Part II

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

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Reflections on the Asian Crisis: Causes, Culprits, and Consequences

Jack Boorman

"Let us live in as small a circle as we will, we are either debtors or creditors before we have had time to look round".
Goethe

"An ounce of prevention is worth a pound of cure"
Benjamin Franklin, Franklin's Gazette, 1734

In recent weeks, many individuals and groups have started reflecting on the Asian crisis and the lessons that could be drawn from it in order to strengthen the international monetary system. The Fund has taken an active part in these discussions. This conference provides a perfect opportunity to pursue this work. This paper first considers recent developments in emerging capital markets. In light of these, it then attempts to review what went wrong in Asia. It concludes with reflections on what to do primarily to help prevent another crisis but also to improve the management of the next one – which will eventually come.

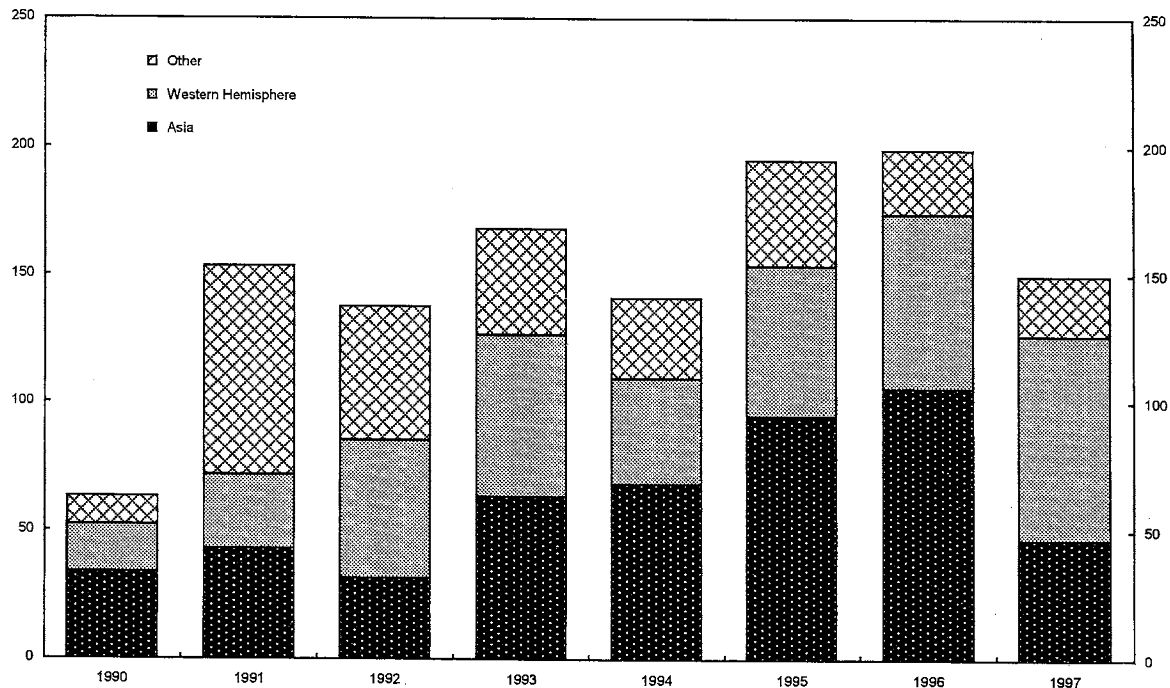
I Recent Developments in Emerging Capital Markets

Introduction

During the 1990s emerging markets' access to international capital markets improved dramatically. As demonstrated by Chart 1, private capital inflows to these countries quadrupled from around $50 billion in 1990 to almost $200 billion in 1996 before declining somewhat last year to around $150 billion. The Mexican crisis of 1994-95 had only a temporary and limited effect on the scale and geographic distribution of capital flows and the cost of external borrowing.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Chart 1 Net Private Capital Flows to Emerging Markets



Source:
World Economic Outlook Database.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Regional Composition

A larger number of countries have been able to attract these private capital flows. As an indication, the number of countries rated by international credit-rating agencies, often viewed as a prerequisite for the issuance of Eurobonds, has risen from 11 in 1989 to 49 in 1996. The regional composition of these flows continued to favour Asia and Latin America through most of this decade. Asia's share of these flows rose steadily until 1996 reaching around one half (about $100 billion). Last year this share fell to one third (just under $50 billion).

The regional distribution of private capital flows has been closely linked to the macroeconomic performance of countries in the various areas, reflecting an improved ability of investors to discriminate among countries according to the quality of policy and economic performance. Three factors were behind the general improvement in access to international markets: (i) search for higher yields by investors in mature markets caused them to move down the credit spectrum and increased demand for high-yield sovereign and corporate bonds issued by emerging market countries; (ii) institutional investors' seeking to diversify their portfolios took a sanguine view of the economic fundamentals in most emerging markets which had improved through macroeconomic stabilisation; and (iii) extensive structural reforms including the opening up of international trade and capital flows.

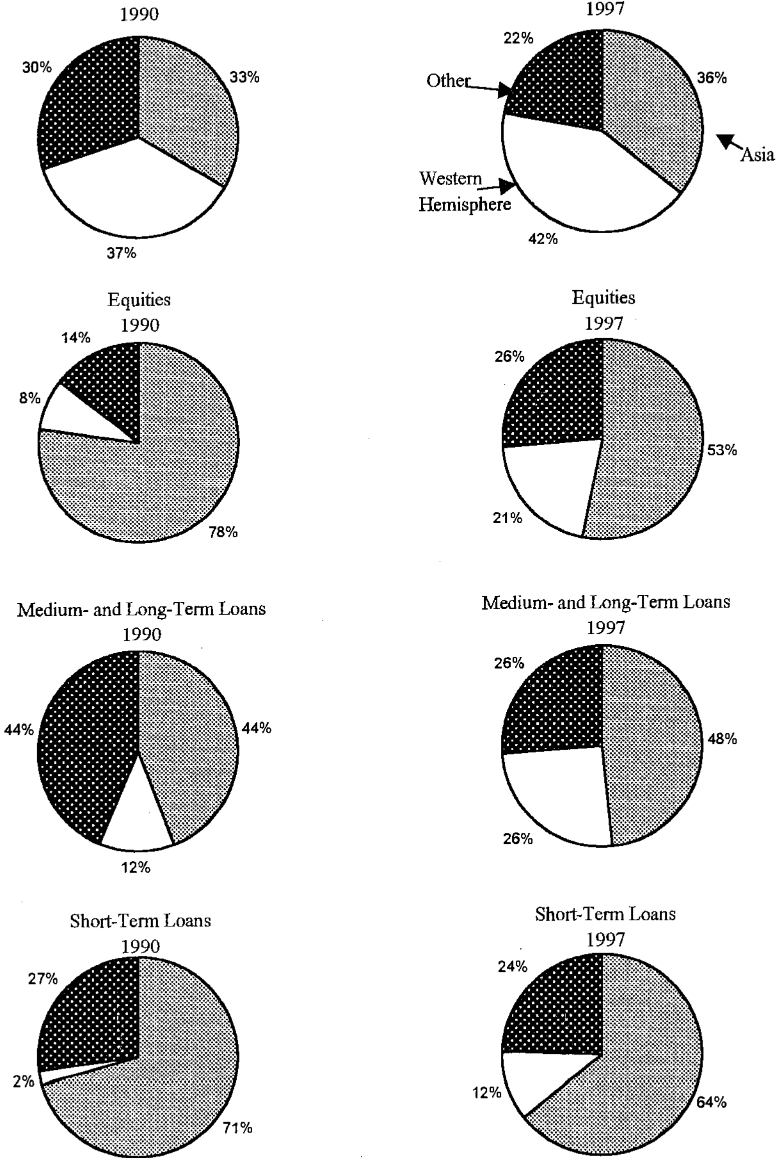
Type of Instruments

The composition of external financing by emerging markets in the 1990s was characterised by the increased reliance on bond issuance as opposed to bank loans although these remained important. However, there were some differences between Asia and Latin America. While in Latin America bonds have been the dominant instrument, in Asia bank loans continued to be the main source with a marked increase in the share of short-term loans. Inflows into equity have been relatively small with the larger share going to Asia (Chart 2).

The rise in borrowing by emerging markets reflected a general improvement in the terms and conditions under which borrowers in emerging markets could access global markets. As Chart 3 shows, yield spreads on sovereign bonds declined sharply on Latin American and European sovereign bonds from peaks reached during the Mexican crisis but rose sharply in recent months following the Asian crisis. Spreads on Asian sovereign bonds rose sharply in recent months but were hardly affected by the Mexican crisis. Moreover, the average maturity for sovereign bonds, which

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Chart 2 Private Capital Flows to Emerging Markets: Regional Shares by Type of Flows[1] (in percentages)

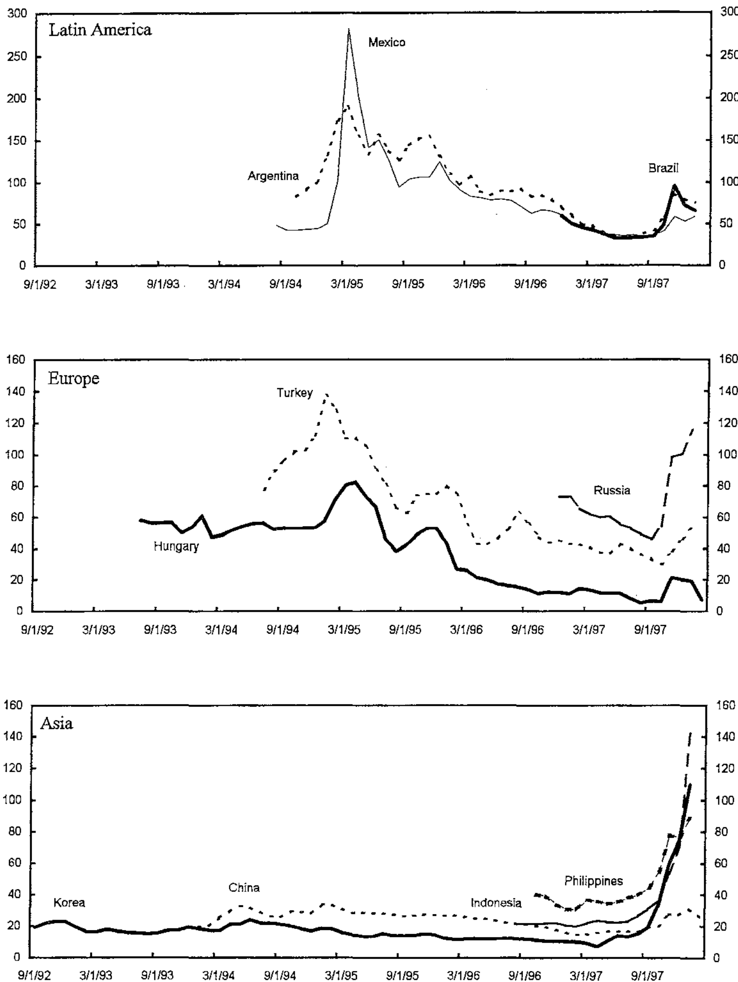


Source:
DCBEL Database.

