Part IV

The Role of Regional and Global Institutions in Crisis Prevention and Management

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The Role of Regional Institutions

José Antonio Ocampo

The role of regional institutions in the international financial system is one of the most prominent items missing from the mainstream discussion and agenda on international financial reform. It is absent from the main Northern reports[1] and from the views on financial reform which come from the IMF (though the position of the new IMF Managing Director is more positive in this regard). The main manifestation of this gap in recent years was in the opposition to the creation of an Asian Monetary Fund in 1997, although this idea was revived in 2000 in the form of a swap arrangement between the ASEAN countries, China, Japan and Korea.

There are four basic arguments for a strong role of regional institutions in this area.[2] The first is a classical risk-pooling argument. Regional and subregional development banks, even those made up entirely of developing countries, are likely to face lower risks than individual members. This creates the potential for profitable financial intermediation.[3] Also, despite contagion, critical demands for funds do not coincide exactly in time, a fact that generates the possibility of a useful role for regional reserve funds or swap arrangements as a first line of defense during crises.[4] If these mechanisms are effective, they can play a useful role in reducing contagion.

The second argument relates to the virtues of complementarity between world and regional institutions. Given the heterogeneity of the international community, world and regional institutions can play useful complementary roles. Thus, aside from those mechanisms that involve major industrial economies, macroeconomic policy coordination will work best in regional organisations. These organisations can also play a useful role in setting norms, in the adaptation of international norms to regional conditions (given different regulatory traditions), and in reducing learning costs and sharing experience with institutional development. They could also establish mechanisms to ensure surveillance of their regulatory systems and, eventually, regional currencies. The fact that, at least in the

1 See, for example, Council on Foreign Relations (1999), and Meltzer and others (2000).

2 For a broader discussion of these issues, see ECLAC (2000, chapter 2), Agosin (2000), Ocampo (1999, 2000) and Park and Wang (2000).

3 The experience of the Andean Development Corporation (Corporación Andina de Fomento) reflects this.

4 See, for example, the experience of the Andean, now Latin American Reserve Fund (Agosin, 2000).

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area of trade, globalisation has been accompanied by strong regionalism, further points to the virtues of such complementarity.

The third is an argument for competition, particularly in the supply of services to smaller and medium-sized countries. World institutions are likely to serve best those actors who have some systemic influence. Smaller players do, in fact, face a very unfavourable power relation vis-à-vis large institutions. This creates a strong argument for a division of labour whereby regional institutions can and should play a stronger role in relation to small and medium-sized countries. Indeed, the best defense for smaller players is competition in the provision of services to them. Hence, the competition between world and regional organisations in the provision of development bank services, emergency financing or technical support is, undoubtedly, the best arrangement for small and medium-sized countries.

The last may be called the "federalist" argument. No matter what arrangements are adopted, the voice of small and medium-sized countries is unlikely to be strong in global institutions. This may lead, in turn, to a lack of commitment ("free rider" attitude) on the part of these countries. This can be remedied by the establishment of regional institutions in which their voice does matter, together with a sense that those institutions are truly part of a broader international order. Moreover, the sense of "ownership" of these institutions by developing countries creates a special relationship between them and member countries that helps to reduce the risks that regional and subregional development banks and reserve funds face, further encouraging the virtues of risk pooling.

These are strong arguments for giving a prominent role to regional institutions in the world order. The best example in this regard is, undoubtedly, the European Union. Indeed, these arguments point to the need to think of the virtues of providing global public goods in the area of finance (as well as in many others) through a network of either complementary or competitive institutions. The International Monetary Fund of the future could be viewed, in this regard, as the apex of a network of regional and subregional reserve funds and swap arrangements[5] – i.e. a structure more akin to that of the European Central Bank than its current centralised one. In turn, competition in the provision of development finance between the World Bank, the regional development banks and a growing set of regional and subregional banks entirely owned by developing countries is probably the best arrangement in this area, together with increased direct access by all developing countries to international private capital markets.

5 See United Nations Task Force (1999) and Ocampo (2000).

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A Regional Approach to the Exchange Rate

Heiner Flassbeck

In our discussion, a crucial topic remains unresolved. Everybody talks about globalisation but only a few mention that we have a globalisation of markets but not of politics. The fact that globalisation has not yet reached politics is, in my opinion, the main contradiction in international policy. It leads people to protest against the laissez-faire approach to globalisation. Politicians are pressing workers and companies in our countries to adjust "flexibly" to globalisation, while the very sector that fails to adjust to globalisation at all is politics.

