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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 movements, 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 countries 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 Cooperation 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 interest 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

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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 macroeconomic 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, provided 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 outflows 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.