[1] Gross primary market financing

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

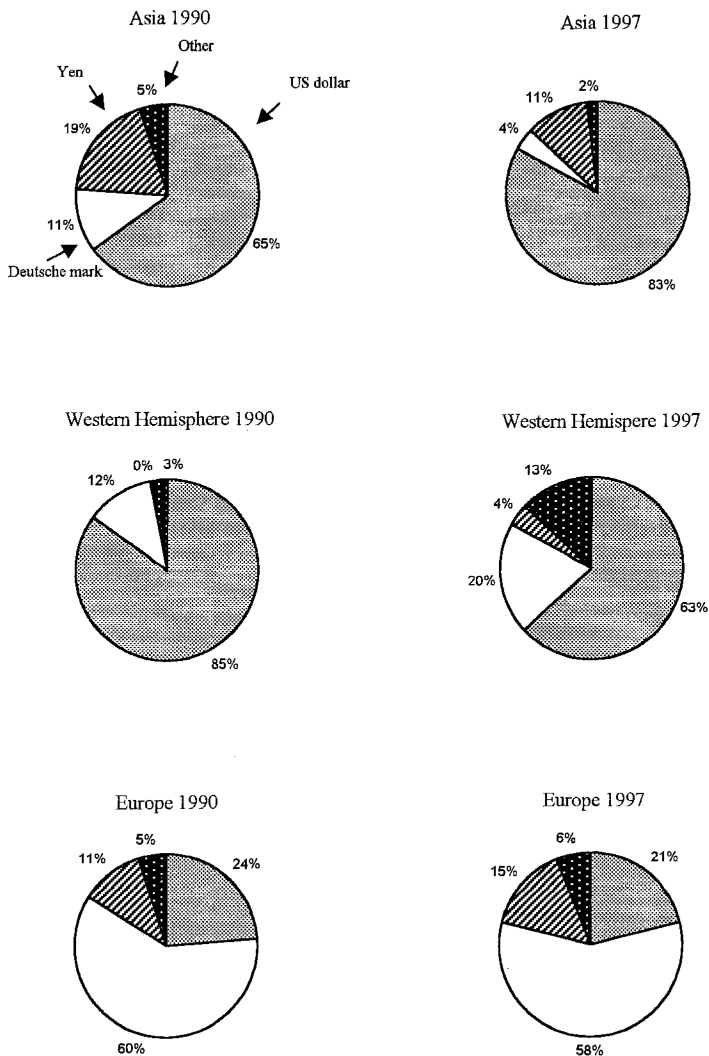
Chart 3 Secondary Market Yield Spreads on US Dollar-Denominated Eurobonds by Selected Emerging Markets[1] (in basis points)



[1] Latin America: Republic of Argentina bond due 12/03, United Mexican States bond due 9/02, and Republic of Brazil bond due 11/01.
Europe: National Bank of Hungary bond due 6/98, Republic of Turkey bond due 6/99, and Ministry of Finance Russia bond due 11/01/
Asia: People's Republic of China bond due 11/03, Republic of Indonesia bond due 5/96, Republic of Philippines bond due 10/16, and Korea Development Bank bond due 2/02.

Sources:
Bloomberg; and Reuters.

Chart 4 Emerging Market International Bond Issues by Currency of Denomination: Selected Regions[1]



Note:
[1] 1997 figures are based on data for the first quarter

Sources:
Capital Data Bondware; and IMF estimates.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

had fallen sharply in the wake of the Mexican crisis to 3.9 years, rose dramatically in 1996 to 9.8 years. At the same time, the currency composition of bond issues has changed in Asia and Latin America between 1990 and 1997 (Chart 4). In Asia the share of US dollar-denominated bond issues rose from 65% in 1990 to over 80% in 1997 at the expense of smaller shares for yen and Deutsche mark denominated issues. This probably reflected the stability of the pegs of most Asian currencies to the US dollar. The opposite was true in Latin America where the share of US dollar-denominated bond issues fell from 85% in 1990 to just over 60% in 1997 while the shares of issues denominated in yen, the Deutsche mark and other European currencies rose. In the case of European emerging market bond issues, the currency composition barely changed with about 60% being in Deutsche marks.

Derivatives

The rise in international investors' exposure to emerging markets was accompanied by the development of offshore derivative products. Derivatives enhance the ability of investors to manage the risks associated with their emerging market investments and foster arbitrage between different instruments. A noteworthy feature of these products is that they allow investors to circumvent official controls on financial transactions. One example is the over-the-counter (OTC) non-deliverable forward (NDF) foreign exchange contract, which allows investors to hedge foreign exchange risks on financial instruments of emerging market countries that have underdeveloped local forward and futures markets or rely on capital controls. The price of these contracts is linked to movements in a particular emerging market currency, but settlement is made in US dollars. The Asian segment of this market has been particularly active. Other derivative instruments include exchange-traded emerging market debt derivatives, such as futures and options on Brady bonds, emerging market index funds, OTC swaps and options on stocks, and equity derivatives.

Hedge Funds

The recent financial market turmoil in Asia drew attention to the role of institutional investors, particularly of hedge funds. Some have suggested that hedge funds precipitated the sharp movements in assets prices in Asian markets, either through the sheer volume of their own transactions or through the tendency of other market participants to follow their lead. However, little concrete information is available about the extent of hedge funds' activities. As a result, there is no consensus on the implications of

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

these activities for financial stability, much less on whether and how to adapt the regulatory framework in response. Hedge funds are eclectic investment pools that are not subject to the usual disclosure and prudential requirements that apply to, say, mutual funds, even though they engage in the same type of transactions as other institutional investors. A recent Fund study on the role of hedge funds has concluded that, despite their ability to leverage their capital, hedge funds are much smaller than other institutional investors (e.g. pension funds, mutual funds and banks) and that observers are sceptical that they precipitated the financial crisis in Asia or even played a major role in it. Indeed, the broadening of international investment vehicles, of which hedge funds are but one example, has had a positive effect on global financial markets.

II What Went Wrong in Asia?

A striking feature of the Asian crisis is that the weaknesses in affected Asian economies did not arise from the classic macroeconomic problems – excess demand, trade fueled by loose fiscal and monetary policies, resulting in high inflation and large current account deficits – which characterised the debt crisis of the 1980s. Indeed, most of the countries hit by the crisis pursued relatively sound macroeconomic policies for many years. Their fiscal positions were in surplus, inflation performance was good, and, in most cases, current account positions seemed manageable. The primary sources of difficulties instead lay in the financial and corporate sectors and the way in which capital movements were regulated.

Background

By way of background, a short sketch of the situation of each country leading up to its request to the Fund for assistance is useful.

Thailand

The macroeconomic situation in Thailand was deteriorating prior to the crisis. By 1996, the failure to dampen overheating pressures had become increasingly evident and the current account deficit reached 8% of GDP – a warning signal by any standard. The financing of an external current account deficit of this magnitude was facilitated by the opening of an important channel for short-term capital movements through the establishment of the Bangkok International Banking Facility (BIBF) in 1993. The express aim of the BIBF was to enhance the capability of Thai finan-

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

cial institutions in international lending and other international banking business, thereby reducing the cost of foreign borrowing for Thai entrepreneurs. Foreign banks were afforded two incentives for participation in the BIBF which tilted the playing field toward shorter-term financing, and away from long-term capital. First, the BIBF enjoyed various tax privileges; and second, indications that the future granting of licenses to establish banks in Thailand would be determined, inter alia, by the scale of foreign banks' participation in the BIBF. The three years following the establishment of the BIBF saw a burgeoning of the current account deficit (by some 3% of GDP), financed by short-term capital inflows. The facility allowed weak domestic financial institutions to intermediate short-term capital inflows. These institutions lacked the ability to assess and manage risks of intermediating such capital. Moreover, Thailand maintained a fixed exchange rate, and responded to overheating by tightening monetary policy, thereby putting upward pressure on domestic interest rates. This both encouraged residents to borrow in "cheap" dollars, and foreign investors to take long baht positions – the so-called carry trade.

As markets began to perceive the unsustainability of the current account deficit in the context of slowing exports and concerns about competitiveness, the exchange rate came under attack. Following speculative pressures on the baht, the authorities introduced measures restricting domestic financial institutions from undertaking certain types of transactions with foreign financial institutions, which were designed to limit speculators' ability to take short positions, as well as limiting the ability of speculators to unwind existing short positions.[1] Notwithstanding these measures, capital outflows continued. The authorities defended the exchange rate through ultimately unsustainable intervention in the forward market. (By mid-July the forward/swap obligations amounted to about $28 billion compared to spot reserves of $31 billion.) In the face of persistent outflows, on July 2, 1997, Thailand abandoned its exchange rate peg and allowed the baht to float. Later in July, the Thai authorities asked the Fund for help – but only when their net foreign exchange reserves were nearly depleted as a result of attempts to defend the exchange rate.

1 These included: a temporary limit on baht lending to nonresidents through foreign exchange swap and other transactions in order to prevent the build-up of baht positions on the offshore market; limit on outright forward transactions with and selling baht against foreign currencies to nonresidents; and, daily reporting requirements on foreign exchange transactions with nonresidents.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Indonesia

The turmoil in Thailand soon spilled over to Indonesia and the rupiah fell sharply on July 27. While the macroeconomic imbalances in Indonesia were not as pronounced as in Thailand, the economy suffered from deep rooted structural problems. Trade restrictions, import monopolies, and regulations impeded economic efficiency and competitiveness, and also reduced the quality and productivity of investment. Indonesia's regulations regarding capital account transactions were quite liberal. The system permitted a broad range of money market and credit transactions between residents and nonresidents. In particular, it allowed resident entities, especially nonbank private sector companies, unrestricted offshore borrowing from nonresidents. In contrast to Korea and Thailand, Indonesia's external debt difficulties are concentrated in the corporate sector, rather than the banking sector. Indonesian corporations became overexposed, particularly at the shorter maturities. These difficulties did not stem from the structure of exchange controls. Rather, it reflected an inability – or unwillingness – of the domestic banking system to exert discipline over corporations' financial structure, and a willingness of the foreign creditors to extend short-term credits, notwithstanding the structure of corporations' liabilities. As a result the corporate sector in Indonesia accumulated sizable external liabilities denominated in foreign exchange.

As in Thailand, the banking system was weak. Nonperforming loans accounted for almost 14% of total loans at state-owned banks at end-June 1997, and a number of insolvent institutions continued to exist with central bank subsidies.

Following the fall of the rupiah at the end of July, measures to tighten liquidity conditions failed to stem the growing exchange market pressures, and the authorities allowed the rupiah to float on August 14. In late September, after a period of relative stability, the rupiah depreciated sharply, triggered by Indonesian banks buying foreign exchange to cover their imprudent exposure to exchange rate risk in the form of options. This led Indonesia to ask the Fund for help in early October 1997.

Korea

A cyclical slowdown in economic growth in Korea and emergence of financial difficulties in key corporate conglomerates *(chaebols)*, which reflected overinvestment in projects that were not able to earn adequate rates of return, created pressures in the financial sector in 1997. Non-performing loans grew rapidly and banks' spontaneous access to international capital markets shrank, and came to an abrupt halt in November. The difficulties

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

in the financial sector reflected a combination of factors. Exchange controls limited the ability of corporations to access foreign savings directly. Instead, the controls forced corporations to access international capital markets through capital intermediation by banks. As a result, the *chaebols* became heavily dependent on debt intermediated by Korean financial institutions. Corporate entities, many of which were pursuing unwise expansion strategies in the context of weak corporate governance, fell into difficulties and were kept afloat by further extension of credits. The management and supervisory and regulatory authorities paid little attention to the analysis and containment of risks.

Against this background, the downward pressures on the Korean currency intensified in the last week of October, and equity prices fell sharply, reflecting diminished confidence about prospects for an orderly workout of corporate debt problems and the growing difficulties encountered by the financial sector in rolling over external loans. After intervening heavily to defend the currency, the authorities allowed the currency to float in late November and asked for Fund help – again, only after they had virtually exhausted their reserves.

Financial Sector Flaws

In all three countries, weaknesses in the financial sector lay at the heart of the crisis. In particular, these weaknesses included: limited capacity of financial institutions to assess and manage risks and inadequate prudential supervision in the context of Thailand and Korea of regulations encouraging intermediation of short-term capital inflows by weak financial institutions. These deficiencies were a recipe for disaster reminiscent of the Mexican crisis of only a few years earlier.

