Reforming the International Financial Architecture: Emerging Market Perspectives

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Introduction

Il SaKong and Yunjong Wang

The recent Asian financial crisis which first began in 1997 has raised a critical question on the adequacy of the existing international financial architecture and provided an impetus for discussion on how it can be modified or redesigned. The basic institutional framework of the current international financial architecture was laid more than 50 years ago when the Bretton Woods system was established. Obviously, today's international financial environment is so much different that it poses new challenges to the global financial system. In fact, the speed and breadth of contagion of the Asian financial crisis seems to reflect the change.

There have already been many reports and policy recommendations put forward regarding this issue. They include the G-7 Finance Ministers' Report, the Meltzer Commission Report, Task Force Report sponsored by the Council on Foreign Relations, and the Financial Stability Forum's recommendations. However, these reports and policy recommendations are frequently criticized because emerging market views are not fully recognized and their concerns are not fully reflected, although emerging markets are most vulnerable to the systemic risks of the global financial system. Certainly, the global community should make every effort to consolidate emerging market views in establishing a viable new international financial architecture.

An Eminent Persons Group, consisting of experts mostly from emerging markets, was formed with the sponsorship of the Ford Foundation to gather its consensus views regarding critical issues of international financial architecture. For this purpose, an international conference was organized by the Institute for Global Economics and the Korea Institute for International Economic Policy to concentrate on discussing these critical issues among Group members and international experts. This volume is the proceedings of the conference.

The International Financial Architecture: Issues and Propositions

Since the recent wave of currency and banking crises that began in East Asia, existing institutions and arrangements became widely considered as being inadequate for dealing with very large and extremely volatile capital flows, as Griffith-Jones notes in her contribution to this volume. At this critical juncture, three years since the inception of the Asian crisis, she evaluates what progress has been made so far towards reform of the international financial system. Overall, there has been some progress made, but it is clearly insufficient. In terms of positive developments, IMF lending facilities for both crisis prevention and management have been expanded and adapted while the Fund's total resources have been increased. Adaptations are continuously being made: for example, a week before the Prague Annual Meetings, the Fund's Contingent Credit Lines (CCL) were modified. Important institutional innovations have also been introduced, such as the creation of the Financial Stability Forum (FSF), to identify vulnerabilities and sources of systemic risk, to fill gaps in regulations and to develop consistent financial regulations across all types of financial institutions. The creation of the G-20 – a forum to discuss international financial reform that includes both developed and developing countries – is another positive development.

Griffith-Jones notes that there have been two serious problems in the area of financial architecture reform. First, reform has been insufficient, given the magnitude of the changes required to create a financial system that supports growth and development in the dramatically changed context of the 21st Century, which is characterized by very large but extremely volatile and highly concentrated private capital flows. Second, progress made has been asymmetrical in three key aspects, and a more balanced approach is urgently needed.

Firstly, far more progress has been made on important measures taken by developing countries that are being asked to introduce a very large number of international standards and codes in order to be less vulnerable to crises. However, far less progress is being made on equally important and complementary international measures. As many leading economists have stressed, crises such as those in Asia were not just caused by country-specific problems, but also by imperfections in international capital markets, such as the herding behavior of global investors, which led to rapid surges and massive reversals of capital flows.

Secondly, the insufficient participation of developing countries in the key policy fora and institutions is a problem that needs to be overcome. With regard to the international financial institutions, more representative governance needs to be discussed in parallel with a redefinition of their functions. Griffith-Jones asserts that the developing countries should be fully represented in the Financial Stability Forum itself, because the issues discussed there have profound effects on their economies and their insights can make a valuable contribution to the Forum.

Thirdly, we have all placed excessive focus on crisis prevention and management, mainly for middle-income countries. This is important, but it may have led us to neglect the equally important issues of appropriate liquidity and development finance for low-income countries. Low-income countries need sufficient multilateral lending and official flows as well as speedy debt relief. It is a source of concern that multilateral lending to low-income countries, especially via international development assistance, has recently fallen sharply.

In conclusion, Griffith-Jones emphasizes the need for the international community to overcome any possible complacency on this matter by reminding us that the man who neglects to fix his leaking roof in sunny days is unable to do so when stormy weather comes.

Capital Account Liberalization and Its Critique

The first set of reform agendas focuses on issues related to capital account liberalization. Stable flows of international capital and appropriate exchange rate arrangements have become an important policy decision for emerging market economies. Capital flows and exchange rate regime are closely interrelated since the choice of capital account liberalization heavily influences the choice of exchange rate regime as the international financial market becomes more integrated. On the other hand, regulatory and prudential measures for highly leveraged institutions (HLIs) have also been discussed in line with stable capital flows in emerging markets.

