixed or pegged rates. As the experience of the major reserve currencies shows, free-floating can result in significant misalignments and gyrations in exchange rates. Given their structural rigidities, developing countries have little capacity to respond, and hence such misalignments and gyrations could undermine the success of the so-called outward-oriented strategy.

It is probable that if currencies in East Asia had been allowed to float in the early 1990s, when inflows were in excess of what was needed for current account financing and there was rapid accumulation of reserves, the result could have been further appreciations. It is not clear that abandoning the pegs would have reduced the incentives for lending or unhedged borrowing; a vicious circle could have emerged between capital inflows and currency appreciation.

Fixing exchange rates can result in appreciations (e.g. Russia or Brazil) or depreciations (e.g. Malaysia). Differences among pegged, floating and fixed exchange rates lie not so much in the extent to which they can prevent volatility of capital flows or contain their damage to the real economy as in how the damage is inflicted. Argentina and Hong Kong succeeded in maintaining parity with the dollar, but in real terms they suffered as much as and even more than some of their neighbours.

Regulation and Control of Capital Flows

The issue is not to fix or float, but whether or not to allow full freedom to financial capital. However, developing countries rarely use regulation and control over capital movements. This has many origins:

- *Loss of policy autonomy:* Developing countries now enjoy much less policy autonomy than at any time in the post-war period in setting the pace and extent of their integration into the global financial system. First, systemic pressures on governments have increased as a result of liberalisation and integration of financial markets. Due to the greater exit option enjoyed by capital, governments policies have now become

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hostage to financial markets, and the kind of policy discipline that these markets impose is not always conducive to rapid growth and development. Second, policies in these countries are also subject to pressures from major industrial powers and multilateral institutions. Finally, a number of policy instruments are no longer available to some countries due to their commitments as part of their membership to blocs such as OECD or NAFTA.
- *Increased payments deficits:* Developing countries are now running larger trade deficits without growing faster.[4] This is because many developing countries have liberalised trade rapidly without having established competitive industries in the first place. On the other hand, as a result of increased reliance on exports, they are all pushing against stagnant and protected markets in the North, competing fiercely with each other and facing large terms of trade losses. As a result, attracting private capital of any kind becomes essential to maintain a momentum of growth. However, by generating instability, private capital aggravates the payments difficulties rather than providing a viable solution.
- *Cost of and access to external finance:* Controls are opposed, at national or global level, when they would have the effect of lowering the volume of capital inflows and/or raising their cost even when such measures could be expected to be effective in reducing instability and the frequency of crises in emerging markets. A large majority of them have been unwilling to impose control on capital inflows during the boom phase of the financial cycle. Also, they are generally unwilling to introduce bond covenants and collective action clauses and have been asking industrial countries to take the lead in this respect. Some developing countries are even concerned that emphasising private sector involvement could undermine investor confidence and access to international capital markets. They are also opposed to differentiation among sovereign risks in the Basel capital requirements for international bank lending.

Variations of National Capital Account Regimes

Despite a loss of policy autonomy and increased reliance on foreign capital, the existing scope and autonomy have been exploited differently in different countries. There is indeed considerable variation within the South in the extent to which policy autonomy has been used in the domain of finance. For instance, while India and China have pursued a much more gradual and cautious approach to international capital flows, many countries in Latin America have rapidly opened up their capital account and financial

4 See UNCTAD, *Trade and Development Report 1999*.

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sector. Again, a comparison between the policies adopted by Malaysia and the others in response to the East Asian financial crisis shows that policy options even under crisis conditions are not as narrow as generally assumed.

Until systemic instability and risks are adequately dealt with through global action, the task of preventing financial crises falls on governments in developing countries. Since there is no global agreement that forces them to open up their financial markets, developing countries have the autonomy to manage capital flows and choose whatever capital account regime they deem appropriate. They should not be constrained by international agreements on capital account convertibility or trade in financial services.

VII Regional Cooperation

There is also much that could be done at the regional level, particularly among like-minded governments who are prepared to establish collective regional defense mechanisms against systemic instability and contagion. In this respect, the experience of Europe with the monetary and financial cooperation and the ERM, introduced in response to the breakdown of the Bretton Woods system, holds useful lessons. Regional monetary and financial cooperation among developing countries – including exchange rate arrangements, macroeconomic policy coordination, regional surveillance, common rules and regulations over capital flows, and regional mechanisms for the provision of international liquidity – could be a viable and more easily attainable alternative to global mechanisms designed to attain greater stability.

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Comment on “On Financial Instability and Control,” by Yilmaz Akyüz

Amar Bhattacharya

While sharing few of the more rhetorical points that Yilmaz Akyüz mentioned, I agree very much with him that there is fairly incontrovertible evidence that developing countries are more subject to vulnerability in the sense of currency, financial and debt crises than industrial countries. I would also add to that perspective that the costs associated with such crises tend to be greater in developing rather than in industrial countries. I have some disagreement with Yilmaz about trade deficits and the link to private capital flows for developing countries. He says that developing countries have been running larger and larger deficits but that it is not clear what their link to growth is. This is a little bit of the “chicken and the egg” problem: are these deficits really trade deficits because of problems on the trade side or were they actually larger trade deficits induced, as Guillermo Le Fort was in some sense suggesting, by very large capital inflows?

One way to put some of the story in perspective is to look at private capital flows to developing countries in the context of current account imbalances. At the peak of capital flows to developing countries, net private capital flows were on the order of about $300 billion compared to a current account deficit of only $80 billion for developing countries. So the magnitude of private capital flows to developing countries has never been a problem. What has been a problem is its concentration and its instability.

There is quite incontrovertible evidence that capital flows, especially banking flows and, even more so, short-term flows tend to be pro-cyclical and boom-prone, as was mentioned by José Antonio Ocampo. The combination of this behaviour of flows with a kind of structural condition that Yilmaz mentioned leads to a rapid build-up of vulnerability in developing countries. But it takes two to tango. For those who look at it from the market perspective, I always say that wherever there is a borrower there is a lender.

If there is a withdrawal of private capital, the first problem is that the rug is pulled out from under you in a way that the punishment is typically not commensurate with the crime. A second problem is that the scale of private capital has become larger and larger relative to available official capital. A third problem is that the withdrawal of private capital to one country sometimes has a contagion effect on other countries, although the

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experience of both the Mexican crisis and the East Asian crisis suggests that global systemic effects have been less than we would have thought. I think that the balance of action still largely lies on the domestic compared to the international side. It doesn't have to do with any normative aspect, it has to do with the nature of the markets and the fact that, as Bill White has repeatedly pointed out, the risks are less for the lenders than they are for the borrowers.

International Management of Private Flows

In terms of the management of private capital flows, there are a set of international actions that are important in the regulation and supervision of private capital flows of which several elements were highlighted in our discussions. The first is the importance of norms, standards and codes. For anybody who thinks that there has been too little action, I would say that there has been too much. Indeed, in the last three years every kind of norm has come out of the woodwork and, in some sense, the challenge is prioritising them and making them case-applicable. The second, as has been pointed out by Mark Allen, is that there is a case for transparency and regulation in terms of international financial markets, not just in regard to the Basel Capital Accord, but more in the context of market integrity.

Is there the "elephant in a small pond" problem? Are the frontrunning and double plays creating problems? As was noted, Australia, Singapore, Hong Kong, and some of the smaller, more sophisticated markets feel that they have been subject to this kind of speculative pressure. An interesting case, which emerged when I did a survey some time ago, was that these players were not in Chile. One of the unintended effects of the Chilean intervention in the composition of flows was that it kept out certain kinds of players because the transaction costs associated with a double bet were too high. So Chile was not subjected to the same kind of propriety trading as some of these very liquid, very sophisticated markets.

There are other aspects on the international level which we talked about, such as strengthening the lender of last resort – where I think the SRF as well as the CCL have been important innovations – and the related issue of private sector engagement. I am putting this on the table because I want to come back to the question of "is there enough or not enough?". These are all areas in which there is action forthcoming. A large number of fora and cross-institutional arrangements have been put into place. So there are the legitimate questions of whether there are duplications or gaps, where we are in the balance between these many fora and if these add up to a coherent whole.

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National Management of Private Flows

At the national level, before one gets to the regulation and supervision of private capital flows, I think it is essential to consider that the long-run objective must be more robust systems of integration. I don't think any developing country has the option of not becoming integrated into the international financial system. So the question is: what are the prerequisites that need to be put into place for successful integration? If you look at the literature of the mid-1990s, it heavily stressed strong macroeconomic fundamentals and, in particular, strong fiscal policy. We have come a long way since that. We have come to a lot of the micro-prerequisites for financial integration that José Antonio Ocampo described: corporate governance, account auditing, robust financial systems and good legal frameworks. Many of these are critical elements of integration because they are essential for reducing the information asymmetries and risk premia which are the two problems to which developing countries are so susceptible. It is too easy to immediately rush to the regulatory side when it is important to recognise that the long-term agenda is really one of building robust market underpinnings. I agree with Yilmaz' point that there is a range of regulatory regimes that developing countries have and could put into place. It is important to look at the lessons of these regulatory regimes a bit more carefully to think more intelligently about choice.

Where I would go further than Yilmaz is to say that the regulatory regime does not narrowly apply to capital account but, much more broadly, to the sets of regulation that underscore the double mismatches in the end that José Antonio Ocampo described. Capital account is one of the regulatory regimes you have to be concerned about, but they also have to relate to sovereign debt management, and they have to apply to the financial sector and to the corporate systems.

I can illustrate this by giving you a range of regulatory aspects that are also market-friendly or can be price-based. An example is the case of banking systems. Yung Chul Park said, "What can I do? The OECD prevents me from putting in a restriction on short-term capital borrowing by both banks and corporates". However, we can lay out a menu of things that are within the national purview. For example, it is perfectly fine to move to better and more asset price sensitive capital adequacy measures like those used in Chile. It is perfectly within the purview of a national system to regulate the net foreign asset exposure of the banking system as part of your supervisory regime. It is perfectly fine, as in the case of countries like Korea, to say that a bank that lends to a company that has a 500 percent debt-equity ratio is undertaking inherently more risk than if it is lending to a corporation with a 100 percent debt-equity ratio. It is perfectly within

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national parameters to make your capital adequacy ratios and your risk parameters more sensitive to leverage.

For countries where such instruments are less sophisticated or tuned, it is perfectly fine to use more blunt instruments like sectoral limits. In the case of Malaysia, which Yilmaz mentioned, the government put sectoral limits on real estate lending in place before the crisis in 1994-95. Perhaps if they had done it a little bit earlier it would have made more of a difference. However, there is evidence that it did have some bite.