Weak Risk Management

The limited capacity of financial institutions to assess and manage risks engendered imprudent and improper decisionmaking. Borrowing was used to finance unsound investments and projects, many of which were unable to earn a satisfactory rate of return. As a result, the quality of bank assets deteriorated sharply, ultimately leading to the loss of market confidence that helped spark the crisis. Poor risk management led to mis-matches of maturities and exchange rate risk, causing a fundamentally unstable financial structure, with unhedged positions and a concentration of liabilities at the short end of the maturity spectrum.

Foreign players in these markets also failed to anticipate the problems. Many of them were operating in Asia on the basis of little information,

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

wishing not to miss out on the boom but without appreciating the risks. When the problems in Thailand became evident, they began asking tough questions about the vulnerability of other economies in the region. This is part of what has been referred to as "contagion".

Some institutions were simply unwilling or unable to assess the risks they were taking. The case of Korea provides a glaring example, where a number of off-shore institutions (guaranteed by domestic Korean banks) took highly leveraged bets on exchange rate movements in ASEAN currencies. When these deals went bad due to the fall in exchange rates, such investors seemed genuinely surprised at the magnitudes of the losses they incurred.

Inadequate Prudential Supervision

Regulators did not require financial institutions to analyse the risks of on- and off-balance sheet items and paid little attentions to lending and trading strategies, and liquidity management. Indeed misguided regulation – notably in Korea – forced transactions off-shore and off-balance sheet, where enormous risks could escape from the limited capabilities of the supervisors – almost to the point where the attitude of investors seemed to be: "If we can't have our casino close to home, we'll play elsewhere." At the same time, corruption and conflict of interest pervaded the regulatory systems in all three countries. Cozy relations between companies, banks, and supervisors encouraged a rolling-over of debts long after the bank should have foreclosed. And these problems were obviously exacerbated where loans were extended to companies owned by well connected individuals. Finally, poor regulatory standards meant that some banks – notably in Thailand – could show loans on their books as performing, when this was untrue by any reasonable measure.

In the case of Korea, the regulatory framework provided incentives for short-term flows through the banking system, further increasing the vulnerability of the system. Exchange controls limited the ability of nonresidents to purchase equities and bonds issued by Korean corporations, and residents' ability to borrow directly from international markets. As a result, the *chaebols* became heavily dependent on debt intermediated by Korean financial institutions. In addition, lack of competition from well managed international financial institutions perpetuated the weaknesses in the financial system. As noted earlier, Thailand tilted the playing field toward short-term flows channelled through the BIBF.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Additional Factors

Beyond the financial sector, but related to it, additional factors were at play.

Public Sector Support to the Corporate Sector

In a number of instances, public sector support to ailing corporations or implicit guarantees of support in case of need compounded difficulties. In some cases, corporate entities, which were pursuing unwise expansion strategies in a climate of weak corporate governance, were kept afloat by further extensions of credit at the behest of the government. This allowed them to further deteriorate their balance sheet and that of the lending financial institutions. In others, as Paul Krugman recently argued, financial institutions in the region were able to operate with an implicit guarantee.[2] Banks could raise capital at home and abroad. These liabilities then financed highly speculative investments with a payoff expectation of: "Heads I win, tails somebody else loses." This behaviour fueled a speculative boom, making the financial situation that much more precarious.

Exchange Rate Policy

An important factor in the overall picture was historically fixed exchange rates which engendered expectations of continued exchange rate stability and lulled investors into complacency. To some extent, the complacency seemed warranted, given the strong macroeconomic performance that underpinned those expectations.

Investors' Behaviour

On the part of investors, the search for higher yields led to excessive risk-taking. This behaviour may have been more pronounced in Japan where a sluggish economy and unresolved problems in the financial sector may have encouraged imprudence in the search for investment opportunities. In the case of Korea, for example, the search for higher yields by domestic investors led to behaviour tantamount to gambling: unhedged borrowing in yen to lend in rupiah, with an expectation of capitalising on the higher yields in rupiah.

2 See *What happened to Asia?* on P. Krugman's website.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

III What Needs to Be Done?

Prevention is better than cure. This principle has been a driving force behind both the reflections on reform of the international monetary system in the wake of the Asian crisis and the work of the Fund, which has always put surveillance at the core of its activities. Accordingly, most of this section of the paper is devoted to crisis prevention. A variety of issues will be considered. On each of these topics, both reforms that could be undertaken by many different actors and avenues for strengthening Fund surveillance are addressed. No system of crisis prevention will ever be foolproof of course. This section therefore also considers improved mechanisms of crisis management.

Crisis Prevention

Part I of this paper described how capital flows have evolved during the past decade, not only in volume but also in composition and how capital markets have gained in sophistication, including through widespread use of derivative products. Part II analysed causes of the Asian crisis, including the surge in capital inflows to many Asian countries in the 1990s and their recent abrupt drying-up, the central role of banking systems in intermediating these flows, weaknesses in regulatory and supervisory frameworks, and macroeconomic policy inadequacies. Combining these elements, improving the functioning of the international monetary system, and the Fund's surveillance over it, could centre on five elements: improving information provision to market participants, increasing the transparency of economic policies, facilitating the dissemination of Fund's views of members' policies, strengthening financial systems, and promoting orderly capital account liberalisation.

Data Provision

Comprehensive, accurate and up-to-date data are essential ingredients of sound decisionmaking by both private market participants and public entities. With hindsight, the Asian crisis revealed that the data known to market participants – and sometimes to the Fund – regarding foreign exchange reserves and short-term indebtedness, as well as comprehensive information on the health of the financial system of certain countries, suffered from severe deficiencies. When the facts finally came to light (as they always do): market reactions were severe, and they endured when skepticism about official statistical information contributed to difficulties

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

in re-establishing market confidence. Improving data provision to the public therefore is crucial. In some instances, this requires significant modifications to statistical systems, and in others improved dissemination of existing data.

Improving Statistical Systems

With the furious pace of innovations in international financial relations, statisticians face a formidable task when attempting to develop comprehensive, timely and accurate statistics for countries' international investment positions. A number of sources, including the BIS, the OECD, the World Bank, and private companies, report data on external indebtedness. Many countries compile data on debt liabilities through a domestic or external liability registration or surveying process. Monetary survey data and commercial banks' financial statements can also provide data on foreign liabilities of the banking sector. However, all these sources suffer from weaknesses, due to limitations in coverage or lack of completeness stemming from the absence of a comprehensive reporting requirement. Even the use of all these sources together may fail to give a complete picture of a country or a sector's external liabilities. This is particularly true for short-term liabilities.

Statistical improvements are thus needed. It must be recognised that this is bound to be a complex and lengthy task. The existence of complex relations between on-shore and off-shore institutions (e.g. foreign subsidiaries of domestic firms), the development of off-balance sheet transactions such as swaps, forward contracts, and options, and difficulties in the classification of certain instruments in domestic or foreign debt, all present very real obstacles to deriving a true picture of a country's international investment position. Nevertheless, efforts must be made to overcome this obstacle. In the first instance we should focus on short-term debt given its volatility and its role in the Asian crisis, and the IMF has started a process aimed – in the first instance – at identifying gaps in the coverage of available data and at offering recommendations for better reconciliation of existing data sources and improved data compilation.

Enhancing Data Dissemination

Regular and timely data dissemination of a wide array of economic statistics is not only beneficial to market participants but also in the best interests of national authorities. Indeed, rapid publication of accurate data in both good and bad times is for governments one of the best protections against the false hope that current difficulties will miraculously vanish and that corrective measures can be safely postponed.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

This lesson, which emerged from the analysis of the Mexican crisis, led the IMF to launch in 1996 the Special Data Dissemination Standard (SDDS) and to establish and maintain an associated Dissemination Standard Bulletin Board (DSBB) on the IMF's website (www.imf.org). The SDDS specifies coverage, periodicity and timeliness for 17 data categories of macroeconomic statistics, along with advance release calendars and other aspects of data access, integrity and quality. The DSBB was conceived as the location to identify members subscribing to the SDDS and as a convenient source for access to countries' information about their statistical practices (metadata). In addition, the DSBB eventually became a location for access to some subscribers' national data. At present, 43 Fund members subscribe to the SDDS, 37 of them have their metadata posted on the DSBB, and 12 of these have hyperlinks from the DSBB to national internet data sites. The SDDS is in a transitional period until the end of 1998, by which time subscribers should be in full compliance with the standard.

The IMF is presently considering ways in which the SDDS could be strengthened. In particular, the sequence of events leading to the Thai and Korean crises suggests extending the SDDS to cover foreign exchange reserve liabilities (including off-balance-sheet transactions such as forward contracts and other financial derivatives), private external debt, and indicators of financial sector soundness (so-called macro-prudential indicators). Of these three elements, inclusion of foreign exchange reserve liabilities in the standard is perhaps the one presenting the least technical difficulties. As discussed above, coverage of private external debt, including short-term debt, may require significant new data compilation efforts. Definition and inclusion of some macro-prudential indicators, such as data on sectoral concentration of lending and the maturity structure of assets and liabilities, may possibly be derived from existing analytical accounts of the banking sector and other bank supervisory data. However, derivation of other key prudential ratios would appear to depend critically on national rules for asset classification, valuation, and provisioning. Their eventual inclusion in the SDDS might thus be dependent upon a prior major international effort to establish commonly accepted bank accounting standards, including rules for loan classification and provisioning.

Policy Transparency

Beyond good data, sound judgment on investment and other economic decisions require a clear understanding of the design and conduct of national economic policies. Policy transparency can help avoid shocks provoked by abrupt changes in private agents' behaviour caused by unantici-

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

pated policy changes. It can also increase policy credibility, with for instance positive consequences on the climate for long-term productive investment.

In the past decade, numerous initiatives have been implemented in different countries to improve policy transparency. Some of these initiatives concerned monetary policy: a number of industrial countries clarified the central objective of their central bank (maintenance of price stability or achievement of a public inflation target), while providing it with a framework conducive to fulfilment of its objective – e.g. by granting the central bank operational independence. Others pertained to fiscal policy, such as New Zealand's adoption of the pioneering Fiscal Responsibility Act of 1994. The outcome of these initiatives suggests that transparency in fiscal and monetary operations – defined as public openness in government institutions, fiscal and monetary policy intentions, public sector accounts, indicators and forecasts – can indeed contribute to macroeconomic stability, allocative efficiency, and fairness, increase confidence in a government's economic policies, and thus limit the risk of financial market shocks.

In the fiscal sphere, a recent review points to the importance of a number of sound practices, which might be considered possible elements of an eventual code of fiscal conduct.[3] Examples of such practices are: a clear demarcation between the public and private sectors, publication and quantification of the extent of government intervention in areas such as support to banks and enterprises, information on the costs of any quasi-fiscal activities of state-owned financial institutions and non-financial enterprises, public disclosure of budget documents, open procurement and hiring practices, audits of budget operations subject to public scrutiny, no recourse to discretionary tax concessions or negotiated tax liabilities, and fiscal accounts covering the entire general government.

Dissemination of Fund Views

The Fund may also be in a position to improve information about members' policies by making known its views on them – and, perhaps, in so doing creating increased incentives for appropriate changes, when necessary. When approaching this issue, the Fund has been mindful of two widely shared considerations: first, increasing the transparency of IMF policy assessments may be a powerful means to strengthen the effectiveness of surveillance; second, dissemination of information must not come at the

3 See G. Kopits and J. Graig (1998), *Transparency in Government Operations*, Occasional Paper No. 158, IMF, Washington D.C., January.

detriment of the quality of the policy dialogue between the Fund and its members, including the candid exchanges that take place in the context of the IMF's main vehicle for bilateral surveillance known as the Article IV consultation process.[4]

Balancing these two factors, the Fund had traditionally made public the results of its multilateral surveillance exercises, the bi-annual *World Economic Outlook* and *International Capital Markets* reports, and disseminated a vast amount of applied research. In April 1997, considering the general trend toward increased openness in a number of member countries – including through the release of concluding statements and joint press conferences following Article IV consultations – the Fund's Executive Board decided to go a step further. It agreed to the issuance of Press Information Notices (PINs) on a voluntary basis, following the conclusion of Article IV consultations, for member countries seeking to make known the views of the IMF to the public. PINs are typically 4 to 5 pages long: they contain a background section with factual information and the Fund's assessment of the member country's economic prospects and policies, as reflected in the IMF Executive Board's discussion of the Article IV consultation. Since the inception of this policy, Article IV consultations have been concluded with roughly 110 member countries. Approximately half of them have elected to have the Fund issue a PIN.