Since the recent Asian crisis, the issue of choosing an appropriate exchange rate regime has been actively discussed. One widely shared conclusion is that soft-peg exchange rate regimes are extremely vulnerable in a world of volatile capital movements. Consequently, new orthodoxy based on the impossible trinity hypothesis favors two-corner solutions – greater flexibility or credible institutional assurance, like the currency board system or dollarization. Nevertheless, questions whether such corner solutions are adequate for developing countries have arisen of late. Fear of floating is still conspicuous in many developing countries having nominally adopted a free-floating exchange rate regime. Developing countries are sensitive to exchange rate fluctuations because the cost of exchange volatility outweighs the benefits when compared to developed countries. In this regard, some variants of intermediate exchange rate regime could be viable options for developing countries, the specific type of which could vary depending on an individual country's economic conditions. As noted by Wang and Yang, monitoring bands proposed by John Williamson could be a compromise solution,[1] but this intermediate regime still needs further enhancement of estimation techniques for fundamental equilibrium exchange rates in order to make those estimation results more workable in practice.

Wang and Yang also point out that the international community has been muted in reducing the systemic risks generated by G-7 currency fluctuations. The flexible exchange rates of G-7 currencies quite often tend to wildly overshoot and generate equally disruptive misalignments. In particular, the sharp swings in the yen-dollar rate contributed significantly to the outbreak of the Asian crisis. In this regard, the stability of G-3 currencies would be highly beneficial to developing countries that have to succumb to exchange rate pressures caused by G-3 currency movements. Although the criteria of optimum currency area for those anchor currency countries are not fulfilled, thus raising the possibility of an asymmetric shock, some arrangements for preventing a serious exchange rate misalignment of G-3 currencies and subsequent monsoon impact on neighboring developing countries would be desirable.

There is a growing concern that the liberalization of capital flows can subject emerging market economies to the risk of abrupt capital outflows on account of macroeconomic imbalance as well as the contagion effect. This raises the issues of whether emerging market economies should exercise some controls over capital flows into emerging markets. At the national level, market-based restrictions on capital flows, such as the Chilean type, can be an important policy issue. On the other hand, capital control at the time of crisis is also an important issue to discuss. In line with this, the sequencing of capital market liberalization brings an important but difficult choice for countries that are preparing to open their capital account.

Ffrench-Davis examines two contrasting approaches: an across-the-board opening versus a sequential process. Full opening of a country's capital account does have a tendency to deter domestic macroeconomic mismanagement in various cases of instability originating internally such as large fiscal deficits, permissive monetary policy, arbitrary fixing of the exchange rate and political instability. However, full opening can also import financial instability from abroad, with capital inflows leading to a worsening of macroeconomic fundamentals by generating bubbles, which sooner or later will burst.

Ffrench-Davis also casts some doubt on the argument that strict prudential regulation and supervision of domestic financial institutions could resolve the problem of macroeconomic disequilibria. Firstly, a significant share of capital inflows is not intermediated by domestic financial institutions. Secondly, sources of instability are inherent in the volatility of expectations that obviously also involve financial intermediaries and even national authorities. During booms, regulations are generally ineffective in reducing the strong incentive to lend, as overdue loans and provisions are low, prices and guarantees are biased upward, and the reinvestment of a high level of profits facilitates financial institutions to meet the capital requirements that are necessary to increase lending. On the contrary, non-performing loans (NPLs) increase during crises, which carry rising provisions. That reduces the financial intermediaries' capacity to increase lending, as NPLs bite into capital requirements, in a context in which low profits also reduce the funds available to increase the capital base of financial intermediaries.

[1] Williamson, John (2000), *Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Options*, Institute for International Economics.

His conclusion is that across-the board opening of the capital account could have been premature in most emerging market economies and thus should have been postponed, moving only in a selective direction, until a long-term process in which other major reforms had been consolidated and new equilibrium prices had been established. He strongly emphasizes that more attention should be focused on the management of booms rather than crises. Given that existing institutions and instruments have been ineffective in warning of impending turbulence, it becomes particularly relevant to design an appropriate domestic regulatory framework and prudential macroeconomic policies that aim at controlling booms before they become unsustainable. Noteworthy among such measures is the reserve requirement on financial inflows, within a comprehensive set of prudential stabilizing policies, which Chile used with success in times of capital surges.

de Brouwer of the Australian National University discusses problems created by Highly Leveraged Institutions (HLIs), the so-called "hedge funds," in light of the excessive capital market turbulence and market integrity. He acknowledges that HLIs can be an important stabilizer in financial markets by boosting liquidity in financial markets and increasing efficiency. However, it is not right to think that they are purely benign players in financial markets. As discussed by the U.S. President's Working Group on Financial Markets, the Long Term Capital Management (LTCM) debacle showed that failure by banks to prudently manage credit to large market participants, and the failure of some of these institutions to prudently manage market and liquidity risk, can substantially increase systemic risks.

As discussed by the FSF Working Group on HLIs, the financial market dynamics that occurred in East Asia and South Africa in 1997 and 1998 showed that the activities of a relatively small number of HLIs could undermine the integrity of financial markets. Players with large concentrated positions could have a disproportionate effect on market prices, not least because other players would mimic the large players or would not take contrary positions. HLIs could use unacceptably aggressive tactics in markets to bring about price changes to their advantage.

Limited progress has been made in improving counterparty risk management of hedge funds by banks. The prevention of highly leveraged players from undermining the integrity of financial markets in the future is an issue as yet unresolved by the international community. HLIs are key players in financial markets but it is important to deal with the problems that may arise from their activities so that countries can feel confident of receiving benefits from international financial integration.