To give an example, I think in our globalised, free-trading economies it is absolutely essential to have something like a globalised monetary regime or a global exchange rate regime. But politically this is out of the question at present. Why is it out of the question? Many countries, particularly the larger ones or the big blocs, are not willing to commit themselves. They hand out conditional credit to other countries via the IMF, but would never accept any obligation for their domestic economic policy stemming from international developments.

The same lack of a globalised view leads to the idea or ideology of pushing countries into the corners of either fully flexible exchange rates, on the one hand, or absolutely fixed rates on the other. It is an attempt to find a unilateral solution for a problem that is multilateral by definition. This inconsistency proves to be disastrous.

Hence, the real test for the credibility of the proponents of globalisation and liberalisation preaching the benefits of a global free market is the monetary question. The idea of pushing neighbouring developing countries like Brazil and Argentina into different corner solutions, has failed. To put it in slightly provocative terms: the IMF healed Brazil by killing Argentina, and the problem is that the Fund did not even reflect on that. I was involved in negotiations with Brazil in 1999, and tried to convince the G-7 and the IMF to consider the consequences for Argentina of floating the Brazilian real, but nobody listened. First, we solve the Brazilian crisis, they said, and then we will see what happens in the rest of Latin America. However, in my view, this kind of inconsistent policy cannot go on. Unilateral solutions have proved to be untenable, not only in the long run but even in the short run.

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In the final analysis, Argentina proved both corners to be wrong. Currency boards or dollarisations fail, as the real exchange rate may still be very flexible if trading partners depreciate. To restore competitiveness, deflation is a not an instrument, as it worsens the overall situation of the country. Free floating fails, as it tends to move the real rate far beyond the flexibility needed to cope with external disequilibria, destabilises trade, and prevents a reasonable monetary policy with low interest rates. Unilaterally managed floating cannot work on a global scale either if there are no multilateral rules to avoid competitive depreciations. The basic problem is: there is no such thing as a country's exchange rate. Your exchange rate is always the exchange rate of many others. Put simply: unilateral solutions cannot deal with a multilateral problem.

It seems to have been forgotten that Argentina's currency board, once praised by the IMF and the G-7 as one of the successful "corner solutions" in international monetary affairs, has been a persistent invitation to international investors to buy high-yield Argentine assets. With a spread of up to 1000 basis points even in normal times, an absolutely fixed exchange rate and very low inflation, Argentine assets seemed to be a perfect bargain and direct proof of the benefits of open capital markets to lenders and borrowers. The question of how investors in fixed capital inside Argentina could survive with real interest rates that were about ten percentage points higher than those in the United States never occurred to those praising Argentina for its open capital account.

Like every other country in trouble, Argentina needs low real interest rates, a lower but stable real exchange rate and a stimulating fiscal policy. Any arrangement now under discussion with the IMF that doesn't deliver such a constellation of the most important variables, will fail and push the country over the cliff. In addition, a solution for Argentina has to be designed without killing Brazil and the other Latin American competitors again. To achieve this, the country and its trading partners urgently need an exchange rate regime which is flexible enough to allow for the adjustment of fundamental disequilibria accumulated during the currency board phase and stable enough to avoid future cumulative depreciations and wide gyrations of real rates which destroy the trade relations as well as the financial system in this part of the world. However, the European experience with managed floating of that kind indicates that such a system will only be workable with the assistance of the central bank of a reserve currency. Obviously, this can only be the US dollar.

If stability and prosperity in the globalised world are to be sustained and regained, governments and central banks of the reserve currency countries have to assume responsibility for a proper working of the system far beyond austere rescue packages and irrelevant structural adjustment programmes.

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Short of a world monetary order a solution will hardly be found. Only if this is realised dare we say that globalisation has reached the level of politics.

As long as such a solution cannot be realised the second-best way out is to head for regional solutions. Regional solutions may even offer advantages not offered by others. However, I do not join the traditional optimal currency areas debate. As general economic criteria are hardly available, a regional solution is mainly a question of political will and the political ability to force domestic adjustment and to assume responsibility for the system as a whole. Europe, with Germany as the anchor, is a good example in this respect. In all its crises, Europe always came out stronger than before and, most of the time, with the vision to reach a specific objective like monetary union.

