

Reforming the Global Financial Architecture

Montek S. Ahluwalia



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COMMONWEALTH SECRETARIAT

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Abbreviations

ADB	Asian Development Bank
BIS	Bank for International Settlements
CCL	Contingency Credit Line
ERM	Exchange Rate Mechanism
EFF	Extended Financing Facility
ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Programme
FSF	Financial Stability Forum
GAB	General Arrangements to Borrow
GDDS	General Data Dissemination Standard
GDP	Gross Domestic Product
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IFI	International Financial Institution
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
LTCM	Long Term Capital Management
MOU	Memorandum of Understanding
NAB	New Arrangements to Borrow
OECD	Organisation for Economic Co-operation and Development
OFC	Offshore Financial Centre
PIN	Public Information Notice
SDDS	Special Data Dissemination Standard
SDRs	Special Drawing Rights
SRF	Supplemental Reserve Facility
WFA	World Financial Authority
WTO	World Trade Organization
UNCTAD	UN Conference for Trade and Development

Introduction

The 1990s have seen a spate of currency and financial crises affecting emerging-market countries, the frequency and severity of which have raised serious doubts about the stability of financial markets facing these countries as they open their economies and integrate with the rest of the world. This in turn has sparked the search for a new financial architecture which would reduce the degree of instability in the system and improve its capacity to handle instability when it arises.

Recognition of the potential instability in the system was slow in coming, despite early warnings. The ERM (Exchange Rate Mechanism) crisis of 1992 was a pointer to what lay ahead, but it did not generate calls for systemic reforms because it was primarily a currency crisis and the industrialised countries affected did not experience a generalised financial crisis with disruptive effects on the real economy. Two years later, when the fiftieth anniversary of the Bretton Woods Agreement was celebrated and the functioning of the international financial system was subjected to in-depth examination, there was relatively little concern about instability. The developing countries raised familiar concerns about the system's inability to assure an adequate flow of resources for development and structural adjustment, but the dominant view among industrialised countries was that the system was functioning well and no major changes were needed.

The Mexican crisis in 1994 was a full-fledged currency, cum financial, crisis which should have signalled the need for a systemic overhaul, but the warning was muted primarily because the crisis was handled well and Mexico made a quick recovery. The crisis did highlight the special problems posed by currency crises arising in a

situation of financial fragility, the interaction between the two, and also the problem of contagion (the tequila effect). However, although these issues began to receive attention in academic and official forums, the problem was not seen as a potential threat facing most emerging markets and possibly even undermining the stability of the international financial system.

The East Asian crisis in 1997 was the real watershed in this respect. The international financial system was seen to have malfunctioned seriously. Some of the best-performing developing countries, which had been regarded as exemplars for others to emulate, were plunged into a crisis of exceptional severity with little warning. One of the worst hit countries, Korea, was not even a developing country, having recently graduated to industrialised country status.

Reacting to East Asia, the USA took the initiative of convening an ad hoc group of 22 industrialised and emerging market countries (originally called the Willard Group after the Washington DC hotel in which they met, and later re-christened the G-22) to discuss the issue of financial instability affecting the international financial system. These consultations, held in April 1998, can be said to mark the official start of the search for the new financial architecture, which was first pursued in three Working Groups set up by the G-22, and later in other inter-governmental forums and the Bretton Woods Institutions themselves.

The urgency to put a new architecture in place increased sharply after the Russian crisis in August 1998 and its ripple effects in Wall Street in the form of the collapse of Long Term Capital Management (LTCM). Emerging-market crises were no longer just distant events but were seen

to have repercussions which could affect major financial markets in industrialised countries. Fears about the stability of the system intensified later in the year when the Brazilian Real came under attack, and it looked as if an East Asian style currency collapse might sweep over Latin America. The threat of an international financial meltdown, which could do irreparable damage to international capital markets, did not seem too remote.

Predictably, the crisis atmosphere produced a wide variety of reactions and suggestions. The International Monetary Fund (IMF) came in for intense criticism from different perspectives. Some critics, for example Friedman (1998) and Schultz, Simon and Wriston (1998) complained that the Fund actually helped create crises because of the moral hazard generated by its bail-out operations and that the institution should therefore be abolished. Others such as Radelet and Sachs (1998) criticised it for prescribing the wrong policy mix which had not only failed to handle the crisis, but actually made things worse than they need have been. Calomiris and Meltzer (1998) advanced proposals to restructure Fund lending practices so that the danger of moral hazard would be minimised. There were proposals for creating entirely new institutions such as a new world central bank (Garten, 1998), a world financial authority (Kauffman, 1998) and an international credit insurance corporation (Soros, 1999). Prime Minister Tony Blair of the United Kingdom, speaking at the New York Stock Exchange in October 1998, called for a Bretton Woods for the new millennium, which seemed to suggest that wide-ranging changes in the system were needed and might even be politically acceptable.

The mood began to change in the course of 1999 as fears of a financial melt-down abated. The East Asian economies began to recover faster than expected, with Korea rebounding much more vigorously than anyone had thought possible. Brazil also stabilised more easily than was at first expected and the danger of contagion

in Latin America was effectively contained. As financial markets calmed down, the appetite for radical reform of the international financial system also declined. Signalling the new perception in their meeting in Cologne in June 1999, the G-7 Finance Ministers explicitly ruled out the creation of any new institutions and made it clear that their aim would be to work with the existing system, strengthening it where necessary.

There is nothing wrong with incremental change as long as it yields positive results; this monograph attempts to evaluate the outcome of the discussions from this perspective. It identifies the key issues in reforming the international financial system and the extent of consensus in each area, and provides an assessment of the extent to which the initiatives being considered will help make the system less vulnerable to crises. Chapter 2 describes some of the critical features of contemporary financial crises and the reasons why developing countries are especially vulnerable to such crises. Chapter 3 reviews the major proposals emerging from the new architecture discussions which are aimed at reducing the probability of crisis occurring, i.e. crisis prevention; while Chapter 4 examines mechanisms which have been proposed for dealing with crises after they occur, i.e. crisis resolution. Chapter 5 deals with the need for an appropriate governance structure for the emerging international financial system and stresses the importance of ensuring effective representation for all stakeholders including the developing countries.

An important limitation of the new architecture discussions, which should be noted at the outset, is that they focus narrowly on the problem of protecting emerging market economies from financial crises. Other deficiencies in the functioning of the international financial system, which are also of concern to developing countries, have not been addressed in these discussions. For example, the increased volatility of exchange rates among the major currencies, witnessed after the collapse of the Bretton Woods

system in the mid-1970s, has long been felt to create an adverse external environment for the developing countries, but this issue is not addressed. Other issues of concern are the declining levels of aid and stagnation of other official flows, the high burden of debt for many low-income countries, in the face of poor export prospects, and declining primary product prices. There is also the problem that private capital

flows, which are often presented as a reliable and plentiful source of external capital which can substitute for declining official flows, are in practice concentrated on a relatively small number of developing countries. All these issues have been on the international agenda for some time, but they are not on the agenda of discussions on the new financial architecture and therefore are not dealt with in this monograph.

Some Features of Latter-Day Financial Crises

Since the search for a new architecture was prompted by the frequency and severity of financial crises in the 1990s, it is useful to understand the nature of these crises and why the old architecture is unable to deal with them. In this chapter we discuss the special features of contemporary crises, which make them different from balance of payments problems faced by developing countries in the past, and which therefore call for a very different response, both from the country affected and from the international community.

2.1 Nature and Causes of Contemporary Crises

Contemporary crises differ from traditional episodes of balance of payments problems in important respects. The latter typically originated in the current account, with a macro-economic policy imbalance, or an external shock or domestic supply shock leading to a widening of the current account deficit which needed to be financed. Contemporary crises, on the other hand, originate from the capital account and are caused by a loss of confidence, which leads to a large outflow of capital and a denial of access to new financing.¹ The specific mechanisms at work may vary from crisis to crisis. In East Asia, the factor that triggered the capital outflow was the refusal of international

banks to extend fresh credits in a situation where the short-term debt had become very large. In the absence of fresh credits the repayment due on existing debt caused a massive outflow. Another mechanism which could cause a similar outflow is liquidation of portfolio investment by foreign investors. A capital outflow can also take place independently of the perception of foreign investors if there is domestic capital flight, which is always possible in a situation where there are no restrictions on movement of capital.² This was clearly the mechanism at work in Russia and to some extent also in Brazil.

Free mobility of capital is a pre-requisite for such crises and capital mobility has indeed increased enormously in the past two decades. This process has been driven by the dismantling of capital controls in the industrialised countries from the end of the 1970s and by the subsequent explosion of new financial instruments, which has vastly increased the options and investment choices available to international investors. It has been greatly facilitated by the impact of information technology which has greatly accelerated the integration of markets globally.

Many developing countries liberalised capital controls in the 1990s with the explicit objective of gaining access to the huge pool of resources available in international markets, and

1 The Latin American debt crisis of the 1980s also took the form of a denial of access to new financing and an inability to service the debt, but it is not a contemporary crisis because the source of balance of payments pressure could be traced to current account developments. High fiscal deficits had led to excessive borrowing abroad by governments leading to a build up of debt. The switch in US policy to combat inflation led to high interest rates, a dollar appreciation and an economic slow down. Export earnings of the indebted countries declined while high interest rates increased the debt service burden, both developments operating directly to worsen the current account. The dollar appreciation clearly increased the debt service burden in terms of export earning capacity. The denial of financing was essentially a recognition of the unviability of the current account position. This is very different from the sudden loss of confidence which characterises of contemporary crises.

2 Domestic capital flight may be triggered by a loss of foreign capital or it may occur independently. There is evidence in some cases that capital outflows are triggered by domestic capital flight rather than withdrawal of foreign capital.

Table 1 Capital Flows to Emerging Market Economies*

Annual Average	1984-89	1991	1995	1996	1997	1998
Private Capital Flows (net)	13.5	118.1	195.3	213.8	148.8	66.2
of which						
- Direct Investment (net)	13.0	31.5	99.6	113.5	142.6	132.4
- Portfolio Investment (net)	4.4	24.7	40.7	74.0	66.7	27.1
- Other net private flows+	-3.8	62.0	55.1	26.4	-60.5	-93.3
Official flows (net)	26.2	36.0	23.2	-17.9	24.4	43.6
Total capital flows	39.7	154.1	218.5	195.9	173.2	109.8

Source: World Economic Outlook, IMF

* Emerging market economies include developing countries, transition countries and newly industrialised Asian economies

+ Other net private flows include official and private borrowing from the private sector

private flows to emerging market economies did expand enormously in the 1990s. As shown in Table 1, private capital flows were half of net official flows in the period 1984–1989 but they had increased to more than 8 times the level of official flows in 1995. However, this has also made these countries vulnerable to the volatility of private capital flows. Free mobility implies that capital can move out if there is a sudden loss of confidence and the frequency of crises in the 1990s suggests that many developing countries have not been able to manage the risks arising from this situation in an effective manner.

An extensive literature has evolved in recent years on the nature of currency crises which helps explain the mechanisms at work.³ First generation models explained the occurrence of a crisis as the predictable outcome of macro-economic policy inconsistencies, for example maintaining a fixed exchange rate with an excessively expansionary monetary policy. The policy inconsistency leads to a decline in reserves and if markets perceive this inconsistency as being unsustainable in future, it could lead to a collapse of the fixed exchange rate even before the reserves run out. Second generation models go beyond the identification of policy inconsistencies – the so called fundamentals –

and focus on more intangible factors such as changes in the perceptions of investors or ‘market sentiment’ triggering a crisis in situations where a country has become vulnerable in some dimension.

An important feature of these second-generation models is that there is an inherent uncertainty about whether a crisis will be triggered in a particular situation. All that can be said is that if the country is in a zone of vulnerability, (for example because it has an excessive level of short-term debt relative to foreign exchange reserves) then a sudden change in expectations of investors, which may take place for a variety of reasons, can lead to a self-fulfilling crisis. The change in expectations may not be directly related to a worsening of fundamentals. It could occur independently of any change in fundamentals because of contagion from developments in other countries. The situation is unpredictable in the sense that a loss of confidence may or may not take place, but if it does, it becomes self-fulfilling and the country is pushed from a ‘good’ equilibrium to a ‘bad’ equilibrium from which recovery is not easy. These models are similar to the ‘multiple equilibria’ model of Diamond and Dybvig (1983) which explains banking crises arising from a run on deposits.

3 For a review of this literature see Eichengreen (1998) and Eichengreen and Mussa (1999). For individual contributions see Krugman (1979), Obstfeld (1986), Radellet and Sachs (1998) and Velasco and Chang (1998).

Table 2 Current Account Turnarounds in East Asia (per cent of GNP)

	Current Account Deficits		Turnaround (2-1)
	(1)	(2)	
	1997	1998	
Thailand	-2.0	12.8	14.8
Korea	-1.7	12.5	14.2
Malaysia	-5.1	12.9	18.0
Indonesia	-1.8	4.0	5.8
Philippines	-5.3	2.0	7.3

Source : World Economic Outlook

Contemporary crises are not only difficult to predict, they are also difficult to manage for two reasons: they explode quite suddenly, leaving very little time for the authorities to react, and the financing gap associated with them is very large. In East Asia, for example, the reversal of capital flows in 1997 for the five affected countries amounted to \$107 billion, or about 10 per cent of their combined GDP and most of the outflow occurred in the second half of the year.⁴ Both the size of the outflows and the speed of reversal reflects the fact that a loss of confidence is essentially a stock adjustment process, where a large change in flows can occur in a very short period. Outflows would not necessarily continue on this scale year after year, but the impact in the short term can be highly destabilising.

Since resources on the scale needed to finance such capital outflows are usually not available, and the outflows also cannot be stopped and reversed very quickly, countries are forced to 'adjust' to the capital outflow by generating a large improvement in the current account. The scale of the adjustment forced upon the East Asian countries can be seen from Table 2. Malaysia had to adjust to a turnaround of about 18 per cent of GDP in the current account while both Korea and Thailand experienced turnarounds of over 14 per cent. Indonesia had to make a much smaller adjustment of only 5.8 per cent.

In a text-book world it is possible to generate an improvement in the current account while protecting total output and employment by using a combination of policies involving a reduction in aggregate demand and a depreciation of the exchange rate. The reduction in aggregate demand reduces the domestic demand for tradables, which in turn improves the current account, but it is also likely to create unemployment in the non-tradable sector because of rigidity of money wages and labour market inflexibility. Depreciation of the exchange rate is expected to counter such unemployment by switching domestic demand away from tradables and towards non-tradables, and also encouraging additional production of exports and import substitutes. However, in practice there are limits to the extent to which exchange rate depreciation can help reduce imports or generate additional exports in the short run. A large current account improvement in the short term is therefore likely to be achieved only through a severe contraction in demand, which reduces imports but typically also leads to a contractionary effect on output and employment. This is precisely what happened in East Asia. The large turnarounds in the current account were all achieved through a massive import contraction which was also associated with a sharp decline in output. GDP in 1997 declined by 5.5 per cent in Korea, 6.8 per

4 See World Bank (1998). A substantial part of the reversal was on account of the withdrawal of commercial bank financing, mainly in the form of a refusal to roll over existing short-term debt which had reached very high levels in Thailand, Indonesia and Korea.

cent in Malaysia, 8 per cent in Thailand and as much as 13.7 per cent in Indonesia.⁵

The economic contraction in East Asia occurred because the collapse in the exchange rate generated severe negative effects on the balance sheets of banks and corporations which had large unhedged exposures to foreign borrowing. The role of negative balance sheet effects in contemporary crises needs to be clearly understood because it converts the normally expansionary effect of a depreciation, operating through the stimulus to exports and import substitutes, into a contractionary effect. Negative balance sheet effects on firms, leading to bankruptcy in extreme cases, obviously discourage investment and also reduce access to bank credit, both factors leading to contractions in output. If the banking system also suffers from excessive foreign exchange exposure, the exchange rate depreciation can erode the capital of the banks which has a contractionary impact on bank credit from the supply side. Even if banks have no direct foreign exchange exposure, they can suffer indirectly if their clients have excessive exposure because non-performing assets begin to mount, leading to banking distress.

High interest rate policies are traditionally recommended to discourage capital outflows, but these policies can hurt domestic banks, if there is a maturity mismatch in the banking system. The inability to use interest rate policy because of fragility in the banking system makes it difficult to prevent a collapse of the exchange rate which, as we have seen, has its own balance sheet consequences. A weak banking system can also create fears about bank failures, which can trigger a flight of domestic capital through the open capital account, thus worsening the initial currency crisis. Managing a currency crisis in the face of a weak banking system is therefore doubly difficult.

Is a disruptive outcome unavoidable once the crisis is triggered or is it the result of inap-

propriate policies? Critics of the IMF have argued that misguided policies were responsible for the depth of the crisis in East Asia.⁶ They have argued that the IMF erred in prescribing traditional remedies such as fiscal and monetary tightening when the circumstances preceding the crisis did not indicate imbalances in these areas. They have also criticised the IMF for exacerbating the loss of confidence by focusing too much attention too suddenly on the weakness of the banking system, which may have added to the panic rather than calming it, thus intensifying the crisis.

The IMF on its part has admitted that some mistakes were made in the early stages. It has conceded that the initial fiscal targets were too tight because they did not make adequate allowance for the fact that the exchange rate collapse would have severe negative balance sheet effects, which would generate strong deflationary pressures in the short run. It has also admitted that the closure of 16 unviable banks in Indonesia, though essential, should have been done in a manner which avoided uncertainty about the safety of the rest of the system. The Fund's own analysis of the failure of its East Asian programmes to bring about an early stabilisation is contained in a Fund Staff study by Lane et al. (1999). The study points out that the financing provided in the Fund programmes was sufficient only on the assumption that the programmes would suffice to restore confidence and halt the capital outflow. When that did not happen, the continuing outflows led to a much greater collapse in the exchange rate than had been anticipated, which in turn had large negative balance sheet effects. The critical issue therefore is whether another set of policies could have been more successful in restoring confidence and thereby containing the extent of the capital outflow. We return to this issue in Chapter 4 when we discuss problems in designing adjustment programmes to deal with contemporary crises.

5 See *World Economic Outlook 1999* (Table 2.6).

6 See especially Radelet and Sachs (1998) but also Furman and Stiglitz (1998).

For the present, we will only note that the most important objective in handling a crisis of confidence is to try to restore confidence, so that capital flows return to normal levels. However, confidence once lost is not easily regained. Fiscal and monetary policies take time to have effect and in a world in which capital can move as rapidly as it does today, a great deal of damage can be done before the crisis resolution strategy begins to take hold.

2.2 Why Developing Countries are More Vulnerable

The frequency of crises affecting emerging markets in the 1990s is sometimes attributed to the high volatility of private capital in international financial markets, but this is not by itself a sufficient explanation since industrialised countries face the same capital markets, but they have not faced crises of similar severity.⁷ Developing countries clearly have special characteristics which make them more vulnerable and these characteristics have to be kept in mind in devising mechanisms for crisis prevention and crisis resolution in the new global architecture.

Some of the features which make developing countries especially vulnerable to severe crises are the following:

Lack of information: Investors have much less information about conditions in developing countries than about industrialised countries and this creates potential instability. Investment flows which are initially based on inadequate information are more liable to change based on new information or perceptions which may not be very robust. Lack of information also leads to herd behaviour, with less informed investors simply following the lead of those who are supposed to know better, creating familiar boom-bust cycles. The practice of judging performance of individual fund managers relative to

others makes it optimal for individual fund managers to move with the herd unless they have significantly better information which tells them to do otherwise.

Contagion: Contagion is a new phenomenon of the 1990s to which developing countries are particularly vulnerable. A loss of confidence in one country, which may be objectively justifiable in terms of deteriorating fundamentals, leads to a loss of confidence in another country purely through contagion, even though the fundamentals in the second country are quite sound. This phenomenon can be explained in terms of the inadequacy of the information needed for investors as a group to discriminate between countries. The expected behaviour of the group can be a determining factor even for the well-informed investor aware of the soundness of fundamentals since it will be rational to exit if other investors as a group are expected to panic and this is likely to affect the market.

Thin markets: The thinness of developing country markets relative to the size of global capital flows makes developing countries more vulnerable because changes in capital flows, which are relatively small measured by global standards, can cause large changes in asset prices. This generates euphoria in good times, as rising asset prices appear to validate the expectations underlying initial inflows, but it also produces panics in bad times. The nervousness about the destabilising capability of hedge funds arises precisely because of the perception that these funds can mobilise resources that are relatively large compared to the thin markets in developing countries, making it easier for them to destabilise these markets.

