Floor Discussion of "The International Institutions' Current Approaches and the Prospects of Their Future Activities"

Crises, Markets and Rational Expectations

The papers presented by Jack Boorman and Ariel Buira led Charles Wyplosz to reflect on financial markets and rational expectations. "In fact, financial markets are performing according to rational expectations. Rational expectations allow for mistakes – not systematic mistakes – but it does allow for mistakes. This is a genuinely important point to understand if we want to cope with this kind of crisis. Markets have a very low probability of a huge disaster so there is a low risk premium. This does not mean that the markets are irrational, it simply means that they don't think the probability is a very high one. In this sense, they are rational and there is nothing wrong with what we observe, we just observe bad luck."

Wyplosz continued by referring to the specific weaknesses of the countries which experienced the crisis. "Jack Boorman gave us a long litany of the weaknesses that have been observed in the Asian countries which have gone into crisis, leaving us with the impression that these were messed-up countries. Are these the only countries with these characteristics, and if not, how many countries have similar situations and are just very happy that no one is talking about them? It seems to me that in reality, most countries have these same weaknesses and it is just a fact of life, so it is not necessarily very useful to explain crises by these weaknesses; I think it is something deeper."

Boorman responded to Wyplosz by saying, "I don't want to give the impression that if you had only been looking at these five or six things that I mentioned, everyone would have gotten it right. In the *post mortem* phase, it is always easy to point to characteristics that turned out to be elements of weakness. Nor do I want to convey the impression that it is easy to select the other countries that are facing the same difficulties as these countries, because I don't think that these countries were fundamentally flawed. We have to think first and foremost of prevention, but prevention does not only include policy, it also includes institutions. One of the ways in which these countries failed, which led to this crisis, was the failure to have institutions that could withstand stress. It is easy for an institution to

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get through the good times. There is a temptation to relax supervision and regulation, and you allow things to go on in the market that shouldn't be going on. The lesson is that you have to play to a rather high standard. You have to insure that the institution is not just good for the next week or next month, but that the institution is going to be able to withstand a reasonable degree of pressure. How you calibrate this is a very difficult thing, but this needs to be the approach of regulators and supervisors."

Yung Chul Park said that in the case of Korea, the financial institutions were not supervised in the proper way. "The supervisory authorities did not even understand what was meant by prudential regulations. But this is understandable because prior to financial liberalisation around 1993, supervision in Korea was control and regulation oriented. During the period of deregulation, we simply lifted these regulations and a vacuum was created during the transition period. It takes a long time to put a prudential regulation system in place, and we are still struggling to establish an effective supervisory system. This is something that some of these emerging market economies may learn from the Korean experience."

Howard Brown remarked that in spite of all the controversy on the diagnosis and prescription, all of the participants would surely agree that "the commercial banks have behaved absolutely appallingly in Asia, and since there is no one here from a commercial bank, I feel pretty comfortable in making this assertion. I include the commercial banks in the emerging markets and also some of the banks from the more developed economies. Some will go further and suggest that this is *prima facie* evidence of a failure of regulation and supervision and that, therefore, we need an international supervisor or regulator which might just be the IMF taking on some extra activities in its spare time or perhaps a new institution. Stephany seems to be pointing in this direction when she plies for regulation of short-term flows in some countries. I imagine if that were to be effective, you would need to coordinate it internationally. Is there a need for an international supervisor or regulator and if so, where is it best housed?"

Rumman Faruqi also suggested the need for "greater attention for the development of a framework to deal with these investors and some of the speculation which seems to be destabilising the markets. This is an area where the BIS might be in a better position to develop those guidelines. I would be interested to know what others, especially Mr. Witteveen, think about what ought to be contained in this framework and how you could go about regulating short-term investors."

H. Johannes Witteveen responded by suggesting how international bank credit might be monitored. "I don't think we need a new supervisory institution since it is always difficult to create new institutions. We need coop-

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eration and a specific framework. In the BIS, several banks have cooperated quite well in developing common rules for capital adequacy. They could cooperate in the same way in developing certain methods for influencing the amount of short-term international bank credit – either for certain individual countries or groups of countries or even for the market as a whole. If total international liquidity increases more than a certain percentage, it creates all kinds of dangers and more room for speculation.