It is important to note that, for 40 years, Europe has been in a transitional stage. Soft pegs or hard pegs should not be tabled as the end of the story. Exchange rate systems should be discussed as transitional stages. And the main question should be: can the system I choose be a reasonable transitional stage towards something like monetary union either on a regional level or even, ultimately, at global level? Here I think some form of peg, more flexible than in Asia, perhaps even a little more flexible than in Europe, is extremely helpful, for example, for the accession countries in Eastern Europe. If the exchange rate problem is solved, many other problems of openness are solved too.

Leslie Lipschitz said earlier that he supports completely flexible labour markets. I said, perfectly flexible means, in the European case, that you should be able to have a unit labour cost increase of 2 percent annually. An increase, not a drop of 20 percent or something like that in Argentina now. I quickly admit that in the case of negative supply side shocks you need real wage flexibility to adjust without inflationary second-round effects, but under any normal circumstances the stated unit labour cost flexibility is sufficient. I think it is extremely important to discuss these points concretely, namely to define flexibility, and not just to use popular phrases like "flexibility". If wages are flexible enough, they can 'substitute' exchange rates changes, which are always very difficult to handle in whatever exchange rate regime. As long as wages are not fully flexible in the above-mentioned sense, intermediate exchange rate regimes are necessary and workable. In the literature, the opposition to an intermediate regime has gone far too far.

A different question is whether exchange rate changes are a proper instrument to fight real shocks. I don't think they are. They can only substitute for the flexibility of nominal wages. But exchange rates cannot absorb real shocks. The academic discussion of exchange rates is clearly inconsistent on this point. We have now been teaching the whole world,

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for more than three decades, that inflation is not an instrument for economic policy, because we cannot fool people about the *value of money over time*, which is inflation. Everybody agrees that people learn quickly and attempts to fool them will fail in the long run. The same holds for the *value of money in space*, that is the exchange rate. Nonetheless, the mainstream view asserts that the exchange rate is a policy instrument permanently available in all countries to fight real shocks. But if the public learns that the change in the value of money over time is an attempt to fool them about their real income or real wealth, they will learn the same about the exchange rate. So arguing the case for floating as an instrument for fighting real shocks is not consistent.

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A Predictable Framework for Crisis Resolution

Paul Jenkins[1]

I will focus my remarks on what needs to be done to prevent and manage crises, both regionally and at the global level. A set of principles and presumptions should be established that help prevent crises by improving efficiency and stability in capital markets. For crisis management, they must create conditions for more orderly negotiations between debtor countries and creditors.

I think that there is a consensus, at least at the level of principle, that large assistance packages do distort international capital markets, not the least by truncating the distribution of expected returns facing lenders. And it is in part for this reason that some efforts to reform the private sector have become a fairly standard feature in the international assistance packages. But the international community and its institutions are much less successful in translating this rather vague agreement that the private sector should bear the consequences of its lending decisions into consistent and concrete actions, particularly when faced with the requirements of real world financial crises.

The results have tended to be ad hoc, arbitrary and confusing for the private sector. We are in a situation where countries deemed to be of systemic importance are still provided with assistance packages that would have been unthinkable a few years ago, and certainly which far exceed ordinary Fund access limits. When private investors are expected to participate in debt restructuring, the impression is often created that what the official sector is really after is burden sharing. The contribution asked seems to be driven by the expediency of a need to fill a certain balance of payments gap, rather than any other considerations.

The result is that a new source of risk is being introduced in the international capital markets, with lending decisions based on guesses of which countries are too politically important to be subjected to debt restructuring, rather than by assessments of underlying risk and return. Clearly, a market in which private investors make the decisions to invest, but the official sector bears much of the risks, cannot be efficient. But nor

1 The views expressed are not necessarily those of the Department of Finance or the Government of Canada.

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can a market be efficient when the official sector intervenes in an unpredictable or even haphazard manner.

The state of affairs has some clear implications for the international institutions, both at the global and regional levels, and their efforts to achieve what has become known as private sector involvement. Certainly there is a role for arrangements that have been discussed for a few years, collective action clauses for example, that make it more likely that borrowers and creditors go renegotiate their debts in the midst of the often difficult and tumultuous circumstances of financial crises. And there is a role for mechanisms whereby the international community, say the IMF, could endorse a country's decision to declare a standstill on debt repayments. But I think it is right to say that these arrangements alone are rather far along the list of steps that are necessary. They alone would not be effective in achieving more stable and efficient capital markets, unless one thing is achieved: a fundamental commitment to limiting official financing for countries in crisis.