Financial sector weakness: Weaknesses in the financial sector, especially in banks, have

⁷ Industrialised countries have experienced currency crises in the 1990s, for example the ERM crisis of 1992 which affected the UK, Spain and Italy. However the currency crisis did not lead to a disruptive outflow of capital and a denial of access to global capital markets. The crisis remained a currency crisis in which there was a speculative attack because the market judged the exchange rates to be unsustainable. The speculative attack succeeded, but once the currencies had depreciated to a level judged sustainable, the attack ceased.

emerged as one of the most important causes of financial crises. With a weak banking system, capital inflows in the boom phase are likely to be intermediated in an imprudent manner, leading to an excessive build-up of foreign exchange exposure and of short-term foreign debt, either by the banks themselves (for example, Thailand and Korea) or by corporate borrowers (for example, Indonesia).⁸ Liberalisation of the capital account also sometimes generates feedback effects which increase the weakness of the financial system. As high quality corporate clients take advantage of access to world capital markets and shift to apparently lower-cost borrowing abroad, pressure is put on domestic bank margins and the asset portfolio of the banks also deteriorates, both factors tending to reduce bank profitability. This may encourage banks to enter into riskier activity to improve profitability. On the liabilities side, they may be tempted to borrow short term abroad, thus increasing their foreign exchange exposure; on the asset side, they may be tempted to expand into riskier domestic activity, for example lending for real estate development, backed by collateral values which are overpriced because of asset price bubbles. The absence of a domestic market for long-term debt, which is another dimension of financial sector weakness, also weakens the banking system because it creates pressure on banks to provide long-term finance, increasing their maturity mismatch and making them more vulnerable to interest rate changes. A weak financial sector not only contributes to vulnerability by encouraging an excessive inflow of foreign exchange exposure, it also makes it more difficult to manage a crisis should it occur, since interest rate policies cannot be deployed to contain capital outflows without damaging the banking system further.

Exchange rate regimes: The ‘soft-peg’ exchange rate regimes adopted by many developing countries are widely regarded as having contributed to vulnerability. This is because they give the appearance of a firm commitment to maintain exchange rate stability, which encourages borrowers to ignore exchange risk and build up substantial unhedged foreign exchange exposure. In the absence of strong institutional mechanisms which can effectively anchor the exchange rate, situations can arise when the rate becomes unsustainable; this inevitably leads to an exchange rate ‘adjustment’ which is then viewed as a failure of policy with a loss of credibility. This particular feature of soft-peg regimes has led many to argue that countries should either have fully flexible exchange rate regimes which would encourage more explicit recognition of foreign exchange risk or else adopt rigid monetary arrangements (such as a currency board) which would provide credible exchange rate stability.

Implicit guarantees: Many developing countries operate within an institutional framework which is seen by investors as offering ‘implicit guarantees’ which are then said to encourage imprudent lending to these countries, leading to excessive inflows which make them more vulnerable to crises. Public sector banks and large public sector corporations are often seen to have implicit government guarantees. In fact even private commercial banks are sometimes perceived to have the implicit guarantee of the government behind them because of the belief that government would not allow such banks to fail. In Thailand, implicit guarantees were extended even to non-bank financial companies as the Bank of Thailand is reported to have repeatedly confirmed to foreign investors that the government would ‘back Finance One (a non-

⁸ A strong banking system would avoid these problems by maintaining limits on its own direct foreign exchange exposure and protecting its indirect exposure by limiting bank credit extended to corporations which are over exposed to foreign exchange risk.

bank finance company) all the way'.⁹ Such implicit guarantees obviously create moral hazard by encouraging lenders to ignore the financial condition of the banks.¹⁰

Political factors: Political uncertainty is not unique to developing countries but it has a more damaging effect on investor perceptions when it occurs in developing countries than in industrialised countries because it is generally seen as signalling a possible deterioration in economic management. It is interesting to note that many of the recent crises were associated with periods of political uncertainty. The Mexican crisis, for example, was preceded by an atmosphere of political uncertainty created by the Chiapas rebellion, the assassination of a Presidential candidate and a change in government. The Indonesian crisis was clearly deepened by the climate of political uncertainty associated with a likely change of guard after 30 years of the Suharto Presidency. In Korea, a Presidential election was underway at the time of the crisis and this may have contributed to the initial panic because it created some uncertainty about how the government would react.

To summarise, developing countries which have liberalised the capital account in order to integrate more fully with international financial markets are more exposed to risk than industrialised countries facing the same markets. A sudden loss of investor confidence, which may be

triggered by a variety of factors, including pure contagion from developments occurring in other countries, could lead to a massive outflow of capital which could be highly disruptive. That the existing financial architecture has not been able to handle this problem effectively is evident from the increased frequency and severity of crises suffered by emerging market countries in this decade. Reforms are needed which would minimise the probability of such crises occurring, i.e. crisis prevention, and also handle them more effectively when they do occur, i.e. crisis resolution.

Crisis prevention and crisis resolution are the two main themes that have dominated the new architecture discussions and the next two chapters deal with them in sequence. However it should be noted that crisis prevention and crisis resolution are not two separate watertight compartments. There are close linkages and two-way interactions between the two. Preventive measures not only reduce the probability of crises occurring, they also reduce their severity if they do occur, which makes crisis resolution easier. Equally, the knowledge that effective crisis resolution measures exist can sometimes help to forestall panic reactions, thus preventing crises from occurring in the first place, or at least making them less severe. More recently, it has also been argued that the extent of crisis prevention undertaken by a country should determine the extent and terms of international assistance extended to it in the event of a crisis.

9 See Corsetti and Srinivasan (1999).

10 It has also been argued that the expectation of an IMF bail-out is another type of implicit guarantee which encourages imprudent lending by foreign investors. This criticism was first raised at the time of Mexican bail-out and was repeated in East Asia. Its validity in East Asia is surely doubtful since investors suffered large losses in that region. Expectations of an IMF bail-out probably did influence the decisions of lenders to continue lending to Russia despite evident problems in the months before the crisis, because it was viewed as 'too big (or too politically important) to fail'. However it is precisely in that case that the bail-out did not occur, which should correct expectations in future.

Crisis Prevention in the New Architecture

The time-worn maxim that an ounce of prevention is worth a pound of cure is especially applicable to financial crises because the costs of managing such crises once they occur are very high compared to the cost of trying to avoid them. This is especially so if the impact of crises on the welfare of the poor is taken into account. The new architecture discussions have focused on six critical areas of crisis prevention. These are:

- ❖ improving macro-economic management;
- ❖ increasing availability of information and strengthening surveillance;
- ❖ strengthening the financial system in developing countries;
- ❖ international action to strengthen the financial system;
- ❖ exchange rate regimes;
- ❖ policies towards capital controls.

A number of initiatives have been proposed in each area, some of which are only a restatement of well-known principles, but several new ideas have also surfaced. There is a broad consensus on most of the ideas being advanced to help prevent crises, but there are important differences in some areas, especially in relation to policies towards capital controls.

3.1 Improving Macro-economic Management

The least controversial prescription for crisis prevention – the equivalent of ‘motherhood’ and ‘apple pie’ – is that countries should pursue sound macro-economic policies. These policies are obviously important in themselves because they

determine economic performance. They also represent the so called ‘macro-economic fundamentals’ on which knowledgeable investors assess prospects for the economy, which in turn determines investor perceptions. The establishment of sound fundamentals must therefore be the first requirement for any crisis prevention strategy.

An important lesson from the experience of recent crises is that the soundness of macro-economic fundamentals has to be assessed on the basis of indicators which go beyond the traditional areas of fiscal and monetary policy. An extensive literature has developed in recent years seeking to identify reliable indicators of currency crises, but the empirical results obtained thus far are mixed at best. Some indicators do appear to be associated with certain crises, but they do not seem to be present in others. There are also cases of false alarms where a particular indicator may signal a crisis which does not materialise. We do not therefore have indicators which signal crises with high reliability. However the following indicators are generally regarded as important.

Traditional indicators of fiscal and monetary discipline: these remain important in the eyes of investors and rating agencies. These indicators did not signal problems in Mexico in 1994, nor in East Asia in 1997, but they were clearly important in both Russia and Brazil.

The current account deficit and the extent of real exchange rate appreciation: the particular level of the current account deficit, or the extent of real appreciation of the exchange rate which signals an alarm, may vary from country to country, but

any significant and continuing deterioration in these indicators is clearly a cause of worry. These indicators flashed an alarm in Mexico in 1994, but the warning was missed because the perception at the time was that a current account deficit not caused by a fiscal deficit was not a cause of concern since it reflected a private sector deficit financed by private capital flows. It was presumed that private capital markets were efficient and stable and that no intervention was needed. Perceptions changed after the Mexican crisis and when the same indicators sent warning signals in Thailand they were picked up by IMF surveillance as early as 1996, but the Fund could not persuade the Thai government to take early corrective action.

Slow down in export growth: this could be a sign of external unviability, especially in conjunction with a deterioration in the current account deficit, an appreciation of the exchange rate and strained debt service capacity.

Debt-servicing capacity: measures focusing on aggregate external debt and debt service in relation to exports of goods and services remain relevant. This is especially so if there is a high level of floating rate debt which can lead to a sudden strain because of interest rate changes.

Short-term debt in relation to usable reserves: this is a new indicator which has become the focus of attention following the East Asian crisis. The ratio of short-term debt to reserves had reached very high levels in most of the crisis affected countries of East Asia by the end of 1996. It was 103 per cent in Thailand, 170 per cent in Indonesia and as much as 284 per cent in Korea. It is interesting to note, however, that this indicator did not indicate a problem in Malaysia where it was a relatively modest 43 per cent.

Adequacy of foreign exchange reserves: this is an important indicator which shows the ability of a country to withstand speculative pressure at least for some time. In a world of free capital move-

ments, the adequacy of reserves must be determined not just with reference to traditional current account flows (for example in terms of months of imports of goods and services) but with reference to possible capital account shocks also. The 'quality' of reserves is also crucial. For example, Thailand committed a very large portion of its reserves in forward sales to defend the Baht so that the reported level of reserves became a misleading indicator. Similarly, Korean reserves had been deployed to help overseas branches of Korean banks to meet their short-term obligations arising out of the fact that subsidiaries of Korean firms abroad, which had borrowed from these banks, were unable to meet their dues. The accidental disclosure of the extent of erosion of reserves on this account precipitated the panic in Korea.

Excessive real growth of bank credit: growth of bank credit in real terms at a much faster pace than the potential growth of real GDP is a sign of excessive financial expansion which often reflects imprudent bank lending and can be a prelude to banking sector problems.

None of these indicators individually can be regarded as necessary or sufficient. Fiscal deficits were large in Russia and Brazil but not in Mexico or East Asia. The current account deficit signalled a problem in Mexico and Thailand but not in other East Asian countries. Even short-term debt was not in the danger zone in Malaysia. However the indicators listed above, taken together, are widely regarded as important indicators of economic health. Weakness in these dimensions indicates potential vulnerability which will be noticed by investors and should lead to early corrective action.

3.2 Increasing Availability of Information and Strengthening Surveillance

Since lack of information is one of the factors which makes developing countries vulnerable to euphoria, panic and contagion, anything that improves the quality of information can be expected to contribute to greater stability. The

new architecture discussions reveal general agreement on the need to increase the volume, quality and transparency of information available to markets. The impact of an increased flow of good quality information should not be exaggerated, but one can readily agree that more information is generally better.¹¹

A number of important initiatives have been taken in recent years which should help improve the flow of information to markets:

The IMF's Special Data Dissemination Standard (SDDS), introduced in 1996, encourages countries wishing to access international capital markets to commit themselves to standards of quality and timeliness of release of critical economic and financial data.¹² The system is being expanded to provide more comprehensive and timely data on external debt, with separate reporting for different maturities which should enable easy identification of possible short-term debt problems. The quality of data on the international reserves position are being improved to show reserve related liabilities (for example commitments in forward transactions) and also other potential drains on reserves.

The Code of Good Practices on Fiscal Transparency developed by the IMF will help to improve the quality of fiscal data to ensure that they reflect the true fiscal position of the government, including especially the position regarding guarantees and other contingent liabilities. The code also requires a clear statement of the underlying macro-economic assumptions on which the Budget is based as well as projections for the next two years and the specific assumptions underlying them. This would enable a much

more thorough evaluation of the fiscal strategy and performance of the government and draw attention to the need for corrective steps if domestic and external developments deviate from the underlying assumptions. Countries are being encouraged to adopt the Code voluntarily. No developing country has done so thus far but systematic application of these principles by the Fund in its normal surveillance and programme work will undoubtedly focus greater attention on these issues and is likely to lead to increased disclosure in developing countries.

The Code of Good Practice and Transparency on Monetary and Financial Policies which is currently being prepared will establish standards for monetary and financial data.

Additional information can reduce the risk of crises only if it somehow encourages market behaviour which is less risk prone. This is expected to happen because an increased flow of good quality information is likely to improve the quality of analysis of economic performance and policy, which should lead to more informed market behaviour. Much of this analysis is done by market participants themselves and additional information will make their task that much easier. It will also help improve the quality of analysis of institutions such as the IMF and the rating agencies, which are important sources of analysis.

a) IMF surveillance

There is general consensus that stronger Fund surveillance could help in crisis prevention if it leads to early corrective steps by the authorities concerned. The record of Fund surveillance in the context of crises is somewhat mixed. It failed

11 It should be emphasised that dissemination of information can also have negative effects on flows if the information points to a deterioration in performance. However a continuous flow of information will ensure more gradual transitions from positive to negative perceptions which would lead to a more gradual variation in flows which is better than an abrupt transition associated with a collapse. For a detailed assessment of the issues involved in transparency and disclosure see Stiglitz and Bhattacharya (1999).

12 Forty-six countries have subscribed to the SDDS so far. Details of their statistical methods, sources of data, timeliness of release, etc. are posted on the IMF's electronic SDDS Bulletin Board with hyperlinks to country sites where the actual data are available. The IMF also has a less rigorous General Data Dissemination Standard (GDDS). Countries which cannot meet SDDS standards are urged to subscribe to the GDDS.

to spot the brewing crisis in Mexico in 1994, but it did catch the same signals when they surfaced in Thailand though, as it happens, corrective action was not taken. However Fund surveillance clearly failed to spot the vulnerability of the rest of the region which led to the spread of the crisis from Thailand. It did not spot the growth of short-term debt, which is viewed as the villain of the piece in retrospect, even though data were available in the Bank for International Settlements (BIS). Nor did it spot the weakness in the financial sector which became the centre of so much attention after the crisis exploded. Hopefully, surveillance will improve in future and, equally importantly, will meet with greater readiness to take corrective action by governments.

Fund surveillance can also help by keeping markets better informed, but this role may conflict with the confidentiality traditionally associated with Fund consultations. Governments in developing countries are willing to provide the Fund with data and information which may not be in the public domain, and also engage in a frank discussion on policy options under consideration, because they view the Fund as a potential source of finance in times of difficulty and also as a certifier of good policies. The assurance of confidentiality is an important element in this relationship. In the absence of such assurance, the quality of the consultations is likely to decline and governments may be tempted to engage in 'strategic denial' which is in any case a common tendency in the incipient phase of a crisis. Against these arguments there is the view that as a public international organisation, the Fund has an obligation to make its assessments more freely available to markets as this would improve the functioning of markets and possibly also reduce the need for public international resources to manage crises at a later stage. There is force in both arguments and a balance has to be struck. The consensus at present is that the balance must tilt towards greater disclosure and this is happening.

The practice of releasing Public Information Notices (PINs), which summarise in

broad (and somewhat sanitised) terms the outcome of Board discussions of Article IV consultations, provided the country under review requests a release, is an important step forward. In 1997–98, only about 50 per cent of the countries for which Article IV consultations were completed requested release of PINs but this has since increased to 80 per cent. The extent of information revealed by the PINs about the nature of the Board discussion, especially on contentious issues, is also likely to increase over time.

A pilot project was initiated in April 1999 under which, Fund staff reports prepared for Article IV consultations would be released with the permission of the governments concerned. Sixty countries have agreed to participate in the pilot project and 16 Fund staff reports are on the Fund web site. The lead given by some countries will be followed by others, especially as market pressure pushes countries seeking access to capital markets towards greater voluntary disclosure. This is a desirable trend which will improve the quality of information available to markets.

Similar considerations have led to increasing the transparency associated with Fund programmes including publication of the letter of intent on the basis of which Fund financing is made available. There is a good case for complete transparency on the conditionalities agreed to with the Fund, and also the Fund's assessment of why they are needed.

b) The role of rating agencies

International credit rating agencies are another source of information for markets. Their reputation was not enhanced by the East Asian crisis because they clearly failed to spot the extent of the problems before the crisis. They may even have exacerbated the crisis by maintaining high credit ratings right up to the time the crisis broke, thus encouraging capital inflows till the very last minute. This was followed by a succession of quick downgradings after the crisis, signalling continuing deterioration, which may have contributed to the sense of panic. Hopefully, their

performance will improve in future as they internalise the lessons from their failure in East Asia.

The rating agencies have some important advantages over the Fund as far as informing markets is concerned. They may have less access to data and engage in less intensive discussion with governments than the Fund, but they have the advantage that they can reflect market perceptions about government policies and their credibility to a much greater extent. Fund reports would find it difficult to reflect market perceptions which are not objectively measurable, though they are obviously extremely important. Rating agency reports are also updated more frequently to reflect sudden developments and to that extent they provide a more continuous flow of information in a fast-changing world. Finally, rating agency reports grade countries on an ordinal scale whereas Fund staff assessments are qualitative, without a summary grading statistic. The ordinal grading system has the advantage that it enables frequent adjustment to reflect marginal changes in assessment of risk factors, even when the change is small. This did not happen in East Asia but we are likely to see more frequent adjustments in future to keep abreast of changes in the degree of vulnerability.

c) Dialogue with private creditors

A new approach whereby developing countries can inform markets and remain in touch with them is through a structured private-official dialogue along the lines initiated by Mexico in 1996. Senior Finance Ministry and Central Bank officials hold quarterly briefings of representatives of foreign banks, equity investors, asset managers, pension funds etc. Building on this experience, the Institute of International Finance (1999) has proposed that developing countries which have a significant involvement with international financial markets should undertake such interaction on a systematic basis. The nature of the interaction can be varied, depending upon

whether the country is in one of four different phases, i.e. normal conditions, incipient crisis, full-fledged crisis resolution and post-crisis market re-entry.¹³ The first two phases are clearly relevant for crisis prevention. The phase of incipient crisis refers to a situation in which some external shock or internal policy deterioration creates nervousness in markets, which is reflected in rising spreads or in steps by leading international banks to reduce exposure. An unexpectedly negative assessment by one of the rating agencies or by the Fund could also have the same effect, focusing market attention on policy deficiencies which may be identified in such reports. In such situations, the Institute of International Finance has suggested that the authorities may seek to calm markets by intensifying discussions with creditors, either by initiating the process themselves, or at the instance of concerned investors. The occasion can be used to inform markets of the factual position which may not be fully known, and also to resolve doubts which may exist about the government's plans to deal with the situation.

A systematised private-official dialogue along these lines could contribute significantly to developing confidence which is an important determinant of financial stability. It also makes it possible to intensify the dialogue when the situation deteriorates and there is a threat of a crisis, without creating a panic reaction in the markets. The feedback provided to the government through such dialogue might encourage an earlier recognition of incipient problems, at least as perceived by investors.

d) Regional surveillance mechanisms

A new idea which has surfaced in the aftermath of the East Asian crisis is the possibility of regional surveillance, or at least some form of regional consultation, on financial market developments. The case for such consultations rests on the fact that if contagion is a common danger facing

13 See Institute of International Finance (1999), pp. 32–34.

countries in the same region, then each country has an interest in keeping abreast of developments in other similarly placed countries and sharing information on current market perceptions. There are many regional groupings in which member countries consult on a variety of subjects and these consultations could be expanded to include assessments of the perceptions of international investors and financial markets about conditions in the region.

The limitations of regional surveillance should also be recognised. It is not easy to transform a regional forum, designed for sovereign governments to discuss issues of mutual co-operation, into a forum for undertaking a collective and genuinely critical assessment of developments or policies in an individual member country. Regional forums can be very useful in developing a common understanding of the perceptions and concerns of foreign investors and financial institutions about the countries in the region and also in hearing the views of individual members on the seriousness of perceived problems in their countries. However they are unlikely to permit the kind of frank and objective examination of policies of individual countries that is needed for effective surveillance.

The effectiveness of regional consultations will vary depending upon regional circumstances. It will be greater in regions where there is greater regional integration and extensive economic co-operation. The quality of these consultations for purposes of surveillance could be greatly enhanced if they took place not just on the basis of documentation produced by the countries themselves, but also on the basis of the latest Article IV consultation report prepared by the Fund staff. These reports are in any case available to all member governments through their representatives on the Fund Board. However Fund reports on neighbouring coun-

tries are unlikely to receive attention at Ministerial level except perhaps at times of crisis. The use of these reports in regular regional consultations would at least present to the forum an independent assessment of the kind of problems in individual countries which are of concern to investors and which, if not attended to, could affect investor perception of the region as a whole through contagion effects.