Is it desirable to go still further? The general issue of transparency of Fund advice clearly remains alive, especially in the wake of the Thai experience where repeated confidential warnings of impending serious difficulties went unheeded. It has been pointed out that the Fund's Articles of Agreement contains a provision stipulating that, by a qualified majority of votes in the Executive Board, the Fund may "decide to publish a report made to a member regarding its monetary or economic conditions and developments which directly tend to produce a serious disequilibrium in

4. Article IV refers to Article IV in the Fund's Article of Agreements. This article is the one that enshrines the Fund's surveillance responsibilities. Specifically, it states in part that "each member shall: (i) endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances; (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does note tend to produce erratic disruptions; (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and (iv) follow exchange policies compatible with [these] undertakings" and that "the Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with [these] obligations".

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

the international balance of payments of members.[5] It should be noted that this provision has never been used, perhaps because the Fund has been concerned that involuntary dissemination of views based on confidential information provided by a member would have serious long-term consequences on the quality of the dialogue with its members.

Overall, while it is difficult to predict the evolution of the balance of arguments between the benefits of transparency and those of confidentiality, one would expect that more and more countries would on their own come to value the benefits of regularly providing to market participants the Fund's assessment of their policies.

Financial Systems

In a large number of countries, long-simmering financial system weaknesses have at one time or another severely affected macroeconomic developments. The Asian crisis is, in this respect, only the latest manifestation of an often repeated pattern. This consideration has led numerous international bodies to consider how financial systems could be strengthened. In April 1997, the G-10 published a report on financial stability in emerging market economies. In September of the same year, the Basle Committee on Banking Supervision issued its Core Principles for Effective Banking Supervision. In January 1998, the IMF produced a document entitled Toward a Framework for Financial Stability. Other institutions, including the World Bank, have also been active in this area.[6] All these efforts of course built upon the extensive work done by the BIS for a number of years, which resulted for instance in the 1988 Basle Capital Adequacy Accord and the subsequent Market Risk Amendment.

Principles for Sound Banking and Financial Systems

These various endeavours have helped identify key elements of sound banking and financial systems. These elements include: a legal environment conducive to the full enforcement of contracts, including effective bankruptcy procedures; internationally accepted accounting principles; robust payment and settlement arrangements; demanding standards for

5 Article XII, Section 8, of the Articles of Agreement of the International Monetary Fund.

6 See Group of Ten (1997), *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems*, BIS, April (available on the BIS website); Basle Committee on Banking Supervision (1997), *Core Principles for Effective Banking Supervision*, BIS, September; IMF (1998), *Toward a Framework for Financial Stability*, International Monetary Fund, Washington, D.C., January.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

disclosure of key financial information; effective systems of risk control; adequate capital requirements; a structure of ownership of financial institutions conducive to strict stakeholder oversight; openness in banking and financial markets, within essential prudential safeguards; competent management; deposit insurance arrangements, lender-of-last-resort facilities, and exit policies conducive to the preservation of stakeholders' incentives to exercise oversight and act prudently; independent but accountable supervisory and regulatory authorities; sufficient supervisory powers, including powers to issue and withdraw licenses, request and verify relevant data, conduct on-site inspection, restrain unsound practices, and force the exit of financial institutions; and international cooperation and coordination of national supervisory authorities.

In addition, these efforts highlighted that development of a set of sound principles and practices in a variety of domains could significantly contribute to the strengthening of financial systems. This set prominently encompasses international, high-quality accounting and financial reporting standards, which would ensure that information contained in financial statements of both non-financial enterprises and financial institutions is accurate, timely, comprehensive, and comparable across countries.

Financial Sector Surveillance

The Fund's role in financial sector issues stems from its responsibilities in promoting sound macroeconomic policies and the potential impact of banking crises on the macroeconomic environment. It stems also from the near-universal membership of the IMF, which makes it very well placed to disseminate standards and best practices for use in the financial sector, such as the Core Principles for Effective Banking Supervision recently developed by the Basle Committee on Banking Supervision. These considerations had led the Interim Committee of the Board of Governors of the Fund to call for greater attention to financial sector and capital account developments in the aftermath of the Mexican crisis.[7] Recent events in Asia confirm the merits of that call.

With limited resources, the Fund's attention to financial sector issues will have to be selective and its focus put on the identification of problems that have a potentially significant macroeconomic impact. A full assessment of the health of individual financial institutions or the certification of

7 See "IMF Updates Surveillance over Members Economic Policies," In: *IMF Survey*, April 21, 1997; and *Communiqué of the Interim Committee of the Board of Governors of the IMF*, April 28, 1997 (both documents available on the IMF website).

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

the overall soundness of financial systems go beyond the scope of Fund surveillance. Rather, Fund surveillance should aim at probing vulnerabilities in financial systems and at increasing the awareness of their potential consequences. Such an assessment could be facilitated by the examination or development of bank soundness indicators in key areas, such as foreign-exchange exposure of financial institutions, sectoral credit concentration, exposure to large holdings of securities, and the share of resources obtained from the central bank. It could also encompass examination of aspects of the institutional, legislative, supervisory and prudential regulation frameworks that could entail risks for the soundness of the financial system. In cases of widespread problems in the financial system necessitating major restructuring, Fund involvement would likely be addressed in the context of a programme supported by the use of Fund resources, in close collaboration with the World Bank – which would be expected to have primary responsibility over banking system restructuring – and possibly other multilateral institutions.

Even with this limited agenda, adequate conduct of financial sector surveillance will require devotion by the Fund of a substantial amount of staff resources. It will also require upgrading the skills of Fund staff in financial sector issues.

Capital Account Liberalisation

Capital account liberalisation can be greatly beneficial to countries that undertake it and, overall, to the international economy. It can broaden the means to finance trade and investment in recipient countries and thus boost investment and growth. It can provide investors with increased opportunities for portfolio diversification and achievement of higher risk-adjusted rates of returns. It can provide access to sophisticated technology in financial intermediation and make domestic financial systems more efficient. At the same time, it carries well-known risks if, for instance, macroeconomic conditions are not adequate or liberalisation is not appropriately coupled with a strengthening of the domestic financial system. A proper objective is thus the promotion of orderly capital account liberalisation.[8]

Recent events in Asia reinforce these conclusions, as they provide examples of difficulties created by both disorderly capital account liberalisation

8 For detailed discussions of these issues and of the future role of the Fund, see *The Role of the IMF: Past, Present, and Future*, Remarks by Michel Camdessus at the Annual Meeting of the Bretton Woods Committee, Washington, D.C., February 13, 1998; and *Capital Account Liberalisation and the Role of the IMF*, Remarks by Stanley Fischer at the seminar on Asia and the IMF, Hong Kong, September 19, 1997 (both available on the IMF website).

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

and insufficient capital account liberalisation. As discussed in Section II, in Thailand, free capital flows coupled with weak financial institutions and ineffectual banking supervision can be seen to have led to excessive short term borrowing from abroad and easy financing of risky long-term projects and speculative activities – in the context of rapidly rising domestic asset prices. In Korea, exchange controls forced corporations to access international capital markets through banks. As a result, large corporate conglomerates became heavily dependent on debt intermediated or guaranteed by Korean financial institutions. In addition, these institutions' short term debt rapidly grew, as a substantial share of their resources came from borrowing from international banks and as this type of interbank financing is usually provided at short maturities. Thus, the financial structure of both non-financial and financial corporations came to suffer from severe weaknesses.

Given its mandate and its nearly-universal membership, the Fund is uniquely placed to play a central role in efforts to promote orderly capital account liberalisation. As a matter of fact, it is already actively supporting members' efforts toward liberalisation. The Interim Committee of the Board of Governors of the IMF considered that an amendment to the Fund's Articles of Agreement would provide the Fund with the most effective means to fulfill this role.[9] Such an amendment would make the promotion of capital account operation a specific purpose of the IMF and extend, as needed, the Fund's jurisdiction through the establishment of carefully defined and consistently applied obligations regarding the liberalisation of such movements. With the use of safeguards and transitional arrangements, it would allow the IMF to encourage the liberalisation of capital flows while paying due regard to the varying circumstances of member countries.

At a recent IMF-sponsored seminar in Washington, there was a wide consensus on the benefits of capital account liberalisation. At the same, many participants cautioned that the pace and sequencing of liberalisation had to be carefully adapted to the specific circumstances of each country, including their macroeconomic situation and financial system structure.

Crisis Management

While stringent efforts should be made to reduce the likelihood of crises, it

9 See *Communiqué of the Interim Committee of the Board of Governors of the IMF*, April 29, 1997; *Communiqué of the Interim Committee of the Board of Governors of the IMF*, September 21, 1997; and *The Interim Committee Statement on The Liberalization of Capital Movements Under an Amendment of the IMFs Articles*, September 21, 1997 (all documents available on the IMF website).

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

is certain that no system can guarantee that future crises will not happen. Thus, we need to extend our reflection to how financial crises should be managed. This section considers first the role of the Fund and of other official creditors during crises. It then turns to the involvement of the private sector in the resolution of crises.

Role of the IMF and of Other Official Creditors

Since the Bretton Woods conference, the general rationale for IMF financial support to members is enshrined in Article I(v) of the Articles of Agreement, which reads: "[The purposes of the Fund are:] To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." This rationale remains as valid today as it was more than fifty years ago.[10]

Put differently, the provision of financial resources by the IMF conditional on the implementation of a strong programme of economic policies remains an essential part of crisis management: prompt implementation of corrective policy measures by the affected member(s) is a key to mitigating the impact of a crisis and limiting contagion effects; and supply of adequate financial resources is essential to ensure balance of payment financing while corrective measures take effect and private sector confidence is being re-established. Thus, the IMF retains a central role in crisis management. To fulfill this role, it is clearly essential that the IMF dispose of sufficient financial resources.

Other international financial institutions and bilateral official creditors are also likely to play important roles in financial crisis management. The size and volatility of private international capital flows increase the probability that, in the event of a crisis, financing needs may be substantial. Therefore, as seen recently, provision of sufficient financial resources may require contributions from a number of official multilateral and bilateral sources. In addition, with high probability, a crisis will reflect structural weaknesses as well, requiring not only adjustment to macroeconomic policies but also structural reforms. International financial institutions with expertise in the relevant structural issues would thus be expected to be

10 For a detailed discussion of the rationale for IMF financial support, see P. Masson and M. Mussa (1995), *The Role of the IMF: Financing and Its Interaction with Adjustment and Surveillance*, IMF Pamphlet Series No. 50, IMF, Washington, D.C.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

closely associated with the design of the programme of remedial policies.

Beside support from a strong reform programme, success of financial rescue packages depends to a crucial extent on their ability to restore private sector confidence. This cannot be obtained when doubts exist about policy direction and rumours abound. Thus, perhaps more than at any times, policy decisions have to be fully transparent in times of crises. Publication of letters of intent, describing the authorities' policy commitments vis-à-vis the Fund and the international community, is one way to achieve this goal. Immediate improvements in the quality, comprehensiveness or timeliness of economic data provision is another.

Involvement of the Private Sector

Provision of official financial assistance in a crisis must not lead market participants to downplay the risk of investing in one country or another: private sector borrowers must face appropriate incentives, which entail that they should appropriately share the profits and losses resulting from their decisions. Limiting moral hazard stemming from official intervention in financial crises requires that the private sector be involved in the resolution of crises.

