Part III

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

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I Changing Attitudes to International Capital Flows

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

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

Official attitudes to international capital flows have also changed greatly

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

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

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

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

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

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

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

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

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

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

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

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

II Measures to Improve Data, Disclosure and Indicators of Vulnerability

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

6 See BIS (2000b), Chapter V.

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

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

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

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

Improving the International Financial Statistics

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

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8 See BIS (1996).

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

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

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

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

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

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

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

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

11 See BIS: CGFS (2000).

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Improving Disclosure with Respect to Position- and Risk-Taking

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

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

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

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

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

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

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

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

Improving Indicators of Vulnerability in Emerging Market Economies

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

15 See BIS: BCBS (1999b) and the follow-up document (BIS: BCBS, 2000).
16 The forthcoming BIS Working Paper (Hawkins and Klau, 2000) provides a useful overview of the current state of knowledge.
17 The IMF has recently embarked upon a major exercise to improve data and contribute to the construction of better vulnerability indicators. See IMF (2000b).

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

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

III Policy Responses Directed to Creditors

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

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

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

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

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

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

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

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

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

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

22 See FSF (2000e).

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

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

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

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

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

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

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

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

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

IV Policy Responses Directed to Debtors

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

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

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

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

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

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

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

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

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

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

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

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

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

V Implementing Policy Recommendations in Practice

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

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

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

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

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

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

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

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

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

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

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

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

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

Guillermo Le Fort

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

The Impossible Trinity and the Capital Account of Today

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

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

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

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

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

The Lack of Instruments

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

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

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

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

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

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

Transparency Is Not Enough

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

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

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

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

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

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

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

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

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

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On Financial Instability and Control

*Yilmaz Akyüz**

I Introduction

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

Types of Instability

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

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

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

Differences Between Industrial and Developing Country Crises

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

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

II Why Are Developing Countries More Vulnerable?

The Role of Domestic Policies

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

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

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

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

The Role of Structural Factors

A number of structural factors determine developing countries' vulnerability:

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

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

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

External Shocks

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

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

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

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

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

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

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

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

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

III Reforming the International Financial Architecture: What Reform?

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

Political constraints and conflict of interest, rather than conceptual and technical difficulties, appear to be the main reason why the international community has not been able to achieve even modest progress in setting up effective global arrangements for the prevention and management of financial crises. Political disagreements do not occur only between industrial and developing countries. There have also been considerable differences among the G-7 members regarding the nature and direction of reforms. A number of proposals made by some G-7 countries for regulation, control and intervention in the financial and currency markets have not enjoyed consensus, in large part because of the opposition of the United States. By contrast, agreement within G-7 has been much easier to attain in areas aiming at disciplining the developing countries.

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

IV The Basel Capital Accord and New Proposals[1]

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

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

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

an investment-grade rating as to a company with a junk-bond one, thereby providing incentives for so-called "regulatory capital arbitrage".
3. Failure to distinguish between the differences in creditworthiness of different sovereign borrowers, except between OECD and non-OECD countries.

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

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

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

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

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V The limits of Prudential Regulations[2]

Effectiveness in Preventing Financial and Banking Crises

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

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

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

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

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

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

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

Preventing Currency Crises

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

Thus, prudential regulations cannot prevent destabilising spill-overs from currency markets to financial markets, nationally or internationally. When banks pass the currency risk onto borrowers they simply turn it into a credit risk, unless borrowers also hedge against it. However, a debtor country cannot hedge against currency declines, except at very high costs resulting from additional credit lines, reserves, etc.

Preventing Emerging Market Crises

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

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

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

VI Policy Autonomy and Scope in Developing Countries

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

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

Exchange Rate Regimes

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

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

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

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

Regulation and Control of Capital Flows

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

- *Loss of policy autonomy:* Developing countries now enjoy much less policy autonomy than at any time in the post-war period in setting the pace and extent of their integration into the global financial system. First, systemic pressures on governments have increased as a result of liberalisation and integration of financial markets. Due to the greater exit option enjoyed by capital, governments policies have now become hostage to financial markets, and the kind of policy discipline that these markets impose is not always conducive to rapid growth and development. Second, policies in these countries are also subject to pressures from major industrial powers and multilateral institutions. Finally, a number of policy instruments are no longer available to some countries due to their commitments as part of their membership to blocs such as OECD or NAFTA.

- *Increased payments deficits:* Developing countries are now running larger trade deficits without growing faster.[4] This is because many developing countries have liberalised trade rapidly without having established competitive industries in the first place. On the other hand, as a result of increased reliance on exports, they are all pushing against stagnant and protected markets in the North, competing fiercely with each other and facing large terms of trade losses. As a result, attracting private capital of any kind becomes essential to maintain a momentum of growth. However, by generating instability, private capital aggravates the payments difficulties rather than providing a viable solution.
- *Cost of and access to external finance:* Controls are opposed, at national or global level, when they would have the effect of lowering the volume of capital inflows and/or raising their cost even when such measures could be expected to be effective in reducing instability and the frequency of crises in emerging markets. A large majority of them have been unwilling to impose control on capital inflows during the boom phase of the financial cycle. Also, they are generally unwilling to introduce bond covenants and collective action clauses and have been asking industrial countries to take the lead in this respect. Some developing countries are even concerned that emphasising private sector involvement could undermine investor confidence and access to international capital markets. They are also opposed to differentiation among sovereign risks in the Basel capital requirements for international bank lending.

Variations of National Capital Account Regimes

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

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

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

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

VII Regional Cooperation

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

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Comment on "On Financial Instability and Control," by Yilmaz Akyüz

Amar Bhattacharya

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

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

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

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

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

International Management of Private Flows

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

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

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

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National Management of Private Flows

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

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

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

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

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

Other Challenges

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

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

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

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

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

Exchange Rate Regime and Capital Flow Volatility

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

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

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

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

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

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

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

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

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

Prudential Supervision and the Unwinding of Liberalisation

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

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

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

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

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

Aziz Ali Mohammed said he was extremely worried about the way financial institutions are integrating. "For example, the fact that Citibank recently joined with Travellers Insurance to create a huge conglomerate, is a cause for serious concern. When we talk about the role of regulators, the issue is: who is regulating the conglomerates and don't we need some kind of merger on the regulative side in order to face up to the merging that is taking place among private financial institutions? A big institution like Citibank can take advantage of the breaking down of the 'Chinese Wall' that existed, to use Mark's term, to front-run the market. They're active both on behalf of themselves, in their off-balance sheet transactions, as well as acting on behalf of their customers. This kind of front-running can also happen in a very peculiar way in other institutions, for example, institutions that are responsible for custodian operations, e.g. the 'backoffice boys'. State Street Bank boasts that it has more than 50 percent of the custodial activity for all the mutual funds in the US. So they are able to use the computerised information, that is now coming in on a daily basis, to know where the heart is long before the heart discovers itself."

Risk Management and the New Capital Adequacy Accord

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

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

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

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

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

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

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

Global Governance of the Financial System

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

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

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

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

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

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

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

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