3.3 Strengthening the Financial Sector in Developing Countries

Efforts to strengthen the financial system have a major role in crisis prevention and the discussions on the new architecture have focused a great deal of attention on this issue. The current consensus is in favour of casting the net very wide to cover not only the banking system, but also the other major segments of the financial system, such as the securities market and insurance, as well as the institutional infrastructure supporting the financial sector, i.e. accounting systems, bankruptcy laws and corporate governance. There is general agreement that regulatory standards and practices prevailing in developing countries fall short of international norms in all these areas and should be upgraded.

a) The banking system

The Basle Committee on Banking Supervision is the accepted international body setting prudential and supervisory standards for the banking sector.¹⁴ Its capital adequacy standards, reflected in the Basle Capital Accord of 1988, are treated as the internationally accepted minimum standard and its Core Principles of Banking Supervision are accepted as the authoritative blueprint for an effective system of bank supervision. The capital adequacy norms are being reviewed with a view to improving the risk assessment system, for which purpose a consultation

14 It was originally established in 1974 by the G-10 central bank Governors to improve collaboration between bank supervisors in the light of the failure of the Herstatt Bank in Germany and the Franklin National bank in New York. Though the Committee does not include any developing countries, it has evolved mechanisms whereby it consults the Central Banks of major developing countries which are members of the BIS

document 'A New Capital Adequacy Framework' has been circulated for comments. Modifications being proposed include varying risk weights according to the quality of risk with the weight exceeding 100 per cent for some assets; varying risk weights for loans to banks in emerging market countries on the basis of the credit rating of banks; a lower sovereign risk rate for countries subscribing to the SDDS and urging regulators to specify higher levels of capital adequacy in countries where the banking system is subject to greater risk.¹⁵

Most developing countries fall short of existing international norms, to say nothing of any revisions that may be proposed in future. Fortunately, there is general agreement in developing countries that banking standards must be upgraded and many countries are already engaged in this process. Implementation problems are bound to arise. One set of problems arises from the fact that the Basle Committee norms and standards were designed for the financial markets of industrialised countries and some modifications may be needed before they can be applied in developing countries.¹⁶ Whatever method of risk assessment is adopted, it will be necessary to allow for a suitable transition period for full implementation of the new norms to avoid an undue shock to the system. However these difficulties are not insuperable. Suitable modifications to meet country-specific circumstances and an appropriate phasing can be worked out in a manner which does not dilute the essential prudential purpose of the exercise, or delay it unduly.

It must be emphasised that mere adoption of international standards will not solve all problems. The state of Japanese banks is only the latest example which shows that financial fragility can arise even in an industrialised country

fully subscribing to international norms if these norms are not effectively enforced through a strong supervisory system. Development of a strong supervisory system is not easy. It requires highly specialised supervisory skills, which are scarce even in industrialised countries. It will take several years for supervisory authorities in developing countries to develop such a skill base, and even then it may not be possible, given the constraints of public sector salaries within which supervisors have to operate. The supervisory authority must also be sufficiently independent of government to be credible as a regulator. This is particularly important where the banking system includes large public sector banks as is the case in many developing countries. A large public sector presence in banking typically generates pressure for regulatory forbearance towards these banks in the form of weak enforcement of supervisory measures, including penalties.

Improvements in the banking system in many countries will require a complete change in the way banks function, including changes in their governance systems, internal control mechanisms and in personnel skills. These institutional changes can only take place over a period of time. However, the process can be accelerated by increased competition, including opening the banking sector to international players. This process is underway in most developing countries and is likely to be accelerated by the liberalisation of financial services under the auspices of the World Trade Organization (WTO). The resulting increase in competitive pressure is likely to be an important force affecting the pace of improvement in the banking system in developing countries.

A particularly difficult issue which may arise in many countries is whether international banks which are willing to inject the necessary capital

15 The Basle Committee's approach of categorising assets into different risk buckets with different risk weights is under attack in some quarters as representing a crude approach to risk management and there is a view that banks should be encouraged to evolve proprietary models of risk management which will take account of covariances of risks of different types of assets. However, there is no consensus yet on whether this is an acceptable basis for banking supervision, especially in developing countries.

16 Market to market practices for example presume the existence of highly efficient and liquid markets which may not exist in many developing countries.

and management skills should be allowed to take over weak domestic banks. Takeovers of domestic banks by foreign banks has been controversial even in OECD (Organisation for Economic Co-operation and Development) countries, as many recent examples reveal, and similar hesitation can be expected in many developing countries. However the logic of integration with global financial markets, and the need to improve the domestic banking system, suggest the need for greater flexibility in this area.

b) Securities markets and insurance

Securities markets in developing countries, though still relatively small compared to banks, will increase in importance over time and the efficiency of these markets is important to develop a strong financial system. The emergence of strong equity markets will help reduce the extent of leverage in the system which otherwise contributes to financial fragility. The development of strong and liquid bond markets will also help by reducing the present very high dependence upon banks as a source of long-term debt, which subjects banks to the risk of excessive maturity mismatches.

Regulatory standards in securities markets need to be improved to create confidence in the integrity and transparency of the market, especially in price discovery. The International Organisation of Securities Commissions (IOSCO), in which developing countries are well represented, has done excellent work in establishing sound regulatory principles and minimum standards. These need to be adopted and enforced in emerging markets.

Insurance companies are major players in the securities markets and the quality of regulation and supervision of these institutions is an important part of a well-functioning financial system. This is another area where there are large gaps in many developing countries. The International Association of Insurance Supervisors (IAIS) was set up relatively recently in 1994, to develop practical standards for

supervision of insurance. It has issued papers on principles for insurance regulation and supervision for emerging economies similar to the Basle norms on capital adequacy.

c) The accounting and auditing system

A strong accounting system is a precondition for efficient financial intermediation because the ability of banks, as well as investors in the capital markets, to evaluate the financial strength and performance of companies depends upon the transparency and accuracy with which corporate accounts reveal the true financial condition of a business. Accounting standards in many developing countries are deficient in several respects. The absence of mandatory consolidation of accounts with the accounts of subsidiaries makes it difficult to ascertain the true profitability of a business. The lack of segmented income reporting, the absence of requirements for disclosure of related party transactions and of the extent of deferred tax liability are other features which make published accounts non-transparent.

The International Accounting Standards Committee (IASC), which represents professional organisations in 88 countries, has issued 35 international accounting standards governing various aspects of accounting which serve as guidelines for national accounting bodies to follow in framing their own standards. It has also developed, at the request of IOSCO, a core set of International Accounting Standards (IAS) for adoption by IOSCO as the minimum standards which must be met by companies making international securities offerings. One approach to improving accounting standards is for all countries to move as rapidly as possible to international standards set by the IASC. However full international harmonisation may not be easy – it has not yet been achieved even among industrialised countries. Standards in most industrialised countries and many developing countries were developed independently before the IASC was established and there are differences from the IAS for many countries. The US Securities and Exchange Commission is unwill-

ing to accept the IAS because it regards the US standards as more rigorous. Harmonisation of accounting standards may also be resisted because changes in accounting practices lead to changes in tax liability and the willingness to change accounting standards will depend upon whether tax laws can be changed to avoid higher tax incidence.

Even if complete harmonisation is not possible, there is an urgent need to upgrade standards substantially to come closer to international levels of disclosure and transparency. Larger corporations in many developing countries often voluntarily observe higher standards so that they can access international markets for debt and equity and IOSCO's endorsement of core international accounting standards will encourage compliance by corporations seeking to make international offerings. However a general improvement of domestic accounting standards is also needed. It is sometimes argued that it is difficult to get small firms to change, but this problem can be overcome by prescribing higher standards for firms above a critical threshold size, or for firms listed on the stock exchange.

As in other areas, improvements in accounting standards must also be accompanied by effective enforcement with appropriate penalties for misrepresentation and fraud. Poor enforcement is often as important a deficiency in developing countries as lower standards.

d) Bankruptcy laws

An effective bankruptcy law is another essential element for a strong financial system which is often missing in developing countries. Bankruptcy laws are necessary to provide assurance to creditors that they can recover loans and also to give borrowers an incentive to repay. Without such laws, either financial intermediation will not take place to the extent that it should, or banks and financial institutions will be inherently more fragile, especially during a downturn.

The general principles which a good bankruptcy law must fulfil are well known. It must strike a fair balance between debtor and creditor interests, enabling creditors to enforce their claims through liquidation if necessary while also providing a reasonable chance for failing businesses to be resuscitated by bringing in fresh capital with a change of management if needed.¹⁷ There are no established international standards in this area and actual practice varies considerably, even among industrialised countries, in the way the interests of debtors and creditors are balanced. However, industrialised countries generally have strong legal systems which provide adequate clarity about the rights of creditors and an assurance of effective enforcement. Many developing countries are lacking in this respect.

Better laws are definitely needed, but as with any law, much depends upon how it is interpreted by the courts and enforced in practice. This became evident in Indonesia when the ability of foreign creditors to enforce their claims came into question. Changes in the law may have to be buttressed by changes in legal procedures to ensure speedy outcomes and even perhaps training of judges to familiarise them with the economic compulsions underlying the legal changes which need to be made. For all these reasons, progress in this area is likely to be slow, but a start should clearly be made.

e) Corporate governance

Corporate governance is usually included in the litany of what is needed to strengthen the financial system and this aspect will become increasingly important as corporations shift from banks to the capital market as a source of finance. However, this is a relatively new concern even among industrialised countries and there are no established international standards. Corporate governance models differ considerably in different countries with the Anglo-Saxon model, the German model and the Japanese model differing

17 An important feature of the law must be the establishment of the seniority of various claimants to avoid creditors engaging in a grab race for assets which would push the firm into liquidation in a manner which does not realise full value.

on several issues, such as the role of outside directors, single versus two-level boards, the role of workers' representatives, the role of banks etc.

The OECD has recently issued a set of principles for corporate governance and a Memorandum of Understanding (MOU) has been signed with the World Bank aimed at promoting wider adherence to these principles in developing countries. However the principles are couched in fairly general terms, such as transparency, fairness, accountability and social responsibility. The manner in which they are translated into detailed rules for corporate governance will vary from country to country, and in practice will be strongly affected by the existing commercial and corporate culture. Needless to say, improvements in accounting standards are a critical precondition for effective implementation of corporate governance principles.

To summarise, strengthening the financial sector is an important element in any strategy for crisis prevention and there is a broad consensus that improvements are needed over a very large area. Some of the action needed goes well beyond banking and financial policy as narrowly defined and covers many other institutions and systems which are essential for efficient financial intermediation. Reforms in these areas are mutually supportive and developing countries should make a determined start on all these fronts; however it would be realistic to recognise that actual progress is likely to be gradual at best and the potential vulnerability of developing countries on account of weaknesses in the financial sector is likely to remain for some time. This needs to be kept in mind in designing other policies and determining the need for other institutions to deal with financial vulnerability.

3.4 International Action to Strengthen Financial Systems

Action by developing countries to strengthen

their domestic financial system can be supplemented by action at the international level which will discourage behaviour which increases potential instability. Several initiatives have been identified in this context.

a) Banking regulations in industrialised countries

Imprudent lending by commercial banks in industrialised countries was as much responsible for precipitating the financial crisis in East Asia as imprudent borrowing and some corrective action is needed at the industrialised country end also. The regulatory framework in industrialised countries must bear part of the blame because it prescribes a risk weight of only 20 per cent on short-term loans to commercial banks in developing countries against 100 per cent for long-term loans. While this may appear to be a legitimate risk-minimising measure for the individual lending bank, it has the consequence of providing a regulatory incentive to shift towards short-term loans, thus increasing total risk in the system.¹⁸ The practice of assigning the same risk weight to loans made to all commercial banks in developing countries also fails to distinguish between banks on the basis of the credit standing of the individual bank, or on the basis of the regulatory standards in the developing country concerned. This deficiency would be corrected if the proposal to introduce different risk weights depending upon the credit rating of banks, which is part of the Basle Committee's proposed revision of capital adequacy standards, is accepted.

Industrialised countries should also push for improved regulatory standards in offshore financial centres (OFCs) which can be used by financial institutions in industrialised countries to undertake activities that may not be allowed under home country regulations or which are subject to stricter regulation at home. Even if OFCs cannot be forced to change, national reg-

18 The risk arises because financial systems at the borrowing end do not exercise sufficient prudence to avoid short-term borrowing. Adequate prudential behaviour on the part of borrowing banks would eliminate the problem but until that happens, the lending banks should take into account the likelihood of risk prone behaviour by the borrower.

ulators can certainly discourage institutions under their supervision from transacting in OFCs where the regulatory standards are inadequate by imposing higher risk weights on loans to banks and institutions in such OFCs and also by insisting on greater disclosure. Concerted action by all industrialised country regulators is obviously more likely to be effective in this situation than isolated action, since it avoids putting the banks of some countries at what may be seen to be a competitive disadvantage vis-à-vis other industrialised country banks.

b) Regulation of hedge funds

The role of hedge funds in provoking currency crises first came to notice in the ERM crisis in 1992 and has surfaced again in the context of East Asia. Some studies have suggested that their role in East Asia was quantitatively less important than similar activity by other investors such as investment banks and also that they were followers rather than leaders.¹⁹ However these conclusions can be questioned on the grounds that even though their total activity in forex markets may not be large relative to banks and other investment institutions, they take more concentrated positions and also change positions more frequently, and it is these factors, rather than the overall level of activity, that affect market stability. Part of the problem in reaching firm conclusions is that there is little information on the transactions of hedge funds because they are not subject to disclosure requirements. Whatever the facts, there is widespread suspicion that these institutions can and do manipulate the relatively thin markets of developing countries and that they should be better regulated to prevent destabilising behaviour.²⁰

The case for regulation can be made on one of three different grounds: ensuring investor protection, limiting systemic risk and protecting market integrity. Regulation to protect the inter-

est of investors in hedge funds is clearly not a concern of developing countries and it finds little support in industrialised countries because those who invest in hedge funds are presumed to be capable of looking after themselves. Limiting systemic risk is a legitimate concern, but such risk arises principally because of leveraging and the consequent possibility of defaulting on loans from banks and also the possible destabilisation of asset prices if the hedge fund is forced to liquidate its positions very quickly. However this problem is best tackled not by regulation of hedge funds but by better prudential regulation of banks lending to these institutions. There is reason to believe that banks have financed these institutions without adequate appreciation of the risks involved in complex derivatives, which are extremely difficult to quantify. One way of reflecting this risk is to prescribe higher risk weights for loans to such institutions which might help reduce the degree of leverage, and therefore the danger of systemic instability.

The third possible reason for regulating hedge funds is that they distort market integrity by manipulating markets; it is this that has been emphasised after the crisis in East Asia. It is argued that they are able to do this because the resources at their command are large relative to the thin markets of developing countries and that some regulation is necessary to protect developing countries from such manipulation. There is no consensus on this issue, however, because it is difficult to distinguish in practice between market manipulation and taking positions in anticipation of market changes that would occur in any case. The most commonly quoted example of market manipulation is the speculative 'double play' involving simultaneous short positions taken by hedge funds and other large operators on the Hong Kong currency markets and the equities market in 1998. The authorities' effort to defend the currency was

19 See Eichengreen and Mathieson (1998).

20 Nor is this suspicion limited to their activities in developing countries. For an assessment of the role of hedge funds in the Australian currency market see Rankin (1999)

expected to lead to high interest rates which would depress property and equity prices and the resulting gains on the equity leg of the transaction were expected to finance losses on the currency leg.²¹ However, purists would argue that similar double plays are possible in other markets as well, and as long as there is no collusion this should be regarded as a legitimate strategy.

Even if it was agreed that some regulation is necessary, it is not clear what regulations could help prevent market manipulation without simultaneously interfering in the functioning of the markets. As long as hedge funds engage in transactions that are permissible, there is little justification for restricting them alone from undertaking the transaction. At most a case can be made for disclosure of large positions taken by hedge funds in order to increase the transparency of their operations, but such disclosure would have to be applied to other large players also. Besides, disclosure requirements in one market will not enable effective monitoring of the activity of hedge funds. A hedge fund may conduct a transaction in a 'target' currency with an international bank as the counter party in an offshore market, and the impact in the target market will be felt only in the form of positions taken by the international bank to hedge its own exposure from the original transaction with the hedge fund. To identify hedge fund activity with respect to a particular currency it will be necessary introduce extensive reporting requirements on large transactions by all players in all markets, along with elaborate mechanisms for exchange of information. Even this might be evaded by operating through lightly regulated offshore financial centres.

This issue is being examined in various groups, such as the Basle Committee, the BIS

Committee on the Global Financial System, the US President's Working Group on Financial Markets and most recently the Financial Stability Forum. On present prospects, the most that is likely to emerge in this area is increased disclosure requirements for large exposures.

c) The role of the IMF and the World Bank

The IMF and the World Bank can help to accelerate the process of financial sector reform in several ways. Many developing countries may need technical assistance in developing detailed national level regulations which reconcile the requirements of international standards with the specific circumstances of the individual country. The Fund and the Bank are in a position to provide such technical assistance when needed. They can also provide information about 'best practice' in other developing countries which can be an important input in determining the pace of reform.

IMF surveillance and World Bank country economic work can also be used to monitor the progress made by each country in upgrading standards in different parts of the financial system. Following the experience in East Asia, the two institutions agreed to collaborate closely in future to study financial sector developments in the more important emerging market economies, with each institution focusing on its area of special responsibility.²² A joint IMF-World Bank Financial Sector Assessment Programme (FSAP) aimed at evaluating the health and vulnerability of the financial system has been launched on a pilot basis. Based on the FSAP report the IMF will produce Financial Sector Stability Assessments (FSSAs) which will inform Article IV consultations. These initiatives will not only improve the assessment of

21 It was in response to this situation that the Hong Kong Monetary Authority resorted to the unusual strategy of directly intervening in the stock market to defeat the second leg of the double play. This intervention was widely criticised at the time but in retrospect is recognised to have been a successful strategy.

22 The IMF is expected to concentrate on macro-policy issues including aspects of the financial sector which impinge on macro-policy. The IMF and the World Bank together will work on financial sector regulatory issues and the Bank will concentrate on structural issues such as recapitalisation and restructuring of financial institutions and institutional weaknesses in the legal structure, accounting, bankruptcy laws, corporate governance, etc.

financial sector problems in the course of surveillance, they will also keep the Fund and the Bank better informed about financial sector developments in these countries and thus ensure that adjustment programmes for the financial sector can be designed relatively quickly in the event of a crisis in these countries.²³ The G-7 Finance Ministers have also indicated that Fund-Bank reviews of developments in the financial sector should be used to encourage countries to make rapid progress towards full compliance with international standards.

Intensified surveillance of financial sector developments by the Bretton Woods Institutions raises some delicate issues.

- ❖ The scope of financial sector related issues is so vast that this could potentially extend Fund surveillance and Bank diagnostic work over a much wider area than in the past, covering difficult issues in entirely new areas such as accountancy standards and bankruptcy laws. Comprehensive coverage of such a large area is simply not feasible.
- ❖ Even if intensified surveillance is limited to the banking system, it is not easy to assess the health of the system without fairly intrusive supervision. It is relatively easy to evaluate the extent to which prudential norms correspond to international standards, but it is extremely difficult to assess whether these norms are actually being enforced through effective supervision. Evaluating the end result in terms of the balance sheet strength of the banks is difficult enough for national regulators and it is unlikely that the Fund and the Bank will have sufficient access to information to do a good job.

Because of these difficulties, assessing the health

of the financial sector is likely to prove much more difficult than traditional assessments of fiscal and monetary policy where there is much greater consensus on the criteria for good performance.

Diagnosing financial fragility is particularly difficult because one must look not just to the static position revealed in the balance sheet at a point in time, but also to the vulnerability of the system under different types of stress situations. These diagnostic problems are likely to multiply in times of crisis when it becomes necessary to define the conditionalities related to financial restructuring which are necessary to restore stability. It will always be possible to argue – as Feldstein (1998) did in the case of Korea – that the financial restructuring conditions being imposed go beyond the requirements of what is strictly needed for stabilisation.

d) The Financial Stability Forum

A missing element in the global financial architecture is the lack of an effective representative forum for overseeing the functioning of the financial system as a whole. The IMF, with its intergovernmental Executive Board, may have been an adequate overseer of the system in the days before the enormous growth of private financial markets. It is not ideally placed to perform this role in a global financial system that is dominated by private capital and in which financial markets are internationally integrated but subject to national regulation and supervision. The efficiency of international private markets is obviously affected by the extent of international harmonisation of national regulations in each financial market, and this is the responsibility of international bodies representing national regulators, i.e. the Basle Committee, IOSCO and IAIS, all of which operate outside the ambit of Fund supervision.

Suggestions have been made in various

23 Experience in East Asia showed that there was not enough time for the Fund to consult the World Bank on the design of the financial sector restructuring component of the East Asian programmes. Bank restructuring and recapitalisation falls within the area of structural change which is in the World Bank's area of primary responsibility.

quarters, including Kauffman (1998), Eatwell and Taylor (1998) and the UN Committee on Development Planning for the creation of a World Financial Authority which could act as a global overseer, and indeed even supervisor, of the international financial system. The case for a global supervisor rests on the argument that financial markets are so inter-related and global that they need to be brought under unified supervision. Eatwell and Taylor (1998) have elaborated a proposal along these lines for a supra-national body exercising regulatory and supervisory powers over the international financial system, including powers to develop rules aimed at minimising systemic risk and to enforce them.²⁴ This would require a radical departure from the current situation in which international bodies such as the Basle Committee, IOSCO and IAIS have no mandate to enforce standards. They only recommend broad principles and guidelines, leaving it to national regulators to define detailed regulations and enforce supervision.

An international supervisory body to prescribe and enforce standards is clearly not a practical possibility in the foreseeable future. The loss of sovereignty implied would make it unacceptable to most countries. However, a limited step towards establishing a mechanism which could oversee the functioning of international financial markets in an integrated fashion has been taken by the establishment of the Financial Stability Forum (FSF). The FSF was established in June 1999 as a 33-member body at the official level comprising three representatives from each of the G-7 countries and two representatives each of the IMF, World Bank, Basle Committee, BIS, IOSCO and IAIS. Membership was subsequently expanded to include the Netherlands, Australia, Hong Kong and Singapore. The FSF is a consultative forum which will review the functioning of the international financial system and identify possible

problem areas which may require regulatory changes. It will not however recommend new standards – this function will continue to be performed by the international bodies representing regulatory authorities in each sector. The FSF has decided to focus initially on three important issues which are highly relevant for financial stability: offshore financial centres, the activities of highly leveraged institutions and short-term capital flows.