The globalisation of international financial markets, the switch away from syndicated bank lending toward sovereign bond issues, and the lack of modern experience with participation of bondholders in the management of sovereign liquidity crises have raised concerns that crisis management procedures developed in the 1980s may no longer be fully adequate. In particular, there is a risk of a disorderly sovereign bond default stemming from aggressive creditor litigation, if a sovereign were to face severe liquidity difficulties. Such a disorderly default would make resolution of the crisis, including adoption of a strong adjustment programme and provision of new financing, that much more difficult.

This prospect, which has been given serious consideration by both the G-10 and the IMF, has led to reflections along three lines: introduction of new legal provisions in sovereign bond contracts, establishment of an international bankruptcy court, and allowance of IMF-sanctioned temporary debt standstills.[11] All three types of proposal have appeals and drawbacks. Introduction of clauses in bond contracts on sharing, qualified majority voting, and bondholder representation could facilitate orderly

11 For the G-10 analysis of this issue, done in the aftermath of the Mexican crisis, see Group of Ten (1996), *The Resolution of Sovereign Liquidity Crises*, May (available on the BIS website).

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

renegotiation in case of necessity. However, it would only apply to new bonds and not to the large existing stock of bonds. The appeal of an international bankruptcy court is in the parallel with national bankruptcy procedures: such a court might be able to prevent a race to seize assets while a country is given breathing space to "restructure". However, this analogy is not perfect: sovereigns cannot be sanctioned as corporate management can be for past inappropriate policies; thus, moral hazard on the debtors' part could be high. In addition, variations in national bankruptcy procedures might make it very difficult to agree on a single international code. Finally, IMF-sanctioned debt standstills could contribute to crisis resolution: it might facilitate provision of conditional financing from the Fund and catalyse resources from other sources. However, care should be taken that the possible imposition of standstills does not affect the efficiency of capital markets and create incentives for excessive borrowing on the debtors' side.

After initial consideration, establishment of an international bankruptcy mechanism has received little support. Conversely, while substantial questions remain to be worked out, further work on the other two proposals – new legal clauses in bond contracts, and IMF-sanctioned temporary debt standstills – would appear worthwhile.

Two Final Thoughts

In conclusion, let me return with two thoughts on crisis prevention and, specifically, on Fund surveillance.

The earlier discussion of crisis prevention highlighted the benefits that could be gained from dissemination of various standards and codes, such as the Basle Core Principles for Effective Banking Supervision, international accounting and disclosure standards, and an international fiscal code of conduct. As outlined above, much work remains to be done in these areas, and achieving international agreement may be far way off in some cases. However, looking ahead, one might expect the Fund to play an increasingly important role in encouraging members to adopt internationally-agreed standards and, in its areas of expertise, monitor compliance with those standards.

Events in some Asian countries have reminded us that for surveillance be effective governments must be willing to pay due attention to its warnings and recommendations. To strengthen the effectiveness of surveillance, cooperation between regional fora and the Fund might be enhanced. While the Fund has unique responsibilities in surveillance, regional fora have an inherent interest in effective surveillance over economic policies in their region, given the risks of contagion, and a unique perspective stemming from in-depth knowledge of local conditions. There would thus

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

appear to be natural opportunities for cooperation between the Fund and regional fora. In particular, regional fora may be in a position to apply appropriate peer pressure to help implement recommended policy changes.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Comment on "Reflections on the Asian Crisis: Causes, Culprits and Consequences," by Jack Boorman

Stephany Griffith-Jones

This is a very good paper which has a lot of interesting and valuable information on the domestic causes of the crisis, the differences between the countries, and the role of derivatives. I want to complement and develop points, rather than necessarily argue with Jack's paper.

At first, a general point is that people who have in the past criticised institutions like the IMF, should consider that there are too many difficult issues out there that need to be resolved. I think that we all need to work together as the world has become so complex – among other things, because of the globalisation of capital markets – that the simple black and white solutions don't really work anymore. The paper's emphasis is on domestic financial imperfections, but what doesn't come out so strongly in the paper, although it did much more in the presentation, is the emphasis on imperfections in the international capital markets. What Greenspan has called these "visceral engulfing fears" that shake markets are a deeply worrying trend. The fact is that these imperfections in the financial sectors, both domestic and international, have undermined the extremely dynamic and strong economies in Asia. I think that the most worrying thing about the Asian crisis, and previously about the Mexican crisis, is that these imperfections in capital markets seem to be strongest for economies that either are, or are perceived to be, highly successful. Mexico was supposed to be the most successful reformer in Latin American, the Czech Republic was supposed to be the most successful reformer in Central Europe, and the same was said about the Asian tigers. It's a sort of curse of the successful economies, curse of the successful reformers, and we see this pattern again and again, as Charles Wyplosz shows in his paper.

The pattern you see is when economies are successful, the capital flows in, eased by capital account liberalisation. Then exchange rates get overvalued, or overvalued exchange rates get sustained, and the prices of key assets like land, buildings and shares increase sharply. As a result of increased real incomes and perceived wealth effects, individuals increase consumption and companies increase investment. Banks, of course, are also contributing to this process because they are intermediating these capital

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

flows. Inevitably the current account deteriorates. Initially this doesn't seem to matter because everybody is loving this country so much that they continue pouring money into it. However, at some point there is a change – it can either be big or small, economic or political, domestic or international – which triggers a very large change in perception, even though the change in the real economy, may actually be far smaller. Then there is this massive outflux. None of us knows how to fully deal with this extremely complex issue, but I think that we have to see what can be done to prevent this from happening. Also, to prevent the problem that I think is a little bit underplayed in Jack's paper, the problem of contagion. I mean, would Korea have had such a massive crisis if things hadn't developed in Thailand? Or, back in the 1980s, would Brasil have had such a big debt crisis if there hadn't been other countries in the region which had previously entered into debt problems as well?

I would like to stress the need for more study on the supply and lend factors. How do different investors and lenders behave? In Jack Boorman's paper there is an analysis of hedge funds, which apparently didn't play as big a role as some people think. However, we need to revise the roles that different institutions – whether it is banks, mutual funds, hedge funds, or non-financial companies – play. How do they behave? Then, from understanding that, we should also explore how their behaviour can be modified. We have to look at issues like more regulations in source countries, or perhaps tax incentives to stimulate more long-term behaviour in the source countries. Returning to the point that was made, for example, by Mr. Witteveen, I think that there is a need for better regulation in the source countries, especially of short-term flows by banks. If it isn't done at the level of the source countries, you may have either recipient countries that are overwhelmed by these flows, even if they try to stop them, or you may have countries that don't seem to be able to sufficiently stop them. I mean, I find it very surprising that the Koreans with their tradition of always being very cautious, always privileging long-term flows, suddenly were receiving these massive amounts of short-term flows. I am afraid that this may happen again and again. One part of the jigsaw must be that the source countries apply tighter regulations on these potentially volatile flows. Regulations of institutional investors, like mutual funds, should also be considered, because at the moment they are totally unregulated from the macroeconomic point of view. The mutual funds played an important role in the Mexican crisis so there is a need not just to focus on improving on what countries can do, but also improving the functioning of international capital markets. Together with Jane d'Arista of Boston University I have elaborated some measures that could be taken, which I will present at the end of my comment.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

At the national level, again, I think we need to think of new and creative ways of responding to this new world of highly mobile capital flows. I'm sure that improving the data, improving transparency is very valuable. There are a whole range of new instruments, derivatives and so on, where the information available to central banks is very, very weak. I'm sure that all that can be done by the Fund, and by others, to improve this situation would be extremely valuable. However, there are limits of course, because as we discussed earlier, even when there is very good information, the problem is how it is analysed and how it fits into these changing fads. Then there is this additional problem of rapidly changing circumstances. For example, if you are trying to analyse financial sector soundness, you find that a financial sector looks very different with one particular level of exchange rate and particular interest rate, than it does three months later, in the middle of a crisis, with an exchange rate that is double the level and with an interest rate that is triple the level. So how does one improve information on that? Should we use simulation models? How should one weigh the likelihood of a crisis? I think that these are very serious problems which deserve more thought.

There is also a whole new area for domestic macroeconomic management in this globalising world where crises are not caused by fiscal deficits anymore. Now we have these crises that are caused mainly by private deficits and it is much more difficult to know how to prevent these. Perhaps the key in avoiding these crises is that one should be very prudent in good times, when there is more flexibility, because once things start to deteriorate, the options that the policymakers have are very few and very unpleasant. You can either increase interest rates, or you can let the collapse of your currency happen, or you can cut government spending drastically – none of these being very attractive options. So I think that the main actions must be taken before. In this context, some kind of domestic discouragement of short-term flows could play an important role. Not on its own, but in the context of good macroeconomic policy management. Maybe we have to start thinking of new policies of a more counter-cyclical kind. Maybe if there is a big boom in spending in the economy, spending by the private sector, either in consumption or investment, one should think about increasing tax rates during boom times, so that aggregate spending is slowed down, dampening this overenthusiasm of the private sector. Generating a surplus in the boom times creates space for avoiding future crises. Also, the way in which people borrow, both the government and the private sector, needs to be reevaluated. Borrowers tend to focus too much on the financial costs of borrowing, engaging in short-term borrowing because it is much cheaper. However, if you take into account the risk of any future financial crises, the cheap cost of borrowing may actually

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

turn out to be very expensive. Therefore new criteria need to be developed for how you assess the structure of your debt.

To prevent a crisis, you may also need very high levels of reserves. Roy Culpeper rightly said that the two countries that haven't had a crisis in Asia are China and Taiwan, countries that haven't liberalised their capital account. However, they are also countries that have extremely high levels of foreign exchange reserves. Now this, of course, is a great luxury, because not every country is in this position. For poor countries to tell them you must not spend on hospitals, you must not spend on schools, but you must have high levels of reserves is a very difficult trade-off, but maybe it is a necessary condition if you want to have a very open capital account.

In terms of financial regulation, you may need to introduce some cyclical elements. For example, countries that have capital inflows that are very volatile may need more stringent capital adequacy rules and other prudential ratios than developed countries do. The bi-ratios are not enough for developing countries, they need far higher ratios. I think they also need, from a domestic point of view, stricter supervision of short-term flows. I'm not sure what can be done about the issue that Jack raised in the context of Indonesia. That is, what can you do about excessive short-term borrowing by companies? How can you regulate that? I feel that this is one of the most difficult issues. It is not just the Indonesians that are wrong, it is difficult for any central bank to regulate those flows. Finally, one may also think about the explicit introduction of cyclical elements in the regulation of banks and other financial institutions. For example, regulators should be looking at what proportion of bank assets are guaranteed by assets whose prices are inflated during the boom and may collapse during the bust period. Maybe they should limit such potentially volatile priced assets, so as to take into account the risk of future possible crises. In other words, one needs to be a bit more pessimistic during the boom times and a bit more lax during the crises times, in order to have a more counter-cyclical attitude.

Stabilising of Portfolio Flow to Emerging Markets: a Proposal

Capital flows to emerging markets have grown at a breakneck speed in the last ten years. Portfolio flows have grown especially fast. Indeed, portfolio flows to the emerging markets of Latin America and Asia grew by more than fifteen-fold between the late eighties and mid-nineties. A major source for these rapidly growing portfolio flows to emerging markets are institutional investors from developed economies, such as pension funds, US mutual funds and UK unit trusts.

Capital flows to emerging markets have clear and important benefits.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

These benefits are particularly clear for foreign direct investment, but portfolio flows also have important positive effects, such as lowering the cost of capital for creditworthy firms. At a macroeconomic level, foreign capital flows can complement domestic savings, leading to higher investment and growth. Portfolio flows from developed to emerging economies also have significant long-term benefits for savers in developed countries, who should get higher yields in emerging economies, with higher long-term growth rates than developed economies.