In the context of the BIS, with some consultation with the IMF, periodic decisions could be taken as to whether international bank credit to certain countries or groups of countries has increased more than is desirable. There should be instruments of the main central bank to discourage this, for example, by non-interest bearing reserve requirements which is very effective. If the main central banks would do this, the smaller central banks would probably have to follow. Then you would have a certain restraint from the source countries. The borrowing countries could use a similar mechanism, then international bank credit would become more expensive and would be discouraged. It would not solve all the problems, but it would be an important and logical contribution. We should not forget that we only got this dangerous phenomenon of the business cycle under control in the advanced countries because we have effective monetary policy, but we have nothing of the kind in the international economy. In the international economy, these enormous capital movements can become so powerful that they easily overwhelm the small and emerging countries. This is something that the international community should study."

Boorman said that Chile maintained effective regulations concerning borrowing by corporations. "They will only permit corporations who have a certain rating from the rating agency to borrow. Also, they will only allow minimum levels of overseas fundraising, which limits the corporations in the country who can actually access this kind of borrowing. This set of regulations applies to short-term borrowing. Whether we should take this further is difficult to answer, especially if we want to think in terms of an international organisation or regulatory/supervisory body. Country situations differ dramatically and they need to be dealt with on an individual country basis. Having said that, there is enormous scope for countries to learn from each other, and the Fund would be a good centre for information on this. There is enormous scope for other international organisations, particularly regulatory bodies, international organisations of commodity markets, IOSCO, BIS, to cooperate far more than they do and for the leading agencies in those areas to develop and propagate best practices. The Fund can help in the surveillance area as we are doing with the core principles from the BIS."

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The IMF

The discussion about creating an international institution to supervise and/or regulate capital flows led the participants to discuss the role of the IMF during the crisis in more detail. Many had suggestions as to how the IMF might respond to future crises. Kunio Saito began this part of the discussion by elaborating on the approach used by the Fund. "The Fund has often been criticised for using the same approach since the 1950s, but these days we are doing some different things as well, such as dealing with governance issues. However, then I am told that that is not what the IMF is supposed to be doing – at least that is not what they did in the 1950s. Nevertheless, that is one of the things that we began doing because it is what the international financial community wants us to do."

He then turned to the specific issue of the IMF's austerity programme. "It has been suggested that the austerity programme causes recession and bankruptcies and makes debt payments more difficult. Unfortunately, the crisis was not handled as it should have been, and it has been blown up to a scale that the region has not experienced before, with a loss of confidence on both the investment side and the consumption side. But the recession exists, with or without the IMF, and there will be a very tough economic situation for the rest of this year. Under these circumstances, Mr. Buira asks why continue the austerity programme? Why not accommodate the situation and let the Central Bank act as the lender of last resort? Why shouldn't the IMF behave in the same way and accommodate the situation? I see two problems with this. One is the policy substance. If we do this, we just address the symptom, the other adjustments do not take place, and while the recession may not be as bad and bankruptcy may be less, the basic problem is still not addressed. Unfortunately, this time around Asian countries face basic problems. Second, accommodative stances are not appreciated by the market. One example is the Indonesian budget. After the programme was approved, there was some misunderstanding in Indonesia about the announced, rather expansionary budget. The result was further deterioration in terms of the market and the rupee started to depreciate again."

Ariel Buira agreed that the crisis was not handled well. "When it is not well-handled, you have a recession, and then there is no way out. You have to apply an austerity programme and pro-cyclical fiscal policies and so forth. There is no other choice because deciding to relax fiscal policy would lead to a collapse of confidence in the viability of public finances and deepen the crisis, so on that point we agree. Should the IMF be a lender of last resort? You suggest that this would address the symptom and not the basic problem. Well, it depends on what you think the basic problem

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is. If you think the basic problem is fiscal imbalance and monetary imbalance, of course it would make no sense for the Fund to be lender of last resort. But I was careful to say that the Fund should be a lender of last resort *only* to those countries which have good policies."

Charles Wyplosz turned the discussion to the issue of IMF jurisdiction on capital account liberalisation and related it to the amount of IMF intervention. "Jack Boorman told us that there is a majority in favour of this, but I presume this is an IMF majority which is heavily weighted with a few members and which is not necessarily a majority of interested countries. I have no problem with the IMF going around the world encouraging countries to think about capital account liberalisation, provided that all of the necessary caveats are built in. What I would like to stress is that there are very different views about how to liberalise capital accounts and I have a strong fear of a single guru who decides what is good and what is bad. In other words, I am concerned that the IMF would become the first and last word on the issue, when in fact there is a tremendous amount of controversy and debate about it. I would like to have more than one authority in place so that there is a healthy debate.