The FSF fills an important gap in the system but as presently constituted it is not a sufficiently representative body because no developing countries are included. The G-7 founder members had initially indicated the possibility of further expansion and, as noted above, four countries were added shortly after the Forum was established, but none of these were developing countries. It is not clear if further expansion is envisaged, but inclusion of the ‘systemically important’ countries is surely essential if the forum is to achieve the minimum degree of representation, participation and ‘ownership’ that is needed.

3.5 The Choice of Exchange Rate Regime

Since the exchange rate policies followed by some of the East Asian countries were widely held to have contributed to the crisis in that region, the choice of exchange rate regime is regarded as one of the critical elements of crisis prevention in the new architecture. An often quoted formula is that ‘soft-peg’ exchange rates – i.e. exchange rates that appear to be fixed but where there is no credible institutional assurance of fixity – are prone to generate crises and must be avoided. Developing countries must therefore choose between two polar extremes of a fully flexible exchange rate or a genuinely fixed exchange rate based on a credible institutional arrangement which ensures fixity, such as a currency board, or even outright dollarisation. Are these indeed the only options?

24 The Eatwell–Taylor proposal envisaged making the IMF and the World Bank ‘accountable’ to the World Financial Authority (WFA) which would also provide the framework within which the IMF could develop into a lender of last resort.

It is a well-known proposition in macro-economic theory that a country cannot simultaneously achieve the ‘impossible trinity’ of full capital mobility, exchange rate stability and independence of monetary policy. It is possible, at most, to achieve any two of these objectives, making it necessary to sacrifice the third. This leaves countries with three internally consistent options.

- (i) A country can achieve both exchange rate stability and monetary independence provided it gives up capital mobility and retains capital controls. This was the world of Bretton Woods when most countries had significant controls on capital movements.
- (ii) Once capital mobility is introduced by dismantling, or very substantially liberalising, capital controls, then exchange rate stability can be achieved only if the country gives up monetary independence. Either monetary policy must be completely subordinated to the objective of maintaining the exchange rate or the very possibility of an independent monetary policy must be statutorily abandoned by moving to a currency board arrangement as in Hong Kong and Argentina.²⁵ An extreme version of this approach is outright ‘dollarisation’ which has been advocated for some countries.
- (iii) A country can opt for both full capital mobility and monetary independence, but in this event it cannot ensure exchange rate stability. It must give up this

objective and opt for free-floating exchange rates.

The alternatives outlined above indicate that a country wanting exchange rate stability must either choose option (i), which involves continuation of capital controls, or give up monetary independence.

The idea of abandoning monetary independence in order to avoid exchange rate uncertainty has many supporters in academic circles, but it is unlikely to be acceptable to most developing countries. It is certainly not a simple way of guaranteeing exchange rate stability without attendant costs. On the contrary, exchange rate stability is in effect bought at the cost of transmitting external shocks to domestic employment and output levels; this can be just as disruptive as exchange rate shocks if labour markets and real wages are not highly flexible, conditions which are not easy to ensure. Abandoning monetary independence may be an attractive option for small, very open, economies, trading dominantly with a single currency area (and having a history of hyperinflation such as Argentina), but the majority of developing countries will want to retain the flexibility to use monetary policy to pursue domestic objectives.²⁶ These countries must either retain capital controls to achieve exchange rate stability as in option (i) or if they want to allow capital mobility they must accept exchange rate flexibility as in option (iii).

Since most developing countries are engaged in progressively liberalising capital movements, it follows that they must plan for greater exchange rate flexibility. It may be possible to work with exchange rates set within

25 The currency board arrangement ensures that if deficits exceed the level of financing available there will be an automatic drain on reserves and a corresponding contraction in money and credit which is expected to bring about the necessary adjustment in the current account. The same objective could be achieved by tailoring monetary policy to keeping exchange rates stable but a currency board arrangement is viewed as having greater credibility because it makes the process automatic.

26 Logically one can argue that economic integration will lead to the emergence of optimal currency areas and therefore fewer currencies. The establishment of the Euro is a major step in that direction but it has to be recognised that very extensive groundwork had been done in Europe to make the Euro politically acceptable and it is still not universally so, even in Europe.

relatively narrow adjustable bands as long as extensive capital controls are in place, but as controls are liberalised, exposing the economy to the possibility of large-scale capital movements, the exchange rate must be allowed to move more freely within a much larger band. It is important to recognise that even countries which have capital controls will need to accept greater exchange rate flexibility if the controls have been operated in a manner which has allowed a substantial build-up of short-term debt or of portfolio inflows with the assurance that repayments and repatriation will be allowed freely. In such situations, even though capital controls are nominally in place, the potentially volatile stock of capital which can flow out can be quite high. The presence of capital controls therefore reduces the degree of vulnerability, but it does not eliminate it entirely.

Recommending a flexible exchange rate regime does not imply that there should be no central bank intervention under any circumstances. Nor does flexibility mean an indifference to large movements of the exchange rate. Countries seeking greater stability of the exchange rate within a wide band can always try to achieve this through Central Bank intervention designed to deal with temporary pressure, combined with appropriate use of monetary policy. However there are limits to how far these instruments can be deployed to resist market pressure. Allowing exchange rate flexibility has the advantage of avoiding the kind of prolonged misalignment which is often a prelude to a sudden and steep devaluation such as occurs in a crisis. It also creates greater awareness of foreign exchange risk, which encourages more prudent behaviour on the part of both borrowers and lenders.

It may be thought that exchange rate flexibility is likely to deter capital inflows, but some moderation of flows is better than the alternative where economic agents are lulled by apparent stability of the exchange rate to take on excessive exchange risk, leading to very severe problems being experienced periodically. The disruption

caused by such periodic crises may be worse than any negative effect of continuous fluctuations or even gradual depreciation in the exchange rate. As pointed out by Citrin and Fisher (1999) a number of countries which have integrated with world markets and operate flexible exchange rate regimes – for example Chile, Peru, Mexico, South Africa and Turkey – have managed the turbulence in 1997–98 reasonably well.

3.6 Control over Capital Movements

An area in which differences persist is the role of controls over capital movements in preventing crises. Before the East Asian crisis, developing countries were generally encouraged by the IMF to liberalise restrictions on capital movements as a logical extension of market oriented reforms, which would enable them to gain access to international capital and also improve the efficiency of resource allocation. Following the crisis in East Asia, there is much greater recognition that liberalisation of capital movements can subject developing countries to the risk of destabilising capital outflows, especially in situations where there are macro-economic imbalances and/or the financial sector is weak. This raises the issue of whether developing countries should retain some control over capital movements as a crisis prevention measure.

One can distinguish two schools of thought on this issue. The mainstream view, as modified after East Asia, holds that liberalisation of capital controls must remain an important goal of policy, for the usual efficiency reasons, but it must be implemented with proper sequencing to ensure that liberalisation follows the establishment of sound macro-economic balances and a strong financial system. This approach concedes that developing countries may need to retain certain types of capital controls in the short run, but only as an interim arrangement which should not be made an excuse for delaying rapid progress in strengthening the financial system to allow a move to full capital account liberalisation as early as possible.

The alternative view, advocated by econo-

mists ranging from ardent free traders such as Jagdish Bhagwati (1998) to critics of liberalisation such as Dani Rodrik (1997), holds that the efficiency gains from full capital liberalisation are marginal at best compared to the risk involved and developing countries would therefore be well advised to be extremely cautious in this area. The sceptics recognise that foreign direct investment (FDI) needs to be distinguished from other capital flows, for example commercial bank loans or portfolio flows. There is a general agreement that FDI brings important benefits in terms of access to technology and to markets, and experience shows that it is much less volatile than commercial bank loans and portfolio investment. FDI therefore needs to be strongly encouraged but policy towards other capital flows, especially short-term borrowing and portfolio flows, should remain cautious.

a) Policy implications for developing countries

Despite these differences in approach there is a consensus on several issues. Since most developing countries have weak financial systems, and this situation is not likely to change very quickly, the policy implications in the short term are that developing countries should not liberalise capital flows too rapidly. There is general agreement that since short-term flows are the principal source of risk, the aim of policy should be to control short-term flows while liberalising long-term flows, especially FDI, as much as possible. Controls on FDI are sometimes motivated by a desire to limit the proportion of foreign ownership of equity in particular sectors; even the USA has such limits in a few sectors. Such controls may be justifiable in the light of other national objectives, but they cannot be defended on the grounds of promoting financial stability. Controls on long-term lending can also be liberalised without much danger, pro-

vided banks retain prudential limits on their own foreign exchange exposure and also take note of the foreign exchange exposure of their corporate clients. However, while liberalising such flows, suitable reporting systems should be put in place which enable effective monitoring of external debt.

An important policy issue is whether capital controls should rely upon discretionary systems or upon market-based instruments. The Chilean variety of controls, which required that a certain proportion of all non-equity flows be held in the form of unremunerated deposits with the central bank for one year, are widely recommended as a market based system. Applying the deposit requirement to all flows has the advantage that it does not require the authorities to distinguish between short-term and long-term debt, and yet a one-year unremunerated deposit requirement applied to all flows obviously discourages short-term flows much more than long-term flows because the implicit tax on the longer the maturity flow is much lower. In Chile the proportion of the flow held as an unremunerated deposit has varied reflecting the pressure of capital inflows.²⁷ A practical problem with administering Chilean style controls is that the development of new financial instruments such as derivatives makes it possible to disguise what is actually a debt flow into the form of an equity flow. Exempting equity flows from deposit requirements therefore provides a potential loophole that would reduce the effectiveness of these controls. On the other hand, extending the coverage to include equity would be cumbersome.

An interesting asymmetry in the present consensus is that while developing countries which have not liberalised capital flows are no longer being pushed to do so, and indeed are even being advised to sequence this liberalisation to follow strengthening of the financial

27 The deposit proportion was initially set at 20 per cent and this was raised to 30 per cent but later lowered to 10 per cent and subsequently removed completely when inflows dried up. Studies have found that the Chilean controls did not affect the total volume of flows but only altered their maturity. Thus if the objective was to limit the size of the inflow, because of the danger of exchange rate appreciation, the controls were clearly ineffective but if they were motivated by stability considerations, the lengthening of maturity should surely count as a success.

sector, countries that have already liberalised capital flows, but do not have strong financial systems, are not being advised to reintroduce controls. It could be argued in such cases that the priority must be to accelerate financial reform but, as pointed out earlier, the development of a strong financial sector takes time. In these circumstances it may be relevant for countries which have liberalised prematurely to take a step back if necessary. It will be interesting to see how this issue is handled in IMF surveillance.

The policy towards capital outflows presents difficult choices. The new orthodoxy concedes the case for retaining controls on short-term inflows as long as the financial system is weak because a surge in these flows is often the precursor of a financial crisis. However it is opposed to retaining any controls over outflows in normal times on the grounds that capital outflows provide domestic residents with opportunities to diversify their asset portfolios, which adds to the stability of the system. Many developing countries retain various degrees of controls over capital outflows in the belief that this increases the resources available for investment domestically. The validity of this belief depends upon the efficiency of the capital market. It could be argued that by keeping domestic capital in the country, all that is actually achieved is to reduce the inflow of foreign capital that would otherwise take place. On this view, capital controls on outflows, to the extent they are not evaded, only prevent diversification of asset holdings by domestic residents without increasing the total availability of capital domestically.²⁸

A more plausible argument for retaining capital controls is that even if there is no danger of outflows in normal times, there is a danger of large and sudden outflows at times of crisis. The existence of a regime under which capital out-

flows are controlled can prevent large-scale flight of capital in the event of a crisis, without having to impose controls as an emergency measure.

On balance, since most developing countries envisage a gradual move to liberalising capital controls, they should begin to liberalise outflows of capital in normal conditions in a gradual manner. Once again, it may be desirable to allow greater mobility for long-term flows while discouraging short-term outflows which are more likely to reflect a purely speculative shift and could contribute to the destabilisation of financial markets. An effective way of doing this without resorting to discretionary mechanisms, which have their own problems, would be to impose Chilean-type unremunerated deposit requirements on outflows of the type commonly proposed for inflows.

The area where there is least consensus is on the use of controls on outflows at times of crisis (for example when debt restructuring is being attempted). The use of capital controls in such situations is obviously not relevant for crisis prevention as it relates to policies adopted for crisis resolution. We will return to this issue in Chapter IV.

b) The role of the IMF in capital controls

At present countries are not bound to follow any particular discipline regarding capital controls and the IMF's Articles of Agreement do not give it any mandate to regulate this area of activity. This is a legacy from the days of the Bretton Woods Agreement when the elimination of restrictions on current payments was regarded as central for the efficient functioning of the international economy, but capital restrictions were regarded as normal and there was no expectation of liberalisation in this area. However, this situation is clearly somewhat anomalous given the enormous increase in inter-

28 The existence of differential rates of taxation in different countries provides a possible justification for retaining capital controls. High rates of domestic taxation can push domestic capital out of the country in search of low tax regimes abroad because the private return on capital invested abroad may exceed the domestic return (both net of tax), even though the social return domestically is much higher. However, with most developing countries having moved to moderate tax rate regimes, this consideration is much less important.

national capital flows since the collapse of the Bretton Woods system and the fact that most developing countries are progressively integrating with global financial markets.

The Interim Committee, at its meeting in Hong Kong in 1997, suggested consideration of an amendment to the Articles to include liberalisation of capital movements as one of the purposes of the IMF. This initiative was overtaken by the East Asian crisis which made many developing countries reluctant to liberalise capital movements mainly because they wanted to retain the flexibility to use capital controls to manage possible balance of payments crises. However, there is a case for giving the Fund some mandate to monitor, and ultimately even supervise, the regime of capital restrictions adopted by members, with a view to ensuring transparency and creating orderly conditions in international capital markets. An area of particular importance is the need to evolve a consensus on the kind of temporary restrictions that can be imposed at times of crisis.

The new mandate could explicitly recognise that countries would be free to adopt any regime of capital restrictions they like, and also change it at will, but they would accept the obligation to inform the Fund of the restrictions they impose on capital account transactions and also the rationale for any changes made therein. Such an arrangement would be no more than a mere formalisation of the existing situation, but it could, over time, evolve into a more rule based regime along the following lines.

- ❖ Although countries would be free to impose restrictions on capital flows, the requirement that the rationale of the restrictions and the policy objectives they are expected to serve, be reviewed as part of Fund surveillance would, over time, lead to a consensus on best practice which would also lead to a convergence on such practices.
- ❖ Restrictions imposed in emergency conditions (for example in the context of

standstills for debt restructuring exercises) could be given some sort of implicit seal of approval by the Fund. This is potentially a highly controversial issue and may not be acceptable to creditors. However, it may be possible to live with 'constructive ambiguity' which is effectively the position today because provisions allowing the Fund to lend into arrears, provided a country is undertaking a strong adjustment effort and is engaged in serious negotiations with its creditors, gives the Fund an implicit certification role albeit falling short of formal sanction. This is a potentially important issue in crisis resolution as we shall see in Chapter III.

- ❖ The most substantive development would be if developing countries were willing voluntarily to undertake obligations to avoid imposing restrictions on certain types of capital transactions, for example debt repayments, except after consultation with the Fund and then too only for a temporary period. The Fund's involvement in supervising such obligations and the requirement of prior consultation should help to increase investor confidence in the policies of debtor countries. Developing countries will have an incentive to undertake such obligations voluntarily if financial markets viewed them with favour, as reflected in credit ratings and yield spreads.

Many developing countries may be concerned that even a limited mandate might put them under pressure to liberalise too quickly, especially in the context of a Fund adjustment programme. This is a legitimate concern which cannot be lightly dismissed. However, it should be possible to retain flexibility in this area by explicitly recognising the right of countries to determine the pace of liberalisation. Any system which enables countries to accept voluntary

obligations not to intensify restrictions on capital movements is likely to have a positive effect on investor confidence. Investors could then make investment decisions keeping in mind the restrictions which exist, but with some assurance that these restrictions will not be intensified unilaterally, except under a discipline which ensures that such restrictions are temporary.

On balance, developing countries probably stand to gain by moving to a rule-based system in the area of capital controls in which the Fund is given a wider mandate in this area. The reluctance of developing countries to accept this could be overcome if it is seen as part of a larger package of reform which includes other items of interest to developing countries, such as strengthening the Fund's capacity to act as a lender of last resort in times of crisis, and also giving the Fund a more explicit role in providing some international respectability, if not legal sanction, to emergency restrictions on capital payments imposed at time of crisis.

3.7 Prospects For Crisis Prevention: An Evaluation

The crisis prevention measures discussed in this chapter cover a very wide area of economic policy and institutional development. It is difficult to be confident about how effective they will be in preventing crises, especially since the relative importance of action in each of these areas will vary from country to country. However it is reasonable to suppose that countries which take action in most of the areas outlined in this chapter will greatly reduce their vulnerability to crises.

An aspect of crisis prevention which may cause concern is that some of the measures recommended may lead to a reduction in the flow of capital to developing countries. This is probably true of measures aimed at strengthening

prudential norms in the banking system and introducing greater awareness of risk, as they will tend to moderate an excessive flow in exuberant times. However this moderation is entirely desirable since experience shows that surges of capital, based on an inadequate appreciation of the risks involved, only lead to imprudent lending and excessive capacity expansion, building potential vulnerability which can lead to a highly destabilising reversal at times of crisis. A policy environment which moderates inflows in the upswing, and correspondingly avoids destabilising outflows in the downswing, may actually generate a higher average level of flows over a longer period, with a greater assurance of stability.

Some of the other measures recommended as part of crisis prevention will indisputably increase the total volume of flows. Better macro-economic management, an improved flow of information with greater transparency, better surveillance and more effective interaction with private creditors can be expected to create a favourable environment for investors, primarily because of the expected effect of good policies on economic performance. On balance, sustained pursuit of crisis prevention measures is likely to lead to an optimal flow of capital which is more desirable than maximising the flow at any given time.

There are some areas in which differences persist as to what is the most appropriate policy, for example the nature of the exchange rate regime and the pace of capital account liberalisation. The two are inter-related since choices on the extent of capital account liberalisation constrain the choices open for exchange rate arrangements. This is an area where policy choices are likely to vary across countries and this variation is likely to continue for some time.

Crisis Resolution in the New Architecture

Since crises will occur periodically despite the best efforts at crisis prevention, the new architecture must provide suitable mechanisms for crisis resolution to deal with these occurrences. There is much less agreement in this area than in the area of crisis prevention because of differences on certain critical issues, especially the role of public international resources in managing crises, and the issue of moral hazard. Much depends on the extent to which the crisis is perceived to be caused by conscious pursuit of wrong policies or by pure contagion and also the extent to which it is likely to have systemic effects.

Those who view crises as being caused by investor panics, which can arise even when fundamentals are basically sound, emphasise the need for an international lender of last resort that can provide large amounts of liquidity to quell the panic and thus avoid unnecessary disruption of employment and output. Very different conclusions are drawn by those who believe that most crises are not caused purely by irrational investor panic. Loss of confidence may seem to be triggered by some random event, but it turns into a crisis only in situations when the country has become vulnerable on some fronts, for example because of imprudent build-up of short-term debt. This vulnerability reflects a deficiency in policies, or in the institutional framework, which needs correction. Providing international resources to 'bail out' countries in such situations only generates moral hazard, i.e. it encourages imprudent behaviour by both lenders and borrowers in future, making such crises more likely.²⁹ This 'principled' argument against large-scale international

financing is re-inforced by the practical consideration that international public resources are in any case extremely scarce compared with the scale of resources which could move as a result of a change in market sentiment.

The new architecture discussions have sought to balance these conflicting views, and a consensus of sorts has emerged, but there are significant differences in perceptions on many issues. The general consensus can be summarised as follows:

- ❖ There is complete agreement on the need to encourage the development of efficient private financial markets, but there is also a consensus that the international community cannot leave crisis resolution entirely to private markets. This is because crisis situations often lead to temporary dislocations in which markets 'dry up'. They also lead to 'systemic effects' which can severely disrupt markets for an extended period. The existence of externalities makes crisis resolution an 'international public good' justifying the use of international resources.
- ❖ Crises impose an especially heavy burden on the poor in crisis-hit countries and this provides another justification for international financing as a means of promoting methods of crisis management which are less likely to hurt the poor.
- ❖ The danger of moral hazard associated with international public financing to

29 Many critics of the IMF have argued that the Mexican rescue package in 1995 was responsible for the neglect of risk on the part of lenders which generated an excessive flow of funds to East Asia in the years preceding the crisis.

help countries in crisis is real, but it can be met by appropriate design of conditionality. Some have argued for strong post-crisis conditionality to discourage reliance upon international resources, while others emphasise the need for pre-crisis conditionality which generates stronger incentives for taking preventive steps.

- ❖ Since public resources are scarce, crisis resolution strategies must place greater emphasis on ‘involvement of the private sector’. Countries must be encouraged to look for private sector solutions as much as possible, both in anticipation of difficulties and also after problems have arisen. The conditionality associated with any international effort at crisis resolution should be tailored to achieve this end.
- ❖ Moral hazard considerations suggest that creditors should not be shielded from the consequences of imprudent lending and must therefore ‘take a hair cut’. This is a form of involuntary private sector involvement.