Misconceptions About the Limiting of Official Finance

There are a number of ways such limiting of official financing could be operationalised. One way would be to adhere more strictly to access limits as a percentage of quotas, either the existing ones or alternative ones. Another way would be to look at rules relating to the financing of current account deficits together with reserve flaws. But the fundamental objective would be to prevent situations in which massive capital outflows are financed with official flows. So it would imply operationalising the long forgotten Article VI of the Articles of Agreement of the IMF (see box). Of course, this is not a new proposal. The ideas behind it have figured, at least implicitly, in the debate on private sector involvement over the last few years. But if implemented, they would represent a fairly major shift. And like a lot of changes, these ideas are subject to criticism, which I think is based on some misconceptions or misunderstandings. I will briefly discuss five of these.

The first misconception is that governments are being motivated mainly by the desire to shift the financial burden of assisting countries from themselves to the private sector. In fact, that would be a rather bad objective. The proper objective of private sector involvement is not burden sharing. It is not a zero sum game in which international institutions transfer to the private sector the financial responsibility for crisis management. Rather it is to create the conditions for stable international capital markets, something that should be a positive sum game for the private sector.

The second misconception is that the debates often cast the problem in terms of rules-based versus case-by-case approaches. Certainly, we support

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Articles of Agreement of the International Monetary Fund

Article VI: Capital Transfers

Section 1. Use of the Fund's general resources for capital transfers

a) A member may not use the Fund's general resources to meet a large or sustained outflow of capital except as provided in Section 2 of this Article, and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund.
b) Nothing in this Section shall be deemed:
c) to prevent the use of the general resources of the Fund for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking, or other business; or
d) to affect capital movements which are met out of a member's own resources, but members undertake that such capital movements will be in accordance with the purposes of the Fund.

Section 2. Special provisions for capital transfers

A member shall be entitled to make reserve tranche purchases to meet capital transfers.

Section 3. Controls of capital transfers

Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(*b*) and in Article XIV, Section 2.

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a framework that sets up some predictable rules of the game. One of these would be the presumption that official resources would be limited, much more so than they are now. But beyond that, a well-defined framework would clarify the circumstances under which the international community would sanction a country's decision to declare a standstill, as well as clarify the principles to guide renegotiation of external debt such as equal treatment between and among official and private creditors. Of course, any such rule would need to be a guideline and not a straitjacket. A framework for private sector involvement would provide more clarity amid financial crises, but it should not be applied in a rigid fashion, without reference to the countries concerned. This is to say that any rules-based system would have to be applied on a case-by-case basis. So this distinction between rules-based versus case-by-case does not make sense.

The third misconception is that the Article VI solution is intended to tilt the balance towards borrowers and away from lenders. This is just not true. The private sector has always been involved in resolving financial crises, so whether it should or should not be involved is not an issue. What is an issue is whether there should be a predictable framework that provides some ground rules for this involvement. Clearly a predictable framework is better than a set of unpredictable ad hoc arrangements. Because when you do not know what happens when debt needs to be restructured in some future crisis, you cannot properly assess the risk of the loan, and there is a danger that if you cannot price it properly you are not going to make the loan. The result that one would expect is that investors are less willing to provide loans, even to the more creditworthy emerging countries, and this translates into less investment in emerging markets, slower growth, the persistence of poverty and a less dynamic and prosperous global economy.

Providing more predictability is not just a matter of the official sector laying down some arbitrary rules for the private sector, it also requires us to consider carefully our own actions as official creditors and insure that these contribute to fairness and flexibility. For over 40 years we have had the Paris Club as a forum where governments renegotiate debt from countries no longer able to pay them. But it is more than just a place, a creditor club, which deals with bilateral debt; it is increasingly a place where the official sector establishes principles and precedents, what we call soft law for the treatment of similar cases in the future, and which increasingly are providing an example for the private sector creditors. We need to make sure that in establishing the soft law the official sector takes adequate account of the interests of the private sector and does so in a consistent and fair manner, and again, does not become a source of uncertainty, but rather predictability.