In this context, de Brouwer examines four main proposals made by some non G-7 nations to limit position-taking and manipulative activities by HLIs. These are to require public disclosure of positions, to require banks to impose margins on all hedge funds and other borrowers when providing swap or repurchase facilities, to implement a code of conduct for participants in financial markets, and possibly to introduce regulations on foreign exchange trading through electronic brokering systems. However, none of these four proposals is currently under active consideration by any international body. The challenge in implementing these reforms is to limit the destabilizing effects that can arise from speculation, while at the same time maximizing the benefits, such as increased efficiency and liquidity.

Building Infrastructure for New International Financial Architecture

The second set of agendas in this volume cover the institutional limitations on the current international financial system. The international community has an important role to play in reducing vulnerability to crises by ensuring that appropriate international standards for regulation and supervision are met and that the information is openly available to financial market participants and the public more generally. In addition, reform issues related to the current international financial institutions (IFIs), including the IMF and the World Bank, are critically examined in light of emerging market economies and developing countries.

There have been numerous calls for harmonizing and enforcing common standards and regulations on global financial industry by establishing more international bodies to act as global policemen. As Tan notes, the establishment and enforcement of common standards could raise a question of sovereignty in managing the financial systems and conducting monetary and fiscal policy in emerging market economies. Enforcement will typically be difficult unless some stringent and observable parameters are devised and subjected to international surveillance. Regarding implementation and enforcement, opinions are divided on whether the process should be voluntary or compulsory. Although the advocates of common standards claim that the universal acceptance of common standards will help stabilize international financial market and reduce the frequency of financial crises, there is no evidence to support such an argument.[2]

Interestingly, Tan proposes a regional approach towards common standards: for example, core principles for effective banking supervision, which are consistent with the Basle Initiative 2001. Such regional initiatives that involve, in particular, proper supervisory agency, capital regulations, criteria for licensing banks, lending procedures, information-reporting systems, risk management profiles, accounting standards, timely corrective actions, consolidation and cooperation amongst banks. Since these are crucial and sensitive core principles to be upheld, the regional approach can begin from East Asia or even within ASEAN.

In response to widespread criticism of the role of the IMF in the financial crises of the late 1990s, several prominent groups have proposed significant changes in the organization's operation and policies. Based on a critical review and comparison of these proposals, Blecker recommends the following reforms in order to make the IMF a more effective instrument for preventing financial instability, managing financial crises, and promoting balanced and equitable global growth.

First, the IMF's mission should be narrowed to the promotion of financial stability, not as an end in itself but as a means toward the larger end of broadly shared and sustainable macroeconomic prosperity. IMF lending should be restricted to short-term assistance and should not lead to prolonged micromanagement of national economies. The Fund should not engage in long-term development lending or oversee structural reforms outside of its core areas of competence. Poverty assistance and development lending should be left to other agencies, such as the World Bank. The IMF should make public its evaluation of countries' financial and macroeconomic conditions and subject these evaluations to critical outside review.

Second, the IMF should establish criteria by which member countries can prequalify for loans on preferential terms in the event of a financial crisis. The prequalification criteria should be targeted on policies that can reduce the risk of a financial crisis occuring and minimize the impact if one does occur, such as prudent banking regulation, sound debt management, controls on short-term capital inflows, transparency and disclosure standards, adequate foreign exchange reserves, deposit insurance reform, and collective action clauses in bond contracts.

[2] See Park and Wang (2000) more detailed discussions on the related issue. Park Y. C. and Y. Wang (2000), "Reform of the International Financial System and Institutions in Light of the Asian Financial Crisis," Discussion Paper 00-02, Korea Institute for International Economic Policy.

Third, the conditionality attached to IMF loans should be focused on measures that directly address the particular sources of a country's balance of payments problems. Fiscal or monetary austerity should be prescribed only to the minimal extent necessary and programs should be designed to minimize employment losses and ensure a speedy recovery. Long-term structural reforms should not be required as a condition of short-term lending. Countries that have prequalified should receive conditionality more easily along with lower interest rates and more rapid disbursement of funds. Countries should be allowed to suspend payments to foreign creditors during a financial crisis. As much as possible, the Fund should try to distinguish between crises generated through the capital account versus the current account, between contagion effects and fundamental disequilibria, and between countries that are merely illiquid and those that truly insolvent, and design its programs accordingly.

Fourth, countries should be required to maintain realistic and defendable exchange rates as a condition for IMF assistance. The IMF should abandon its support for adjustable peg exchange rates, which invite speculative attacks especially in countries with open capital market. However, the Fund should not attempt to force all countries into the "corner solutions" of either permanently fixed or freely floating rates. Rather, the Fund should be willing to accept viable forms of intermediate regimes such as wide crawling bands adjusted for inflation differentials.

Fifth, in order to both avoid moral hazard problems and enhance distributional equity, IMF programs need to put more emphasis on burden sharing by creditors in responses to financial crises. Mechanisms such as requiring collective action clauses in bond contracts and encourage payment standstills by countries in crisis should be used to force creditors to agree to stay "bailed in" and to negotiate reasonable debt restructuring and debt reductions when necessary. The IMF should not bail out creditors, especially large international banks, but rather should seek to compel them to make proper risk evaluations in their lending activities.