Translating these general principles into specific mechanisms for crisis resolution which can be built into the new architecture poses several problems.

4.1 The Role of the IMF in Crisis Resolution

The IMF is the principal crisis manager in the international financial system and there is general agreement that it needs to be strengthened to perform this role effectively. Opinions differ however on how this objective is best achieved and, in particular, on whether the scale of Fund lending in future should be expanded, as most developing countries would argue, or whether it needs to be focused on more limited types of situations, as is being argued in many influential quarters.

a) Some recent innovations

Some important steps have been taken in recent years which provide the Fund with greater procedural flexibility and also with new instruments specifically designed to handle latter-day crises.

- ❖ The Emergency Financing Mechanism, introduced in 1996 after the Mexican crisis, enables the Fund to bypass its normal lengthy procedures and respond quickly in crisis situations. This is an important procedural innovation given the speed with which crises now explode.
- ❖ The Supplemental Reserve Facility (SRF), introduced in December 1997, enables the Fund to provide short-term financing in excess of normal access limits to meet the needs of countries hit by a sudden disruptive loss of market confidence. SRF assistance is provided in conjunction with a standby arrangement or Extended Financing Facility (EFF), but only when there is reasonable expectation that strong adjustment policies and adequate financing will result in an early correction of the balance of payments difficulties. Drawings under this facility involve a penal rate of interest (300 to 500 basis points above the normal rate) and are repayable within 18 months of the date of drawing which may be extended by one year.
- ❖ A new facility, the Contingency Credit Line (CCL) was introduced in April 1999 to provide advance assurance of finance from the Fund to well managed emerging market economies, wishing to protect themselves from possible future crises induced by contagion. The terms on which these funds are provided are the same as for the SRF but, unlike the SRF, which is negotiated in a post-crisis situation, the CCL is negotiated in advance of a crisis to provide assured access to resources in the event of a crisis. The CCL is not only a potential

instrument for crisis resolution, it also has a potential role in crisis prevention, since the existence of a CCL arrangement may increase market confidence in a country's ability to handle sudden problems. The facility has been established initially for a two year period and is scheduled to be reviewed in April 2000.

This is an impressive expansion of the Fund's armoury, but many issues related to the Fund's role in crises resolution remain unresolved.

b) The effectiveness of IMF adjustment programmes

The effectiveness of Fund programmes in dealing with contemporary crises came into question after East Asia and this is clearly one of the factors accounting for the erosion of support for the institution. As pointed out in Chapter 2, the primary objective of any strategy to handle a crisis of confidence must be to restore confidence so that capital flows return to normal levels but this is not easy to achieve in a short period of time. As the term 'market sentiment' implies, a great deal depends on psychological factors which are inherently difficult to influence.

In order to restore confidence, adjustment programmes must clearly address all the policy misalignments which may have directly provoked the crisis, or created the vulnerability which made the crisis possible (fiscal imbalances in some cases, or real exchange rate appreciation, or imprudent build up of short-term debt). Some of these weaknesses may not have been evident before the crisis, but once they surface after the crisis it becomes necessary to take corrective steps if confidence is to be restored.³⁰

However, even a comprehensive programme of corrective policies cannot ensure successful adjustment if financing is inadequate.

Even if all necessary corrective policies are adopted, there will be a time lag of at least a year, and possibly even two, before capital flows return to normal levels and until that happens, the financing gap can be very large. If a crisis-hit country which has taken all the corrective steps needed could finance most of the gap which arises in this interim phase, it could adjust relatively smoothly to the post-crisis situation with a minimum of pain, other than that which is involved in correcting policy deficiencies. However, if financing on the scale required is not available, the country has very few options. It can adopt severely restrictive policies to bring about a large current account improvement in the short term, which would protect the exchange rate at the cost of domestic output and employment levels, or it can allow the exchange rate to collapse and bring about the same turnaround through negative real balance effects, or it can introduce capital controls. Each of these options presents serious problems.

Some of the criticism of the IMF's East Asia programmes needs to be re-examined in the light of these considerations. The Fund has been severely criticised for recommending tight fiscal policies and high interest rates in East Asia, even though the crisis was not caused by loose fiscal policy. But the original cause of the crisis is not strictly relevant. If a loss of confidence triggers a capital outflow, and if adequate finance is not available to cover the outflow, and capital controls are also to be avoided, then the country has to bring about a turnaround in the current account to accommodate the outflow. Restrictive fiscal policy can be viewed as a legitimate policy intervention aimed at improving the current account, albeit at the cost of economic contraction, in order to avoid a collapse in the exchange rate which would impose other costs.

The reason why this strategy did not

30 It is interesting to consider Feldstein's (1998) criticism of the IMF's Korea programme from this perspective. Feldstein argued that the Fund should have limited its conditionality to macro-economic issues relevant for restoring stability instead of expanding its conditionality to include larger issues of financial sector reform. This raises the issue whether reform of the financial sector was itself crucial for restoring confidence. It is difficult to pronounce definitively on this issue since the counterfactual cannot be tested, but the remarkable rebound of the Korean economy certainly suggests that some of the criticisms of the Fund programme were overdone.

succeed in East Asia, as pointed out by Lane *et al.* (1999), is that the financing provided in the Fund programmes was sufficient only on the assumption that they would succeed in restoring confidence and halt the capital outflow. When this did not happen, a currency collapse became unavoidable leading in turn to severely negative balance sheet effects which were highly disruptive. To be fair to the Fund, it should be recognised that although the Fund did not anticipate the currency collapse initially, it did recognise that meeting the original fiscal deficit targets in the face of the contractionary balance sheet effects generated by the exchange rate collapse would be excessively deflationary and the fiscal targets were greatly relaxed.³¹ The economic contraction which occurred in East Asia therefore cannot be attributed directly to excessively tight fiscal targets as these were never actually implemented. It would be more correct to attribute it to over-optimism about the speed with which confidence would be restored once Fund programmes were in place, which led to inadequate provision of finance in support of the programme.

This raises some interesting questions. Did the Fund simply err in being over-optimistic about the speed at which confidence would return, or was it pushed into making an over-optimistic assessment against its better judgement because it knew that the resources available to it were limited in any case? In other words, did the lack of resources create a situation where there was too much reliance upon adjustment and too little upon financing? Did the Fund overstate the weaknesses in the financial system as an underlying explanation for the crisis and did this in turn deepen the crisis? To answer these questions, one has to speculate on what

would have happened in a counterfactual situation and this is obviously not easy.

The high interest rate policies recommended by the Fund have also been criticised on the ground that they have severe negative effects on the real economy and also on the banking system where banks are weak. However, this must be weighed against the alternative of an uncontrolled exchange rate depreciation which also has negative balance sheet effects. The critical issue is whether a temporary increase in short-term rates actually helps to stabilise the currency by increasing the interest differential in favour of domestic assets. Furman and Stiglitz (1998) have argued that higher interest rates could actually have the opposite effect of increasing capital outflows if the negative effects on the real economy increases default risk, and if this effect is sufficiently strong to offset the incentive effect of the increased interest differential. However, the relative size of the two effects needs to be empirically verified before this point can be conceded in a particular case. The negative effect is obviously greater where the banking system suffers from a maturity mismatch and is undercapitalised and where corporations are highly leveraged.³² Much also depends upon the period for which interest rates are hiked. It should be noted that interest rates in Korea and Thailand declined fairly quickly from the very high levels to which they were raised in the initial phase of crisis management.

The balance of evidence seems to suggest that an increase in short-term interest rates is an appropriate response when faced by a large capital outflow which cannot be financed. If this is combined with a reasonable adjustment programme there is a good chance that interest rates will decline reasonably quickly. The critical issue

31 The initial specification of fiscal targets calling for an improvement from the earlier position, which varied from a small fiscal surplus to small deficits, was justified by the Fund on the grounds that the fiscal position needed to be improved to meet the cost of bank restructuring. This is a valid argument, but the cost needed to be met over a period of time. In the short term there was a case for a more relaxed fiscal stance, had the negative balance sheet effects been correctly anticipated.

32 The development of efficient and liquid capital markets which lead to a greater reliance upon equity and upon bond markets for long-term debt, will obviously help to minimise the damage of high interest rates to the banking system. Countries having such markets have greater flexibility to use interest rates to manage crises.

is whether the adjustment programme will restore confidence and this is partly a function of the corrective policies introduced and partly also the volume of financing made available.

One way of avoiding high interest rates and yet containing capital outflows in the face of a crisis of confidence is by introducing capital controls. This was recommended by Krugman (1998) and it was the implicit alternative favoured by many of the critics of the Fund in East Asia. Capital controls appear to be an attractive option when a crisis is in full swing, but countries are extremely reluctant to resort to them because of the fear that it may undermine the possibility of a quick return to normalcy, especially as far as access to capital markets is concerned. Capital is likely to flow more freely to countries where investors have the assurance that they can exit whenever they wish; resort to capital controls violates this requirement. Indeed, if investors come to expect that controls may be imposed in times of difficulty, they are likely to exit in anticipation of a crisis. The possibility that controls may be used can therefore increase the instability of the system *ex ante*.

It is interesting to note that of the East Asian countries affected by the crisis, only Malaysia resorted to capital controls and then only of a limited nature, which were also quickly relaxed. There is no evidence that the intensity of the crisis was lower in Malaysia because of the use of capital controls nor its speed of recovery faster. It is true that Malaysia has not suffered in investor perceptions as much as some would have feared, but that may be due in large part to the limited nature of the controls and the early relaxation. Brazil, on the other hand, went out of its way to indicate that it would not resort to capital controls, precisely in order to retain investor confidence. The current consensus is that the imposition of generalised capital controls to handle crises of confidence may introduce more costs than benefits, though debt

restructuring is an area which needs to be explored in certain situations. This is discussed in more detail later in this chapter.

c) Crisis management and the poor

Another difficulty in designing adjustment programmes relates to the impact on the poor who are in no way responsible for creating crises, but often suffer the most in the aftermath. The negative impact on the poor can also last well beyond the period when normalcy is restored because falls in real wages resulting from exchange rate depreciation may not be easily reversed.³³ Since one of the main arguments for providing international public financing in support of crisis management is that it can help mitigate the effect of a crisis upon the poor, there is a strong consensus that crisis management strategies supported by the Fund must pay special attention to the impact on the poor.

A minimal requirement is that adjustment programmes must not worsen the negative impact on the poor, which may already be substantial. If fiscal discipline requires a reduction in total real government expenditure this should be achieved while protecting those expenditures which are of particular importance for the poor. A reduction in total subsidies may be unavoidable, but the focus should be on cutting subsidies which are not effectively targeted, of which there are usually many, while preserving those subsidies which are effectively targeted at the poor. It is also necessary to protect expenditure on social services, especially health and education, which are not only important for the welfare of the poor but also affect their future earning capacity. Achieving these objectives is not easy because it means the cuts have to be deeper elsewhere, but this is a legitimate distributional objective of policy.

It can also be argued that adjustment strategies should go beyond avoiding negative impacts and actually make a positive contribution through programmes specifically aimed at increasing income levels of the poor and other

33 Real wages in Mexico had not recovered to the pre-crisis level of 1994 even by 1998.

vulnerable groups who are adversely affected by the unemployment caused by a crisis. An important problem in implementing this approach is that the effectiveness of these programmes cannot be taken for granted. International experience suggests that leakages to non-target groups can be very large unless the programmes are very carefully designed and efficiently implemented, and that this is very difficult to achieve in the short period that is relevant for crisis management. Expansion of existing programmes, which have a tested delivery capability, may be more effective than the creation of new programmes.

While recognising the importance of protecting the living standards of the poor as far as possible, it must also be recognised that country authorities, as well as international organisations, will face practical problems if adjustment programmes are overloaded with too many social objectives. This can distract attention from the immediate task of crisis management and possibly also politicise the design of adjustment programmes. Yet delay in implementing adjustment can sometimes cause more damage to the poor by prolonging and deepening the crisis. Where poverty alleviation objectives have not been built into the existing strategy, and there are not enough well functioning poverty alleviation schemes, it will be difficult to incorporate new programmes into adjustment programmes, at least in the short run. However where such programmes already exist, it is much easier to strengthen them. This is clearly an important area for IMF-World Bank collaboration, with the Bank helping to formulate appropriate criteria for Fund programmes which would ensure that the pro-poor components of expenditures in the government budget are not reduced. The Bank can also directly finance social sector programmes as part of its own development lending, but this would be part of a longer-term strategy.

d) The Contingency Credit Line: last resort lending

The recently introduced Contingency Credit Line (CCL) responds to a long standing demand of the developing countries for an international 'lender of last resort' facility which should be available for well-managed countries to deal with crises caused by irrational panic or by contagion from problems elsewhere.³⁴ The Fund Board had discussed the need for a 'short-term financing facility' of this type in 1994 (before the Mexican crisis), but agreement could not be reached on the conditionality to be associated with such drawings, since there was obvious moral hazard if access was unconditional.

The CCL deals with the moral hazard problem by prescribing extensive pre-qualification requirements while also keeping open the possibility of post-crisis conditionality (see Box 1). As a result, the facility is much more circumscribed than advocates for last resort financing typically have in mind.

- ❖ The pre-qualification requirements may deny the facility to countries which do not have any apparent problems, if the Fund finds that their policies are likely to lead to a balance of payments problem in future. Access can also be denied on the ground that the country is not taking sufficient preventive action in the form of a credible programme to upgrade regulatory and supervisory standards in the financial sector.
- ❖ Prequalification does not ensure automatic access to financing because post-crisis conditionality may be imposed at the time of the activation review before resources can be drawn. The need for such conditionality arises because external circumstances may have

34 The G-24 Ministers in their meeting in Madrid in October 1994 had urged the Fund 'to expedite its work on the establishment of a new, short-term, and fast disbursing facility aimed at assisting member countries to deal with large private capital outflows arising out of sudden market speculation not generated by fundamental disequilibria or similar factors beyond their control.

Box 1

Conditionality associated with the new CCL

Pre-qualifying conditionality

Four pre-qualifying conditions have to be met by countries seeking access to the Contingency Credit Line facility.

- ❖ The Fund must be convinced that the country's policies would not on their own lead to a balance of payments problem.
- ❖ The country's policies, broadly defined, should also have been positively assessed at the last Article IV consultations and subsequently. A positive assessment in this context includes the country's adherence to 'relevant internationally accepted standards' including the SDDS, the Basle Core Principles, the code of transparency in fiscal policy, the code of transparency in monetary and financial policy and such other standards as may be agreed in future. This implies that substantial action towards financial sector reform of the type recommended for crisis prevention is a pre-condition for CCL access.
- ❖ The country should be maintaining 'constructive relations' with private creditors, with a view to facilitating appropriate involvement of the private sector. It should also have made satisfactory progress in limiting vulnerability through management of the level and structure of its external debt. In this context the Fund will consider initiatives taken in the area of debtor-creditor

discussions, creation of private contingency lines, introduction of call options in debt instruments, and action taken to allow modification of international bond contracts.

- ❖ Finally, the country must have submitted a satisfactory financial programme, including a quantified framework which it 'stands ready to adjust as needed'.

Post-crisis conditionality

Approval of a CCL programme does not provide automatic access to the approved amount on the occurrence of a crisis. The country can draw up to 5 per cent of quota immediately upon approval of the CCL (or at any time thereafter), but the remaining amount will be made available in the event of a crisis subject to an 'activation review'. At this stage the Fund would determine :

- ❖ Whether the financing need is of the type for which the CCL was intended (i.e. caused by disruption of capital flows due to development in other countries);
- ❖ Whether the financial programme submitted when requesting the CCL has been observed; and also whether the country is committed to adjusting its policies to deal with any real economic impact that may follow from the contagion.

Based on the findings of the activation review, the Fund would determine the amount of the CCL to be released immediately and the phasing of the rest of the amount, as well as any related conditionality which may be additional to what was agreed at the time of approval.

changed since the CCL was negotiated, making the earlier agreed macro-economic programme insufficient.³⁵ The crisis could also reveal new internal weaknesses which were not evident earlier, but which surface because of the

crisis. The state of the banking system is an obvious area where the extent of weakness may turn out to be much larger once a crisis arises and where strong corrective action may therefore be needed. The need to negotiate conditionality after the

³⁵ External developments strong enough to generate contagion effects via investor confidence are usually also strong enough to generate real effects via trade; these effects call for adjustment action.

crisis makes the CCL more like the negotiation of a normal Fund programme whereas the whole idea of providing advance assurance of finance was the ability to draw resources without having to negotiate in the midst of a crisis. However, it can be argued that the possibility of introducing post-crisis conditionality makes it possible to avoid having to negotiate frequent adjustments of the economic programme agreed at the pre-qualification stage to reflect changing circumstances. Besides, negotiation of additional conditionality at the activation stage may be much easier than for an entirely new programme, since there would be a presumption of shared perspectives on policy built into the CCL programme itself.

No country has opted for the CCL thus far. While this may simply reflect that fact that financial markets have calmed down, reducing the perceived need for such a facility, there is also reason to believe that the pre-qualification requirements are too stringent. Countries in a strong position are unlikely to be willing to subject themselves to stringent pre-qualification scrutiny. Countries in a weak position are likely to fear that seeking a CCL arrangement may be viewed as a negative signal by markets and may actually trigger a crisis. These issues will no doubt be considered when the facility is reviewed in April 2000.

e) The adequacy of resources with the IMF

The adequacy of the IMF's resources remains a controversial issue. The SRF and the CCL facilities enable the Fund to provide crisis-hit countries with financing beyond the normal access limits, but the resources available with the Fund are not sufficient to enable it to meet the total demand that may arise if there are crises in a few major countries. The latest quota increase, which provided an additional \$65 billion of usable resources, may be sufficient to meet the normal requirements of developing countries for Fund

financing but it is much less than what would be needed if the Fund has to deal with crises in several countries.

Central banks acting as lenders of last resort do not face resource constraints because they can create the money needed. Keynes' original vision of the Fund envisaged giving the institution the flexibility to create 'bancor' but that idea was still-born then and would find little support today. Fischer (1999) has argued that the Fund can perform the role of an international lender of last resort even though it cannot create liquidity, and also may not be able to provide all the necessary financing from its own resources, as long as it can 'arrange' finance from other resources. This is the approach that has been followed thus far. In all the major crises of the 1990s the resources of the Fund had to be supplemented by financing from other bilateral and multilateral sources (see Table 3). However there are practical difficulties with this approach as is evident from the East Asian experience.

At first sight, the Fund's efforts at 'arranging' financing can be said to be impressive because it was able to mobilise a total of \$117 billion for East Asia from different sources in a very short period. The reality is much less impressive because the bilateral contributions for Korea and Indonesia, which were almost half of the total package for these countries, were only a 'second-stage back up' with considerable uncertainty about the circumstances under which they would become available. If the bilateral contributions for Korea and Indonesia are excluded, the total volume of resources mobilised for East Asia was only \$ 76 billion, compared with \$ 49 billion (including the US contribution which was unambiguously available) for Mexico in 1995. A comparable figure for the three East Asian countries, using GDP as the scaling factor, would be close to \$200 billion!³⁶ As pointed out earlier, inadequate financing may have been a factor

36 This is of course a very crude comparison as GDP may not be the appropriate scaling factor, but it does suggest that the resources made available for East Asia were much smaller than for Mexico and this may be part of the reason why the programmes failed to restore confidence.

Table 3 Composition of Recent Rescue Packages (\$ billion)

	IMF	World Bank	Regional Development Bank	Bilateral	Total
Mexico 1995	17.7	-	-	31.1 ¹	48.8
Thailand 1997	4.0	1.5	1.2	10.5	17.2
Indonesia 1997	11.2	5.5	4.5	21.1	42.3
Korea 1997	21.1	10.0	4.2	23.1	58.4
Russia 1998 ²	15.1	6.0	-	1.5	22.6
Brazil 1998	18.1	4.5	4.5	14.5 ³	41.6

The rescue packages for each country represent resources available over differing periods for each case.

1 Comprises US\$20 billion from the USA, US\$1.1 billion from Canada and a US\$10 billion credit line from the BIS.

2 Conditional commitments through end 1999. Of these US\$1.5 shown under bilateral consists of Japanese support co-financing the World Bank.

3 From industrial countries including direct assistance from Japan and from others through BIS.

explaining the depth of the crises in East Asia, but there was no way the Fund could have quickly mobilised a larger volume of resources given its own resource constraints and the difficulty in raising bilateral financing.

The use of World Bank and Asian Development Bank (ADB) resources as part of the crisis management package also needs to be reconsidered. It can perhaps be justified in the specific circumstances of the East Asian crisis because no other source was available at the time, but this does not mean it should be accepted as a regular feature of the new architecture. Direct involvement in crisis lending operations only distracts these organisations from their primary function, which is to provide long-term development finance; this distraction is particularly undesirable in an environment where the flow of such lending has been declining in real terms over the past decade. The World Bank should, of course, be free to negotiate adjustment lending operations for crisis-hit countries as part of implementing structural reforms or

creating social safety nets in the post-crisis phase, but this should be a separate activity with no compulsion to disburse funds in the very short time needed for a crisis resolution package.³⁷ A more logical role for the Bank in crisis resolution is in the post-crisis recovery phase, when it could use its guarantee facilities to help countries to regain access to commercial markets earlier than might happen otherwise.³⁸

The options available to empower the Fund to provide larger volumes of finance in crisis situations are limited. One would be through a larger expansion in quotas. However, this increases the Fund's general financing capability and it could be argued that this is not the best way to provide for the large but sporadic financing requirements associated with severe crises. An alternative approach would be to give the Fund assured access to special borrowing facilities which can be automatically triggered for use in crisis management situations. The GAB and the NAB provide such back-up at present, amounting to a total of \$38 billion, but use of

37 Structural adjustment lending requires time to design an appropriate policy framework and this process should not be hurried to fit within the very short timeframe appropriate for crisis management.