Similarly, there are several types of regulation that you can think of on the corporate side. I have been personally pushing a "tax-based regulation" of borrowing by corporations. What do I mean by that? Every corporation files for a tax deductibility on interest payments. You can use tax deductibility on interest payments to get disclosure of the borrowing structure of corporations, which is one of the problems that many developing countries face. You could tilt incentives against short-term and unhedged borrowing by giving less deductibility. It is, again, a market-based mechanism for tilting incentives against such type of corporate borrowing. In order to tackle the Indonesian type of problem you could also put in a market-based stipulation saying that you allow corporations to borrow abroad only if they meet certain market tests. Corporations must meet a market-based credit rating in order to be eligible for certain types of external borrowing, because there is a social risk or an externality associated with such kind of borrowing,. This could ensure that corporations are subject to some kind of administrative approval. For those of us who have worked on East Asia, we know that Malaysia and the Philippines had very tight regulations on corporate borrowing coming out of their own experience in the mid-1990s and the Brady operations. As a result, neither country had a corporate sector problem during the East Asia crisis. They had problems somewhere else. Even before one comes to the Chilean type of control there is a range of instruments that one can think about in terms of tackling the essential problem of this double mismatch. I agree very much with Guillermo that one could use ways of making them more price-based and market-responsive rather than quantity-based.

Other Challenges

In defense of the IMF, it is very difficult to judge how many crises were prevented because of Fund surveillance. It is not quite fair to extrapolate into the future based on the past. Many of the steps that are being taken, not only in the IMF but in these various fora such as the Financial Stability Forum and the G-20, are intended to strengthen international and regional surveillance. I think it is important to also use regional mechanisms to

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pursue and enhance surveillance. The Manila Framework Group and the western hemisphere's finance ministers' process are examples of such regional surveillance.

There was a sense that financial shocks in industrial countries posed potential problems for developing countries. It is absolutely correct, although since the 1993 interest rate shock the financial crises have had less to do with industrial country problems and more to do with mechanisms of contagion, etc. I am not saying that they don't have to do with market imperfections, but that they have less to do with policy shocks emanating from industrial countries. Nonetheless, an asset market problem in the US could potentially have huge repercussions in developing countries.

Yilmaz said that the Basel Capital Accord primarily deals with regulating international bank lending. Actually, it has as much to do with regulating banks in the emerging markets. On the one hand, it has an unintended consequence because there is a huge consolidation effort going on at the international level leading to larger and larger international banks and these banks are able to operate on thinner and thinner margins and with effectively perhaps less capital than before. On the other hand, you are asking developing countries' banking systems to operate with tougher and tougher capital adequacy standards. One interesting side effect is: what does that do to franchise value and contestability in emerging markets and will emerging market banking systems be able to survive in this kind of world of international consolidation? In the process, as well as the impact, it says much about the developing country's own banking system.

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Floor Discussion of "Recent Initiatives to Improve the Regulation and Supervision of Private Capital Flows"

Exchange Rate Regime and Capital Flow Volatility

Reacting to Bill White's paper, José Antonio Ocampo argued that no exchange rate regime on its own can bring about stability of capital flows in emerging economies. "Countries at both extremes, with either a totally fixed currency board system or totally flexible exchange rates, are going to have an extremely pro-cyclical policy if they don't have regulations on capital flows. Why? Because in the fixed system, you have no way of stopping external financing from going into domestic expenditure. And with flexible exchange rates, during the period of capital inflows, you will have an appreciation of the currency, generating significant capital gains for all the debtors in the international markets and fueling domestic expenditures. That's why if your objective is to control and restrict booms, the essential instrument is capital account regulations. A basic defense of intermediate exchange rate regimes is that authorities can use such regulations to support the adoption of anti-cyclical macroeconomic policies."

Yung Chul Park supported Ocampo's view on the inherent pro-cyclical nature of capital flows. "Our recent experience is that once these foreign investors expect a fairly robust upturn of the economy, they start bringing money into the economy. That immediately leads to an appreciation of the currency. Once the currency appreciates, the textbook then tells you that on a certain day in the future, the currency will depreciate and that this expectation will stop the inflow. But the problem is that it doesn't happen. Once the currency starts appreciating, everybody waits until the last minute to see what happens to the economy. In the meantime, instead of generating the expected depreciation, the currency continues to appreciate because many people believe that the upturn is going to go on for a while. The currency appreciates from three to six months and even to a year, and after about six months these investors – the money market managers and the investment and commercial banks – start to be on guard for any clues that the currency may depreciate. The primary thing they look at is the current account. So when, after six or eight months, the appreciation affects the current account and the surplus shrinks and turns into a deficit, everybody leaves. This is what happened and may happen again in East Asia. The stability of the flexible exchange rate system in a world of capital

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mobility has not been established. Until we know that the market has a mechanism for restoring stability, it is very hard for these emerging market economies to have a full-fledged flexible exchange rate system."

Ariel Buira elaborated on the inherent instability of financial markets. "We have a sort of paradoxical situation: if a country is successful because it has undertaken all kinds of reforms, has its fiscal accounts in order and is growing and attractive, then it receives large capital inflows. These inflows give rise to an appreciation of the currency and, after some time, a current account deficit emerges. When the current account widens, there is a perception of risk and then anything can turn market sentiment around. It may be a good, a bad or a dubious reason, or a combination of minor things, that can detonate a reversal in sentiment. This is the built-in instability of the system that one must be aware of. You are sitting on a bomb. Unless you are able to limit the flows – which I am not sure you can do successfully – it certainly helps to have a small deficit in the current account and very sound public financial support, but even then something can still change the market's sentiment."

Stephany Griffith-Jones called this paradoxical process "the curse of the successful reformer". "The more successful you are, the more you attract these flows and the more you have distortions. If you evaluate economic reforms – just to broaden the discussion – this is an Achilles heel. It is an intrinsic contradiction in the model: the capital inflows undermine the effectiveness of reforms. When a country is simultaneously liberalising the trade and capital accounts, capital surges in. The misalignment – not just the volatility – that results from the exchange rate appreciation makes it, for example, more difficult to export (which is supposed to be the main engine of growth). In addition, you have the risk of crisis which is costly. Because even if the risk is not that big, it sometimes turns out to be bigger than the government may have thought and if things do go wrong, they will go very wrong. They will slow down your growth and lead the country into a recession. So I would argue that if you are in favour of markets, you should be especially worried about these capital inflows. They introduce this contradiction which results in less growth, both because of the risk of crisis and the slower export growth."

Given this contradictory process, Griffith-Jones advocated a much stronger policy response than the one suggested by Bill White. "I am very worried by Bill's candid and honest paper which I understood to be saying that we can't do very much. That isn't good enough because the pattern, as Yung Chul Park said, could develop again in Asia. We have a very big problem and although each of us may define it differently, we do not have strong enough responses."

Bill White recognised that floating exchange rates are not a panacea.

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"While having many advantages, floating exchange rate regimes are still subject to all sorts of problems. They are prone to extrapolative movements which can overshoot fundamentals and then rebound quickly to the discomfort of market participants. Movements in nominal exchange rates also drive wedges between the prices of tradables and non-tradables, leading to accusations of there being two economies and political pressures to alter the stance of monetary policy in turn. My only conclusion would be, going back to Churchill's famous comment on democracy, that for all its faults, a flexible exchange rate regime is still commonly better than the alternatives. Turning now to a current issue in this regard, it seems to me that the principal error being made in Korea at this moment is not letting the exchange rate appreciate as much as it should. If this leads to a recurrence of the earlier tendency to borrow abroad at short maturity because it is perceived to be cheaper, then this may prove to be very dangerous."

White agreed with Ariel Buira and Stephany Griffith-Jones that good policies often lead to excessive capital inflows. "Most of the excesses have their roots in good things happening. You can see that in Mexico prior to the crisis of the mid-1990s where there was an enormous shift towards fiscal prudence, the signing of the NAFTA treaty and the privatisation of the banking system along with many other welcome reforms. Yet, we all know how this ended up. The same thing happened in Southeast Asia. A lot of structural changes were undertaken to open up and improve the economy in various ways and macroeconomic policies were generally sound as well. Nevertheless, rational exuberance eventually transformed itself into something irrational and this created the conditions which led to the crisis. In the same vein, we observe stock market valuations in the industrial economies and their justifications on the basis of 'new era economics'. This dynamic process creates a real dilemma for policymakers. First, how can one identify the circumstances in which justifiable optimism is actually turning into excessive optimism? And second, even given such a conviction, what can be done about it? Needless to say, I am not suggesting that these complications imply policymakers should not have introduced welcome structural and macroeconomic reforms in the first place."

Prudential Supervision and the Unwinding of Liberalisation

Following up on a point made by Stephany Griffith-Jones that some developing countries, particularly low-income countries, may have gone too far in their financial liberalisation, Louis Kasekende suggested that the IMF could take the lead in advising these countries to unwind some of their liberalisation measures. "This is a point on which we, especially in Africa,

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might need more assistance. We need more research to understand the problems we are faced with. Reimposing capital controls may be one of the policy options for the African countries."

Mark Allen reacted that he could think of the desirability of unwinding liberalisation for prudential reasons. "Together with the World Bank, we have stepped up a programme on financial sector surveillance and stability. It involves special missions looking at issues of financial sector stability, country by country. The main approach I would suggest unwind liberalisation only if necessary for prudential reasons. The answer may be to deal with things from the prudential side and not from the liberalisation side. If it's impossible to supervise the system properly through the prudential system, then we can make a case for doing it through a capital controls system. That would be the focus of the advice I would give."

Mark Allen also argued that some large financial institutions need to be better regulated and supervised. "I have heard from people inside Citibank that they transact about 50 percent of world currency trade and for smaller currencies, it may be even higher. I really wonder whether it isn't a major market distortion that some large financial institutions have this knowledge of where positions are being taken and what's happening and are therefore able to front-run the market on the securities side? We ought to look into establishing a 'Chinese Wall' or even putting currency trading and securities trading into separate institutions. There may be a major potential crisis or scandal lying in this area."

Roy Culpeper fully agreed with Allen, but observed that his proposal to erect a "Chinese Wall" between the securities and currency side of financial institutions was made at a time when domestic systems were moving exactly in the opposite direction. "Firewalls are pulled down, and financial integration between different kinds of operations is encouraged and facilitated."

Aziz Ali Mohammed said he was extremely worried about the way financial institutions are integrating. "For example, the fact that Citibank recently joined with Travellers Insurance to create a huge conglomerate, is a cause for serious concern. When we talk about the role of regulators, the issue is: who is regulating the conglomerates and don't we need some kind of merger on the regulative side in order to face up to the merging that is taking place among private financial institutions? A big institution like Citibank can take advantage of the breaking down of the 'Chinese Wall' that existed, to use Mark's term, to front-run the market. They're active both on behalf of themselves, in their off-balance sheet transactions, as well as acting on behalf of their customers. This kind of front-running can also happen in a very peculiar way in other institutions, for example, institutions that are responsible for custodian operations, e.g. the 'backoffice

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boys'. State Street Bank boasts that it has more than 50 percent of the custodial activity for all the mutual funds in the US. So they are able to use the computerised information, that is now coming in on a daily basis, to know where the heart is long before the heart discovers itself."