Sixth, the IMF should stop promoting capital market liberalization in all developing countries and should not require countries to allow free operation of foreign banks, neither of which is essential to avoid balance of payments crisis. Less developed countries should not be forced to open up their capital markets to short-term capital flows, which can foster economic instability and undermine long-term growth objectives.

Seventh, the IMF needs to be made more democratic, transparent, and accountable. Emerging market member countries and their citizens need greater voice in the formulation of IMF policies and should cooperate in the definition of prequalification criteria including social dimensions. The content of IMF programs should be made public and subject to outside scrutiny and peer review. Affected countries need to have more input in the design of stabilization programs.

Industrial countries are likely to object to many points made by Blecker, particularly the idea of giving emerging market economies and developing countries a larger representation in running the IMF. If the decision-making process at the IMF is not politically neutral, and for that reasons the emerging market economies and developing countries cannot expect more active voice in the Fund decision-making process, then the G-7 and the IMF should strengthen the independence of the Executive Board and give the Fund financial independence.[3]

[3] See also de Gregorio, Eichengreen, Ito and Wyplosz (1999), "An Independent and Accountable IMF," Geneva, International Center for Monetary and Banking Studies and Center for Economic Policy Research.

Private Sector Involvement and Social Policies

The final set of agendas in this volume covers the issues relating to Private Sector Involvement (PSI) as a crisis prevention and resolution mechanism and social aspects of the new international financial architecture regarding poor countries. On equity grounds, these two issues have gained a great deal of attention from the international community. In practice, however, there is a conflict of interests between creditors and debtors.

Efforts for achieving greater private sector burden sharing are basically motivated by the perception that the public resources are not sufficient to prevent or resolve crises and official assistance to crisis countries creates a source of moral hazard on the part of private sector creditors and investors. If private sector creditors were bailed out through official assistance without bearing any cost of the crisis, their habitual imprudent lending and reckless investment decisions would continue.

Park reviews whether the Korean experience of debt restructuring could be a successful example for the PSI. He concludes that the process was much delayed and somewhat ad hoc. Furthermore, the burden sharing was not fair in terms of spread and government guarantees. In this regard, Park strongly argues that some rule-based rules tailored to different types of crises need to be developed for PSI in order to replace the arbitrary approach now being pursued to bail in private creditors. The instruments of payment standstills, collective action clauses, and the creditors committee would preferably continue to be discussed as an agenda for PSI.

The last paper prepared by Soludo examines the content and implications of the new global financial architecture for poverty reduction and social inclusion in the least developed countries (LDCs). He concludes that much of what is on offer today is a refurbishing of some old ideas. He contends that new international financial architecture is necessary, to the extent that it emphasizes improved mechanisms for delivery of social programs and focus essentially at the nation states, but is very far from providing sufficient conditions for progress. In terms of the implications, he argues that both new international financial architecture and current trends of globalization may lead to multiple equilibria in the global economy, i.e., localized poverty traps coexisting with prosperity havens. In such an increasingly globalizing world, the global framework is as much a key part of the problem as it should be an important element of the solution. He concludes that poverty eradication and social inclusion should be seen as an international public good to be collectively provided, without which global information capitalism and the fight against poverty at the national level are unsustainable.

A Concluding Remark

Throughout the discussion the primary concern shared by all participants was how to enhance the stability of international financial markets, with special attention paid to minimizing the vulnerability of emerging market economies. In doing so, important policy recommendations included in the major reports on international financial architecture have been thoroughly discussed in order to identify critical issues from the emerging market perspective. However, it still remains to gather consensus on these issues, not only among the Eminent Persons Group members, but also other financial experts and policy makers, especially from emerging markets.

It is our sincere hope that this volume will contribute towards gathering consensus views on establishing a new international financial architecture which will fully reflect emerging market concerns.

Keynote Speech

C. Fred Bergsten
Director, IIE

Those of you who know the history know that after every crisis, the G-7, the G-10 – all the G's – and the IMF, put out statements which basically say, "Next time, we will never make big bailout loans to those countries that get themselves in trouble." Then some country gets itself in trouble, and they make an even bigger bailout loan than the last time. It happened to Thailand, Indonesia, Korea and Brazil. So the words often are not that important because they are aimed at a particular audience to try to create some mood music but it may or may not apply when the evil day comes.

In thinking about the determination of the architecture and what is going to guide policy in this area, one has to think of it in loose, amorphous terms of reigning doctrines and concepts that one tries to generate support and consensus for.

It was discussed this morning that emerging market economies do not have enough voice; they should have a bigger role in the decision making process, they should have bigger quotas at the IMF, their ideas should be more specifically engaged, and they should not be dictated to by others. I agree with all that, but I do not think that is the most effective way for the emerging markets to influence the architecture and the way the system is run, partly because I do not think that course is likely to succeed. The G-7 and the IMF governing structure pretty much have a stranglehold on the official, formal decision-making bodies; you can push a little bit, you can create a G-20, but I do not think it is likely to be successful. More importantly, I do not think it is necessary.