38 This is entirely appropriate where market access is needed by the government. However when it is the private sector which needs to regain access, the requirement that governments should counter-guarantee the Bank's guarantee is not entirely appropriate. Ideally the World Bank should be able to extend guarantees to the private sector on the basis of credit assessment and suitable pricing.

these resources requires the specific consent of the contributing countries in each case; each contributing country has a veto on the use of its resources for each particular purpose. What is needed are pre-arranged lines of credit which can be drawn upon to finance SRF and CCL programmes approved by the Fund Board if the Fund's own resources prove inadequate. These lines could be co-ordinated by the BIS and provided by the central banks of the industrialised, and also the major developing, countries which are members of the BIS on an appropriate burden-sharing basis. If it becomes necessary to access resources from the World Bank or the relevant regional development bank, this should be in the form of bridge finance to the Fund, which can be repaid by the Fund in a short time.

A more radical approach to solving the Fund's resources problem outlined in Ahluwalia (1999) would be to amend the Fund's Articles to allow the Fund to issue SDRs to itself, for use in lender of last resort operations, subject to a cumulative limit on the total volume of SDRs that could be created by the Fund for this purpose. The limit could be determined by an 85 per cent majority, as is the case for a general allocation of SDRs and should be set fairly high at, say, SDR 100 billion. The Fund could then finance SRF or CCL operations through this mechanism. These SDRs, on repayment by the borrower, would not be available for general use by the Fund but should be credited back to the Fund's SDR limit to be available only in another crisis situation. This arrangement has several advantages. Unlike a general allocation of SDRs, it would not amount to a permanent increase in unconditional liquidity available to all countries. The liquidity would be injected into the system only in the context of lender of last resort programmes when it would be linked with appropriate conditionality and it would be extin-

guished on repurchase. Since any programme using these resources would have to be approved by the Board, the additional liquidity involved would be subject to substantial support from the G-7 countries, though not necessarily from all of them.³⁹

Unless some initiative along these lines is taken, the Fund's ability to manage large crises will continue to be dependent upon its ability to mobilise individual country contributions. This has obvious disadvantages.

- ❖ The size and even content of the programme will be affected by the political climate in contributing countries at that particular time. This creates a sense of discrimination because some rescue packages will be seen to receive bilateral support more easily than others (for example the generous US support to Mexico in 1995 compared with the more limited support to East Asia). There is also the danger that the Fund's conditionalities may be seen to be tailored to the specific expectations of bilateral donors as alleged by Feldstein (1998) in the case of Korea.
- ❖ The Fund may feel under pressure to rationalise under-funded programmes against its own better judgement. There is a real danger of making over-optimistic assumptions about the speed at which confidence can be restored or the ease with which fresh private investment can be attracted. When these optimistic assumptions do not materialise, there is a danger that the programme itself may be discredited, making recovery that much more difficult.

The inadequacy of resources with the Fund will also lead to calls for regional financing arrange-

39 The report of the Council on Foreign Relations (1999) makes a similar suggestion for financing lending by the Fund in the context of systemic crises. However its proposal is for a general increase in SDRs which does not require amendment, with an agreement that industrialised countries would contribute their SDRs to a pool which could be used by the Fund to supplement its own resources. However this lending would be parallel to Fund lending and the credit risk would be borne by the countries, and not by the Fund.

ments such as the Asian Monetary Fund which was mooted by Japan at the time of the Asian crisis. Co-operative arrangements with Central Banks in the same region providing each other with limited lines of credit are a normal phenomenon but any mechanism for providing large volumes of assistance in crisis situations would have to involve some adjustment programme. How this aspect would have been handled in the context of the Asian Monetary Fund was never explicitly spelt out, but the broad approach appeared to be to provide a pool of resources which would be made available for crisis-hit countries in the region 'in parallel' with a Fund programme and therefore based on Fund conditionality.⁴⁰

Such regional financing arrangements are clearly a departure from the principle of multilateralism. They may seem to be justified in situations where the Fund does not have all the resources that may be needed, but countries which share a special regional interest are willing to provide additional resources to deal with crises in their region. However such arrangements will certainly create differences in the degree of financing available in different situations, and inevitably also differences in the degree of conditionality applied in different cases.

f) The alternative view: A smaller role for the IMF

Whereas developing countries typically call for a larger role for the IMF to deal with the very large financial needs which can arise in crisis situations, there is an alternative view that countries will never be sufficiently motivated to take the necessary preventive actions unless they are encouraged to believe that they are on their own. This is essentially the moral hazard argument, which calls for a reduction of the scale of Fund lending, especially in situations where there is no systemic threat to the system. This is the approach adopted by the Task Force on the

International Financial Architecture sponsored by the Council on Foreign Relations (1999) and, in a more extreme form, by the Meltzer Commission appointed by the US Congress.

The Task Force report recommends that the Fund should make a distinction between 'country crises' which do not threaten the functioning of the international monetary system or the performance of the world economy, and 'systemic crises' which are defined as multi-country crises where private markets often dry up and where failure to interfere would threaten the performance of the world economy. For country crises, the Task Force has recommended that the Fund should reduce its potential involvement and adhere strictly to its present access limits of 100 per cent of quota annually and 300 per cent cumulatively. This would rule out SRF type financing in a country crisis, however severe, if it did not threaten the performance of the world economy.

In the case of systemic crises, large-scale lending is acceptable, but the Fund should distinguish between cases where the country's problems are of its own making and those where problems have arisen because of developments beyond the country's control. In the former case, Fund assistance should be offered with strong conditionality and should be funded only through NAB/GAB, so that it would require a special majority of the creditor countries funding the programme to agree to the arrangement. Where the country is judged to be suffering for no fault of its own, it should be financed from a new 'contagion facility' which should replace the SRF and CCL. Unlike the CCL, there would be no pre-qualification and also no Fund programme or conditionality. It is proposed that the new facility would be funded by a special one-time allocation of SDRs in which all countries would contribute their share to a common pool from which lending would take place. Use of the facility would also require a super majority of

40 It was never clear whether the requirement of parallel financing required only that a Fund programme should be in place, or whether all the conditionalities specified by the Fund would also be specified in the parallel programme.

Box 2

Meltzer Commission (majority) recommendations for restructuring and downsizing the IMF

The recommendations regarding the Fund supported by the majority of the Commission are :

- a. Surveillance is important but it need not be extended to OECD countries as their performance is reviewed extensively in OECD and BIS.
- b. The long-term financing windows supporting policy reform (e.g. the EFF and ESAF) should be closed and shifted to the World Bank and the regional development banks. (This is not just a locational shift to avoid duplication but also implies a scaling down of these flows since the World Bank is expected to narrow its focus to only the poorest countries).
- c. The Fund should limit itself to performing a quasi-lender of last resort function providing short-term assistance to 'solvent emerging economies' facing liquidity crises. It should not expect to lend to industrialised countries which can rely on their own central banks.
- d. Fund financing should be very short term (120 days with a maximum of one rollover) and there should be a penalty rate related to the sovereign yield paid by the country in the week prior to the IMF application to provide incentives to shift to private financing as soon as possible.

- e. There should be no detailed policy conditionality involving prolonged negotiations. Assistance should be provided promptly without conditionality but only to countries deemed eligible on the basis of pre-qualification. The emphasis on pre-qualification reflects the view advanced in Calomiris and Meltzer (1998) that it would strengthen incentives for taking preventive action and thus reduce moral hazard.
- f. The only criteria for pre-qualification are the prudential standards in the financial sector, including capital adequacy of banks, the existence of market discipline on financial institutions and especially freedom of entry for foreign financial institutions.
- g. The only post-crisis requirement is that Fund assistance should not support 'irresponsible budgetary policies'. (It is not clear how this condition can be fulfilled except through conditionality.)

Several members of the Commission – C. Fred Bergsten, Richard Huber, Jerome Levinson and Esteban Edward Torres – have submitted notes of dissent criticising the majority view. They acknowledge that the Report has some constructive proposals and agree with the need to refocus the Fund and delineate its responsibilities more clearly vis-à-vis the World Bank. However they have stated that 'some of the central proposals are fundamentally flawed and/or unsubstantiated. They rest on misinterpretations of history and faulty analysis [and] would greatly increase the risk of global instability'.

the creditor countries and the loans would be 'in association with the Fund', i.e. the donor countries will bear the credit risk.

Some of the recommendations of the Task Force are clearly innovative. Recognising the distinction between a systemic crisis and a country specific crisis and providing a special SDR-based mechanism to provide finance in support of systemic crises would certainly strengthen the capacity of the Fund to act as a true lender of last resort. Differentiating between countries experiencing crises due to policy mistakes and those hit by contagion, with lower conditionality in the latter case, is also an impor-

tant step forward. However, the proposal to restrict Fund lending to normal access limits in the case of country crises may be too restrictive. It seems to be based on the presumption that if there is no systemic threat to the world economy there is no need for large-scale Fund lending. This approach can be questioned on several grounds.

- ❖ The distinction between a country crisis and a systemic crisis may be difficult to make since a crisis in an individual emerging market country, if not properly handled, could snowball into a larger crisis affecting other countries.

- ❖ Even if the crisis is caused by internal policy weaknesses, it cannot be solved solely by corrective policy since the crisis-hit country may not be able to regain normal access to markets for some time, even after it has made all necessary policy corrections. This means it will have a very large short-term financing need until such time as confidence is restored. Refusal to provide financing in such situations will force the country into a severe contractionary phase which involves unnecessary cost. This could be avoided through Fund financing and as long as the financing is short term, at penal rates, and is associated with appropriate policy conditionalities, there should be no fear of moral hazard.
- ❖ Finally the burden of an excessive contraction because of inadequate financing falls very heavily on the poor; allowing larger than normal access can surely be justified on this ground.

The Task Force's proposal to eliminate both pre-qualification and conditionality in the case of countries affected by a systemic crisis through no fault of their own will be welcomed by potential beneficiaries since it appears to move towards Bagehot's classical description of a lender of last resort, lending freely but at a penal rate. However, it is not clear how eligibility under this facility will be determined. Since CCL type pre-qualification is explicitly excluded, there will have to be much greater reliance upon pre-crisis surveillance to certify the quality of a country's macro-management, but even so, this would have to be combined with a specific assessment of whether country policies subsequent to last surveillance review might have been at fault. The recommendations that there should be no Fund programme associated with such lending is somewhat surprising. Even if a country is hit by contagion 'for no fault of its own' in a systemic crisis, such a crisis is likely to generate real effects

and it is surely necessary to adjust to these effects. Cushioning the impact of contagion, without ensuring that countries make the minimal adjustments needed to deal with the real shocks associated with the crisis, does not seem well-advised.

The Meltzer Commission has suggested a much more drastic downsizing of the Fund, restricting it to act only as a 'quasi-lender of last resort' and that too with a very narrow mandate. The detailed recommendations regarding the Fund are summarised in Box 2. Several Commissioners have expressed serious reservations with the majority view and have submitted dissenting notes.

The Commission's majority recommendations would restrict the Fund only to providing short-term finance to meet liquidity crises. The traditional role of providing finance to help countries deal with conventional balance of payments problems arising out of a deterioration in the current account is effectively eliminated, presumably because of the belief that all such financing needs can, and should, be met from the markets. This may be feasible for the relatively small number of developing and transition economies which have access to private markets, but the majority of countries do not have such access. Besides, countries which have access to financial markets can easily lose it in times of difficulty. The Fund's traditional role of providing medium-term balance of payments financing under standby arrangements is therefore still needed. Indeed, many recent successful stabilisation efforts, e.g. Mexico, Uruguay, Turkey, the Philippines and Argentina, would not have been possible under the Meltzer Commission proposals. The case for longer-term EFF financing from the Fund also remains strong as long as developing countries have to phase in adjustments over a longer period and cannot access capital markets. It is interesting to note that the Task Force of the Council on Foreign Relations did not question the need for these facilities, but only recommended that the normal access limits should not be exceeded except in a systemic

crisis. The Meltzer Commission goes much further and recommends elimination of these windows entirely.

The Commission's conception of the lender of last resort role is also excessively restrictive. Limiting the term of financing to 120 days, with a maximum of one rollover, may not be appropriate for any liquidity crises. Only Korea in 1998 would have found such financing to be adequate and Korea was clearly a case of exceptionally successful adjustment. One can easily envisage liquidity crises which require a more prolonged period of recovery and restricting Fund financing to a very short period would easily reduce the credibility of the Fund's intervention and jeopardise the chances of restoring confidence. The longer period provided in the SRF/CCL (18 months with a one-year extension if needed) allows more reasonable time for investor perceptions to improve. One can understand the concern to minimise the period for which such resources are used, but this is adequately met by the penalty rate which is applicable.

The proposal to abandon conditionality and replace it by pre-qualification is also impractical. In any case, such pre-qualification could not be based solely on the status of the financial sector as the Commission has recommended. Policy failures in other areas, e.g. fiscal imbalances or poor exchange rate policies, can also lead to crises and it would be odd to ignore such problems when pre-qualifying countries for assistance. The difficulties in devising a discipline for pre-qualification have been discussed earlier in this chapter, in the context of the CCL, and it is not clear how these difficulties can be overcome except by replicating CCL procedures. Although the Commission recommends the abandonment of conditionality, it also specifies that the Fund should not lend in support of irresponsible budgetary policies; this clearly implies fiscal conditionality – a contradiction that is left unexplained.

It would also be difficult to insist that countries which do not meet pre-qualification

requirements should be denied finance even if they are willing to undertake appropriate corrective steps after a crisis has occurred. Such denial could precipitate a contractionary spiral followed by an unduly delayed recovery during which the poor would suffer heavily. The costs involved in this option are surely too large compared with the intangible gains of stronger incentives to take precautionary action. The traditional approach of providing financing based on post-crisis conditionality therefore has to be kept open. The argument that a shift to pre-qualification increases the incentive to take precautionary action is valid, but this is at best an argument for introducing an optional window, based on pre-qualification, which provides easier access to finance in the event of a crisis. This is precisely what the CCL was expected to achieve and we need to see how it work in practice.

Other ways of encouraging countries to take preventive action can also be explored. One way would be to introduce discriminatory pricing for Fund assistance based on the quality of preventive action. Fund surveillance could be used to classify countries into different categories based on prudential criteria and countries in lower ranked categories (i.e. higher risk) could be made to pay a penalty rate for Fund financing. If this country classification is also made public, it would have an impact on market perceptions and affect the rate of interest at which countries can borrow in normal times. Higher rated countries should be able to borrow at finer rates which should increase the incentive to strengthen preventive steps.

To summarise, the role of the Fund in crisis resolution remains a subject on which there are conflicting perceptions. Developing countries, focusing on the potential instability of private financial markets and their tendency to 'dry up' in times of difficulty, typically emphasise the need for the Fund to play the role of lender of last resort. There is general agreement that some sort of lender of last resort is needed and also that the Fund is the logical institution to play that role. However, there is not enough agreement on

what exactly the role implies. Developing countries generally want a Fund with larger resources at its disposal which can intervene decisively in times of crises, with appropriate conditionality ensuring that resources are well spent. Sceptics, mainly in industrialised countries, question the desirability of large-scale financing on the grounds that it provides a soft option, discouraging developing countries from taking adequate protective action and encouraging private lenders to expect bail-outs. Much of this scepticism seems to be based on an exaggerated notion of the efficiency of financial markets and also on an inadequate appreciation of the stabilising role that can be played by the Fund in many situations. Nevertheless there is agreement even among sceptics that the Fund must be able to intervene decisively when faced by a systemic crisis and this agreement is an important outcome of the architecture discussions. The consensus on this point needs to be broadened to allow the Fund to play a stabilising role even in individual country crises. It should be possible to do this in a manner that does not create moral hazard or encourage excessive dependence on Fund assistance.

4.2 Private Sector Involvement

The need to involve the private sector in crisis resolution has received a great deal of attention in the discussion on the new architecture. This is partly because public resources are scarce and crisis resolution strategies must use them carefully; it is also the result of the belief that private sector solutions introduce the right incentives for good behaviour while avoiding the moral hazard usually associated with provision of public resources. Action in this area is now viewed as a relevant factor in determining a country's eligibility to receive financial support in the event of a crisis, thus linking the availability of public resources *ex post* to the strength of efforts made

to involve the private sector *ex ante*.

a. Contingent credit arrangements

The simplest way of involving the private sector in crisis resolution is to negotiate contingency credit arrangements with commercial banks of the type negotiated by Argentina (\$6.2 billion), Mexico (\$3.0 billion), Indonesia (\$1.5 billion) and several others. The potential borrower pays an upfront commitment fee (in effect an insurance premium) to obtain assured access to finance if needed. The extent to which these arrangements provide net additional finance in crisis situations has been questioned on the grounds that banks offering contingent credit lines may, in the event of a crisis, decide to reduce their exposure through other windows. When Mexico tried to draw on its credit line in September 1998, the banks first tried to discourage the drawing, arguing that it was not really needed, and subsequently threatened that it would only force them to offload other Mexican debt. Yields on Mexican paper did go up immediately after the drawing, but they settled down again quite quickly.⁴¹

The concern about the absence of additionality in these arrangements is probably exaggerated, but it is not entirely misplaced. The net additionality could be less than it seems if, in the build-up to a crisis, when the banks perceive that the risk of a crisis has increased, they engage in dynamic rebalancing of their exposure by reducing their existing exposure to a greater extent than they would have done in the absence of a contingent credit commitment. However the process itself provides useful market signals which should prompt countries to take corrective action.

A more serious limitation of such arrangements is that the total volume of finance available through them is likely to be limited as is evident from the numbers cited above. Large-scale reliance on these facilities is also likely to lead to pricing arrangements which would reflect

41 Part of the problem in the Mexican case was disagreement about the circumstances in which the lines would be drawn. The banks' understanding was that the lines would be drawn only if alternative financing was not available and not because changes in market conditions regarding interest rates made the contingency line attractive. The interest rate built into the credit lines was only 100 basis points above Libor, and market condition had widened the spread considerably.

the risks involved. Banks are unlikely to agree to pricing arrangements which fix the spread at the time of disbursement, or, if they do, it is likely to be at the cost of much higher upfront fees which reflect the probability of a crisis occurring. The pricing arrangements are also likely to be structured in a way which discourages the borrower from using the arrangement except in real difficulty by fixing the spread at a high enough level.

b. Borrowing to build reserves

An alternative to contingency credit arrangements is a strategy of borrowing to build reserves to levels which would strengthen investor confidence and thereby reduce the probability of a crisis. Higher levels of reserves provide more comfort than a contingency arrangement because reserves are more visible and can also be more freely used when needed. Developing countries integrating with international financial markets definitely need to shift from traditional norms for determining the desired levels of reserves which typically focus on current account variables (for example in terms of 'months of imports') and focus instead on broader concepts of liquidity requirements which include consideration of pressures which could arise from the capital account. The maturity structure of debt is an obvious consideration in this context.

The choice between negotiating contingency credit and borrowing to build reserves has to be made on the basis of relative costs. The cost of borrowing to build reserves is essentially the difference between the interest rate paid on longer-term borrowing and the interest rate earned on reserves which are typically invested in lower-yielding liquid securities. The cost of contingency credit lines is the upfront fee, plus the interest rate that would have to be paid in the event the line is drawn. It is possible that the contingent credit arrangement may be the cheaper option, especially if the need for drawing on the facility is likely to arise only sporadically, and then for a relatively short period, but this depends critically upon the mechanisms used for determining the commitment fee and the

interest rate charged at disbursement. In practice, countries would be well advised to follow a mix of both approaches.

c) Call options in inter-bank lines of credit

Another method of obtaining advance access to liquidity is through embedding call options in inter bank lines of credit which allow the borrowing bank to extend maturities under specified conditions. The trigger that would activate the option needs to be clearly defined and exercise of the option could involve a penal interest rate. Since call options have to be negotiated by the banks as a form of insurance against possible illiquidity, the willingness of the banks to negotiate such arrangements obviously depends upon the pricing. It is relevant to ask whether it should be left to the banks to decide on whether to build in such options on the basis of their own assessment of liquidity risk, or whether there should be some regulatory compulsion or incentive to use these instruments. The latter approach has some merit.

4.3 Debt Restructuring and Crisis Resolution

Restructuring of debt payments is a potentially important mechanism for crisis resolution, especially in circumstances where large debt repayments are due and new financing is suddenly withdrawn. Markets view an interruption in debt service payments very negatively, and for very good reasons, and official opinion has generally mirrored this view. However, in certain circumstances, debt restructuring may be the lesser of two evils. The parallel with bankruptcy laws is relevant. Bankruptcy laws are based on the premise that the value of a firm as a going concern is greater than the value of its assets in liquidation. In order to avoid a grab race for assets which pushes a firm into liquidation, firms facing liquidity problems are allowed to obtain temporary respite from recovery action by creditors to give the debtor time to find the finance needed or seek a voluntary restructuring of debt. This may yield an outcome which is more favourable for both debtors and creditors, especially when

the problem is one of liquidity and not solvency.