Risk Management and the New Capital Adequacy Accord

Roy Culpeper wondered whether the proposed new capital adequacy accords, which place considerable faith in the sophisticated risk management systems of large banks, would really reduce systemic risk. "In my view, they are the beginning of a two-tiered system: one for the large money centre banks, based on their own risk management models and systems, and one for everyone else. Isn't this getting us further away from being able to monitor and regulate systemic risk? It seems to be a leap of faith to believe and trust in the risk management systems of these institutions. Perhaps the most basic point is that these risk management systems are geared more to the risks faced by the financial institutions themselves rather than the systemic risk. Afterall, if I ran a big money centre bank I'd be most interested in the risks to my own balance sheet rather than to any kinds of systemic risk from the positions that the bank might be taking. All of this suggests that we haven't really learned anything from the Long-Term Capital Management debacle. LTCM had two Nobel prize winners, one of whom was a Canadian, putting together a very sophisticated risk management model and look what happened. The rest is history."

Stephany Griffith-Jones added that she was highly worried about the inclusion of the risk models of large banks to which Bill White referred in his point on transparency. "Bill said that if we include the use of the banks' own risk models in the new capital accords then, as Roy also mentioned, the system may actually become more risky than before. Why are we doing this, it sounds a bit crazy? Can't we do a bit better? These risk models – plus the herding – almost inevitably lead to this kind of perverse behaviour. The problem is that often these loans to developing countries are not large enough to cause a systemic threat to the banks, so they don't care that much. Why do we rely more and more on the banks' own risk models if experience tells us that the externalities exist and occur over and over again? In my view, it is necessary to think of a more interventionist approach by the regulators. And if we think that regulation can't do it – though I personally think it can – then we should look very seriously at other things like incentives in the markets. We know that all those bonuses bankers and traders get contribute to short-termism and herding. So why don't we think in terms of taxes and other incentives, perhaps through

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regulation, as John Williamson has suggested in a previous Fondad conference in Budapest?"[1]

Bill White responded that the supervisors were not simply letting the big banks do whatever they thought best. "The national supervisors themselves, and the national supervisors interacting internationally through the Basel Committee, are trying to get a very good understanding of the way in which these risk models are put together and used in practice. The supervisors are insisting on top-of-the-line analyses being done internally by the banks. Moreover, if a bank does seem to be behaving according to the standards laid down by the supervisory authorities, then the use of the internally generated models will simply not be allowed for the purposes of the calculation of regulatory capital charges. We are not talking about two solitudes here. There is, in fact, constant interaction between the banks themselves and the regulatory authorities in all major regulatory jurisdictions."

White stressed that the distinction between the individual institutions, and the risks that they face, as opposed to the risk that the system as a whole might face, is getting increasing attention from the supervisors. "The concept of the 'fallacy of composition', whereby collective actions lead to different outcomes than individuals acting alone, is well known in economics. There may well be applications in the area of banking supervision as well. Consider, for example, the issue of short-term as opposed to long-term bank loans. Short-term loans, from the perspective of an individual bank, are riskier than longer-term loans. That is the basis on which the existing Capital Accord treats such loans. Nevertheless, consider the implications for a country whose banks all tend to rely on such short-term international lending. Given some common shock, they may prove collectively unable to mobilise the resources to repay the loans, and thus the short-term loans may actually prove riskier than those of longer-term. So, to repeat, at the level of the individual institution, you can come up with a series of policies that are absolutely sensible, but if everybody uses them at the same time problems may nevertheless emerge. For example, if a large number of important financial institutions use similar risk models, everybody may be advised by them to head for the exits at the same time. It is important to note that the supervisors are increasingly aware of such problems, and that in recent years there have been many new forms of interaction between the supervisors, central bankers and even Treasury officials. The supervisors increasingly recognise that their traditional 'bottom-up' approach, while entirely valid in most circumstances, may be subject to a

1 Teunissen, Jan Joost (ed.), *The Management of Global Financial Markets*, Forum on Debt and Development (FONDAD), The Hague, 2000, p. 105.

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kind of side constraint in certain cases. Thus, it may also be useful to have a 'top down' approach to explore the implications when individual institutions all pursue sensible policies simultaneously. There is no question that there is an issue here that is currently being addressed in a very serious way."

Global Governance of the Financial System

Wouter Raab was concerned about the lack of progress in implementing ideas about improving global financial governance. "There are many oft repeated ideas regarding the improvement of capital flows supervision. However, it concerns me that these ideas find implementation, monitoring and follow-up to be very difficult. What conclusions can we draw from the deficiencies in the monitoring? Progress is very uneven and lagging behind the discussions we have had for many years.

This raises the issue of global governance of the international financial system: do we have the institutions in place to follow up on the many discussions we have? There are now many groupings: the G-7, G-10, G-20, the Financial Stability Forum (FSF), the BIS, the Bretton Woods Institutions and other important groupings. But it seems we are moving from one meeting to another and we don't have time for implementation of the suggestions we make.

The IMF and the World Bank were founded to follow up on these sort of issues, because they have a universal membership and a representative structure through which everybody can make its voice heard. The question is: why are we not letting the Bretton Woods institutions play the role they are supposed to play?

I thought that there was a certain movement in the right direction by the discussion on strengthening the Interim Committee, but it hasn't produced many results apart from a name change from Interim Committee into International Monetary and Financial Committee (IMFC). It worries me that some groupings appear to be in favour of having even fewer meetings of the IMFC.

We still have many things to do to create an effective system of global governance. We have the analytical discussions behind us, know what the challenges are, have had many recommendations and suggestions as to what to do, now it's time for implementation. Unfortunately, however, it seems that the global governance structure is lacking."

Bill White agreed that the progress being made in improving the overall governance of the international financial system had been more limited than some might have hoped. "The relations between the various groupings have always been a bit confusing and, frankly, they recently seem to

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have become even more confusing. We now have the G-7, G-8, G-10, G-20, the Financial Stability Forum, and the IMFC, with many of these groups having been created very recently. Even supposing that each of these groups adds value to deliberations pertaining to the international financial system, there is still the question of how all these efforts fit together. In this regard, the proposed mandate of the Financial Stability Forum seems particularly useful. The FSF is supposed to look at gaps, overlaps and priorities with respect to measures directed to crisis prevention. Nevertheless, the FSF faces exactly the same problem as the more traditional groups active in this area. There is generally no international law to force people, subject to national law, to follow internationally determined recommendations. This has led the FSF in its recent deliberations to focus on implementation issues; in particular, how various incentive systems might be used to encourage people to do the right thing of their own volition."

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Part IV
Reforming the IMF

The Future Role of the IMF: A Developing Country Point of View

Aziz Ali Mohammed

I Introduction

This paper seeks to address some of the issues that have arisen out of the recent worldwide debates on the future role of the International Monetary Fund in the wake of its management of the Mexican, Asian, Russian and Brazilian financial crises. The debates have been particularly intense in the United States during and since the passage of legislation in the US Congress authorising an increase in the US quota and its credit line in the New Arrangements to Borrow (NAB) and following the submission of a report by a US Congressional Commission headed by Alan Meltzer.[1]

At one extreme is a position taken by conservatives like George Schultz (a former US Treasury Secretary) who proposes the abolition of the IMF on the ground that its crisis lending operations generate an unacceptable degree of moral hazard for the private financial system as well as for sovereign borrowers. In the same camp are abolitionists on the far left of the political spectrum who regard the IMF as the modern-day replacement of 18th century "gunboat" diplomacy. They are convinced that the IMF serves the imperialist designs of its principal shareholders, and imposes harsh conditionalities on the populations of poor countries to ensure the servicing of debts owed to creditor governments and financial institutions in the advanced capitalist countries. Others with a less hostile orientation advocate the merging of the IMF into the World Bank Group.

At the other extreme is the view that if the IMF did not exist, it would have to be invented. It is regarded by its supporters as playing a constructive role as an international credit cooperative serving its universal membership with impartial macroeconomic policy advice, technical assistance and financing for countries encountering temporary balance of payments problems. At this end of the spectrum, the debate focuses on how to enlarge its role in the global economy in a variety of ways, for instance, as a genuine lender of last resort and as a creator of international liquidity through its prototype SDR mechanism; as an umpire in orderly debt nego-

1 International Financial Institutions Advisory Commission (IFIAC), *Report*, March 8, 2000.

From: Reforming the International Financial System: Crisis Prevention and Response, FONDAD, December 2000, www.fondad.org

tiations between private and official creditors and their sovereign debtors; as an international authority endowed with powers to declare a "standstill" on legal actions that private creditors might take to enforce their claims on sovereign debtors; and finally, as an overseer of the international monetary system through the exercise of effective surveillance over the exchange rate policies of the major international currency countries.

Within this broad range of views, a series of intermediate positions have been advanced by official and non-official groups, including academics and representatives of non-governmental organisations and by representatives of developing countries.[2] The majority of the Meltzer Commission would restrict the IMF to a crisis prevention and response role through very short-term, essentially unconditional liquidity support for a limited number of relatively strong emerging countries that would have pre-qualified for IMF assistance. It would also eliminate the Poverty Reduction and Growth Facility (PRGF), restrict IMF surveillance to non-OECD member countries and write off all IMF claims against its HIPC members. However, four members of the Meltzer Commission take a sharply different view on some of the major recommendations made by the Commission's majority.[3] In an address in London,[4] delivered late last year, the US Treasury Secretary Larry Summers observed that "to say that the IMF is indispensable is not to say that we can be satisfied with the one we now have." He then proceeds to argue that in a world dominated by private capital flows, the IMF must accept "a more selective role that is focused on emergency situations" and "a more limited role in the poorest countries focused on growth and poverty reduction." The PRGF would be maintained and selectivity in respect to other transactions would be enforced by lending for shorter maturity and at higher interest charges. The US

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2 The US Treasury, responding to the IFIAC Report in a document dated June 8, 2000, finds itself "in fundamental disagreement" with that Report's core recommendations for further reform. Among recent reports from US non-official bodies, mention may be made of three: (1) Council on Foreign Relations Independent Task Force Report, *The Future of the International Financial Architecture*, New York, September, 1999; (2) International Center for Monetary and Banking Studies and Center for Economic Policy Research, *An Independent and Accountable IMF*, Geneva and London, 1999; (3) Overseas Development Council Report, *The Future Role of the IMF in Development*, Washington, D.C., April 2000. An unofficial G-24 position is articulated in a paper prepared by Montek Ahluwalia entitled "The IMF and the World Bank in the New Financial Architecture", in *International Monetary and Financial Issues for the 1990s*, Vol. XI, New York and Geneva, United Nations, 1999. Official G-24 positions are stated in the press communiqués of the Group issued in September 1999 and April 2000 (reproduced in the *IMF Survey*).

3 Joint Dissenting Statement signed by four members: C. Fred Bergsten, Richard Huber, Jerome Levinson and Esteban Edward Torres; three of them did not sign the main Report.