I want to offer an alternative strategy, which I will characterize by the catchphrase in the Nike commercial, "Just do it." If emerging markets as a group, or some subgroup like an Asian Monetary Fund, have a better idea for how to manage their affairs, an idea which happens to run counter to the conventional wisdom in the G-7, the IMF, Washington consensus and the US Treasury, then my advice is to just do it. If you can demonstrate effectively that it works, then I believe it will work its way into the consensus and might even alter the consensus over a period of time.

That sounds a little abstract and I would like to be pragmatic. Let me illustrate with three issues where there is very big debate about the nature of the international financial architecture, where, in my view, the reigning consensus is wrong or at least arguably wrong, alternative strategies are quite plausible and the group of emerging markets – here I do have particularly in mind East Asia as it moves toward an Asian Monetary Fund – could be the leaders.

The first one has to do with crisis prevention. It is very clear that the international monetary system has failed miserably when it comes to crisis prevention. Everybody acknowledges that, so the whole debate about the financial architecture has been primarily aimed at improving crisis prevention. That in turn has led to all the steps that were being talked about this morning – to improve transparency, improve disclosure, reduce market imperfections, all the things that economists love, and that is right and good. But in my view, it is grossly inadequate. So what else should be added?

It seems to me that one element that desperately needs to be added to the financial architecture is a combination of what I call "early warning systems" and "early action systems." By which I mean concerted, dedicated efforts by some group – it could be the world, it could be a subgroup – to systematically attempt to assess where the next crisis might come and try to head it off.

I deliberately distinguish between early warning and early action. Early warning is an analytical exercise, where you are assessing all the data available, the outlook for the countries in question, and trying to forecast where the next disaster might hit. I think the technology of forecasting has now improved to the point where you can do this in a serious way. As Dr. SaKong referenced, my colleague Morris Goldstein and others recently did a study released at the Institute for International Economics on early warning systems. They compiled a database of all 150 crises in emerging markets since 1970, identified 26 causal variables and figured out which had performed best in the past. Then they did an out of sample test to see how that set of indicators would have done in predicting the crises from 1997 forward. The answer is that they got it about 75% right. They did not get Indonesia, and I know of no quantitative model which has shown how to forecast the Indonesian crisis, which probably says it was a pure contagion case intensified by political difficulties. But our model had about a 75% accuracy rate. There will be false positives; sometimes you will foresee one coming that does not happen. My answer to that, which is a bit cynical, is if you think you see it coming and take action and it does not happen, you can claim credit for keeping it from happening and nobody knows it would not have happened. The only way you know a false positive is by doing ex-post analysis and that is not what we are talking about in operation. In any event, I think early warning systems can be seriously pursued.

Early action, in contrast to early warning, is a political and policy exercise. Once you have flashed the early warning signal, then you go to the country that has been warned about and say, "Come on, do something or else we are all in trouble". That is difficult, but it is not unprecedented. The Europeans have done it to a large extent within the various European monetary arrangements, and now the Euro. The G-7 used to do it to some extent among its own membership. It is certainly a plausible exercise, and it seems to me to be an essential exercise, as part of any serious new financial architecture.

Then comes, in a way, the operational point. I also believe that early action and early warning may best be achieved at the regional level rather than the global level. It stands to reason that countries in the neighborhood know what is going on in the neighborhood better than folks half a world away even if they are very smart folks – like the IMF, US Treasury and so on. But folks in the neighborhood may know better.

As far as eliciting early action is concerned, it seems to me that folks in the neighborhood have much greater legitimacy in going to the neighbor. The response is always "But the Asians are too nice and polite, they never talk seriously to each other, and you need fiends like the Americans in there to really be tough." Hopefully the crisis might have changed that a little bit, certainly for Indonesians to go to Thais next time and say, "It looks to us that you may be heading to trouble and last time you did, that really clobbered us. Please do something." It seems to me that is highly legitimate in a political sense and might even be carried forth with some fervor in light of the national interests involved in heading off the problem.

So this is an area where I suggest, "just do it." I am delighted that ASEAN is in fact setting up such a mechanism, as Mr. Muhammad mentioned earlier, and I would wish it the best of luck and indeed I would like to see it broadened to an Asia-wide grouping. It seems the most desirable, least possibly objectionable, component of a future Asian Monetary Fund. It would be a surveillance/early warning-early action mechanism which, if it worked, would obviously enhance the stability of the global system. It is an absolutely cost-beneficial way to proceed, however one looked at it.

Then if it worked, you can say to the rest of the world, "See, we headed that one off, we got our acts together, we succeeded. Why don't you try something like that?" That would have demonstration effects which would fly in the face of conventional wisdom. I say fly in the face of conventional wisdom because those at the so-called center of the system in Washington, whether it is the IMF or US Treasury, have no interest in these ideas. I suspect the reason is that they don't want to be surveiled themselves. The G-7 broke down because the individual G-7 countries, as they got into the 1990s, decided they simply did not want to be subject to each other's surveillance. I will never forget one incident when Japan was running one of its huge surpluses, putting pressure on the whole system in the early 1990s. I said to the German who was then chairing the G-7, "Why don't you have a special meeting and do something about Japan?" and he said "Because if we did that, next year they might try to do something about Germany and that would be unacceptable." It is what I call a "mutual non-aggression pact" and what it does is render totally impotent any effort to avoid, predict and deal with crises ex ante.

