Part II

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

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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 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-

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 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 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.

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 observance 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.

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.

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.

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

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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).

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

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.

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 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.

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 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 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 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 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 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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