4 "The Right Kind of IMF for a Stable Global System" delivered at the London Business School, December 14, 1999.

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Treasury response broadly follows along the lines of the Summers London address.

In another recent report from official sources,[5] the United Kingdom Treasury Committee is not convinced that "the IMF has the correct expertise to undertake major debt relief programmes in developing countries." It wants the IMF to "pull back from such programmes and concentrate on its original mandate." It warns that unless the roles of the IMF and WB Group are clarified, "the level of overlap increases the argument for a merger." In a major area of the Fund's work, i.e. on codes, international standards and financial regulation, the Committee urges that this work be given a "higher priority".

The positions articulated in the preceding paragraphs by authoritative sources in some of the principal shareholder members of the Fund stand in contrast to several major addresses delivered by the former Managing Director of the IMF, Michel Camdessus, in the days just prior to his retirement[6] and the submission made by Stanley Fischer, First Deputy Managing Director, to the Meltzer Commission.[7] Finally, the new Managing Director of the IMF, Horst Köhler, has begun to articulate his preliminary thinking on the role of the Fund.[8]

In the following sections, the main issues regarding the Fund's role are discussed using the arguments of the protagonists but without identifying the source of each argument. Rather, the objective is to present both sides of the issue as a backdrop to articulating a developing country position.

II Issues Arising from Recent Policy Declarations and Reports

There are several issues that have been the subject of contention in recent days: they concern, almost exclusively, the relationship of the IMF to emerging market economies and other developing countries. This might appear natural since the financial crises that have engendered the current debates were centred in this group of countries. There are, however, another set of issues that cover the relations of the IMF with its major shareholders that are notable for their absence from these discussions – issues such as:

5 HM Treasury, Third Report, Treasury Committee, Session 1999-2000.

6 Remarks at the Council on Foreign Relations entitled "An Agenda for the IMF at the Start of the 21st Century" (New York) and at the Institute for the Study of Diplomacy, School of Foreign Service, Georgetown University entitled "The IMF We Need" (both in February 2000).

7 Presentation to the IFIAC, February 2, 2000.

8 Notably, in a speech delivered to the International Monetary Conference in Paris, May 30, 2000. (*IMF Survey*, Vol. 29, No. 11, June 5, 2000).

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- the global implications of exchange rate movements among the principal international currencies about which IMF surveillance has little to say, despite the fact that their fluctuations are major contributors to financial disturbance in other countries;
- the distribution of voting power in the institution that derives historically from an arbitrary quota allocation formula designed to perpetuate industrial country dominance;
- the internal governance of the institution through the interaction of the Executive Board with management and staff and the influence exerted on the latter by a powerful sub-set of the membership;
- the asymmetric character of the conditions being imposed on debtor countries affected by financial crises versus the reluctance to apply a corresponding set of obligations for transparency, accountability and equity on financial institutions in the capital market centre countries.

The following paragraphs do not focus on the foregoing industrial country related issues: they are restricted to considering issues that are currently on the table with respect to developing countries. Some of the argumentation is inevitably repetitive since the issues are overlapping.

Country Eligibility for IMF Assistance

As noted earlier, a strong case has been made for restricting the Fund's financing role to emerging market economies in financial crises and to provide them with short-term emergency loans at penalty interest rates. The basic argument for restricting the IMF role to that of a quasi-lender of last resort in a limited number of cases is that Fund operations generate moral hazard for both private lenders and sovereign borrowers. The Fund's intervention is said to allow short-term creditors (such as the international banks whose claims are not "marked to market") to be paid off in full and, in the case of other creditors, its action is said to delay mutually negotiated debt workouts. Much is made of the "ambiguous" evidence of the impact of Fund programmes in many countries and their usefulness is said to be confined only to cases where financial crises in "systemically significant" countries can produce, through contagion, serious consequences for otherwise solvent trading and investment partners.

The fundamental flaw in arguing from the evidence of past IMF programmes is that it fails to consider the counterfactual. The "before" and "after" dichotomy leaves no room for "with" and "without" considerations, i.e. what would have transpired if the Fund had not intervened. The austerities that are attributed to "IMF programmes" are typically the consequence of a balance of payments constraint arising from events (e.g. sharp reversals in private capital flows) and/or policies that were in play *prior* to

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the Fund's intervention. The availability of IMF financial assistance relaxes that constraint somewhat and makes for a more orderly and less burdensome adjustment process than would otherwise have become unavoidable. Moreover, the argument for restricting Fund action to countries that are "systemically significant" assumes that these can be unequivocally identified in advance. As Michel Camdessus asks: "Who prior to July 1997 would have regarded Thailand as belonging to the 'systemically significant' category?"

The growing integration of an increasing number of developing countries into global financial markets has created a powerful case for treating member countries of the IMF on a more, rather than a less, equal basis when it comes to access to IMF financial support. Also not to be ignored are the legal rights and obligations of members as laid down in the Fund's Articles of Agreement and the accumulated precedents and practices of the Fund, as they have evolved over the past fifty years. These create a case for universal access to the resources of a credit cooperative to which all members continue to contribute.

IMF Involvement in Poverty Alleviation and Debt Reduction (HIPC) Cases

The principal argument for pulling the IMF out of the poverty alleviation area is that as a short-term balance of payments adjustment lender, its core competency is, and should remain, macroeconomic policy analysis. The IMF is said to lack the wide expertise required to deal with poverty issues,[9] which have deep-rooted structural and institutional causes, and which are only treatable over the very long term. There is also the argument that if the IMF were to try to build its expertise in the poverty area, this would add to the degree of overlap that already prevails vis-à-vis the World Bank Group and would strengthen the argument for merging the two institutions. Finally, there is a strongly held view on the part of some in the NGO community that by clothing it with the mantle of poverty – by changing the name of the Enhanced Structural Adjustment Facility (ESAF) to the Poverty Reduction and Growth Facility (PRGF) – G-7 governments are seeking to maintain the IMF's traditional role as gate-keeper for debt

9 As an example, Paul Collier and Jan Willem Gunning argue that "both the sectoral and the household-level analyses needed for a reasonable estimation of the social consequences of adjustment & are beyond the Fund's traditional expertise ... Fund staff have been recruited for their expertise in macroeconomics." (Collier, Paul and Jan Willem Gunning, "The IMF's Role in Structural Adjustment", in *Economic Journal*, Royal Economic Society, Vol. 109, November 1999, pp. 634-651).

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relief operations, thereby justifying the application of IMF conditionality for even the poorest of its member countries.

There are several counter-arguments to the preceding view. Poverty alleviation is simply not possible without a strong macroeconomic policy environment and the IMF has a unique expertise to design the essential policy requirements in this crucial sphere. But advice is not likely to be seriously taken unless there is a promise of financial help to go with it. This is not a matter of "bribing" decisionmakers to undertake reform. Rather, it is only realistic to recognise that countries are not monolithic entities and that the pressures exerted by the spending Ministries (like the military) for larger budgets are difficult to resist unless policymakers concerned with financial sustainability and poverty reduction can deploy some countervailing arguments in support of their recommendations. Indeed, there are always interest groups that are beneficiaries of the status quo (e.g. they would rather hire child labour instead of paying adult wages) and who are apt to be well represented within the governing circles of many countries. Reformers within governments must be able to point to some visible, palpable benefit from pursuing pro-poor policies and this means that the IMF must have resources to offer to back up good advice and technical assistance. Moreover, as pointed out by Stanley Fischer, "governments and markets alike appear to place greater value on financial agreements with the Fund, possibly because the provision of resources is still seen to represent a greater commitment by the official sector."[10]

The IMF has a long record of working with the poorer countries in its membership who are just as likely as better-off countries to suffer balance of payments difficulties from a variety of causes, including terms of trade shocks, crop failures, export market disruptions and natural disasters, not to mention bad economic management. The international community has recognised that poor countries will need IMF help but cannot afford to pay regular Fund charges. It has therefore been willing to entrust the IMF with the necessary means to subsidise its dealings with these members rather than depriving them of the right of access enjoyed by all members under the Articles of Agreement.

The launching of the Initiative for the Highly Indebted Poor Countries (HIPC) in 1996, and its enhancement in 1999, has reinforced the need for an IMF role that it has traditionally played in the Paris Club and in its handling of the Latin American debt problems of the 1980s and of the transitional countries in the 1990s. Creditor countries want debt relief

10 Op.cit., fn. 7 *supra*.

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offered under the HIPC to be used to enlarge spending for poverty alleviation and also an assurance that the debtor country will follow prudent macroeconomic policies to prevent the recurrence of a debt problem. They have authorised the IMF to mobilise a part of its "hidden" reserve (in the shape of gold holdings that are carried on its books at much below current market price) in order to enable the IMF to provide relief on its own claims against HIPC-eligible countries. The IMF has also been able to mobilise additional bilateral funding from as many as 93 of its members (which indicates that a large number of developing country members have contributed) to the PRGF-HIPC Trust for an amount exceeding $1.5 billion (by the end of April 2000). There is no assurance – indeed, a strong risk – that a large part of the bilateral commitments obtained by the IMF would simply fall away because donor governments might be unwilling to go back to their legislative bodies to authorise the switching of appropriations to the World Bank if the PRGF were to be transfered to that institution.

Nor should IMF involvement necessarily require that it develop its own intensive expertise in all aspects of poverty alleviation. The IMF management has recognised the need for close coordination and for a clear delineation of responsibilities between the IMF and the World Bank. Stanley Fischer, the First Deputy Managing Director, in his presentation to the Meltzer Commission, has gone on record to the effect that

> the World Bank *will take the lead* in helping countries formulate their poverty reduction strategies *and in lending for those purposes*. For its part, the IMF has to take into account the fiscal implications of anti-poverty programmes when designing the macroeconomic framework. Together with the World Bank, it needs to ensure that the impact of the necessary macroeconomic measures on the poor has been properly analysed and the potential adverse effects minimised – *the latter typically by means of World Bank supported programmes*[11] (emphasis supplied).

Similar views are attributed to the new Managing Director. Moreover, as argued elsewhere,[12] the deadline-driven country focus of the IMF work

11 The US Treasury response takes a similar line when arguing that there has to be "a clear division of labor between the World Bank and the IMF, with the Bank taking the lead in providing advice on the design of growth-enhancing national poverty reduction strategies and structural reforms while the Fund will focus on promoting sound macroeconomic policy and structural reforms in related areas, such as tax policy and fiscal management." (op.cit, fn. 2 *supra*, pp. 22-23).

12 A paper on the "Future Role of the World Bank Group" prepared by the present author for the Commonwealth Secretariat seminar, June 22-23, 2000, mimeo.

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environment provides an essential complement to the undoubted expertise that the World Bank and the other regional development banks must deploy in the poverty reduction area. Hence developing countries will want the IMF to remain involved to ensure timely outcomes in the poverty reduction and HIPC areas.