So when the G-7 talk loquaciously about crisis prevention and then spend all their time getting everybody to put better data on the internet, you have to forgive me for being a little skeptical because I think there are much more direct and potentially effective ways to do it. I do not want to oversell the idea. I do not pretend any predictive system can be perfect. You will miss someone, you might have some false positives. But not to try it strikes me as ridiculous, missing a huge opportunity and therefore a big lacuna. So any group that would like to do it, particularly at the regional level, should try it. If it works, you will have demonstrated the superiority of the approach and you will be a leader and the result predictably would be then a broader change in the architecture.

The second one, where we already have a fair amount of experience, is in the use of capital controls. You remember as recently as 1997, literally on the eve of the crisis, the IMF was still talking about amending the articles to enshrine the principle of capital account convertibility and essentially ban the use of capital controls. The idea in the IMF was to be able to exercise the same authority over any use of capital restraints as current account restraints. That was partly Camdessus' desire to get the Fund ever bigger and more powerful. But it was also a doctrinal view that total freedom of capital movements in all circumstances was the way to go.

Needless to say, they then backed off. I think there is already a de facto grudging acceptance, even in Washington, of the use of restraints on capital movements of certain types. There is pretty widespread agreement on the Chilean type restraints on capital inflows. As Dr. Ffrench-Davis laid out today, they reduce the magnitude of inflows in good times and can alter the maturity of those flows in a positive direction, and that is pretty widely agreed.

Then come our friends in Malaysia, who amid great controversy put on capital outflow controls of a limited sort in the midst of a crisis. Loudly criticized at the time, it seems to have worked out rather well. You can't say definitively that it was the reason they are growing rapidly again; other countries are growing rapidly again through different techniques. But it certainly denies that it was a foolish or ineffectual kind of move.

More interestingly, I think, are the cases of China and India which have avoided the crisis in large part through the maintenance of inconvertibility of their currencies on capital account. Indeed, they have been held up by the US Treasury, the IMF and myself as the paragons and bastions of stability in the face of crisis, which indeed they were. They were able to do that because of being shielded from the risk of speculative attack by what amounts to a comprehensive set of capital controls. So this is a case where countries have "just done it," either in the teeth of the crisis or more structurally. They have already won kind of grudging acceptance of that particular alteration in the underlying doctrine and it opens a door to others, as Singapore is now doing to some extent and others will probably do to various degrees. That is another example of how successful implementation of an unorthodox, even anti-consensus, approach can work out and work its way into broader acceptance.

The third and final example of what I have in mind is in a way the biggest. That is the question of exchange rate systems. Here we have this peculiar academic and official consensus on the corner solution. I say peculiar because academics always pride themselves as leading the officials but, in this case, the academics followed the officials and justified the corner solution intellectually. You know the idea: either it is a hard fix with a currency board or dollarization or, on the other side, it is a free float, and anything in between is terrible.

As one of the papers said today, we at the IIE have just published what we regard as an important study by John Williamson, which takes the opposite view and says that the corners are very costly and they can disrupt development. Both free floats and hard pegs can lead to prolonged and severe misalignments that will disrupt development in a serious way. And for the same reasons we invented target zones and reference ranges almost 20 years ago, we continue to feel that intermediate solutions are indeed better.

The point is that there is fear of floating in many emerging market economies. In our analysis, that fear of floating is absolutely justified. So we should be searching for intermediate options which marry together the best virtues of both floating and fixing, rather than rejecting any intermediate option and saying you must choose one or the other. Our view is that you can get the best of both worlds with an effective intermediate regime.

What I am suggesting here is that this is the perfect case for the East Asian countries and a nascent Asian Monetary Fund to "just do it" and put those kinds of regimes in place. Indeed, I would dramatize it by going to a basket peg. I know that is controversial and difficult in the region. But Williamson makes a strong case that the underlying economics justify it and that thereby reducing the risk of competitive depreciation would be a big plus for the region, including reducing the chance of a repeat of anything like 1997 and 1998.

As I think many of you in this room know, I blame Taiwan for the Korean crisis. That is a long story but I said it at the time and I stick by it. Had Taiwan not unnecessarily pulled the plug on the New Taiwan Dollar and let it drop 20%, you would not have had the second leg of the crisis, which was, of course, Korea. Korea would have had trouble anyway, given the currency and maturity mismatch that Koreans had let themselves get into. However, I do not think it would have been anything nearly so severe had Taiwan not triggered the second wave of the crisis by what I regarded at the time, and continue to regard, (and the French Treasury agrees with that), as a blatant competitive depreciation of the New Taiwan Dollar.