However, large surges of capital flows to emerging economies can also have problematic effects. Firstly, these surges pose complex policy dilemmas, for macroeconomic management, if they lead to overvalued exchange rates (and a growing current account deficit) and excessive money supply expansion (with risk of increased inflation). Secondly, and more important, these flows pose the risk of sharp reversals, as experienced by Mexico and other emerging economies in late 1994, and this year by the Asian economies. Particularly if such reversals lead to a currency crisis, this can lead to serious losses of output, investment and employment. The Mexican Gross Domestic Product fell by almost 7% in 1995 and in Asian countries the growth will slow down significantly. Furthermore, currency crises can be very damaging for foreign investors. Also, frequent crises could tempt some developing country governments down the wrong path of closing their capital accounts, which would be very negative for investors as well as for themselves.

As the volatility of some capital flows to emerging economies is both large and damaging, there is a need for measures to encourage greater stability, without discouraging, over time, the average level of capital flows.

One way of achieving this objective is improved information and disclosure. Since 1995, the International Monetary Fund has made important efforts to improve its information output on emerging economies which is now also available on the internet. However, unfortunately, as is clear from recent events, though better information and disclosure is helpful, it is not enough to curb volatility. It is difficult to establish *ex ante* fully problematic trends. The theory of asymmetries of information, between investors and recipients, provides useful insights into why this happens. Secondly, even if most of the relevant information is available, the criteria with which it is analysed is even more crucial. Indeed, a glass can be said either to be half full or half empty, even if the glass is transparent. Similarly, an emerging economy can be seen to be successful and creditworthy at one moment or as weak and uncreditworthy soon after, if the criteria of its evaluation change.

There may be different ways to encourage somewhat greater stability of portfolio flows to emerging markets. We would like to propose one, which

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

seems particularly appropriate, as it is consistent with mainstream regulatory thinking which emphasises risk-weighting as a central element.

The proposed measure would imply that institutions like the US mutual funds would be required by their regulators to have risk-weighted capital charge cash requirements for emerging market investments. These cash requirements would be placed as interest-bearing deposits in commercial banks. The risk-weighting would vary by country and through time. The guidelines for risk-weighting would take into account such variables as the ratio of the current account deficit and the external debt to the GDP, the maturity structure of that debt, the banking system's fragility and other relevant factors. This approach is similar to that used by the Bank of England and other central banks to determine risk-weighted provisioning against possible losses on bank loans to developing countries. The guidelines for the US mutual funds would be given by the US securities' regulator (the Securities Exchange Commission) and would be defined by them in consultation with the Federal Reserve and the Treasury, as well as the International Monetary Fund, using these institutions' long experience in analysing currency crises and their causes. Weight would also be given to the views of market analysts. It is important that quite sophisticated analysis is used, to avoid simplistic criteria stigmatising countries arbitrarily.

Given the dominance of institutional investors in the US and the UK markets, this proposal could be adopted first in those two countries, without creating significant competitive disadvantage. However, at a later stage, harmonisation of such a measure should be discussed and coordinated internationally. A clear parallel can be drawn again with bank capital adequacy rules first developed nationally and then coordinated by the Basle Committee.

As the required cash reserves would change with the perceived risk, it would become more profitable to invest in countries with good fundamentals. If these deteriorated in a particular country, investment in it would decline gradually, as its risk-weighting increased. This would hopefully force an early correction, which would encourage a resumption of flows. This smoothing of flows would discourage massive and sudden reversals of flows, thus make currency crises less likely.

The proposed risk-weighted cash requirements could somewhat lower earnings for those mutual funds that do not maintain adequate levels of cash reserves, if deposits have lower yields than other financial assets. However, the introduction of an industry-wide standard of cash requirement would increase investor confidence and attract a larger volume of funding. Our proposal, which would make currency crises less likely, is complementary to measures currently being discussed, such as a new facility by the IMF, which would make currency crises less damaging. Both

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

types of measures are necessary. However, medicine teaches us that prevention is better and cheaper than a cure.

Financial Crises: Towards an Alternative Approach

Ariel Buira

I Introduction

In a world of increasingly integrated financial markets and high capital mobility, the loss of market confidence in a country or currency gives rise to severe financial crises with significant international effects. This paper suggests that the current IMF approach for dealing with financial crises not only falls short of the purposes of the Fund, as set out in its Articles of Agreement, but is ill-suited for dealing with crises of confidence which may be due as much to market misperceptions and overreactions to the news of the day as to policy shortcomings.

Since crises often provide an opportunity for reform, some suggestions are put forward for improving the policy response to speculative attacks for the benefit of the countries concerned, as well as for the international economy.

II The Fund's Current Approach to Financial Crisis

The purposes of the IMF are set out in Article I of its Articles of Agreement. Six purposes are enumerated including international monetary cooperation, the expansion and balanced growth of international trade, the promotion of exchange stability and of a multilateral system of payments, the mitigation of maladjustments in the balance of payments and the provision of resources to facilitate the correction of such imbalances.

"The promotion and maintenance of high levels of employment and real income and ... the development of the productive resources of all members (are) the primary objectives of economic policy" (Article I, ii). Further reference to these primary objectives is made in Article I(v) which specifies that a purpose of the Fund is "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity".

Although the intention was that the availability of the Fund's resources should prevent countries from experiencing financial crisis, in practice the

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

institution has often found itself helping its members cope with crises after they occur (Boughton, 1997, p. 3). In recent years, four countries have requested the support of the Fund following a sudden reversal in market confidence: Mexico (in 1995), and Thailand, Indonesia and Korea in 1997.

These sudden reversals in market confidence have created a new kind of problem for emerging markets and for the Fund. Indeed, the Fund's Managing Director characterised the Mexican crisis as "the first financial crisis of the twenty-first century", recognising that it was different from earlier financial crises and implicitly suggesting that it called for a different response from the Fund.

How has the Fund responded to this new problem? The Fund has taken the view that "a financial crisis calls for a similar response ... as any other balance of payments problem, except that the response should be quicker and possibly much larger than in a more traditional case" (Boughton, 1997, p. 6). In its own words, the Fund has sought to provide "both directly and with the assistance of partners, a package of financing sufficient to promote a restoration of confidence in the framework of an adjustment programme. The latter programme would need to justify the confidence by insuring that the authorities were taking the steps necessary to correct the problems that had 'caused' the loss of confidence and adopting policies that would even otherwise permit a return to a sustainable growth path." (EBS/97/225 Supplemental Reserve Facility, pp. 2-4).

"In all four cases, the Fund provided resources in the credit tranches under the stand-by arrangements with very large and heavily front-loaded access. The size of the stand-by arrangement and the degree of front-loading reflected judgements regarding the amount necessary – given forceful strong adjustment measures and the financial resources made available by other participants in the packages – to restore confidence. In making such judgements, a view had to be taken of the amount of short-term exposure for which there was a significant risk of non-roll over." (EBS/97/225, p. 4). In practice, the above statements would seem to imply that: (i) the loss of confidence is due to poor policies on the part of the country and may be reversed by forceful adjustment measures; (ii) to restore market confidence, first let the crisis erupt and then adopt an economic programme backed with large financial support. To my mind these assumptions may be challenged. Let us consider them in turn.

1. Reasons for the Loss of Confidence

The assumption that any loss of confidence is due to poor policies on the part of the country is questionable. While Thailand had a large current account deficit and the bhat was probably overvalued, the current accounts

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

of other countries in the region that came under attack – Taiwan, South Korea and Hong Kong – were much stronger and Japan continues to run the largest current account surplus in the world. Yet, they all suffered speculative attacks. In fact, short-term capital movements often appear to be less dependent on economic fundamentals than on investors' search for profit, based on perceptions of vulnerability which may arise from a misreading of current national or international political events. More generally, there is wide recognition in the literature, including the papers of the Fund, that capital flows to emerging economies are often volatile for reasons that bear little relation to country risk. Among the more widely accepted economic reasons for this volatility are:

1. Exogenous and unanticipated changes in the financial conditions of the industrial countries can produce severe destabilising effects in capital importing countries, which are unrelated to their policies or creditworthiness. Industrial countries generally formulate their economic policies based on domestic considerations, with little regard to the international repercussions of their actions. On several occasions, this has led to unforeseen rises in the level of real interest rates and exchange rate fluctuations that have increased the cost and sharply diminished the availability of international financing to developing countries.
2. Capital inflows and commercial bank lending have been markedly procyclical, reflecting macroeconomic conditions in both capital-exporting and capital-importing countries. Capital flows from the former when returns are low due to low levels of domestic activity or to low rates of interest. Capital comes to the latter most readily when economic and business prospects are good, while capital flows tend to decline when the economy slows down or when problems or uncertainties of any kind appear in the horizon. Thus, capital markets themselves tend to undermine the creditworthiness of countries. As the BIS stated some time ago, "It may be useful to imagine what would happen in a national context if during the recession banks were suddenly to cut off the flow of new credits to the corporate sector and to begin closing off existing short-term credit lines. The inevitable result will be a financial collapse which will frighten even soundly managed firms, including banks ... Such a financial collapse would therefore not permit any easy inferences with respect to the quality of the pattern of bank lending and of corporate investment before the outbreak of the crisis, whereas the conclusion could safely be drawn that something had gone seriously wrong with the macroeconomic management of the economy."
3. Market behaviour is often characterised by information asymmetries and contagion effects. Country risk analysis, which is far from perfect, is often dominated by "herding" behaviour. Recent episodes of financial

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

market turbulence illustrate that a country might lose its creditworthiness overnight, leaving authorities little time to react. In a number of cases, the sudden loss of creditworthiness may be unjustified. Countries may face abrupt changes in the cost and availability of liquidity when unexpected events, such as major macroeconomic or financial shocks, trigger sudden shifts in market sentiment. As the market liquidity dries up, the country may face excessive adjustment costs. Moreover, as we have seen repeatedly in Latin America and more recently in Asia, there is a tendency to evaluate a country's creditworthiness as a function of its regional location or stage of development rather than on its own merits. When a country in a certain region experiences difficulties with payments markets often tend to suspend new credits to all countries in the same region or with similar characteristics.

The 'bandwagon' effect, which abruptly reduces liquidity across the board, can produce harmful effects on capital-importing countries, and have a destabilising impact on the international economy and monetary system. In many cases, the process of restoring creditworthiness is unduly delayed as investors hold back and wait for the recovery, thus making it more protracted and uncertain. Being cautious, bank regulatory agencies and credit rating agencies may wait to see the compliance with the economic programme over a period of, say, a year before revising their appraisal.

2. Restoration of Confidence and the Costs of the Current Approach

Too often, the current approach seems to imply that the best way to deal with a financial crisis arising from a loss of confidence is to let the crisis erupt and then try to restore confidence with an economic programme and with large financial support.

Typically, a crisis of confidence in a country's capacity to make payments leads to a run on the currency, thus provoking a sharp devaluation (i.e. Mexico 115% in 1994-1995, Thailand 87%, Korea 96%, Indonesia 228%). Such devaluations go well beyond any that might conceivably have been postulated as necessary to restore a sustainable balance on the external accounts.

The sequel to such devaluations is well known – as domestic prices of tradables adjust to reflect their international price, inflation rises sharply and domestic interest rates follow. Wages typically lag behind, leading to a fall in consumer demand and because of uncertainty, falling demand and higher interest rates, a decrease in investment takes place. As these factors lead to a decline of GDP and rising unemployment, the country falls into a recession.

At a time of recession, all theories would advise an expansionary fiscal

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

stance. However, the fiscal policy at the centre of the Fund-supported programme invariably requires fiscal retrenchment or equilibrium and is markedly pro-cyclical. By then, due to the lack of access to non-inflationary sources of finance, this has become the only response available to the authorities, since deciding to relax fiscal policy could lead to a collapse of confidence in the viability of public finances and deepen the crisis.