IMF as the Lender of Last Resort

There is a general acceptance of the proposition that the IMF is the "closest that the international financial system has to a lender of last resort"[13] but an unwillingness "to confirm the IMF in this role" or to accept the logical implications of its playing this role in an effective manner. These implications were spelt out in two papers prepared for the G-24 Research Programme in September 1999.[14] These ideas received support in one of the pre-retirement speeches of Michel Camdessus in which he proposed that

> in the event of a systemic credit crunch" the IMF be "authorised to inject additional liquidity - and to withdraw it when the need has passed – in a manner analogous to that of a national central bank, through the creation and selective allocation of SDRs.[15]

The Independent Task Force of the Council on Foreign Relations proposed a "contagion facility (that) would be funded by pooling a one-off allocation of SDR."[16]

These proposals have met with strong objection from those preoccupied with the moral hazard problem and even supporters have contemplated invoking such a facility in "rare situations of widespread cross-border contagion of financial crises where failure to intervene would threaten the performance of the world economy."[17] However, it is essential to have in place a simple mechanism that could decisively underpin confidence in the international system when confronting speculative excesses in private financial markets. The need for some such mechanism has clearly intensified in light of the continued volatility of private capital flows and the

13 Op.cit., fn. 6 *supra*.

14 Montek S. Ahluwalia, "The IMF and the World Bank in the New Financial Architecture", and Aziz Ali Mohammed, "Adequacy of International Liquidity in the Current Financial Environment", in *International Monetary and Financial Issues for the 1990s*, Vol. XI, United Nations, 1999.

15 Op.cit., fn. 6 *supra*.

16 Op.cit., fn. 5 *supra*.

17 *Ibid*.

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powerful resistance of private sector interests to official proposals for their involvement in the management of financial crises. Hence developing countries would continue to press for an exploration of the merits of establishing an effective international lender of last resort, i.e. one able to create international liquidity freely and to deploy it rapidly to deal with widespread financial crises.

The Role of the IMF in Debt Negotiations

Even without a genuine Lender of Last Resort facility, the IMF has tried to provide large multiples of borrowing country quotas to crisis affected countries as well as to call on the multilateral development banks and individual governments for support. Apart from the problems encountered in obtaining funding, these operations are said to have generated unacceptable moral hazard for the private financial system. The solution for both these problems has been sought in options for involving the private sector in the resolution of financial crisis. Little progress is noticeable because of wide differences of approach among the major financial authorities and the powerful resistance of the private financial services industry, except in the area of encouraging the use of collective action clauses in international bond contracts. From a developing country point of view, the issue needs to be framed in a broader context: that of evolving a more *orderly* as well as a more *equitable* set of arrangements to treat the problems of sovereign debtors. The objective should be to create an appropriate sharing of costs and responsibilities between them and their creditors, whether private or official.

In the absence of an international bankruptcy code, the existing patchwork makes for long delays in reaching agreements during which considerable, if not irretrievable, damage is incurred by the debtor country. A first step in achieving an orderly debt workout, and "the key to stopping an international financial panic, is a temporary standstill on international debt payments, much like the payments standstill that features prominently in most domestic bankruptcy proceedings."[18] While voluntary market-based standstills are much to be preferred, a mandatory stay on legal action by creditors has been proposed through a modification or a re-interpretation of Article VIII.2b of the IMF Articles. The chances of the latter option being implemented are minimal if it requires an amendment of the Articles. However, the possibility of the debtor country being able to declare a standstill – allied with some form of official acknowledgement

18 Steven Radelet, "Orderly Workouts for Cross-Border Private Debt", in op.cit., Vol. XI, fn. 12 *supra*.

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such as an IMF "comfort letter" – is essential as a means of bringing otherwise recalcitrant creditors to the table for negotiations.

Once a standstill is in place, it would be possible to move to an orderly debt workout. Where the problem is essentially that of liquidity (here defined to mean a situation where a rapid return to market access on reasonable terms is deemed likely), it might be sufficient to arrange debt roll-overs with the help of an IMF-supported programme that serves a catalytic function. A more radical idea envisages roll-overs built into all foreign currency lending contracts by way of a *universal debt roll-over option with a penalty* (UDROP) which the borrower would exercise at its own discretion for a specified period (three to six months) at a penalty rate and for a second time at a higher penalty rate.[19]

Where more than liquidity difficulties are evident, it would be necessary to visualise debt restructuring, and in extreme cases, even debt write-offs. The criteria for such debt relief operations would have to be carefully defined as developing countries would not wish their market access prospects to be harmed by the possibility of a too easy activation of such radical solutions. The framework for operations should also clarify the IMF role. This role is apt to be a delicate one, especially if the IMF itself is a creditor and claims a "preferred creditor" status. In any case, it is essential to respect the principle that the IMF is not a party to the negotiations between the debtor country and its creditors. "Developing countries would expect the IMF only to play the role of facilitator – and not an arbiter – for an agreement between countries and (their) private commercial creditors."[20]

Surveillance Issues: Whom Does the IMF Serve?

A number of issues are in contention in the area of surveillance, of which two are of particular interest to developing countries: the content of surveillance and its primary purpose. The first issue relates to scope and coverage, i.e. whether surveillance should be restricted to the core competency of the IMF – macroeconomic policy and sound financial management – or cover wider ground, including in particular, the monitoring of international standards and codes. There has been a growing feeling among IMF critics that "mission creep" has tended to enlarge the coverage of the surveillance exercise to the detriment of its operational focus and that it has moved the IMF into areas where it has no comparative advantage. On the other hand, it has been argued that "effective, credible policy

19 Willem H. Buiter and Ann C. Sibert, 1998, cited by S. Radelet, *ibid*.
20 Speech of the President of the Central Reserve Bank of Peru, Dr. German Suarez, inaugurating the 12th Technical Group Meeting of the G-24, Lima, March 2000.

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implementation hinges on the broader issues of sound economic institutions, structural reforms and the implementation of international standards."[21] Developing countries have been especially concerned about IMF monitoring of the observance of standards and codes as a typical example of "mission creep" and fear that the exercise might evolve from surveillance into conditionality. There is also an apprehension that they would be placed at a disadvantage in capital markets if they are to be judged on the basis of their ability to observe complex standards that might be appropriate for advanced countries but are much too onerous for them, given the stage of development of their own financial markets and regulatory institutions.

Developing countries reject the notion that surveillance should be exercised on a selective basis (as proposed, for instance, by the Meltzer Commission, which would exempt OECD members). Given the cardinal importance of the principle of the uniformity of treatment of members that is enshrined in the Fund's Articles of Agreement, such an opting-out provision would not be acceptable on equity grounds alone.

Another issue in the surveillance area is its primary purpose. Should it be the prevention of financial crises through conveying to member countries – and to markets – its assessment of financial vulnerabilities and the timely issuance of "early warnings"? Or should the purpose of surveillance be restricted to knowledge transfer of "best practices" in the areas of Fund competency? The controversial issue here is how much disclosure of surveillance conclusions should enter the public domain as a crisis prevention imperative. In recent times, critics have argued that IMF surveillance failed to detect vulnerabilities in particular countries and failed to provide early warning on their likely onset. Transparency and disclosure have been justified on the ground that the focus of surveillance should shift from "collecting and sharing information within the club of nations to promoting the collection and dissemination of information for markets and investors."[22]

The issue goes to the *raison d'être* of a public intergovernmental institution. Whom does the IMF serve? – its member governments or the private financial services industry, which is mainly located in a few industrial countries? As a cooperative of governments, the IMF cannot be expected to issue public warnings that are likely to become self-fulfilling prophecies. Nor should insistence on IMF transparency be pushed to the point where it begins to affect the trust of governments in the confidentiality of their exchanges with the institution in the course of exercising the surveillance function. Developing countries would also resist the IMF being pushed into the role of a super-rating agency for the benefit of private markets.

21 ODC Report, op.cit., fn. 2 *supra*.
22 Op.cit, fn. 4 *supra*, Summers.

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IMF Conditionality: Making a Bad Situation Worse

The issue of conditionality has always been a contentious one and has spurred intense debate after IMF interventions in the East Asian countries[23] and the subsequent crises in Russia and Brazil. The main charge made by the critics is that by insisting on fiscal austerity, high interest rates and exchange rate depreciations in the former group of countries and by initially supporting fixed exchange rates in the two latter cases and then reversing course, the IMF prescriptions made a bad situation worse. There is no question that operating in an environment of unparalleled crisis and with either incomplete or inaccurate data, the IMF was forced to make major decisions under enormous time and data constraints. That mistakes were made is now accepted and the IMF did reverse course, but a good deal of damage was done in the interim. There is also a view that in the East Asian programmes, the number and variety of conditions applied were excessive (e.g. the first Indonesian programme included more than a hundred conditions) and that the difficulty of meeting them greatly delayed the return of confidence.

There is growing understanding of the importance of "ownership" of programmes by the borrowing country authorities and a recognition that conditionality might be undermining ownership and thereby contributing to programme failure. The Meltzer Commission, for instance, has recommended that the IMF be precluded from conditioning its support to member countries on the achievement of economic reforms. Conservatives, like Martin Feldstein in the United States, have argued that the structural conditions incorporated into Fund programmes have constituted unwarranted intrusion into the national sovereignty of members. At the other end of the spectrum, liberal advocates, including many in the NGO communities, have demonstrated against the "austerity prescriptions" in IMF programmes as imposing enormous costs on both debtor governments and on the general population, especially wage-earners.

It was noted in an earlier part of this paper that the austerities attributed to IMF programmes are typically the consequence of a balance of payments constraint arising from events and/or policies that were in play prior to the IMF's intervention. It was also observed that there are always contending factions within governments and IMF conditions, including "prior conditions", are frequently used by country officials advocating reform policies as a means of overcoming resistance from other parts of the official apparatus. Developing countries would nevertheless welcome simplifica-

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23 The most acrid critique was launched by Joseph Stiglitz, former World Bank Chief Economist, in an article in the *New Republic*, April 17, 2000.

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tion of IMF conditionality and urge that it be more sharply focused on macroeconomic policies and on those structural reforms that are strictly "macro-relevant". There is also need for greater flexibility in the content and design of programmes on the part of the IMF, when these are proposed by member authorities, in the interest of strengthening their sense of ownership and the chances of success of programmes. Finally, developing countries would continue to resist political economy conditions that are increasingly being applied under the rubric of "governance conditionality."[24]

Capital Account Liberalisation

The issue of Capital Account Liberalisation has tended to recede somewhat from the peak of interest reached at the Annual Meetings of the IMF in Hong Kong in 1997 when recommendations were made for investing the IMF with statutory authority to promote capital liberalisation. A number of studies conducted both inside and outside the IMF subsequently have reached a position that is less ideological; support for opening capital accounts has been qualified with cautions about the process being gradual, orderly and properly sequenced. Developing countries would, however, prefer a Fund position accepting the possibility of capital controls as a regular instrument of national policy rather than regarding them as a temporary device to deal with emergency situations in countries with poor prudential regulation. This recognition is particularly necessary in dealing with the issue of the choice of exchange regimes. Developing countries are being pushed to choose between "corner" solutions: either free-floats or currency-board arrangements. They might well prefer intermediate regimes supported by capital controls, whether of a market-oriented character (as in Chile and Colombia) or of an administrative nature.