That is just an example. If you went to common basket pegging, you would not totally eliminate that problem but you will reduce the risks. The point is there are plausible alternatives to the conventional wisdom that are waiting to be implemented and this region is the natural place to do it because there is a groping, in this country and elsewhere in East Asia, for a new exchange rate regime. There is a fear of pure floating. There is therefore a revealed preference to reject the new conventional wisdom of the corner solution. I think this is one where, if you have a minimum of political will to sit down and work together, you can do it.

This would be a very positive step toward an AMF. You don't get into questions of competing conditionality with the IMF or who determines the conditions if there is another crisis. That is contentious stuff and will have to be worked out down the road if you do get into the conditional lending at some point in an AMF. But every country has to have an exchange regime; it is quite natural for countries in a region to cooperate on their exchange regime, as the Europeans have now been doing for off and on since the Bretton Woods system broke down 30 years ago.

The key point is that you do not have to get anybody's approval. You just do it. You work it out and put it in place. Then, if it works, you have demonstrated your ability to go your own way and that you can have ideas that are at least as good, if not better, than other's ideas, and that maybe even what you do will be emulated elsewhere. Maybe Latin Americans would do it. Maybe other developing countries elsewhere would do it, and you would then have injected a new doctrine into the conventional wisdom, the norms that guide the informal thinking that I suggested at the outset is really what makes up the international financial architecture.

So put these three things together. You could put in place an early warning and early action system. You could contemplate the use of different types of capital restraints, depending on how some of other variables like the exchange rate system were determined. You could work out an intermediate exchange rate regime, perhaps on a common and concerted basis. All of this would add up to a very potent set of regional monetary initiatives.

If those steps were put into place, and if they worked as I think they would, they would do much more to alter the shape of the international financial architecture than all the debates and communiques that have come out of the G-7, the Interim Committee and all the other G's over the last three years since all this has been debated. It is a "just do it" philosophy; the substance is there to make the effort. I take seriously the dedication of countries and individuals in this region to try to develop an independent and autonomous monetary identity. I think that is a very good thing as long as it is consistent with, and supportive of, global stability. There is no reason that it should not be and, indeed if it proceeds along these lines, I think it surely would be. That is what I suggest for the Eminent Persons Group for emerging market economies as they attempt to play a more forceful, more effective and more influential role in the evolution of the international financial system.

Developing Countries and the New Financial Architecture

Stephany Griffith-Jones

I. What Progress on International Financial Reform?

The recent wave of currency and banking crises that began in East Asia – then spread to many other emerging markets, and even threatened briefly to spill over to the US in the wake of Russia and LTCM – generated a broad consensus that fundamental reforms were required in the international financial system. Existing institutions and arrangements were widely seen as inadequate for dealing with very large and extremely volatile capital flows, in which an important part of the volatility was caused by large imperfections in the financial markets themselves.

The seriousness of the situation is underlined by the fact that in the 1990s, out of 120 months, during 40 (that is 33% of the time) there have been important crises. This is particularly problematic for two reasons. Firstly, currency and banking crises – which have recently occurred mainly in emerging markets – have extremely high development and social costs. Indeed, deep and frequent crises in developing countries could undermine achievement of the UN target to half world poverty by 2015. Secondly, there is always the very small – but totally unacceptable – risk that contagion and spillover in an increasingly interdependent international financial system could lead to global problems. Both these problems implied that urgent action was required to overcome the risk that the important benefits that globalisation offers in other fields could be seriously undermined by international financial developments.

Three years after the Asian crisis, and a few weeks after the Annual IMF/World Bank Meetings in Prague it is a good time to evaluate progress achieved on reforming the international financial system.

Some progress has been made, but it is clearly insufficient. Important changes have been implemented. For example, IMF lending facilities for both crisis prevention and management have been quite usefully expanded and adapted and the Fund's total resources were increased. Adaptations are being continuously made. For example, a week before the Prague Annual Meetings, the Fund's Contingency Credit Line (CCL) a new facility that would help countries fight crises spilling over from other countries has been modified; the changes to the CCL crucially include greater automacity in disbursing such loans once a country is in a crisis resulting from contagion and lower cost of the facility. Such modifications were clearly very necessary, since the CCL-created over a year ago – had not yet been used. This was like having new fire-fighting equipment, but not having made the crucial connections to the water supply!

Important institutional innovations have been introduced, such as the creation of the Financial Stability Forum (FSF), to identify vulnerabilities and sources of systemic risk, to fill gaps in regulations and to develop consistent financial regulations across all types of financial institutions. As capital and credit markets become increasingly integrated both amongst each other and between countries, it is essential for regulation to be efficient that the domain of the regulator is the same as the domain of the market that is regulated. Given that regulation is still national and sectoral, an institution like the FSF is valuable to help coordinate regulation globally and across sectors. The creation of the G-20, a body to discuss international financial reform, that includes both developed and developing countries – is also a positive development.

Developing countries have been asked to take a number of important measures to make their countries less vulnerable to crises; these include the introduction of a large number of codes and standards. Though introducing standards is very positive, there are however concerns in developing countries that the number of standards (at more than 60) is too large; developing countries also are worried that standards are too uniform, in the assumption that 'one size fits all'. At a recent conference held at the Commonwealth Secretariat, senior policymakers from developing countries called for greater selectivity and flexibility in the standards they are asked to implement (Griffith-Jones, 2000). A more inclusive process is also necessary, whereby developing countries could participate in the development of these standards and codes, which at present they are asked to implement without having been involved in their design.