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The fourth common criticism I would like to address, relates to the concern that some of the particular measures described encourage involuntary or non-market solutions to payment problems. I think this criticism comes very close to inversion of the truth. In fact, it is massive international assistance packages that are the non-market solutions to the problems, the ones you would consider only under exceptional circumstances in our own domestic economies, because of their potential to distort capital markets. Moving away from these practices is a step back toward market-based solutions.

The fifth and final concern or misconception I like to address relates to the view that by limiting official financing and thereby encouraging or indeed requiring default, the international community is eroding the sanctity of private contracts. My response would be that attaching the highest priority to the sanctity of contracts is incompatible with the functioning of efficient real world markets, in which changes in circumstances sometimes require changes to contractual terms. One can interpret in fact the high-interest spreads on emerging market debt as reflecting the recognition that unforeseen circumstances may require changes in the terms of the contract. From this perspective, the only world in which changes are truly ruled out, is the one in which debt contracts are complete in the Arrow-Debreu sense, taking into account all possible eventualities. Clearly, we are not in such a world, and therefore the possibility of debt renegotiations is something the official sector should contemplate and even embrace.

Conclusion

I hope that my remarks will help clarify the underlying objectives and rationale for efforts to improve financial crisis management, such as those in which we in Canada have been involved for several years. The goal here is not about suddenly introducing non-market considerations into the operation of international capital markets, or arbitrarily imposing costs on market participants. It is not bred of hostility to market forces. Quite the opposite. Our goal is one that the most market-oriented should support: ensuring that assessments of risk and return by international investors are undistorted by uncertainty about the actions of the official sector and that we experience fewer and less severe financial crises.

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The Complementary Role of Regional Groups

Leslie Lipschitz

There is a great deal of ground to cover. I am going to focus, first, on saying a few things that I believe are important. Thereafter, I shall try to respond to some of the provocative points raised.

Let me start with the issue of IMF surveillance and crisis prevention. There is, I think, a degree of frustration with the abstractness in the discussions about reform of the international financial architecture. A sense, perhaps, that we have a whole new alphabet soup of initiatives – FSAPs, FSSAs, ROSCs, CCLs, etc., etc. – but there is insufficient real change on the ground. I believe that there *are* real and important changes in how surveillance is being done in the Fund – particularly with respect to the emerging market countries which are most at risk from capital account crises – and I will try and say something about this. Next I will say a few words on what I see as the complementary role of regional bodies in both surveillance and crisis financing. Finally I would like to address briefly the issues of private sector involvement and access limits on Fund support of countries' programmes.

The criticism of surveillance has been fairly clear. The so-called External Evaluators of Surveillance (a group led by John Crow of Canada) and the last internal IMF review of surveillance came up with similar concerns: The Fund's surveillance of individual countries should be more continuous and rigorous and should be focussed on anticipating and forestalling crises; it should bring all the cross-country and global wisdom available (from the Fund's *World Economic Outlook* and the *International Capital Markets* reports) to bear on this objective; and its coverage should be selective, with structural and institutional issues covered to the extent that they have appreciable macroeconomic relevance. This sounds sensible and straightforward, and, indeed, it does not constitute much of a revolution for the Fund's surveillance of the major industrial countries. But it has wrought a revolution in the process and framework for surveillance of the emerging market countries.

The new process involves supplementing the annual consultations with these countries with detailed quarterly vulnerability assessments and interim monthly updates. The quarterly exercises try to assess the countries based on six independent inputs:

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- Changes in the *World Economic Outlook* that have particular significance for the countries involved. This entails sitting down with the economists doing the world economic outlook and trying to assess which developments – e.g. sharp changes in the terms of trade or in demand for high-tech components – are likely to have an influence on the vulnerability of each of the emerging market economies.
- Early Warning System (EWS) Models. We look at a set of EWS models – some developed inside the Fund, some run by outside financial institutions. These models do not have a great track record – they miss some crises and predict many that never occur – but they do force a process of assessment in order either to accept or reject their results. As such they are useful as one element of a vulnerability exercise.
- Market information on borrowing spreads, equity prices, exchange rates and contagion. Besides a general assessment of the market conditions for emerging economy financing, much of this work is focussed on contagion: for example on pairwise correlations of changes in borrowing spreads across emerging market countries. One objective is to assess whether country X is likely to be vulnerable to a crisis in country Y.
- Financial sector robustness. This draws often on the results of Financial Sector Assessment Program (FSAP) work or other work by our experts on the financial sectors of emerging market countries. In many cases this work entails specific stress tests of the financial sector in relatively adverse counterfactual scenarios.
- Financing requirements. This entails a detailed assessment of the external financing requirements of each of the countries under consideration based on both current account developments and amortisation schedules. It requires a fair amount of detail on the structure of debt and an assessment of rollover ratios and access to financial markets for different types of instruments under alternative scenarios.
- Finally all of this information is pulled together for each country and discussed in some depth with the country desk at the Fund. The country economists on the individual economies have by far the best insight into institutional detail, political constraints, and the state of play on policies; they play a critical role in integrating all of the inputs from the other aspects of the process into a sensible judgment on likely developments and policy imperatives.