IMF Facilities

The subject of IMF facilities is obviously tied in with decisions on the future scope of IMF activities. This paper has argued that the IMF has a lending role with all its members and not only with a sub-set of emerging market countries. Hence the standby arrangement remains the main instrument for providing balance of payments support in all cases where that is required for dealing with current account disequilibria. For coun-

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24 For an analysis of this subject, see Devesh Kapur and Richard Webb, "Governance-Related Conditionalities of the IFIs", presented to the XII Technical Group Meeting of the Intergovernmental Group of 24 in Lima, Peru, March 2000, mimeo.

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tries closely integrated with private capital markets and subject to capital account dislocations, the Supplemental Reserve Facility (SRF) with its premium rates of interest and faster repayment periods that was created in 1997 is essential; it has already demonstrated its usefulness in two large programme cases, Korea and Brazil. The IMF concessional facility, previously known as ESAF and re-christened as PRGF, remains necessary for the benefit of the poorer member countries that cannot pay the Fund's regular charges. The PRGF plays a critical role in defining the conditions for HIPC-eligible countries. Once that exercise is completed, it should be possible to revert to the ESAF designation for the Fund's concessional lending window, if only to put to rest much of the semantic confusion on the appropriateness of the Fund's involvement in poverty alleviation and to focus on the World Bank Group's leading role in this area. Another facility that needs to continue is the CCFF which was designed to help countries subjected to external shocks substantially beyond their control. The latter concept could be extended to cover cases where countries are hit by contagion even though they have been pursuing reasonably sound economic policies. In the same category is the emergency lending that the IMF provides to countries affected by natural disasters.

Two facilities in contention are the Extended Fund Facility (EFF) which enables the IMF to make longer-term loans to members experiencing a payments problem with a structural origin and the Contingent Credit Line (CCL) introduced in 1998 but for which there have been no takers to date. As regards the former, the US Treasury has argued for a limited use of this vehicle – to support "those few, carefully targeted cases where bold structural reforms are needed to secure stabilisation and where the balance of payments benefits of structural reforms may require a long time to appear and where countries have limited capital market access."[25] Since one assumes that the IMF carefully targets the use of its resources, there should be no reason to limit the use of the EFF to a few cases only, perhaps with the exception as an instrument in the hands of principal shareholders like the United States to make "case-by-case" judgements on individual country access to the EFF. There is growing pressure, however, to raise the cost of using Fund resources where its claims remain outstanding for longer periods of time, as in the case of the EFF, and these pressures will need to be resisted.

Turning to the other facility, the CCL was introduced in April 1999 as a deterrent to speculative attack resulting from contagion for otherwise well-managed countries. The CCL has not been activated to date. There is some indication that countries have been hesitant for fear that even

25 US Treasury response, p. 21.

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applying for it might trigger adverse market speculation. Despite the fairly stringent "pre-qualification" requirements for eligibility, the IMF has retained review safeguards that detract from assured access. Yet such safeguards would appear essential, given the political contingency that a CCL negotiated with one government might be activated by a successor regime whose commitment to pursue previously agreed policies remained untested. Indeed, the uncertainty about such a new government's policies might itself serve to trigger the speculative attack for which the CCL would be activated. Given these political realities, one might wonder if a CCL type facility might ever prove practicable enough to attract much use, despite additional financial incentives that might be offered, such as reducing commitment fees or interest charges. However, developing countries would not resist "the idea that countries should be able to borrow more, and/or borrow more easily, and/or borrow more cheaply...if they have pre-satisfied certain conditions."[26]

Governance

The subject of governance has many dimensions. The most topical issue is the choice of the IMF Managing Director and whether one should take for granted the pre-eminence of the Europeans in making that choice as a counterpart to the US deciding the choice of the President of the World Bank. While an initiative taken by the Executive Directors representing the developing countries (the so-called G-11) never did enter the public domain, it is reliably understood to have been the basis of a consensus reached in the full Executive Board that this "very important decision" would be based on a discussion of "the exceptional qualities that the next MD will require" and that "the process for choosing the best person for the job from the possible candidates will, *through the Board*, *involve all the members of the Fund*"[27] (italics supplied). Whether the eventual outcome met the Board's intent is a matter for dispute. However, there is little doubt that the decision of the Directors representing African country constituencies to nominate First Deputy Managing Director Stanley Fischer created the opportunity for a second choice in a process in which the first choice would have been accepted by default.[28] It is now generally conceded that the process of selecting the chief executives of the major international agencies calls for urgent review.

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26 John Williamson, "The Role of the IMF: A Guide to the Reports", Institute of International Economics, Washington, D.C., May 2000, mimeo.
27 IMF Press Release No. 99/56 dated 11/23/99.
28 See Devesh Kapur, "Cascading Frustrations: Leadership Selection in International Organizations", Harvard University, April 2000, mimeo.

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Behind this recent episode of choosing a new Managing Director, however, there loom larger issues about the exercise of political power within the IMF, as determined by the distribution of quotas and the special majority requirements for important decisions. The original concept of the Fund as a credit cooperative has eroded because industrial countries have not needed to borrow from the IMF (the last transactions took place in 1976). With the membership split between "structural" creditors and "structural" debtors, the former group has felt no compunctions about elaborating conditions to be applied to the latter group, since these would not apply to themselves. The current quota distribution also makes it possible for the industrial countries in the G-7 to take decisions which they are able to push through the Bretton Woods institutions. In that sense, these institutions serve a "legitimising" function for decisions already taken by a small sub-set of the membership. The special majority requirement of 85 percent of total voting power for certain decisions gives effective veto power to the United States which enjoys a 17.5 share in total votes. A quota increase in the US requires Congressional approval. As a condition for granting approval, US legislators have attached strictures of a quite egregious character on the IMF. Moreover, since an overall quota increase requires an 85 percent majority decision, it is effectively subject to a US Congressional veto.[29] The US Administration has prevailed upon other members of the IMF to accept these strictures on the plea that otherwise there could be be no quota increase at all.

There is little possibility of achieving changes in Fund governance that would entail an amendment of the Articles of Agreement, if only because the US Congress would not be expected to agree to the surrender of its veto power. Hence the only possibility for incremental change could come from modifications in quota distribution currently under discussion by a special Committee appointed by the Fund.[30] Possibilities for some realignment of voting power emerge from the growing weight of the Asian countries in the global economy and with corresponding reduction in the representation of European countries.

29 Williamson (op.cit., fn. 26 *supra*) quotes a recent study on Fund governance in which the authors cite the conditionality unilaterally imposed by the US Congress on the Fund "as intolerable for a multilateral institution." Askari Hossein and Semir Chebil, "Reforming the IMF: Some Organizational and Operational Issues", in *Banca Nazionale del Lavoro Quarterly Review*, 1999.

30 The Committee was headed by Professor Richard Cooper of Harvard University. Its "Report to the IMF Executive Board of the Quota Formula Review Group" (IMF, 2000) is available at www.imf.org/external/np/tre/quota/2000/eng/qfrg/report/index.htm.

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III Summary and Conclusions

This paper has argued that the IMF has a surveillance and lending role vis-à-vis all its members, and especially in respect of the poorest countries in the context of the HIPC Initiative. Once that debt relief exercise is completed, the PRGF should revert to the ESAF as the concessional window for traditional IMF lending operations in countries unable to pay regular IMF charges. In relation to crisis management, an extension of the IMF role as an effective lender of last resort is advocated as well as a clarification of its role in debt workouts. The surveillance function is seen as critical to the crisis prevention role, although a cautionary note is injected on how the IMF monitors the observance of international standards and codes. Transparency in IMF assessments should not cross the line where it begins to affect the trust of governments in the confidentiality of their exchanges with the institution. Nor should the IMF be pushed into issuing early warnings or serving as a super-rating agency for the benefit of private markets. The conditionality associated with IMF-supported programmes is acceptable, provided it focuses on macro-relevant issues and avoids "governance" prescriptions. In the interest of promoting ownership, a more flexible approach on the part of the IMF to the content and design of programmes proposed by member authorities is recommended. This paper notes that while the IMF role in capital account liberalisation has been s uitably delimited, the Fund should also recognise capital controls as a regular instrument of policy that could facilitate the choice of intermediate exchange regimes. Finally, this paper looked at some issues on the internal governance of the IMF, including the choice of its chief executive, the exercise of political power by a small sub-set of the membership and the case for a realignment of voting power.

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Comment on “The Future Role of the IMF: A Developing Country Point of View,” by Aziz Ali Mohammed

Howard Brown

This is a very good paper. It is balanced, it sets out the issues very well, and for the most part, I agree with the conclusions. One minor criticism of Aziz Ali’s paper, however, is that it doesn’t provide us with an answer to the question, “what do developing countries want?”

In discussing IMF reform, we need to start with a clear idea of what we want the Fund to do, and a clear idea of what the problems are that prevent it from fulfilling that mission. In other words, the diagnosis should come before a prescription. Looking at this from the perspective of a finance minister from an emerging market, what I would want is to never see the IMF in my capital again – with the exception of a short meeting around the Article IV review. In short, what we should be trying to do is put the Fund out of business – or at least the crisis lending business line. How can we do this? I think there are three areas on which we need to focus.

Standards and Codes

Clearly, the most important priority is to go back to basics and strengthen both macro and structural domestic policies. This has always been central to the Fund. It is the primary purpose of surveillance. The issue has become more controversial, however, with the increasing focus on standards and codes. Here, Aziz Ali asks a question: Should surveillance focus on transferring cutting-edge knowledge through standards and codes? Or should it be an instrument of crisis prevention? This is one of the rare instances where I disagree with him, because it seems to me that crisis prevention is exactly the goal of standards and codes.

Many emerging markets argue that the implementation of standards and codes has to take account of individual country circumstances, has to reflect their priorities, and needs to be paced appropriately. I agree entirely. But pacing can’t be a synonym for inaction.

I am mystified by the opposition of some countries to the application of the Basel Core Principles. Given the importance of bank intermediation in

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most emerging markets, the role of banking problems in the genesis of financial crises, and the cost of resolving banking crises, this would seem to me to be a high priority for all emerging markets.

Conditionality

A second area for focus is conditionality. The track record shows that Fund conditionality has not been as effective as we would like. Twenty-eight countries have had Fund programmes for 5 or more of the past 15 years - although sometimes these programmes were inactive. Aziz Ali mentions the criticisms that were made of Fund programmes in Asia. In this regard, we need to distinguish between criticisms of individual programmes and criticisms of the model.