The conjunction of sharp currency depreciation, inflation, recession, falling real incomes, higher unemployment, rising interest rates and falling asset values, almost inevitably leads to a banking crisis. Mortgage holders, who typically account for 20-25% of banks portfolios, often find that they are unable to meet payments that have become a multiple of those originally envisaged. Moreover, the value of real estate given as collateral has fallen to well below the value of the loan it guarantees. Payment difficulties are also encountered by many firms as sales fall and debt service payments rise due to higher interest rates, or to the dramatic increase in the domestic value of their dollar denominated debt following the exchange rate depreciation. In turn, the banking crisis hinders economic recovery as credit becomes scarce and the need to support banks adds to the difficulties of public finances.

The heavy costs of a financial crisis triggered by a loss of market confidence may be illustrated by the Mexican experience. Asian countries that have recently suffered financial crises may be expected to face similar problems.

Following the sudden interruption of capital inflows in late 1994 and early 1995, economic activity in Mexico contracted by 6.9% in real terms in 1995. This was the sharpest decline in six decades, since the Great Depression, and was reflected by a marked rise in unemployment which, coupled with an upturn in inflation, cut the living standard of the population considerably.

Throughout 1995, GDP showed marked declines – compared with the respective quarters of the year before. The worst drop took place in the second quarter when GDP fell by 10.5%, with respect to the same quarter of 1994. Large decreases continued in the third and fourth quarters, even though with 9.6% and 6.6% they were not as large as that of the second quarter.

The diminished availability of foreign resources in 1995 brought about a marked decrease in aggregate demand that was passed on to production. The absorption of the economy – the sum of private and public consumption and investment – fell 15.9%. This contraction was only partially offset by larger exports of goods and services. Therefore, aggregate demand, at 1980 prices, declined by 10.2% in 1995.

Average industrial wages in 1995 fell by some 44% below their 1994 level and rose only modestly in real terms in 1996. Their decline and the

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

rise in unemployment brought about the most severe fall in private consumption ever recorded in Mexico, i.e. 12.9%, with expenditure in durable goods falling 45.7%, whereas the decline in non-durable goods was 8.3%.

Gross fixed capital formation decreased 30.9% in 1995. Its two components reported declines of 33.9% in private investment and 18.9% in public investment. Spending on domestic capital goods fell sharply, 29.4%, particularly on purchases of transportation equipment, 93.5%. Expenditure on imported capital goods fell 35.3%. In order to attain the fiscal balance envisaged in the programme, public sector spending declined 8.4% in real terms, thus contributing to a further decline in activity.

The crisis gave rise to a sharp increase in banks' non-performing assets. The authorities have estimated the cost of the bank rescue programmes at $48 billion or about 13.5% of GDP, while private estimates run higher. Notwithstanding efforts at bank recapitalisation (because the level of non-performing loans has not declined as expected), the banking system remains fragile and fresh credit is scarce.

What started as a speculative attack against the currency, that might have been defeated, developed into a crisis of confidence, which gave way to an economic collapse with grave social, political and redistributional effects and to a major banking crisis, the costs of which will be paid for many years to come.

The Mexican recession was deep, but thanks to the structural reforms of the last decade and the government's determination in the pursuit of the economic programme, it was also short and the recovery strong, with GNP growing at 7% in 1997. Nevertheless, in reviewing what has been generally considered a successful adjustment, one cannot help asking: Was the high cost of this adjustment really inevitable? Could the country have been "provided with the opportunity to correct maladjustments in the balance of payments without resorting to measures destructive of national or international prosperity"?

Financial collapses make deflations and depressions possible because they destroy the confidence on which economic activity depends. The Fund's approach to financial crisis, which is based on austerity, i.e. tight credit, higher interest rates and fiscal retrenchment, does not help avoid recession and banking crises. Thus, it increases uncertainty and compounds the problem. Yet, as we shall see, the Fund could help avoid financial crises by helping sustain confidence in critical moments.

III The Need for a More Prudent Approach

A prudent approach would be for the country, possibly in consultation

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

with the Fund, to determine the level of capital inflows that it is able to absorb without pressures on domestic prices or the balance on current account. Capital flows beyond that level could be discouraged, for instance, through the requirement of non-interest bearing deposits of a given proportion of the amount to be invested, so as to reduce the return on such flows. Over a number of years countries like Chile and Colombia have successfully applied a non-interest bearing deposit requirement to limit portfolio capital inflows.

The liberalisation of capital flows is generally positive for the world economy as it provides greater opportunities to both borrowers and lenders. However, financial markets have shown a tendency towards great swings. Divergent macroeconomic conditions in capital-importing and capital-exporting countries give a cyclical character to private capital flows. Thus, there are periods of overshooting and of inadequate expansion or even contraction of liquidity for a country or a group of countries. To deal with this phenomenon, it has been suggested that countries receiving substantial capital flows should, as a precaution, sterilise a significant proportion of these by holding them in their international reserves. While this policy has been followed by many of the countries concerned, it is a very costly form of self- insurance that may give rise to heavy losses in the central bank – a quasi fiscal deficit – due to the interest rate differentials existing between domestic and reserve currency denominated paper. Like other forms of self-insurance, this one could be replaced by a less costly group insurance, if the Fund or some other organisation were to make it available to countries.

Financial market volatility and overreactions pose new and difficult challenges for which, in many cases, both national financial authorities and the international community are unprepared. Indeed, these problems are often difficult to resolve if not to comprehend fully. Thus, one may well ask whether in present conditions, the full liberalisation of capital movements now propounded by many, is appropriate in all cases. Will countries awash in domestic savings, such as some Asian countries, benefit? Would countries with a weak financial system benefit from full liberalisation? Can a distinction also be made between long-term and short-term capital flows? Should a distinction be made between opening of financial services to competition and full freedom of portfolio flows?

Jagdish Bhagwati of Columbia University, argues, "(Capital markets) are very volatile. Suddenly expectations can turn around. You may be very healthy but suddenly you catch pneumonia. And then you may have to do unspeakable things to your economy just to regain that confidence because you are now hooked to the system ... Markets may do something when you have done nothing wrong and you may have to do something wrong in

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

order to convince the markets that you are doing something right! I would put off (capital account) convertibility for quite a while." Bhagwati observes that many countries have grown well without capital account convertibility, including Western Europe and Japan earlier and China today. "In my judgement it is a lot of ideological humbug to say that without free portfolio capital mobility, somehow the world cannot function and growth rates will collapse" (Interview in The Times of India, 31 December 1997).

The new challenges posed by the growth and integration of financial markets call for a parallel development of international financial institutions to allow them to provide sufficient financial support to member countries and to act as overseers, and when appropriate, as regulators of international capital flows.

IV Toward An Alternative Approach to Confidence Crises

In order to deal with the major issues raised above, an alternative approach to confidence crises could be developed with the following two components: (i) elimination of foreign investors' protection from market risks; (ii) changing the IMF approach.

1. Eliminate the Protection of Foreign Investors

An issue that is implicit in the approach taken in recent Fund supported programmes is the notion that foreign investors should be protected from market risks. The rescue packages provided to Mexico, Korea, Thailand and Indonesia by the Fund and the authorities of certain industrial countries have been tailored to meet all payments to foreign creditors falling due in the short term, thus keeping them from suffering any losses. This raises the issue of moral hazard.

Investors must share the risks arising from the volatility of capital – which currently fall largely on the recipient country. The moral hazard arises from the rescue of investors by financial support packages. Under the current arrangements, they are protected from market forces by the IMF and certain industrial countries, thus allowing them to undertake operations without any risk.

Under market rules, investors take risks and may gain high returns, or suffer heavy losses. However, when foreign risks have materialised they have been saved from their mistakes by international rescue operations organised by the champions of the market. Thus, gains are private but losses are socialised and absorbed by the capital-importing country whose development may be set back several years as result of a crisis of confidence.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Investors must be made aware of the impact of their actions on the economy of the country and provided with incentives to act responsibly from a social point of view. This could mean that if a sudden massive reversal of capital flows, a run on the country, were to cause a financial crisis, the authorities of the country in consultation and under the supervision of the Fund, could force creditors to take certain losses through a bankruptcy type procedure or, impose certain limitations on transfers, i.e. reschedule capital withdrawals in a manner consistent with the country's ability to pay without disruption of its economic activity.

2. *The Policy on the Use of Fund Resources*

The current Fund approach was designed to deal with balance of payments crises that resulted largely from significant imbalances in the fiscal or monetary accounts, but is not well suited to deal with confidence crises in today's financial markets, that often are not the result of such imbalances. By placing emphasis on the contraction of demand and the rise in interest rates to strengthen the balance of payments, this approach discourages investment, compounds the difficulties faced by banks and public finances and, generally, adds to the recessionary impact of the reversal in capital flows on domestic economic activity. Typically, this policy stance deepens the domestic crisis as the problem is allowed to become much greater and more costly before it is resolved.

The essence of the problem is that financial markets may overreact to any ambiguous signal and aggravate the "bad" news. Given the volatility of capital flows, countries often face a confidence crisis in their currency that may bear little relation to their economic fundamentals. Indeed, when markets are nervous, the authorities may freeze their policy stance for fear that a policy shift might be interpreted as an admission of weakness and unleash or intensify a speculative attack that might snowball and get out of hand. However, if the authorities were seen to be in a position of strength, as could be the case if they are known to have ample support from the Fund or other sources, they would be able to show greater policy flexibility in response to changing circumstances.

Essentially, an alternative approach to dealing with financial crises would aim at preventing a speculative attack from developing into a full-fledged crisis by the timely provision of sufficient financial support to sustain confidence coupled, if appropriate, with a policy reform package.

The Fund could provide member countries with good economic fundamentals with a readily available stand-by credit to be drawn in the event of a significant speculative attack on the currency. The amount of such a credit should be sufficiently large to discourage speculators, say the equiva-

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

lent of no less than six months of imports and interest payments. The money would be available "in toto" at very short notice and drawings should not be subject to tranches or prior performance conditions.

In exchange for the support received, the country would commit to undertake any policy adjustments that might be appropriate over a predetermined period, starting shortly after the resources are made available and normally not exceeding six months after the drawing.

The order of magnitude of the financial support to be provided by the Fund under this scheme may be illustrated with reference to Mexico. Recall that Mexico's quota in the Fund is SDR1.7 billion or about $2.5 billion. Mexican imports of goods in 1994 were some $79 billion and external interest payments amounted to $15 billion. Thus, the provision of the equivalent of six months of imports and debt service payments would have amounted to some $47 billion, a sum somewhat larger than the financial package put together by the US, the Fund and Canada.

Obviously, for the Fund to be able to sustain a much increased level of financial support to its members and remain credible, the size of the Fund or its borrowing capacity would have to be increased substantially. However, in practice, most of the Fund's support would – like the nuclear deterrent – remain unutilised. Indeed, if Fund support is timely, sufficient and fully credible, the resources provided are unlikely to be drawn – or if drawn, unlikely to be used since speculators would know they cannot win.

In fact, the Fund would play a role similar to that played by central banks in the national context when they act as lenders of last resort. Experience shows that when the central bank is openly prepared to support a bank facing a liquidity problem, a run on the bank is preempted and the amount of support required from the central bank, if any, is much smaller than would otherwise have been the case.

Would a policy of readily available credit or "payment in advance" give rise to a problem of moral hazard? This seems very unlikely. Recall that major recipients of capital from the markets are successful countries that generally follow sound policies and that this support would be limited to countries that, in the view of the Fund, pursued generally good policies.

Moreover, consider that a country that did not comply with its policy commitments to the Fund would, in all likelihood, become prey to a costly financial crisis as it would probably suffer an outflow of capital and forfeit access to all forms of external credit. Thus, the political and economic costs of non-compliance are likely to be considerably greater than those of adopting any additional policy measures the Fund might recommend.

In fact, the opposite case is more likely. As the Fund, in the normal course of surveillance or in Article IV Consultations suggests policy adjustments, a country desiring unchallenged and immediate access to Fund

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

resources in the event of a speculative attack would be likely to adopt the policy measures suggested promptly, for this would be a small price to pay in order to ensure that it not fall prey to a crisis of confidence. Thus, the scheme proposed could lead to an improvement in the quality of policies pursued by an important and growing group of countries.