Finally, what should the IMF intervention amount be? My reading of this amount is that the amounts were essentially targeted at the needs of the borrower country in the short run, and this is worrisome with regard to the moral hazard problem toward lenders. We are told that lenders lost money, but certainly they were cautioned, and these big amounts were provided to prevent them from losing money. How should we think about this question as to how much money should a country get? In the good old days, there were lots of capital account restrictions, and the IMF money was intended to deal with the current account. In fact, these things were officially measured in months-of-exports. Now, as it were by having current account capital liberalisation, we are having trouble tailoring the amount. If you tailor it to the capital account, you are not going to think in terms of months of capital accounts, probably not even in weeks. If you are going to go into debt, days or hours with fully liberalised capital accounts are important. It is difficult to know where to start and where to end, and I think this is the wrong way of thinking. In a symbolic manner, the IMF should put its money where its mouth is. The IMF should say, we have a programme, we have signed a contract on it, and we put a few hundred million here just to show that we are serious about it. If you believe that financial markets work more or less correctly, then let them do the rest. The IMF has given the stamp of approval and put some money on the line, but these huge amounts of money seem to be out of line."

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Disclosure

György Szapáry suggested that there was room for the IMF to play an important role by disclosing its views, using an approach similar to that adopted by the EMU. "The IMF could first warn the authorities about the deteriorating economic situation and suggest steps to take. If nothing has been done, say, for 3 or 4 months, the authorities would be warned again. If still nothing has been done, after another 3 or 4 months, the Fund would disclose its analysis and critical views. This is an approach that has been adopted in the stability pact by the EMU; since the European Central Bank has no authority over fiscal policy, it established a rule-based approach with a precise time-schedule for warning and disclosing. A rule-based approach to the disclosure of Fund views would be all the more helpful, since, as I observed earlier, one cannot rely on the views of the rating agencies alone. I am aware of all the arguments against disclosure of Fund views – danger of creating panic, moral hazard, etc. – but the threat of disclosure could prompt countries to act. I know that many countries do not like that idea, but it would be worthwhile to discuss and to consider it."

Rumman Faruqi suggested that one of the policy lessons drawn in Jack Boorman's paper is the need for more data requirements, increased transparency of domestic policy management and a greater role for the Fund of disclosing country policies and country risks to the market, etc. "In the case of data dissemination the Fund has set up a system for supplying more sophisticated data to the market. But I was talking to a senior member of a Western bank who told me that one item of data which should not be made public is the data on external reserves. This is because one of the risks of external reserves data is that it could be misinterpreted by the market and generate an overreaction. Also, if the reserve position is provided on a real-time basis, it could turn out to be much more destabilising in market behaviour. One of the points that we need to look at is exactly how should data dissemination be pulled together because the Fund, as well as other institutions, needs to learn how the market reacts as a result of data supplied from different sources.

As for the Fund disclosing information, there might be a great deal of resistance to this suggestion. Some of the Article IV consultations are extremely sensitive and many member governments might feel that their confidentiality was jeopardised if this information is made public. I do not know how the Fund intends to disclose this information and I would like to hear more from Jack Boorman on this issue. There is clearly a risk that if this issue is not handled carefully, it might create some problems."

Mike Kennedy mentioned that the experiments with disclosure at the Bank of England and even the Federal Reserve have been positive and

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tended to help stabilise markets. "It helps because somebody expects something to happen after the information has been disclosed. They expect certain actions to be taken. I would like for Mr. Boorman to elaborate on what happens when you disclose information through the issuance of Press Information Notices (PINs)."

Boorman said that since the PIN process was only started in May of 1997, the evidence is not yet conclusive. "In one sense, the PIN for the US was received with a yawn, for a number of reasons, probably because the US is doing quite well and, therefore, there is not much to criticise and also because there is an enormous number of respected institutions continuously commenting on the US. In New Zealand, I am told that the PIN caused a great deal of discomfort for the Finance Minister. And the PIN for South Africa, a country where there ought to be attention to this, went relatively unobserved."

Susan Phillips believed that substantial work needs to be done in order to determine what exactly should be disclosed. "Some of the solutions that were discussed by Jack Boorman and Stephany Griffith-Jones are market-based solutions, and if you believe in markets, then you want to see more market-based regulatory approaches. But even if you feel that markets have unfairly impinged on a country's sovereignty, you still have to deal with them. In any case, we always seem to come back to markets, and in order for markets to work, there must be transparency and disclosure. While we can identify this as a solution, there is an awful lot of work that needs to be done in order to figure out what should be disclosed. It is simply not that easy with some kinds of instruments. Take derivatives for example, we can all recognise that we need to know what kind of contingent claims there might be on a balance sheet or on a country, but to know exactly what ought to be disclosed is very difficult. One might argue that perhaps there should be a disclosure of the philosophy of risk management, but this is very descriptive and difficult to quantify. When you get down to quantification, some of these disclosures become very challenging. Even within the accounting profession, there is no agreement on what should be disclosed. When we say that we need more disclosure and transparency, we need to be aware that there is a lot of work to be done to identify what is meaningful. We do not serve anyone well if we do a major data dump without putting the risk exposure of a firm or country into context."