Clearly, some of the Fund's initial programmes in Asia were too tight. That mistake was recognised relatively early and rectified. That doesn't mean, however, that the model is fundamentally wrong. Those who argue that the Fund should not require macro tightening in a crisis need to show how the external financing constraint is going to be met. As we all know, the purpose of macro tightening is to reconcile domestic absorption with external financing.

One way to strengthen conditionality is to encourage countries to put the right policies in place before, rather than after, a crisis has hit. It is not credible for us to say, as the Meltzer Commission recommended, that we will lend only to countries that have the right policies. The fundamental reason we lend to countries in crisis is not altruism, but self-interest based on the externalities involved. Those externalities, and hence the rationale for Fund lending, will be present whether or not the country has done the right thing before the crisis. That said, Fund policies and programmes should create incentives for *a priori* action. In this regard, the Contingent Credit Line (CCL) clearly hasn't delivered and needs to be looked at closely.

Bankruptcy Regimes and Standstills

A third issue that needs to be resolved in helping the emerging markets to emerge is the question of private sector involvement. In fact, this is probably the wrong question. The right question should be the role of the official sector in crisis resolution, because we should be able to take for granted that private sector creditors will be involved.

One way to do this is to strengthen domestic bankruptcy regimes. Creditors who can put confidence in an honest, transparent and fair bankruptcy regime will be much less likely to flee at the first sign of trouble.

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Second, the official sector can provide a framework that will foster the cooperative resolution of crises. One element of such a framework is a standstill. Here, Aziz Ali argues that “the chances of the latter option being implemented are minimal.” I disagree. Certainly, such an option will not be implemented this year. But the analytical logic for a standstill as part of the toolkit is overwhelming and I believe political opinion has swung in this direction as well.

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Comment on “The Future Role of the IMF: A Developing Country Point of View,” by Aziz Ali Mohammed

Ariel Buira

I am in broad agreement with Aziz Ali’s paper which is a very good review and competent summary of the issues on the table in Washington. However, there are some key issues that are not on the table in Washington that should be equally considered and this comment mentions a few of them. These issues may be important for developing countries and for the future of the international monetary system.

The paper occasionally gets a little side-tracked discussing issues that are probably on the table but, to my mind, are not central to the discussion on the future role of the IMF. Examples of this are Aziz Ali’s discussion of the case for poverty alleviation and the discussion of who can have access to Fund resources.

As for the first point of poverty reduction, I don’t have strong views. Poverty alleviation is greatly facilitated by a stable macroeconomic environment and while one should be grateful for every effort to reduce poverty in developing countries, particularly in the poorest countries, the focus of the Fund, to my mind, is on macroeconomic sustainability. The Fund has no particular advantage or qualification to play any leading role on the issues of poverty reduction. This, to me, is a case of mission creep or a concession to pressures on the Fund to act on this issue.

In my view, the appropriate focus on poverty for the Fund would concern Fund-supported programmes. Too often these programmes centre on fiscal austerity and on the reduction of aggregate demand which by their very nature tend to impose a heavy burden of adjustment on the poorest sections of society. They do this both in terms of unemployment and a reduction of real income, real wages. If one is interested in poverty alleviation, what one should probably do is consider the fiscal costs of extending some kind of safety net or protection to these groups and try and include these measures as part of the programme.

The second issue Aziz Ali mentions is access to the Fund. However, apart from the Meltzer Report’s view, the idea of restricting access to the Fund to emerging market countries is not really an issue because it both goes against the IMF’s Articles of Agreement and would not command broad support amongst the membership.

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Key Issues

As a key issue, I would raise the question of the size of the Fund itself. Keynes spoke of a Fund that would be equivalent to 30 percent of world trade. Today, because capital movements have become much more important than trade imbalances, for purposes of avoiding balance of payments crises, perhaps one should think of a much larger sum than 30 percent of world trade. In reality, however, what we have is a Fund that is less than 3 percent. The far too small size of the Fund is the source of many of the problems that have emerged.

Another crucial question I would ask, as a member of a developing country, is what should be the role of the Fund when the next financial crisis occurs, as it surely will, resulting from sudden reversals of capital flows. I tend to agree with the answer given by Aziz Ali that you really have two options: use either the lender of last resort to restore confidence or, if you cannot obtain adequate provision of finance, capital controls and debt standstills. This is the logic of the current situation; this is what we have learned from the past crises.

However, the question still remains of whether the Fund has really been successful in crisis prevention. I am not sure I would agree with Amar Bhattacharya's view. I don't think it has been very successful, because there have been too many crises already. Therefore, the real issue is: what should the Fund do better?

What should the role of the Fund be in crisis prevention? Should the Fund develop into a lender of last resort and should SDR allocations be used for this purpose? In my mind, this would be the logical evolution of the system. In an integrated, global financial system you have to have a Fund that has the capacity to act as a lender of last resort for the whole system and to generate the liquidity as required.

An even broader question is: how can we obtain the benefits of globalisation while minimising its economic costs? A subsidiary to this question is: can the Fund, the World Bank, the WTO and, possibly, the ILO, the UN and UNCTAD develop common goals and help develop common strategies so that one can try to obtain these goals?

Article I of the Fund's Articles says that it should provide support to countries to avoid measures destructive of national and international prosperity. Is the financial support of the Fund sufficient to fulfil this objective? If you look at what has been happening, I think the answer is clearly "no". It was Amar who said that the "punishment was not commensurate with the crime."

There are a number of other issues that have to do with surveillance. For instance, what can the Fund do to help the countries or the system

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deal with the risks posed by asset price inflation? Is this a problem? I think it is. What should the Fund do if these risks materialise in the US? Is the Fund ready to respond?

We have been talking about the ways to get the private sector involved in the issue of debt. The logic is that private sector investors and lenders obtain a high premium from their operations in developing countries because there is a high risk. So when the risk materialises let them take the hit. Let them share in the costs of adjustment.

Since international financial institutions are widely perceived to lack political legitimacy, how can they be made more representative? Can we move from a system centred on one or a very few countries – what one might call an "imperial system" – into a system where decisionmaking allows much wider participation of the membership? Shouldn't we have a system in which broader interests are taken into account?

The issues of debt and private sector participation are a bit of the same order: how can we move from a case-by-case discretionary approach where the discretion is exercised by the G-1, G-5 or G-7 to a situation in which there are rules and principles for a solution that apply equally to all.

Other Important Issues

Other issues come to mind. On surveillance: how stable is an international monetary financial system based on a currency of a country that runs large and persistent external deficits? Should the Fund be worrying about this? Is this not a matter for surveillance? This is a question similar to the one about asset price inflation.

There are also issues that have to do with stability in major industrial countries. We saw the failure of LTCM in Fall 1998 that put a number of major financial institutions in jeopardy. It was close. What would have happened if another institution or speculative hedge fund had failed at about the same time? This raises another question. Can one rely on the internal models of banks and other financial institutions to deal with systemic risks? Or should the Fund or another institution look into this and take a more integral approach in its surveillance? Who is going to supervise these huge integrated financial institutions comprised of huge banks, insurance companies and other financial institutions? Who has the power to supervise them? Can we move from "general recommendations" and "codes of conduct" to actual rules? Can we subject these institutions to rules?

The issue of regionalism ties into the question of a lender of last resort. I currently live in what one would call a "small emerging market economy" with a rather poor record of fiscal management in the 1980s and early

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1990s, with a public debt of over 100 percent of GDP and with very little progress until now on structural adjustment. But since this country, Greece, happens to be a member of the European Union, its currency was not attacked when Korea's, Russia's, Thailand's, Indonesia's and whoever else's currency was. So there is maybe some merit to regional groupings. Maybe this is what the Fund should recommend to those who are not members of groupings?

Yung Chul Park told us about the problems Korea faced in trying to fund a Contingency Credit Line (CCL) from the private sector. He found it impossible. Why should we try to re-invent the CCL when the institution entrusted with this responsibility, the IMF, is not playing its role?

There is also the issue of voting power within the IMF. You might have read what Raymond Mikesell wrote some time ago about how in 1944 he was asked by Harry Dexter White to develop the formula for the quotas (to be calculated on the basis of gold holdings, national income estimates, and average imports and exports).[1] The instruction he received was that he should find a formula that would give the US about 30 percent of the quotas, Britain about half of the US quota, Russia an amount just under that of Britain, and China somewhat less. The poor fellow didn't have a computer at the time so he had to spend several days with his calculator playing around with different variables and different weights for different variables to achieve a formula that roughly approximated this result. After all this effort he came up a with a formula and presented it to the ministers of the Bretton Woods meetings. He had the suspicion that, although he tried to present this as a very technical and scientific exercise, several of the people there were rather sceptical. However, the fact is that this original formula is still the basis of the formulas we are using today. They have had some adjustments, but this is the essence of the quota exercise. Voting power is determined on this basis.

That's not the full story, of course. You know that voting power has two components. Each country has 250 basic votes just for being a member and a vote for every 100,000 SDRs in their quota. In the beginning, with about 40 members, basic votes accounted for 12 percent or so of the total votes. Today, despite the entry of some 140 new member countries, the basic votes account for little over 2 percent. This has changed the balance of voting power in favour of the larger members. You have weighted voting and although most decisions are taken by a simple majority there are a number of decisions that require a qualified majority. At the Bretton Woods Convention, the idea was that you would have only two cases in

1 Raymond F. Mikesell, *The Bretton Woods Debates: A Memoir*, Essays in International Finance No. 192, March 1994.

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which a qualified majority would be used, one being adjustments in quotas. But then, as it turned out, the Articles of Agreement envisaged qualified majorities in nine areas. With the First Amendment, this rose to 18 and with the Second Amendment qualified majorities were required for 53 subjects.

The obvious explanation for the increase in qualified majorities is to protect particular interests that could be affected by a simple majority decision. Decisions subject to qualified majority can only be taken with a consent of members having a high proportion of the total votes. The US has around 17.5 percent of the votes. The concentration of voting power in the hands of major industrial countries ensures that they have the determining influence in the Fund. On top of this some have sought actual veto power either for themselves or a very few countries with similar interests. Today, 18 decisions require an 85 percent majority. That is, one country can veto it. Twenty-one other questions must be decided by a 70 percent majority and thus can be vetoed by the Group of Five.

What decisions require qualified majorities? Quota sizes (and with quota sizes goes the size of the Fund), rates of charges, exchange rate arrangements, issues of SDRs, policies of access to IMF resources, payments to the IMF, the use of the Fund's gold and currency reserves, investment of IMF accounts, publications of reports, remuneration of creditor positions, and temporary suspension of IMF operations: i.e. almost any significant decision is taken by a very few.

Amongst the other important issues that one could also consider are some of the standard issues we have been worrying about for some time, for example, issues like international liquidity and its distribution. Access to international liquidity is a problem for 130 or 140 member countries, but this is not an issue that is currently being considered as part of the reform agenda.