The need for a similar mechanism to permit an orderly restructuring of international debt, in a manner seen to be fair to both debtors and creditors, has been articulated on several occasions since the Latin American debt crisis.⁴² The case for debt restructuring is obviously strongest when the problem is essentially one of liquidity. Restructuring in such cases enables the country to repay its restructured obligations in a relatively short time. Lenders can even be compensated by a higher interest rate on restructured obligations, and the country could return relatively quickly to the international market to raise new finance.⁴³ Where solvency is involved, a debt restructuring alone may not suffice and it may need to be accompanied by a partial write off. This is clearly more painful, and countries placed in such situations may not regain access for some time, but that is not an inappropriate outcome and certainly sends the right signals for the future. However, even in such cases, it may be better to attempt a debt restructuring with a partial write-off in an orderly fashion rather than allow the crisis to spin out of control with a creditor grab race.

a) The official consensus on debt restructuring

The official consensus on the role of restructuring of private sector debt in crisis resolution has evolved considerably over the past two years with a growing acceptance in official quarters that it has an important role, especially because imprudent lenders must bear some of the cost of restructuring. The current state of the consensus can be summarised as follows:

- ❖ Since even a temporary suspension of debt service has a high cost and undermines confidence in markets, countries should make the strongest

possible efforts to meet the terms and conditions of all contracts.

- ❖ However, a temporary suspension of payments can be considered when it is clear, based on consultations with the Fund and other international financial institutions, that even with appropriately strong policy instruments the country will experience an exceptionally severe financial and balance of payments crisis.
- ❖ Unilateral action must be avoided and countries must seek co-operative and voluntary solutions with their creditors. (This is clearly an implicit criticism of the unilateral Russian default.)
- ❖ No category of lenders should be regarded as privileged relative to others. The claims of bond holders must therefore be subject to restructuring in the same way as claims of commercial banks.
- ❖ The Fund should be able to lend into arrears, including arrears on bond holder claims, provided the country is seen to be seriously engaged in negotiations to restructure the debt.
- ❖ It is appropriate that imprudent lenders bear some costs in the resolution of financial crises.

It is important to note that the consensus does not envisage creating any formal institutional mechanism for debt restructuring in crisis resolution situations. In particular, it does not empower the Fund to provide any legal sanction on a standstill on payments, as was suggested by Sachs (1998). However it does give the Fund a critical role in certifying that the pre-conditions exist which justify debt restruc-

42 For a more detailed review of issues see UNCTAD (1998). Raffer (1990) suggested an international treaty establishing an international bankruptcy court for sovereign debt. Other suggestions have focused on less structured arrangements which involve the Fund in various ways as part of the restructuring process, for example Eichengreen and Portes (1995) and Sachs (1998).

43 The restructuring of Korean commercial bank debt in January 1998 clearly belongs in this category as Korea was able to access the market five months later in May 1998.

turing as an exceptional measure. The Fund is not to act as an arbiter determining the terms of restructuring – that must be left to voluntary negotiations – but it is empowered to provide finance to support countries that are undertaking strong adjustment programmes but are unable to make debt service payments, provided that the country is ‘seriously’ engaged in negotiations with its creditors. This does imply some endorsement of the reasonableness of the debt restructuring position of the crisis-hit country but the implicit endorsement does not have any legal sanction.

The ability to ‘lend into arrears’ frees the Fund from becoming hostage to unco-operative creditors unwilling to bear any share of the burden. This is an important area of flexibility in view of the recognition that imprudent lenders must bear some costs. However, this does not mean that the Fund is authorised to provide the full amount of financing needed. Fund financing in such situations is at best equivalent to providing working capital to keep the economy going while the country negotiates with its creditors, a negotiation in which the country has a strong incentive to reach a successful conclusion since that determines restoration of normal market access.

The official acceptance of restructuring of private sector debt as an instrument of crisis resolution and the endorsement of ‘hair cuts’ for creditors in certain circumstances has raised some concern in private sector circles. The Institute of International Finance (1999), for example, has warned that insisting upon debt restructuring as an essential ingredient in crisis resolution may discourage the resumption of private flows in the post-crisis situation. It is argued that one of the reasons for the success of the Mexican package in 1995 was the liberal use of official finance to restore market confidence and the speed of Mexico’s subsequent recovery,

with its unexpectedly early repayment of all official finance, amply vindicated this strategy. This experience is contrasted with the prolonged debt restructuring attempted in the 1980s which led to a long period of loss of access to capital markets. However, as the recent Korean experience suggests, debt restructuring can be undertaken with an early return to markets. Admittedly Korea’s case was exceptional – the problem was clearly one of liquidity and the conversion of commercial debt into sovereign debt was a feasible package because of Korea’s strong fiscal situation. Korea’s strong adjustment programme enabled a quick recovery once rescheduling was in place.⁴⁴

The private sector has also expressed concern that mechanical insistence on debt restructuring in all crisis situations on moral hazard grounds can have destabilising consequences. Creditors will have an incentive to exit at the first sign of difficulty and this could in fact precipitate a crisis. For the same reasons, countries may hesitate to approach the Fund at an early stage, which is normally recommended, because the approach to the Fund may trigger a flight of creditors if there is a presumption of forced ‘hair cuts’. This is clearly an area where some constructive ambiguity is desirable.

b) Extending debt restructuring to bond holders

Fairness requires that if debt restructuring is necessary it should also be extended to maturing bonds but this poses several problems. Renegotiation of commercial bank debt is relatively easy to arrange because the number of creditors is limited and the regulatory authorities in creditor countries can encourage the banks to co-operate. In contrast, renegotiation of bond terms is beset with problems, especially for US-style bonds, which are the instruments most commonly used. Negotiations are difficult to

44 There were also a number of special factors which made the negotiations relatively easy. The creditors were a handful of international banks which had lent to Korean banks and the debt restructuring was facilitated by the conversion of Korean bank debt to Korean government bonds. Such a conversion would have been difficult to justify had the debt been private sector debt and in the absence of government backing of rescheduled debt payments, agreement of creditors may have been more difficult to secure.

organise because bond holders are dispersed and they are also not amenable to encouragement from regulatory authorities. US-style bonds also require unanimity for renegotiating bond terms. These problems can be reduced if future bond contracts are modified to include various provisions, which already exist in UK-style bonds, and which would make renegotiation much easier. These include collective representation clauses which would allow such negotiations to be conducted with designated trustees; qualified majority voting clauses which overcome the problem of unanimous consent; clauses for minimum requirement for legal action; clauses requiring equal sharing of repayment realisations with other creditors in order to remove the incentive for small groups of bond holders to insist on full repayment; and non-acceleration clauses to avoid bond holders seeking to exit at the first sign of trouble or default elsewhere.

Such clauses could be easily introduced into sovereign bonds and quasi-sovereign bonds. They could also be made mandatory for bonds issued by commercial banks which would give debtor countries an opportunity to renegotiate bond contracts if a serious crisis forces some resort to restructuring. There is perhaps less need to introduce such changes in private corporate bonds since it is not practical for the government to trigger such negotiations and have them conducted by the debtors who would be numerous.

Developing countries have been reluctant to introduce such clauses unilaterally because of the fear that they would be viewed negatively by the markets and lead to higher pricing. The post-Mexico G-10 Report, which first recommended modification of bond contracts, had indicated that industrialised countries may be willing to give the lead by introducing such covenants in their own instruments. This has not happened so far and is unlikely. However, even if the industrialised countries do not take action in this area, developing countries may be well advised to introduce the changes on their own. The fears of a negative market reac-

tion may be exaggerated since the risk of a financial crisis is a real risk and is presumably built into the pricing of existing bond contracts. As long as modification in bond contracts does not generate moral hazard and encourage countries to resort to restructuring lightly, it could be argued that it may even improve bond pricing because it ensures an orderly restructuring of debt in the event of a crisis; this is surely better for creditors than the disorderly process which would result otherwise.

c) Controls on other capital outflows

An issue which has not received sufficient attention in the context of debt restructuring is whether, in a crisis situation where debt restructuring is initiated, countries should also impose controls on other capital outflows, at least during the period when the negotiations are taking place. Unless this is done situations may arise where creditors are prevented from taking their money out, while residents, and even other foreign investors, remain free to exit through the open capital account, thus exacerbating the currency crisis. Raising domestic interest rates is one of the ways of discouraging such outflows but, as pointed out earlier, this has its limitations.

The G-7 Finance Ministers (1999) have recognised that in exceptional circumstances countries may need to resort to capital or exchange controls as part of crisis resolution. However there is no agreement on what precise circumstances would justify such a step, nor what should be the coverage of these controls. The IMF has an important role in crisis resolution, but it has yet to evolve a set of rules, or even guidelines, which might help to define best practice in this area. As noted earlier, there is an understandable reluctance to give the Fund any mandate for approving capital controls of any kind, but there is a clear need to evolve a consensus on this issue as it would help create shared expectations about what constitutes a reasonable approach.

To summarise, the new architecture dis-

cussions have made some progress in defining a possible framework for debt restructuring as an instrument for crisis resolution, giving the IMF a limited role in certifying the preconditions in which such restructuring is appropriate and also in providing financial assistance for adjustment programmes associated with debt restructuring.

However, it must be recognised that standstills on debt payments cannot be a ‘first resort’ instrument. They cannot therefore be used to halt a crisis in its early stages – other instruments have to be used for that purpose – but they cannot be invoked as a last line of defence to prevent a crisis from spiralling completely out of control.

Governance Structure for the New Architecture

An aspect that has received less attention in the architecture discussions than it deserves is the need for an appropriate governance structure for the international financial system. Thus far, the governance structure of the Bretton Woods Institutions, with the Interim Committee and the Development Committee at the apex, has served as the effective political level governance structure for the international financial system. It is necessary to review the existing structure in the light of the changes that have taken place in the functioning of the world economy and their impact on the role of the Bretton Woods Institutions relative to private capital markets.

5.1 The Changing Role of the IMF

The role of the IMF has obviously changed dramatically from the days when it was the centre piece of the Bretton Woods architecture. The shift to floating exchange rates in the 1970s, and the enormous growth in private capital markets since then, eliminated the Fund's role as a possible source of finance for industrialised countries. It has also become less important for those emerging market countries which have access to capital markets and can therefore handle the more run-of-the-mill balance of payments problems on their own, though even these countries may need support from the Fund for large-scale crises, because their access to capital markets is subject to sudden interruption in times of difficulty. For the overwhelming majority of developing countries, which do not have significant access to capital markets, Fund financing remains as important as ever.

The elimination of the Fund's financing role for industrialised countries inevitably weak-

ened its ability to influence policies in the major economies, even though these policies can have adverse effects on the rest of the world. The surveillance function of the Fund was at one stage projected as a possible mechanism for overseeing the consistency of macro-economic policies of the major industrialised countries, but this has not happened in practice. The Fund was not a significant player in either the Plaza Agreement or the Louvre Accord, both crucial examples of policy co-ordination among industrialised countries. Its contribution to the process of policy co-ordination among industrialised countries since then is also limited.

Policy co-ordination among industrialised countries is now conducted, if at all, only in the G-7 forum. There is extensive interaction among the G-7 countries at senior official level, at the Ministerial level, and finally at annual summit level meetings. Although the Fund provides inputs into the process, the process itself is not multilateral. The consultations are limited to a relatively small group of countries which are both economically more integrated and also much more politically cohesive than other international groupings. The position of these countries on international economic policy issues is usually decided as part of this process and decisions which concern the Fund and the Bank are then presented at Interim and Development Committee meetings, more or less as a *fait accompli*. Since developing countries are excluded from this process during its early and formative stages, and they do not have the power to force reconsideration at later stages, it is not surprising that they often feel that the G-7 functions, in effect, as the 'Directorate of the World'. This is, of course, a reflection of power realities. Indeed, in

the post Cold War environment, it would not be an exaggeration to say that the G-7 agenda itself is often set largely by the G-1!

The expansion of private capital markets into a dominant position has also forced some reconsideration of the role of intergovernmental forums in overseeing the functioning of the international financial system. Governments in industrialised countries increasingly distance themselves from direct intervention in the functioning of private financial markets, relying instead upon independent regulators to ensure that markets function efficiently. The growing demand for the independence of Central Banks is a reflection of this trend. If this logic is extended to international financial markets, it would imply that oversight of the functioning of these markets must increasingly be entrusted to representative bodies of regulators. This has already happened to some extent. The preferred forum for co-ordination and harmonisation of policies and standards in the banking sector is the Basle Committee and the BIS, with IOSCO and the IAIS playing a similar role in the securities markets and insurance, respectively. Any new governance structure for the international financial system must find ways of linking with the work of these organisations.

The recently established Financial Stability Forum represents an effort to achieve an integrated overview of the system allowing for interaction between governments and the representative bodies of regulators. However, as pointed out earlier, the FSF is not a representative body since it excludes developing countries. It is also interesting to note that the Secretariat of the FSF is located in the BIS and not the Fund. This adds to the perception that the Fund is not viewed by the G-7 countries as the preferred forum for discussing international financial issues which concern the industrialised countries.

These developments have naturally led to a re-positioning of the role of the Fund and the governance structure associated with it, i.e. the Interim Committee. The Fund is no longer per-

ceived by the industrialised countries as the critical international forum for discussion of their own policies, or even as the critical forum to oversee the functioning of the international financial system which is today dominated by private capital markets. It is, however, the undisputed inter-governmental forum for discussing balance of payments problems of individual developing and transition countries, or groups of these countries, and also for considering problems arising from the interaction of these countries with the international financial system. As the principal crisis manager, it has the financing role of providing official resources to help these countries cope with balance of payments difficulties when they arise. It also has the role of catalysing private flows to the same end. And yet there is a case for arguing that this is too narrow a conception. As the emerging market economies integrate more fully with the world economy, problems in emerging market countries will grow in scale and could also have larger potential effects on markets in industrialised economies. There is a need for a forum which can consider these issues in a more holistic manner and in which emerging market countries are adequately represented.

5.2 Towards a New Governance Structure

The deficiencies in the existing governance structure, represented by the Interim and Development Committee, have been known for some time and various proposals for modifying this structure were discussed inconclusively by the Executive Boards of the two institutions only a year ago. The G-7 Finance Ministers, in their report to the Cologne Summit, recommended the continuation of the existing two-committee structure with only marginal changes. The Interim Committee was converted into a permanent International Monetary and Financial Committee, with the same membership as at present, but giving the President of the World Bank a 'privileged role' in the new Committee while the Chairman of the Financial Stability

Forum was given observer status.⁴⁵ The overlap between the two Committees, which was perceived to be a problem earlier, is not significantly reduced, although it has been decided that joint meetings of the Interim and Development Committees can be held on important issues of common interest.

The new arrangement, which was formally implemented in September 1999, is very similar to the previous one and therefore retains some of its drawbacks. A major weakness of the structure is that the composition of the Committees reflects country representation on the Boards of the two institutions, which means that all the systemically important developing countries are not represented. This was one of the reasons why the USA, when it wanted to discuss international stability issues following the crisis in East Asia, chose to convene an ad hoc group of 22 countries which included the major emerging market economies, rather than seek the same discussion in the Interim Committee.

Recognising the need to interact more intensively with the systemically important developing countries, the G-7 Finance Ministers have established a new forum, the G-20, specifically for this purpose. The G-20, which was formally launched in September 1999, consists of 19 member countries and the European Union plus the Bretton Woods Institutions represented by the Managing Director of the Fund and the President of the Bank.⁴⁶ The membership includes the 7 industrialised country members of the G-7 and the key emerging market countries. The Chairpersons of the International Monetary and Financial Committee and the Development Committee will also participate in the discussions. The mandate of the Group is to 'promote discussion and study and review policy issues among industrialised countries and emerging

markets with a view to promoting international financial stability'. The group will have no permanent secretariat, but, like the G-7, it will have a deputies process to support the Ministers.

The establishment of the G-20 achieves the objective of creating a forum for informal consultation with the systemically important developing countries, but it is not a substitute for a more formal structure which would involve these countries and which would be linked to the Bretton Woods Institutions, and to the two Committees which supervise them. One way of involving the systemically important developing countries more formally in the governance structure would be to revive a proposal which was earlier considered in the context of restructuring the Interim and Development Committees. This proposal involved the creation of a single overarching group at Ministerial level to address global economic issues, while retaining the two separate committees to address specific Fund and Bank issues.

The composition of the expanded group was to be the combined membership of the Interim and Development Committees. The Fund and the Bank were expected to be full partners in the new group, while other institutions were envisaged as permanent observers (possible candidates were WTO, UNCTAD (UN Conference on Trade and Development) and BIS). The institutional members were expected to be involved in the preparatory work for agenda items in their specialised areas. It was envisaged that the group could meet twice a year, with a plenary session in the morning for the over-arching group, followed by separate Interim and Development Committee meetings as at present. The group could also meet on other occasions if circumstances warranted without being linked to meetings of the two Committees.

45 The long-standing proposal to convert the Interim Committee into a Council at the Ministerial level does not enjoy sufficient support and remains on hold. This proposal in any case does not alter the governance structure significantly, although it brings about greater interaction between the Fund management and the memberships of the Interim Committee at the political level.

46 The country members of the G-20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the UK and the USA. The EU is the twentieth member.

The creation of a new over-arching Ministerial group, with a direct supervisory role over the Bretton Woods Institutions, and a linkage to other international institutions concerned with the functioning of the financial system, could provide an opportunity to create a top level governance forum with a more representative membership. However, merely combining the membership of the two Bretton Woods Committees would not give adequate representation to systemically important emerging market countries. An alternative approach would be to constitute a group consisting of the top 8 industrialised countries by size of quota in the Fund, plus the top 12 among the other members, which includes oil-exporting countries, transition countries and developing countries, plus all those countries not already covered by this criterion but which currently represent constituencies in the IMF Board.⁴⁷ Adding constituency representatives in this way would ensure adequate representation of smaller countries on a transparent basis.

This formula is likely to produce a group of around 30 countries which would include all the major 'stakeholders' defined in terms of economic potential as well as all members of the International Monetary and Financial Committee. The forum could include the heads of major international institutions concerned with the functioning of the international financial system and the world economy, i.e. FSF, WTO and UNCTAD. It could also include representatives of the international bodies of regulators (i.e. BIS, IOSCO and IAIS) which is necessary given the enormously increased role of private markets. The proposed composition has a somewhat larger membership than is ideal, but some expansion in size is unavoidable if a minimal degree of representation is desired.

An over-arching Ministerial Group of the

type described above would create a formal Ministerial forum which could take an integrated view of the functioning of the global economic system in which operational issues related to the Fund and the Bank would be only part of the agenda. Major issues relating to the role of the Fund and the Bank could be considered by the over-arching group while detailed discussion of operational issues relating to these two institutions could be left largely to the two specialised committees.

Will the establishment of a new over-arching Ministerial Group really add value to the present structure of governance? This is a difficult question to answer. It is easy to be sceptical about what can be gained by setting up political level groupings to oversee the functioning of private market activity. On this view, political level international groupings are useful only when they oversee the policy and functioning of international public sector institutions; if the role of these institutions has been dwarfed by expanding markets then political structures created to oversee the former should not try to expand their mandate to cover market related activity. Against this view, it can be argued that as countries integrate into the world economy, they have to subject themselves to new international disciplines and reshape their domestic institutions in a manner that enables them to cope with the requirements of integration. This is an onerous task under any circumstances and one that often raises fears about loss of sovereignty and a sense of helplessness among many developing countries. This can only be countered by developing a greater sense of involvement and ownership. This is only possible if developing countries are more substantively involved shaping the new institutions and the new rules necessitated by the process of international integration.

47 The 20 countries that would qualify on this basis in the first two categories are the USA, Germany, Japan, France, UK, Italy, Canada and the Netherlands among the industrialised countries and Saudi Arabia, Russia, China, India, Brazil, Venezuela, Mexico, Argentina, Indonesia, South Africa, Nigeria and Korea among the others. All the G-22 participants are included except Australia, Hong Kong, SAR, Malaysia, Poland and Thailand. Some of these are likely to become eligible for inclusion as constituency representatives.

Summary and Conclusions

It is evident from our review that the phrase ‘new financial architecture’ appears, in retrospect, somewhat hyperbolic. What has emerged after two years of discussions is not a blue print for an entirely new architecture, but a set of proposals to fill gaps in the existing system and strengthen it in places. However, as pointed out in the introduction, the incremental nature of the changes envisaged is not necessarily a shortcoming. The critical question is whether these changes will achieve the objective of imparting greater stability to international financial markets, especially from the perspective of emerging market economies. A summary assessment would suggest that there has been a great deal of progress in generating a consensus on crisis prevention, but somewhat less on mechanisms for crisis resolution.

6.1 The Consensus on Crisis Prevention

The architecture discussions have produced a much better understanding of what makes emerging market economies especially vulnerable to financial crises. The factors involved, which are unique to emerging market economies, include inadequacy of information available to foreign investors about economic conditions in the country, weak and poorly supervised banking systems leading to imprudent lending and excessive exposure to foreign exchange risk, other deficiencies in the financial and legal infrastructure and inappropriate exchange rate regimes. Appreciation of these problems has also generated a substantial consensus on how to deal with them and thus reduce the probability of a crisis.