Since 1952 the Fund has maintained that it cannot insure that it is "making its resources temporarily available to members" unless it makes its lending conditional on the adoption of adequate macroeconomic policies. Implicit in this approach is the belief that a financial crisis is always and everywhere the result of poor economic policies. Therefore, unless those policies are corrected, the country will not be in a position to repay the Fund. In this approach, the Fund would appear not to have sufficiently adapted its policies in response to the new nature of the financial risks faced by many emerging market economies in a world of volatile capital.

Is conditionality required to ensure repayment to the Fund and thus to preserve the revolving character of Fund resources? Note that neither the World Bank nor the regional development banks have made demands on borrowing countries of the type characteristic of the IMF programmes. Yet no one imagines that repayment of their loans is less assured than that of loans made by the Fund. In practice, repayment is insured not by project appraisal, but by the fact that no country would willingly risk the drastic consequences for its access to all forms of credit that would result from a default to any one of these banks. The same consideration applies to repayments to the Fund whether or not the loans involved carry upper credit tranche conditionality.

As shown by the experience of France in 1992, international support can fend off a speculative attack and prevent a crisis in a country with sound fundamentals. Thus, the liberalisation of capital markets and the increased scale of international capital flows are recent phenomena that should be matched by an increase in the financial support available to countries. Since the flow of capital is crucially dependent upon the confidence of international investors, ample and timely financial support may prevent a crisis. Thus the Fund should be ready to act quickly before countries fall prey a to a financial crisis, rather than coming in after the event to pick up the pieces.

As provided by Article I(v) of the Articles of Agreement, a purpose of the Fund is "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity". Surely, the avoidance of a financial and exchange market crisis is an objective covered by this provision.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

V Conclusion

Timely international support, which could prevent a crisis and save a country from its high costs in terms of output, inflation and employment, should be available to countries with good fundamentals and sound economic policies (thereby increasing the incentives for their adoption). In certain other cases, support could go hand in hand with the adoption of an economic programme designed to strengthen fundamentals.

If speculators become aware that a country has the full support of the international community and therefore that their chance of success is nil, they will not bother to mount an attack on a currency. This outcome would be in keeping with the purposes of the Fund and the interests of the international community, which inevitably shares the costs and risks of a deep crisis in one or several of the emerging market economies.

As Keynes once said "this is not a Red Cross philanthropic relief scheme, by which rich countries come to the rescue of the poor, it is a piece of highly necessary business mechanism which is at least as useful to the creditor as to the debtor". A development along the lines suggested would permit the world to benefit from the considerable contributions that the liberalisation of international capital flows may make to world economic development, while reducing the risks posed by unbridled speculative capital movements.

References

Bhagwati, J. (1997), Interview in *The Times of India*, 31 December.

Banco de México, *Informe Anual*, various issues, *The Mexican Economy 1995*.

Bank of International Settlements (1983), *Annual Report*.

Boughten, J.M. (1997), *From Suez to Tequila: The Fund as Crisis Manager*, IMF Working Paper 97/90.

Buira, Ariel (1997), *Financial and Development Issues in Emerging Markets*, presentation to the Second Committee of the United Nations General Assembly, New York, November 4.

Calvo, G. (1996), "The Management of Capital Flows: Domestic Policy and International Cooperation", In: G.K. Helleiner (ed.), *The International Monetary and Financial System: Developing Country Perspectives*, St. Martin Press, New York.

Eichengreen, B., R. Portes et al. (1995), *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, CEPR, London.

Folkerts-Landau, D., D.J. Mathieson, et al. (1997), *International Capital Markets: Developments, Prospects and Key Policy Issues*, IMF, Washington.

Goldstein, M., D.J. Mathieson and T. Lane (1991), *Determinants and Systemic Consequences of International Capital*, IMF Occasional Paper No. 77, Washington.

Haussman, R. and M. Gavin (1997), "Fiscal Policy in Latin America: What Needs to be Explained?", IDB Paper presented at the 8th International Forum on Latin American Perspectives, IDB-OECD, Paris, 20-21 November.

IMF (1993), *Articles of Agreement*, Washington, April.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Comment on "Financial Crisis: Towards an Alternative Approach," by Ariel Buira

Pradumna B. Rana

Mr. Buira's basic thesis is that the IMF is ill-suited to deal with a crisis of confidence. This is for two reasons: (i) the IMF equates financial crisis with a balance of payments crisis and uses similar prescriptions, and (ii) the IMF first lets the crisis emerge and then introduces adjustment programmes. Therefore, he proposes an alternative approach to deal with a crisis of confidence. This approach has two components. First, investors must be aware of the impact of their actions. This would mean that if a sudden massive reversal of capital flows were to cause a crisis, the authorities of the country in consultation and supervision of the Fund, could force creditors to take certain losses through a bankruptcy type procedure, or impose certain limitations on transfers. Second, an alternative approach to dealing with financial crisis would aim at preventing a speculative attack from developing into a full-fledged crisis by the timely provision of sufficient financial support to sustain confidence coupled, if appropriate, with a policy reform package.

Mr. Buira's analysis makes eminent sense. I will focus my comments in two areas. First, the IMF has changed over the years. For example, much of the balance of payments difficulties in the 1970s could be attributed to structural factors rather than expansionary demand policies. The IMF, therefore, introduced the Structural Adjustment Facility (and Extended Structural Adjustment Facility). Further changes have been made in IMF policies, and IMF programmes now cover financial sector restructuring, strengthening of corporate governance, and other reform measures. Second, the timely provision of funds from the IMF to preempt a crisis, rather than react to the crisis, is a good idea. However, without policy reforms and "conditionality" such actions cannot be effective. The Philippines, after three decades of IMF programmes, recently graduated from the IMF programmes and has a precautionary facility in place.

Mr. Buira also emphasises the need for a prudent approach in dealing with capital flows. Large surges in private capital inflows can complicate macroeconomic management by leading to economic overheating. Also, volatility and reversals in private capital could be destabilising. In fact, this is an important lesson emerging from the East Asian financial crisis.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

Let me now build further on Mr. Buira's analysis by applying it to the East Asian financial crisis.

Root Causes of the East Asian Financial Crisis

All currency crises tend to be different. But, now a consensus is emerging on the root causes of the East Asian financial crisis. First, the root causes of the crisis in East Asia were structural – weaknesses in the financial and corporate sectors, compounded by policy mistakes in managing private capital inflows and global financial integration. Macroeconomic fundamentals were relatively less important contributory factors. In fact, the region had the strongest fundamentals among the developing regions. Second, the problems in East Asia were not due to fiscal profligacy, but to excessive borrowing by the private sector mainly in the form of short-term capital. Government policies that permitted the borrowing were also, of course, at fault. There was a sudden investor confidence and foreign capital flows reversed in 1997.

The first implication of the differences in the root causes of the crisis is that in the East Asian case, various macroeconomic austerity measures of the IMF had to be complemented by structural measures, including measures to deal with private sector debt and coordination between diversified creditors and debtors. In fact, macroeconomic austerity is only one component of the IMF-led rescue packages to the Republic of Korea, Thailand, and Indonesia. IMF-led rescue packages also seek to: (i) accelerate banking and capital market reform; (ii) promote efficiency in trade and industrial sectors including trade finance; (iii) promote good governance and corporate management; and (iv) mitigate the social costs of adjustment.

Second, structural problems are more difficult to resolve for the following reasons: (a) a set of fully articulated structural reforms is difficult to design in the middle of a financial crisis; (b) the required political and economic consensus might be difficult to achieve; (c) the structural reform agenda will take time to implement, and the results may take even more time; and (d) progress in implementing structural issues will be more difficult to observe and assess.

Asian Development Bank's Assistance to the Affected Countries

The Asian Development Bank (ADB) has argued, from the very beginning, that the East Asian crisis was a different type of crisis and required a different set of prescriptions. There is now an evolving consensus on this view. Accordingly, the ADB joined the IMF-led rescue packages for Thailand, Indonesia, and Korea and committed over $9 billion emergency assistance

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

to support structural reforms and capacity building efforts, and to mitigate the costs of structural reforms.

Thailand. The ADB pledged $1.85 billion focused on financial and social sectors. A $300 million Financial Sector Programme Loan was approved on 19 December 1998. A $500 million Social Sector Programme Loan and a $1.0 billion Export Financing Facility was approved more recently. The latter was organised with 10 international commercial banks.

Indonesia. The ADB has pledged $3.5 billion over the next three years of which $1.5 to $1.8 billion will be new money. A $1.5 billion Financial Governance Reforms Sector Programme Loan is at an advanced stage of preparation. A Social Protection Sector Development Loan is also being prepared.

Korea. A $4.015 billion Financial Sector Programme Loan was approved last December.

Finally, the East Asian crisis has highlighted that contagion tends to be the most serious among neighbouring countries. There may, therefore, be a need to complement individual country and global surveillance with regional efforts. Such an effort will involve peer surveillance and an unique perspective stemming from an in-depth knowledge of local conditions. Under the Manila Framework, and as requested by the ASEAN finance ministers, the Bank is considering the establishment of a regional monitoring mechanism.

Lessons from the East Asian Crisis

Since the Latin American debt crisis of the early 1980s, the incidence of financial crisis around the world has tended to increase. The costs of such crisis have also increased. These trends are expected to continue in the future as integration of financial markets increases. Globalisation also magnifies the benefits of good policies and the costs of bad policies. It, therefore, places a premium on economic reforms. The non-affected countries should not be complacent.

In terms of macroeconomic responses, a consensus appears to be emerging that responsible fiscal management, supported by monetary sterilisation and some nominal exchange rate flexibility, is an appropriate response to surges in private capital. The Bretton Woods system of pegged exchange rates was successful in maintaining low interest rates globally in an environment where capital mobility was low. That situation does not prevail any more, because most industrialised and developing countries have liberalised exchange controls and regulations on repatriation of profits and interest, and have removed discrimination against investors.

The banking system plays a dominant role in the allocation of capital in

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

developing countries, and the health of this system largely determines whether a developing country will be able to exploit the benefits of financial integration and avoid its pitfalls. In many Asian developing countries, since the early 1990s, the financial sector has been partially liberalised and deregulated. However, the banking sector is still very weak and fragile, because institutional development has lagged behind. The poor health of the banking sector needs to be addressed urgently so that vulnerability to globalisation is reduced. Actions are required for: (i) reforming the institutional structure in areas such as the regulatory and supervisory framework, transparency and disclosure of information, accounting systems, market infrastructure, and risk management; (ii) human resource development in various areas such as regulation, supervision and accounting; and (iii) overall governance of the sector to avoid, among others, insider trading and moral hazard types of lending to speculative and corporate sectors. These reforms will take time to implement; hence actions should be initiated now to prepare banks for globalisation. Competition should also be promoted in countries where this is a problem.

Actions should also be initiated to develop well-functioning capital markets to reduce the risks of potential instability in an integrated world. Actions are required in three areas: (i) market infrastructure (where the consequences include high transaction costs, frequent delays in settlement, and outright failed trades); (ii) protection of property rights (in particular those of minority shareholders); and (iii) disclosure of market and company information and control of abusive market practices.

Countries must be prudent in capital account liberalisation. Capital account liberalisation must be sequenced properly. The preconditions for successful liberalisation are: a sound macroeconomic framework consistent with the choice of exchange rate regimes, a strong and well-regulated domestic financial sector, and a strong autonomous central bank. Prudence in capital account means neither a return to pervasive capital controls nor a rush to immediate liberalisation. The role of temporary controls on short-term capital is still very much debatable. An ongoing ADB/World Bank study suggests that such controls could be effective in the short run, but not in the long run.

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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-

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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."

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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."

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org

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."

From: Regulatory and Supervisory Challenges in a New Era of Global Finance
FONDAD, The Hague, 1998, www.fondad.org