I believe that this process is part of a sensible response to the capital market crises of recent years and the in-depth assessments of surveillance – both in-house and external. It goes together with much more candid discussions of vulnerabilities with our Board and more candid staff reports. The best examples of the latter are probably the post-programme monitoring papers on Russia and some of the Asian crisis countries. All of this may not sound like a revolution around this table, but it is totally different from the way the Fund did business ten years ago. It is clear that there is no silver bullet: there will be problems that we do not anticipate, and others that we are powerless to forestall. We will make mistakes. But much has been achieved in response to recent history, and that alphabet soup of new processes and mechanisms is being sensibly integrated into the process of surveillance.

Let me talk now a bit about the regional role and try to address some of the discussions we had earlier. Why not just a regional financing arrangement to supplant the global system? First, the most obvious point is that raised earlier about covariance risk – the notion that no sensible insurance company would provide flood insurance to clients all located in the same valley. It seems obvious that if all the countries that are party to the Chiang Mai Initiative are hit by a large common shock, they will have difficulty bailing one another out. Moreover, common shocks or synchronised cycles are probably more likely as regional economic integration advances. So there has to be money from outside for any crisis that is region wide.

Second, there is the point that Daniel Heymann raised about uncertainty – there is, perhaps a natural tendency to underplay problems in one's own neighbourhood. It is often difficult to distinguish a pure liquidity crisis from a solvency crisis. Moreover, a liquidity crisis that leads to higher interest rate spreads or an exchange rate change may well quickly become a solvency crisis in circumstances where balance sheets are sensitive to interest rate or exchange rate risk, or where there are substantial contingent liabilities. In this light, it seems to me that the position adopted by the Chiang Mai Initiative constitutes a sensible middle ground. As I understand it, this position is as follows: if a participating country runs into a crisis that it wants to characterise as purely a short-term liquidity problem, the principal creditor participants could (if they agree) advance a well-defined small amount of money for a short time. Beyond this, financing will require an arrangement with the Fund. Thus, for example, Japan would not be required to finance a defense of the exchange rate of the Philippines with very little conditionality for an extended period. Any such financing, beyond small amounts and the very short term, would entail an adjustment programme supported by the Fund. Significant regional financing under the Chiang Mai Initiative would thus supplement rather than supplant global mechanisms.

I do not think that the situation in Asia now is very different from that in Europe in the 1970s and 1980s. The Italian crises of 1974-77 and the problems in Greece in the mid- and late 1980s were very characteristic of the difficulties involved in a tough rigorous assessment of one's

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neighbours. In the case of Italy, there was a clear perception in Europe that Fund involvement was essential. In the case of Greece, there was an EU supported programme (designed, incidentally, by a Fund economist who had moved to the Commission) in 1985. In the subsequent years, however, there was enormous pressure on the Commission economists to put a very sanguine gloss on developments under the programme and immediately after it. I recall one mission that I led to Greece where the dissonance between the Commission's assessment and that of the Fund was quite deafening. Clearly, it is difficult to be vigorously critical of the policies of one's neighbours and regional partners, and a degree of distance is helpful.

Two more small points in reaction to some of the things others have said. First, contagion is global: it is entirely possible for Indonesia to be affected by developments in Argentina or Russia. An analysis of capital markets *cannot* be regional it must be global and it requires wisdom on the global economy. Second, it is of no use complaining that markets are irrational – my own view is that risk premia and spreads are often quite erratic and capricious, but one nevertheless has to live with this reality and, most importantly, to put in place policies that make economies robust to such market shifts.

None of this should suggest that the new mechanisms for regional surveillance in Asia – under APEC or the Manila Framework Group for example – are not welcome. They are developing into an important force for strong policies and neighbourly peer pressure. For us in the Fund they have also been enormously helpful in bringing to the fore clear thinking on regional issues and the constraints on policies. But, given the considerations mentioned above, it seems clear that regional arrangements for both surveillance and financing need to be reinforced by the global mechanisms that are in place.