Jack Boorman agreed with Phillips on the complexity of the disclosure issue. "Right after Mexico, we got into a sort of debate with the IIF (Institute of International Finance). We started developing what became the SDDS, and the IIF began to set itself up as the institution through which disclosure would occur. But we took fundamentally different approaches. The IIF laid out 24 or so measures that they thought the

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emerging markets ought to disclose and they started publishing them. While this is good to some extent, it also leads to the problem of data dump. The approach we took was a statistical developmental approach which required quality statistics with integrity resulting from robust statistical presentation systems. In the end, I think we have won that debate. You have to start with the core and it has to be good information. But this is highly complex. Thailand presents an interesting example. We as well as various other people were looking at the problem-loan ratios in Thailand. It turned out that they were highly misleading, because there was a provision in Thai law that if any payment against overdue interest was made, the loan was taken off the problem-loan list. That is not a sensible way to portray problem loans in the banking system. So there are a lot of numbers out there, but they are not always what they first appear to be.

I disagree with Mr. Faruqi's friend who suggests that markets will not work better with more information on the real reserve position of the country. The two things that markets hate most are uncertainty and surprises. In the cases of Mexico and Thailand, there was a good dose of both, which has proved enormously damaging to these countries. The early and continuous release of information is basically intended to prevent uncertainty and surprises. It is better to have the market realise that the Thai authorities have spent 2 billion dollars in the forward market and have the market react in a disciplining fashion, than to find out two months later that the Thais have used all of their reserves in the forward market in a failed attempt to sustain the currency.

As far as the views of the Fund are concerned on disclosure, this is a difficult area and I frankly don't know where we are going to come out. There has been resistance within segments of the Board to each step that has been taken. We have gotten as far as releasing these PINs, and there is still a lot of resistance to releasing the Article IV consultation reports, although I do think it will happen. But there is a difference between the kind of thing that is going on in the EMU stability pact and what we are talking about here. There is a very simple rules-based provision under the stability pact where information about the fiscal position and so forth can be disclosed. Here we are talking about something much more complex and much more judgmental. We are talking about the risks that a country may be running because of a whole panoply of policies. That is a different proposition. As far as our relations with the country are concerned, we already have a system where we warn the countries, and I think that the message is received quite clearly. Certainly the Thai authorities were under no illusion regarding our views about the risks that they were facing. To go public with this information is problematic. This is why I think the next step will be the release of the Article IV consultations, because that is

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a routine analytic piece and people can read into it what needs to be read into it, but it's not a warning at a particular moment in time."

Park rounded off the issue of disclosure by reviewing the Korean reserve situation during the crisis. "In New York, I heard that the Korean authorities lied to Federal Reserve Chairman Greenspan and Treasury Secretary Rubin on the reserve figures. If this is true, it is inexcusable. I cannot believe that we would lie about figures to such influential individuals. About 5 or 6 people knew the amount of falling reserve holdings: the President, the Central Bank Governor, the Minister of Finance, the Deputy Prime Minister for Economic Affairs and a couple of people who were tabulating and reporting these figures. During this period, they did not want to let anyone know about the level of falling reserves until it was decided to go to the IMF. Before that, they wouldn't tell anybody. I don't know why it was such an important national secret, but it was the mentality at the time.

With regard to usable and unusable foreign reserves, there is no standard definition of foreign reserves. After we decided to go to the IMF and after we agreed on the financing package, the IMF and the Korean government agreed on the concept of usable and unusable reserves. Before that, we simply did not know the actual amount of reserves that the Central Bank was holding. Toward the end of October, I was told by the Central Bank authority that the Central Bank lending to commercial banks and other financial institutions amounted to about 50 billion dollars and that this amount of money was lent mostly on a short-term basis. Obviously the commercial banks knew that loans were from the Central Bank, so they used these loans to make long-term loans to the Korean corporations. There was this mismatch problem which resulted in a misunderstanding between the Central Bank and the commercial banks."

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