Much of what is being proposed by way of crisis prevention is a reiteration of convention-

al recipes for good economic management and greater transparency. But that does not make these proposals any less valid. There is complete agreement that the pursuit of sound macro-economic policies is the most important means of avoiding crises. Soundness of macro-economic policies is typically judged by reference to multiple diagnostic indicators of economic health which give the authorities a number of dimensions on which to be watchful.

Lack of good quality information and transparency is an important reason why investor perceptions can change suddenly leading to destabilising behaviour. This can be countered by making available to markets an expanded flow of information focusing especially on indicators that are particularly relevant for financial stability. The standards of quality and timeliness which countries should meet are specified by the Fund in its Special Data Dissemination System. The Codes of Transparency for fiscal and monetary data provide a further basis for improving the quality of information in these areas.

There is general agreement that strengthening the IMF’s surveillance activity, with a special emphasis on surveillance of the financial sector, will help to reduce the likelihood of crises. Surveillance helps by increasing the likelihood of corrective action being taken at an early stage by the authorities concerned and increasingly also by providing a channel of information to markets on the Fund’s assessment of the economy. The latter has not been an important source of information in the past, but the greater transparency now being pursued by the Fund, and the support this has received from member countries, makes it potentially much more important in future. Regional surveillance

is a new idea which has some appeal, though there are formidable difficulties in converting regional economic co-operation forums into effective mechanisms of surveillance.

A potentially useful initiative, which should be tried by countries seeking greater integration with international capital markets, is the establishment of a mechanism for regular structured official-private sector at which representatives of investors meet with officials of the Finance Ministry and the Central Bank. This can help keep governments informed of the concerns of market participants and also allow them to reach out to reassure investors on perceived problem areas.

The most important lesson of the East Asian crisis is that weaknesses in the financial sector play a key role in causing crises. Emerging market economies would therefore be well advised to strengthen their financial systems as a key element in any strategy for crisis prevention. Fortunately, the architecture discussions have produced a strong consensus among the developing countries on this issue and many countries are actively engaged in this process. The core activity is to upgrade prevailing norms and standards in different parts of the financial system to internationally accepted levels. These standards are well defined in banking, insurance and securities markets and less well defined in other areas.

Industrialised country experience amply demonstrates that financial sector weakness can persist, despite adoption of international norms, if enforcement is inadequate. This is certainly true in the banking sector, which is typically the most intensively supervised. Establishing an effective supervisory system in a short space of time is extremely difficult given the scarcity of supervisory skills. Besides, financial ingenuity is likely to stay one step ahead of supervision and this is especially so in developing countries where the financial system is being expanded

and diversified.⁴⁸ Strengthening the financial sector is therefore a process which, however urgently pursued, is bound to take several years of effort. The vulnerability of emerging markets on this score is therefore likely to remain high for some time and this should be kept in mind when considering the need for crisis resolution mechanisms in the international architecture.

Industrialised country regulators should also take some responsibility for preventing crises by discouraging potentially destabilising behaviour by institutions within their jurisdiction. The activities of hedge funds are often discussed in this context. Their role in precipitating financial crises has probably been exaggerated compared with other players acting in a similar fashion, but there may be a case for imposing disclosure requirements for large transactions, and possibly also introducing higher risk weights for bank loans to these institutions to limit their leveraging ability. Some of the prudential norms for banks in industrialised countries favour short-term lending to commercial banks in emerging market countries because the risk weights for short-term loans is lower than for long-term loans and these provisions need to be modified. The risk weights also treat all commercial banks in emerging market countries identically, whereas it may be better to discriminate in favour of banks with a better individual credit rating or where the quality of the regulatory and supervisory regime comes up to certain standards. Industrialised countries should also try to improve the regulatory and disclosure standards in offshore financial centres (OFCs) which can otherwise provide an opportunity for using offshore operations to engage in riskier activity which would not be allowed by home country regulators.

The creation of the Financial Stability Forum is an important initiative in creating a consultative body which can take an overview of the functioning of financial markets and identify

48 The entry of derivatives, for example, introduces new dimensions of risk which are not well understood even in countries where there is much greater experience with these instruments.

possible regulatory gaps. However, the exclusion of developing countries from this group reduces its potential usefulness, especially in creating a sense of participation and ownership of the new rules that undoubtedly need to be evolved.

The choice of exchange rate regime remains an area where differences of perception still exist, though a consensus is slowly evolving. No single exchange rate policy is right for all situations and the choice must depend on the particular circumstances of the country concerned. The issues involved are now well understood. Emerging market countries often want to maintain exchange rate stability because it eliminates exchange risk for investors and thus encourages a free flow of capital.⁴⁹ However, once restrictions on capital movements are removed, it may not be possible to maintain a fixed rate in the face of sudden capital outflows. A large change in the exchange rate in such situations can be highly damaging if economic agents have incurred large foreign exchange exposure in the belief that the government is committed to maintain a fixed rate. Soft-peg exchange rate regimes are therefore best avoided if capital mobility has been introduced.

Countries can probably manage relatively stable exchange rates, or controlled regimes of the crawling peg variety, as long as extensive controls are in place, but once capital controls are liberalised, exchange rate stability can be firmly assured only if the country is willing to abandon monetary independence. While some developing countries may be willing to do so, and adopt currency boards (or even outright dollarisation), most are unlikely to choose this option and for good reasons. These countries must accept much greater exchange rate flexibility. Greater flexibility in exchange rates creates greater awareness of foreign exchange risk, which, in turn, leads to more prudent behaviour.

The policy towards capital controls is an area where opinions have changed considerably after the crisis in East Asia. It is now recognised that liberalisation of capital controls entails considerable risk, especially in situations where the financial sector is weak or there are macro-economic imbalances. As a result, emerging market countries are no longer advised to liberalise capital movements as rapidly as possible, and some control over short-term capital inflows is generally felt to be desirable. Market-based instruments of control, such as the Chilean unremunerated deposit requirements, are regarded as superior to discretionary instruments. There is general agreement that there is no case for controlling the flow of foreign direct investment. The flow of long-term debt can also be liberalised without much danger, but appropriate reporting requirements should be in place.

An area where differences persist is the liberalisation of restrictions on capital outflows. Many who concede the need to control capital inflows for stability reasons do not accept the rationale for controlling outflows in normal times. However, many developing countries retain various types of restrictions on capital outflows in the belief that these restrictions increase the resources domestically available for investment. Retention of controls is also favoured as a precautionary step, even if there is no fear of excessive outflows in normal conditions, because they help to prevent sudden and large outflows which can otherwise take place if there is a loss of domestic confidence. On balance, countries which liberalise inflows must liberalise outflows also, though this process should be gradual and appropriately sequenced. Since the threat of destabilising outflows relates primarily to short-term outflows, there may be a case for experimenting with Chilean style unremunerated deposit requirements applied to all outflows.

An unresolved issue in the area of capital

49 Stability with respect to one major currency still leaves investors subject to exchange risk because of the fluctuations between the major currencies which are substantial. However, this risk is not related to the individual country and is also more easily handled because of the existence of deep and liquid forward markets in these currencies.

movements is the role of the IMF in supervising the regime of capital controls. The Articles at present do not impose any obligation on member countries to liberalise capital controls comparable to the obligation to liberalise current account transactions, nor do they give the Fund a mandate to promote any particular regime relating to restrictions on capital flows. However, in a world dominated by international private capital flows, the exclusion of this area from the mandate of the Fund is an anachronism. There is a case for defining an appropriate mandate which would give developing countries full freedom to choose the pace of liberalisation they like, but also give the Fund the role of monitoring the regime of restrictions on capital movements and encouraging a move towards a more rule based system in this area.

While countries should be free to determine the pace of liberalisation, it should be possible voluntarily to undertake obligations not to impose new restrictions without consultation with the Fund, and also to treat such restrictions as temporary, to be removed in consultation with the Fund. This would increase the level of investor confidence without putting developing countries at any disadvantage. Developing countries may be willing to expand the mandate of the Fund, if it is part of a larger package of reform which also responds to their concerns, i.e. expanding the capacity of the Fund to act as a lender of last resort in times of crisis and perhaps also providing some respectability to restrictions on capital movements which may need to be imposed in crisis situations. It should be possible for industrialised countries and developing countries to agree on a package of reforms which presents advantages to both groups.

Concern is sometimes expressed that some of the crisis prevention measures may discourage capital inflows to emerging market economies. This is certainly true of initiatives to strengthen prudential norms to avoid unhedged foreign exchange exposure on the part of banks in developing countries, to tighten regulatory standards in industrialised countries to reflect the riski-

ness of banks, and to draw attention to exchange rate flexibility in order to create greater awareness of foreign exchange risk. However, this should not be viewed as a disadvantage. Eliminating the element of euphoria in capital flows may reduce their level in a particular period, but that may be a desirable outcome from the point of view of stability. It may not imply any reduction in the average level of flows since the alternative of excessive inflows followed by even more excessive outflows may yield an average level of flows which is actually lower.

6.2 Mixed Signals on Crisis Resolution

Crisis resolution remains an area where there is some progress but there are also significant differences in perception. There is broad agreement on general principles, but it is not easy to transform this into agreement on specific issues. The general principles that are agreed are the following:

- ❖ Crisis resolution cannot be left solely to markets because markets do not always process information appropriately and, in any case, they often 'dry up' in crisis situations, leading to large systemic effects which warrant intervention;
- ❖ There is a case for using international resources to help countries handle crises, but they must be used parsimoniously in view of their scarcity, and also the danger of moral hazard;
- ❖ Crisis resolution must involve the private sector to a much greater extent so that the use of public resources is minimised and countries are encouraged to work with private financial markets which will ensure proper pricing of capital taking account of the risks involved;
- ❖ Imprudent private lenders must take a 'hair cut' to reduce the degree of moral hazard in the system;
- ❖ Adjustment programmes must be designed to ensure that the poor are

insulated as much as possible;

- ❖ The IMF is the principal crisis manager in the system and its programmes must be designed to reflect the general principles enumerated above.

The multiplicity of objectives creates considerable room for differences of opinion on specific issues, including the role of the Fund. Developing countries typically emphasise the potential instability to which emerging markets are exposed because of the possibility of irrational investor behaviour unconnected with any weakness or change in fundamentals. A more self-critical formulation would accept that there may be some weakness – there is always some weakness everywhere – but the scale of investor panic, and the resulting capital outflow, is often wholly disproportionate to the extent of the weakness. Developing countries therefore favour enlarging the capacity of the Fund to act as a lender of last resort, underpinning the stability of the international financial system. They recognise that such lending will have to be accompanied by conditionality and the extent and nature of conditionality is bound to be a subject of intense debate, and perhaps even controversy, because of differences in perception on what are the critical weaknesses to address. However these issues should be resolved separately, without questioning the need for the Fund to be able to provide liquidity on a large scale.

The SRF and the CCL enable the Fund to perform a lender of last resort function to some extent, and since they could not have been introduced without the support of industrialised countries, it is tempting to conclude that there is complete consensus on the role of the Fund in this respect. However the consensus is less solid than it seems. One problem relates to the availability of resources. At present, the Fund's resources are only sufficient to handle the

normal balance of payments needs of member countries. It may not be able to handle a serious capital account crisis in a large emerging market country on its own without weakening its own liquidity position. It certainly could not handle a multiple country crisis, should it occur, without requiring parallel financing. There are several mechanisms which could be used to provide additional resources to the Fund to be used specifically in crisis situations, some of which involve the creation of SDRs as discussed in Chapter 4. However, there does not seem to be sufficient political support in the industrialised countries for such an initiative.⁵⁰

Inadequacy of resources can seriously reduce the effectiveness of the Fund as a crisis manager in the event of a multi-country crisis because its crisis management effort would be dependent upon the ability to mobilise bilateral support from the G-7 and other potential donor countries, rather than on a purely professional assessment by the Fund of what is needed. It may also generate strong pressure on the Fund to rationalise the adequacy of the limited resources available by making over-optimistic assumptions about the speed with which confidence can be restored and capital inflows halted, or fresh inflows attracted, to fill the gap. With inadequate resources even an otherwise optimal adjustment programme will yield poor results, especially in the short term, and this can reduce the credibility of the Fund as a crisis manager. It could also discredit the corrective policies themselves.

These concerns are particularly important because of the view which has gained ground in several influential quarters that the Fund should limit the circumstances in which it will engage in large-scale financing. Prompted by the concern about moral hazard, it is being argued that a system which responds to crises by providing large-scale Fund financing for adjustment

50 It is unfortunate that some of the criticism of Fund programmes, by those who would want the Fund to play a larger role in crisis management, has eroded support for the Fund as an effective crisis manager, and actually strengthened those who would prefer the Fund to play a much smaller role.

programmes weakens the incentive to avoid crises to begin with. The validity of this line of reasoning can be questioned. One might have thought that the pain of a crisis, and the pain involved in taking the corrective action associated with Fund conditionality, would be incentive enough to try to avoid crises. However, those overly concerned with moral hazard seem to feel that if large-scale financing makes post-crisis adjustment easier than it would be otherwise, it clearly reduces the incentive to take precautionary steps. The recommendation of the Task Force of the Council on Foreign Relations to deny large-scale lending for country specific crises where contagion is not involved, and there are no systemic effects, is obviously driven by some such consideration. The Meltzer Commission recommendations which call for a drastic reduction in the scale of Fund operations are motivated by the same concerns.

This approach surely carries the concern with moral hazard too far. It amounts to denying medical treatment to drivers who suffer accidents in the hope that it will encourage them to drive more carefully. A more reasonable approach would be to recognise that markets often display inefficiencies leading to excessive inflows in good times and a complete drying up in times of difficulty. The Fund has a key role to play in such situations. By supporting credible adjustment efforts it can provide the breathing space countries need to bridge the gap between the initiation of corrective action and the return of confidence. Failure to bridge this gap can push the country into a prolonged downward spiral from which recovery could be very difficult, and in any case more prolonged. The argument that such eminently useful intervention should be avoided for fear of creating moral hazard is difficult to accept, especially since the moral hazard problem can be effectively handled through appropriate conditionality and insistence on private sector involvement.

The Meltzer Commission's recommendations limiting the Fund to lend only to countries which meet pre-qualification requirements are

potentially dangerous. Given the experience of financial instability in the 1990s, one should be extremely cautious about weakening an international system which has been built up over decades and which, in many respects, has performed exceptionally well. As the dissenting Commissioners have pointed out '... reform is needed at the IFIs and there are a number of constructive proposals in the report. But its recommendations on some of the most critical issues would heighten global instability, intensify, rather than alleviate poverty throughout the world and thereby surely undermine the rational interests of the United States. These recommendations must be rejected ...'

Perhaps the criticism of the present system which needs most attention is that it does not provide sufficient incentive to take preventive action *ex ante*. One way of improving the incentive structure for *ex ante* action, without disrupting the existing system too much, would be a move to a system in which the interest rate charged for Fund assistance varies with the quality of preventive action. The surveillance activity of the Fund could place countries into different categories according to the quality of preventive action taken. Countries ranked in lower categories (higher risk) could be charged higher rates for Fund assistance. If this classification is also made public it would also have an impact on market perception and the cost of borrowing, thus providing additional incentives for improving performance in this area. Developing countries may resist the move to introduce differential pricing on the grounds that it departs from established practice, but if it helps to reflect some of the criticism of the system, and thus increases support for the Fund's role as a stabilising force in financial markets, there is surely an advantage in experimenting with this approach.

Another criticism which deserves attention is the need to distinguish the role of the Fund more clearly from that of an aid agency. For example, the provision of concessional resources over a long period, as has happened with coun-

tries resorting to successive ESAF programmes, is difficult to justify as part of the balance of payments financing role of the Fund. Such activity is much closer to structural adjustment assistance and could perhaps legitimately be shifted to the Bank. Prolonged use of Fund financing is not only seen as pushing the Fund into long-term concessional lending, which is more appropriate for a development institution, it inevitably also expands the range of policies covered by Fund conditionality to reflect the structural constraints which need to be addressed in these cases. This contributes to the impression of an institution suffering from 'mission creep'. A sharper focus on balance of payments problems would enable the Fund to restrict its conditionality to areas directly concerned with stabilisation and its consequences. However, while some refocusing is desirable, it should not lead to an excessive restriction of the mandate of the Fund in a way which jeopardises its effectiveness.

The need to involve the private sector in crisis resolution has been much discussed and there is some agreement on what needs to be done, but there are also important differences. The area of agreement relates to action that can be taken in anticipation of a crisis which would help in crisis resolution. The major possibilities here are tying up contingency credit lines and borrowing to build reserves. Both initiatives involve costs; but these costs may be worth incurring when weighed against the risks involved in not taking precautionary steps. Countries can also be encouraged to make greater use of these instruments by linking the availability of Fund resources in some manner with the quality of preventive action taken in this area. This could be judged in terms of the combined adequacy of reserves and contingency credit lines in relation to liquidity requirements that may arise. Quantifying the likely liquidity needs obviously poses difficult technical problems but they are not insuperable.

The new architecture discussions have also emphasised the importance of involving the private sector in crisis resolution as much as pos-

sible after the crisis. The principle focus here must be on efforts to revive confidence, which in turn depends on the quality of the adjustment programme. The Fund should help to design programmes which will encourage a quick return to markets and also persuade markets of the soundness of the programme. Paradoxically, it is important to avoid over-optimism about the scope for private financing lest that lead to under-provision of public financing. In fact generous Fund financing to begin with, perhaps including flexibility to increase the level of financing in situations where the programme is proceeding well but private markets are responding slowly, may well be the best recipe for ensuring an early resumption of private financing. In the longer run it may economise on the public financing needed.

Post-crisis private sector involvement also extends to debt restructuring as a method of 'bailing in' the private sector. The idea that some costs must be borne by imprudent lenders is unexceptionable, but it would be wrong to conclude that debt restructuring should be insisted upon in all cases. Adequate pricing of Fund assistance and appropriate conditionality can provide the necessary incentive for voluntary debt restructuring to be attempted wherever the problem is essentially one of liquidity. Where solvency is involved, the problem becomes more complicated. The current consensus envisages consideration of debt restructuring as part of crisis resolution in certain circumstances, but without specifying the manner and terms in which it should be done. The principles that will be followed are somewhat non-transparent but that is perhaps unavoidable.

6.3 A New Governance Structure

An issue that has not been addressed in the new architecture discussions, but which needs to be addressed, is the need for a new governance structure for the international financial system. Traditionally, the political level governance structure of the Bretton Woods Institutions, consisting of the erstwhile Interim Committee (now

renamed the International Monetary and Financial Committee) and the associated Development Committee, have served as the dual political level forums dealing with international financial issues. Over the years, this structure suffered from erosion of credibility for several reasons.

- ❖ Industrialised countries do not see this as the structure relevant to supervise or co-ordinate their own policies – that role has essentially shifted to the G-7.
- ❖ The growth of private financial markets has also reduced the importance of the Bretton Woods Institutions and increased the importance of the regulatory systems under which private markets function and the mechanisms for international harmonisation of these national regulatory systems. These activities take place outside the ambit of the Fund.
- ❖ The recently constituted Financial Stability Forum is an effort to create a body which can take a holistic view of private markets. While the Fund is represented on the FSF, the Secretariat of the FSF is provided by the BIS.
- ❖ Finally, the constituency structure of the two Bretton Woods Committees may be representative of the total membership, but it does not give adequate representation to the systemically important emerging market economies. It was in recognition of this infirmity that the USA convened the G-22 to discuss international financial stability issues after the East Asia crisis rather than use the Interim Committee.

These developments suggest that there is a need to look to a new governance structure which might overcome some of the infirmities of the present system. The suggestion made in Chapter 5 is that we should revive the idea, which was once discussed in the context of reforming the

Interim and Development Committee, of setting up an over-arching Ministerial Group to look at global economic issues, while continuing with two separate Committees to deal with specific Fund and Bank issues.

In order to ensure adequate representation for the systemically important developing countries, the over-arching Ministerial Group could consist of the top 8 industrialised countries by size of quota in the Fund, plus the top 12 of the rest of the membership by size of quota, plus all Ministers who are members of the International Monetary and Financial Committee but who do not qualify on the basis of quota size. This would provide a group of about 30 Ministers. The membership of the Committee should include the heads of the Bretton Woods Institutions as well as the heads of the other international institutions dealing with the world economy, i.e. the WTO and UNCTAD. It could also include as permanent invitees the Chairman of the FSF and representatives of BIS, IOSCO and IAIS to provide a linkage to private markets.

The need for yet another international forum can be questioned and too much should not be expected from what can be achieved by such an initiative. Its real justification lies in the widespread but ill-defined feeling that the global economy is integrating at a rapid pace, but that not enough is being done to create mechanisms which can provide political ownership of the process. Michel Camdessus (2000), in one of his last speeches as Managing Director of the IMF, put the problem in perspective :

‘The post World War generations are the first in history to find themselves in the position of being called upon to influence global affairs not from a position of military conquest or imperial power, but through voluntary international co-operation. The challenge is to find mechanisms for managing the international economy that do not compromise the sovereignty of national governments, that help the smooth and effective working of markets, that ensure

international financial stability but that offer solutions to problems which now transcend the boundaries of the nation-state. A tall order indeed!

Collective responsibility, political ownership and greater participation by developing countries in the critical forums which are seen to give broad directions to the world economy are essential if

we want to develop ownership of, and commitment to, these changes in the developing world. Globalisation and integration are most likely to succeed if they are seen to be supported by international institutions which ensure a high degree of partnership. The absence of such institutions is an important missing element in the existing financial architecture and this is a gap which definitely needs to be filled.

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