Finally, a very quick word on Paul Jenkins' views on private sector involvement and strict access limits on Fund financial support. This is, I think, the most difficult issue that the Fund membership will need to face in the next year or so. There is immense appeal to the notion of very strict rules on access, and to the notion that private market participants need to face stringent market penalties so as to be encouraged to price risk appropriately. But the issues involved – legal and institutional as well as purely economic – are devilishly complicated. I believe that we are at the beginning of the process of resolving them, that there is a great deal of work ahead, and that it is simplistic to suggest that a purist solution can be imposed.

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The Role of Regional and Global Institutions

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I seem to have different views about the role of exchange rates than some others at this meeting. If I heard Heiner Flassbeck right, he said that exchange rate changes are not a good instrument to solve real shocks. I am not sure that is true. A real shock has to be absorbed. The question at issue is whether letting the exchange rate move leads to a more satisfactory overall outcome in the process. Let me use an example drawn from my Canadian experience; namely, the effects of an increase in commodity prices and the terms of trade. The real effect is that the commodity-producing sector must gain at the expense of (say) manufacturing, but this can be done in either an inflationary or a non-inflationary way. In the former case the exchange rate is held constant. Rising profits in the commodity sector lead to higher wages that spread to manufacturing. This in turn leads that sector to try to raise prices to restore profit levels. In the latter case, in contrast, the exchange rate is allowed to strengthen. This reduces the prices of all tradable goods, again to the particular discomfort of the manufacturing sector.

My second point has to do with what Paul Jenkins just said about rescue packages in sovereign crises. I think one of the reasons why the crisis packages have been so big is that people have looked into the abyss of the market solution and have been unwilling to accept that outcome. They say, "No, that is just too painful. We can't do that. There is no way the private creditors and the debtors can sort it out." What is now being suggested as an alternative are means to make the market solution less disorderly and painful. Suggestions include some combination of better financial standards, Fund lending into arrears, and the incorporation of collective action clauses into both new and existing bond contracts. I think further work along these lines would be very useful.

I agree with Leslie Lipschitz that there has recently been a major change in the way the Fund seems to be looking at things. There is now a much greater appreciation of the possible dangers arising from international capital flows. However, I was a little disconcerted by the extent to which his comments seemed to focus on country-by-country problems and issues. Fortunately, near the end of his comments he did note that the problem of capital flows might not be country specific. Rather, there could be

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swings in confidence in international financial markets that could have repercussions everywhere. Moreover, a large number of countries could be affected simultaneously by shared shocks of other kinds; effects on international trade of sectoral difficulties (e.g. IT), changes in world energy prices, profits earned by multinationals from global operations, and the simultaneous and instantaneous access to the same information globally. International financial institutions, including the BIS, must give higher priority to monitoring changing global vulnerabilities and exposures of this sort.

As far as the BIS is concerned, let me go back to the role of regional and global institutions in crisis prevention and management. Let me be very clear about what the BIS is not. It is not an agency that tells people and countries what to do. Rather, it is a cooperative agency. We exist primarily to bring people together in order to talk about the issues of monetary stability and financial stability. We wish to encourage the sharing of understanding and to discuss what can practically be done to address shared problems. The networks established through this cooperative process seem to us to be very important. The fact that everyone knows each other, that they share many similar values, and that they at least understand others' views about economic processes is helpful for both crisis prevention and crisis management. As well, without calling into question the primacy of our clients' interests, we at the BIS also try to develop new ideas and to disseminate them. For example, as noted below, over the last few years we have been doing a lot of work on the possible pro-cyclicality of liberalised financial systems and how such tendencies might be reconciled with other more desirable attributes of such systems.

Crisis Prevention

We at the BIS tend to think financial crises have become more common as the system has become more liberalised. In effect, we have moved back to a world similar to that which prevailed before World War I when commerce was global, capital flows were unrestricted and a high degree of economic volatility was the norm. The question that then arises is what might be done about this, using public policy or the influence of the public sector.

