6

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 conventional 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 riskiness 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 possible 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.