There is also the question of the adjustment process, including the problem of asymmetry and how to deal with structural disequilibria and the correction of balance of payments imbalances without taking measures that are destructive to international and national prosperity. But perhaps the most urgent question today remains: how does one respond to a financial crisis triggered by capital outflows in a manner that is consistent with the IMF's Articles of Agreement?

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Floor Discussion of "Reforming the IMF"

Voting Power and Governance

Referring to the recent painful process of European countries in selecting an acceptable candidate as the new Managing Director of the Fund, Howard Brown observed that "governance really is a contentious issue." Brown said that even the Europeans acknowledged that it would be the last time the selection would happen in such an awkward way. "Indeed, the Board of the Fund has formed a group to make some recommendations as to what the process should be the next time. At the end of the day, we should go for the best person, be it from Germany, Mexico or whatever country."

Regarding the current distribution of quotas and voting power among Fund members, Brown expressed scepticism about the likelihood that the new quota formulas proposed by an outside panel of experts (chaired by Richard Cooper of Harvard University) would be adopted. "Something like 18 of the current 24 members on the Board would lose quotas under the Cooper formula and I expect them to oppose it. But more importantly, a change in the formula is neither necessary nor sufficient to solve the problem. The bigger problem is not the gap between calculated quotas and the actual positions of the member countries in the world economy, but between the calculated quotas and the actual quotas – that's where the anomaly is."

According to Brown there is also a more general problem that is related to, but also separate from, the quota question. "It is the problem of representation on the Board of the Fund. Europe is overrepresented on the Board by one, given their current quotas, and Asia is underrepresented by one, given their actual quotas. The problem is: who are you going to knock off? That's a difficult choice, so I think it is more likely that we will solve this problem by expanding the Board – that's the easy way out."

Godert Posthumus, who was a member of the IMF's Board from 1986 to 1994, suggested a more radical way to address the representation problem. "I agree with those who argue that the current quota formula has to be changed in order to give the developing countries a larger share in the decisionmaking. In my view, the system is completely ossified at the moment and it will be extremely difficult to make any changes whatsoever. The only way I see to set the thing moving – which would not require the immediate support by the whole Fund community – is that Europe takes

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an initiative. Europe should be willing to say: 'We, the EMU, need only one chair, that's enough for us.' Once you do that, you lose a lot of chairs of course, and this might trigger a debate among the constituencies and the whole thing might start to move."

Ngaire Woods agreed with Howard Brown that the new quota formula proposed by Richard Cooper and his group would not solve the problem of underrepresentation of developing countries. "The real solution lies in something that the Cooper Commission wanted to look at but wasn't able to and that is the link between the quotas or voting power, the members' contributions, and their participation in decisionmaking. The real challenge is to think about what the links are, or should be, between the stakes that the different countries and groups of countries have and the different categories of decisionmaking. That is the first priority issue if you want to establish more equal representation in the IMF."

Woods also elaborated on the need for external evaluation of the Fund's policies and programmes. In her view, the IMF is not an institution that has a culture of accepting criticism from the outside. She stressed that the proposal for external evaluation currently on the table "is a very weak and very residual evaluation unit that would have almost no teeth" and advocated that governments sitting on the Board push for "a much more robust external evaluation office."

Another proposal which, according to Woods, developing and industrialised countries should look at more seriously, is the role that an internal ombudsman within the IMF could play to deal with complaints of peoples and groups in countries where the Fund is working. "I am extremely concerned about the fact that this role has fallen into the hands of a small number of NGOs who have no clear transparency nor accountability to groups within the countries that are affected by Fund programmes. Instead of responding in an ad hoc way to these NGOs, the Fund should create an apparatus within its own walls to deal effectively with some of the complaints that are filtering through these NGOs. In my view, an ombudsman could nicely fulfil that role, just as it does in domestic systems. It's a responsibility the Fund should pick up and take on itself."

Adjustment and Ownership

Ruman Faruqi recalled a G-24 study of several years ago, which argued that the traditional Fund programmes, focusing on short-term balance of payments support, were not relevant to a large body of the Fund's membership. "The nature of programmes and the solutions to be proposed ought to take into account the differences rather than the one-size-fit-all programmes. For many of the developing economies, the adjustment proc-

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ess takes much longer and involves structural changes in order for the macro stabilisation to stick. To say that there is only one type of stabilisation and that the Fund was originally created to support that particular type of adjustment is to define the Fund's role too narrowly. If you look at its original role, it was intended to support stabilisation but also growth and capital flows."

Roy Culpeper said that he was astonished not to hear any reference to the issue of ownership of policy in the context of conditionality. "I thought we had reached agreement that unless policy conditions find some domestic residence, they're not going to fly. The empirical evidence point in that direction. Now with the Participatory Poverty Reduction Strategy Papers (PRSP) and the Poverty Reduction and Growth Facility (PRGF), no matter where it's parked, the issue of how you make ownership fly is going to come to the fore, particularly if ownership entails the advancement of a policy package by a country which is non-orthodox. If a country comes forth with a non-orthodox macroeconomic policy package which commands a certain amount of domestic consensus, it would be interesting to see how the Bretton Woods institutions would react. That is the other side of ownership: whether we really mean it. Are the countries only supposed to own the policy packages that will fly in Washington or are they supposed to own the policy package that they want to endorse and implement?"

The Role of the Fund and the Meltzer Report

With regard to the future role of the IMF, Yilmaz Akyüz argued that it was high-time to go back to the drawing board. "As much as I disagree with the Meltzer Report, I feel that we must go back to the drawing board because the patch has become bigger than the hole. We have been patching the system since the 1960s and creating all kinds of mechanisms, facilities, functions, and changing them in response to events in an ad hoc way. The Meltzer Report effectively says: 'The IMF is not in the current account financing business anymore and should not be in the development finance business anymore, it should focus on capital account issues, safety and stability of the financial system, and so on.' This is big thinking, whether you like it or not. It is not about patching the system.

We have been discussing whether we want a lender of last resort, standstill and other mechanisms regarding crisis prevention. Whether this debate will lead to a new institution with a focused objective, I don't know. Instead of patching these mechanisms onto the IMF, I suggest that we start with the problems and then see how we can reform the IMF to deal with those problems. Do we agree on the original objective of the IMF: adjustment to balance of payments shocks in order to prevent deflation, promote

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employment? Or is this function to be taken over by private banks? If the IMF is to behave pro-cyclically, like private markets, then what do we need the IMF for?

In that respect, I don't mind discussing approaches like the one the Meltzer report has. We have to put all of the questions on the table and ask: 'What kind of institution do we need? What kind of global financial system do we want?' rather than take the existing system and mechanisms as given. Otherwise we will still be talking about what to do with the IMF twenty years from now."

Amar Bhattacharya agreed that one should begin with some basics. "Clearly the context has changed and perhaps one way to look at it is: what are the implications for economic and financial governance more broadly and within that, what is the role of the IMF? Whereas the Meltzer Commission comes back with a reductionist view of the world, one could come to the opposite conclusion and say, if anything, one needs to step up the level of economic and global governance, not step down. In that context, I have the following question: should the Fund focus on its main areas of competence being systemic instability as a mandate and macroeconomic policy as a competence?

On the other hand, we increasingly recognise the difficulty of compartmentalising the agenda as narrowly as we would like. In many ways, the nature of shocks has changed; the narrow macro agenda is less important and less interesting, and in many areas we are not looking at a narrow Fund agenda. For example, we no longer talk of surveillance but of enhanced surveillance to include areas outside the narrow ambit of the Fund. When we talk about crisis prevention we are not talking about macroeconomic stability but about elements like financial sector strength and many of the underpinnings that go with it. Even when we talk about crisis response there is a short-run response and there is a response beyond that in terms of dealing with financial corporate distress and social safety nets. We also talk about poverty reduction or longer-term adjustment in developing countries. Finally, we have a new area which Yilmaz hasn't mentioned but is implicit in his comments, which is that there is some global public policy which has to be delivered. The Fund's domains in global public policy have to do with macro policy coordination and making the G-1 or G-3 or whatever behave. There is also the issue of international norms, rules of the game, and agreements. Then there are areas which fall more into the banks' and other institutions' domains, e.g. communicable diseases, environment, and knowledge.

You could think of that as the collective action areas within which the Fund has to behave. The question I have is: what are the international governance mechanisms, as opposed to the governance mechanisms nar-

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rowly for the Fund, that will deliver at the collective level what you want? Is it to come up with new groups? Is it maybe the collection of these things that will deliver it?"

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Appendix

List of Participants in the Conference on "Crisis Prevention and Response: Where Do We Stand with the Debate on the Reform of the International Financial Architecture?", held at the Ministry of Foreign Affairs in The Hague on 26-27 June 2000.

Mr. Yilmaz Akyüz	Acting Director, Division on Globalization and Development Strategies, UNCTAD, Geneva
Mr. Mark Allen	Deputy Director, Policy Development and Review Department, International Monetary Fund, Washington D.C.
Mr. Amar Bhattacharya	Senior Adviser, Poverty Reduction & Economic Management Network, World Bank, Washington D.C.
Mr. Howard Brown	General Director, International Trade and Finance Branch, Canadian Department of Finance, Ottawa
Mr. Ariel Buira	Ambassador of Mexico in Greece, former Deputy Governor of the Central Bank of Mexico, Athens
Mr. Roy Culpeper	President, The North-South Institute, Ottawa
Mr. Rumman Faruqi	Director, Economic Affairs Division, Commonwealth Secretariat, London
Ms. Stephany Griffith-Jones	Deputy Director, Economic Affairs Division, Commonwealth Secretariat, London
Mr. Louis A. Kasekende	Deputy Governor, Bank of Uganda, Kampala
Mr. Guillermo Le Fort	Director of International Affairs, Member of the Advisory Team to the Governor, Central Bank of Chile, Santiago

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Mr. Frans van Loon	Director, Emerging Markets Group, ING Barings, Amsterdam
Mr. Aziz Ali Mohammed	Honorary Advisor to the G-24 Chair, G-24 Liaison Office, Washington, D.C.
Mr. José Antonio Ocampo	Secretary General, Economic Commission for Latin America and the Caribbean (ECLAC), Santiago
Mr. Yung Chul Park	Professor of Economics, Korea University and Chairman of the Board of Directors, Korea Exchange Bank, Seoul
Mr. Godert A. Posthumus	Member of the Dutch Council of State, former Executive Director of the IMF, The Hague
Mr. Wouter Raab	Director, Foreign Financial Relations, Dutch Ministry of Finance, The Hague
Ms. Maria Ramos	Director General, South African Department of Finance, Pretoria
Mr. Randy Spence	Senior Economist, International Development Research Centre (IDRC), London
Mr. Jan Joost Teunissen	Director, Forum on Debt and Development (FONDAD), The Hague
Mr. William R. White	Economic Adviser and Head of the Monetary and Economic Department, Bank for International Settlements, Basel
Ms. Ngaire Woods	Fellow in Politics and International Relations, University College, Oxford

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