There are three different platforms at the BIS for addressing these problems, all using a cooperative approach. First, we have situated at the BIS groups like the Basel Committee that bring together national experts concerned about the health of financial institutions. The recent work of the Basel Committee, particularly on the Core Principles of Banking Supervision and on the New Basel Accord, needs no further elaboration here. Second, the Committee on the Global Financial System (CGFS) is another Basel-based committee, again made up of national experts, which worries about developments in financial markets. About two years ago the CGFS received a mandate from the G-10 Governors to start looking at financial vulnerabilities in a much more serious way. So now, in preparation for CGFS meetings, the staff of the BIS provides up-to-date statistics and analyses of market risks, credit risks and liquidity risks for financial markets in both the industrial and emerging market economies. The third platform supporting the international financial system is the infrastructure. Here, the Committee on Payments and Settlements Systems is playing a big role by helping to develop global standards.

With respect to all three platforms, an important task is motivating people in different countries to actually implement the international standards that will make their domestic financial systems more robust. In this endeavour, the World Bank and the IMF are playing a very useful role. Broadly put, reliance is being placed on the three incentive systems, or “pillars” that underlie the new Basel Capital Accord. First, people must be convinced it is in their own best interests to pursue reforms. Second, oversight from the official community and peer pressure can play a useful role. Finally, market discipline and the rating agencies can also give some impetus for countries to do the right thing.

At this conference, we have concentrated on the issue of crisis prevention at the regional level. One problem with this approach, in so far as the BIS is concerned, is that we have been working hard in recent years to become an institution with global reach rather than one which is primarily regional (European). In fact, we have made welcome progress over the last five or six years even if there is still much to be done. One thing to note is that, unlike the Fund, the BIS is not an organisation with universal membership. Rather, we can allow selective membership and, indeed, have done so by offering shareholder status to only some of the more important emerging market countries. We want global reach and global input to our discussions, but the issue is how meetings and discussions at the BIS can nevertheless be kept small enough to be efficient.

Of course, this approach still leaves us with an inclusion problem that we all recognise. One way we are trying to deal with this is by using cooperation with regional central banks more effectively than we have done in the past. We have opened a regional office in Hong Kong, and are planning to open one in Mexico City. This will facilitate direct contact between the BIS and regional central banks. The other thing we are trying to do is to interact more with existing groups whose purpose is to promote central bank cooperation in particular regions. In Latin America, the principal such group is the Centro de Estudios Monetarios Latino-

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americanos (CEMLA). However, Asia (and to a lesser extent Africa) presents something of a political problem for us because of the multiplicity of regional central banking groups to which Amar and others alluded. Given certain rivalries, the issue of who to cooperate with takes on some importance. Nevertheless, we are proceeding as best as we can by dealing with all initiatives on the basis of their individual merits, and by trying to build on the strengths of the different groups as we see them.

Crisis Management

Crisis management is essentially the Fund's business. The principal way the BIS was drawn into it in the past was through so-called "bridge loans". These occurred when a country was expected to receive a drawing from the IMF, but there would be a technical delay before the money was actually disbursed. In such cases, the BIS would lend the money up front, subject to a takeout by the G-10 central banks (most of whom would be indemnified by their Treasuries). In recent years, as the Fund's disbursement process has improved, there has been much less need for this. In the past, it was also the case that some loans were made primarily for cosmetic purposes. There is now a greater understanding that such loans often offer no material advantage and can even be counterproductive.

Nevertheless, the experience that the BIS has had in negotiating bridge loans might still allow it to play a useful role in assisting initiatives to raise foreign exchange reserves in support of chosen exchange rate regimes. One possibility in this area would be regional initiatives like the Chiang Mai and ASEAN+3 arrangements. Another would be attempts to raise funds in addition to IMF lines. Consider the case of Korea in 1998, where the US Treasury tried to arrange such support bilaterally from many countries. These efforts did not succeed, in part because each participating country had grounds for concern that other countries were negotiating better deals than they were. Demanding, in the middle of a crisis, that the troubled country negotiate simultaneously with a very large number of counterparties was never a very practical proposition. An alternative might have been to use the multilateral templates and legal documents developed by the BIS. This would have ensured fair and transparent treatment of all those involved, and thus facilitated negotiations. This was the outcome when the BIS helped arrange multilateral support for Brazil in 1998. A further role for the BIS might be to provide protection, given its immunities, to the foreign exchange reserves of sovereigns in the midst of a liquidity crisis. Akin to the need for ongoing financing subject to Chapter 11 in the United States, this might be a further small contribution to improvements in how such sovereign liquidity crises are currently managed.

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