Even though there has been quite significant progress on reform of the financial architecture, it has suffered from two serious problems. Firstly, it has been insufficient, given the magnitude of the changes required to create a financial system that supports – and does not undermine – growth and development in the dramatically changed context of the 21st Century, characterised by very large, but extremely volatile and highly concentrated private capital flows. It is essential to develop a clear vision of an appropriate financial architecture in the new circumstances; drawing parallels from the institutional mechanisms developed nationally as domestic credit and capital markets grew, a new international architecture requires: a) appropriate transparency and regulation of international financial loan and capital markets, b) provision of sufficient international official liquidity in distress conditions and c) standstill and orderly debt workout procedures at an international level. The mechanisms that exist and the adaptations made till now, do not fully meet the new requirements.

Secondly, progress made has been asymmetrical in three key aspects, in which a more balanced approach is urgently needed.

A first asymmetry in the reform process is that far more progress has been made on important measures taken by developing countries, which are being asked to introduce a very large number of codes and standards, so as to make them less vulnerable to crises. However, far less progress is being made on equally important and complementary international measures. As many leading economists (such as Stiglitz, Sachs, Rodrik, Bhagwati and others) have stressed, crises-such as in Asia were not just caused by country problems but also by imperfections in international capital markets, such as herding, that lead to rapid surges and reversals of massive private flows. To deal with the problems in the international financial markets, it is essential that international measures both for crisis prevention and management are also taken.

As the G-24 – that represents developing countries – pointed out recently, standards in the area of transparency are being pressed upon developing countries to improve information for markets without equal corresponding obligations for disclosure by financial institutions, including highly leveraged ones, such as hedge funds, who have no reporting obligation. Better information on financial markets would be of great value to policy-makers, especially in developing countries. Transparency should not be a one way street. Furthermore, while valuable progress is being made on attempting to improve regulation of domestic financial systems in developing countries, there is painfully slow progress in filling important gaps in international regulation, of institutions such as mutual funds or hedge funds, or of modifying regulations, as of banks, where current regulations may have contributed – rather than prevented – greater short-termism of flows (as discussed in more detail later). In the field of international regulation, valuable studies have been carried out particularly by the Financial

Stability Forum Working Parties, but recommendations made are on the whole yet to be implemented.

Passing from crisis prevention to crisis management, it seems important that the IMF's own resources are large enough to meet the financing needs of a systemic crisis involving several economies simultaneously, while also retaining sufficient liquidity to meet normal demands on the Fund's resources. Michel Camdessus and others – including the influential US Council of Foreign Affairs – have suggested that this expansion of official emergency financing could be funded in part by temporary and self-liquidating issues of SDRs. Such a mechanism would not add to total world liquidity, except in a temporary manner during a crisis situation – when it would be compensating for reductions or reversal of private flows. This proposal deserves serious analysis and consideration and there seems to be considerate merit in the G-24's call for a study of this matter and discussion at the autumn 2001 meeting of the IMFC. More speedy progress on orderly debt work-outs is also urgent.

A second source of asymmetry in the reform process that needs to be urgently overcome is the insufficient participation of developing countries in the key fora and institutions. As regards the international financial institutions, more representative governance needs to be discussed in parallel with a redefinition of their functions. It is particularly urgent that developing countries (which are now only represented in a very limited way in the FSF Working parties) are fully represented in the Financial Stability Forum itself, as the issues discussed there have very profound effects on their economies and as their insights can make an important contribution to the Forum's valuable work. It is important to note that after their recent annual meeting Commonwealth Finance Meetings called for such developing country participation in the Forum. The inclusion of major developing countries in the G-20 is clearly a welcome step, but it might be of value to include also some smaller developing nations, to reflect their specific concerns. Above all, it would also be helpful if the agenda of the G-20 could be broadened, to include more explicitly the key issues of international financial reform.

A third asymmetry that has emerged in recent discussions on reform of the system is that we have all placed excessive focus on crisis prevention and management, mainly for middle-income countries. Important as this is, it may have led us to neglect the equally – if not more important – issues of appropriate liquidity and development finance for low income countries. As regards liquidity, it is important that existing IMF facilities for low-income countries – such as the Compensatory Financing Facility and the Poverty Reduction and Growth Facility – should be made more flexible, in case the present level of oil prices are sustained or if other terms of trade shocks affect such countries. More generally, the role of the IMF in providing liquidity to low-income countries is crucial. As regards development finance, low-income countries need sufficient multilateral lending and official flows, as well as speedy debt relief. It is a source of concern that multilateral lending to low-income countries, especially via IDA, has recently fallen sharply. Furthermore, in a world of rapidly increasing private flows, it is important that low-income countries, donors and international organisations collaborate to help attract more significant private flows to them. Mobilizing sufficient and stable development finance, both private and official to low-income countries is an essential pre-condition to help ensure growth and poverty reduction in the poorest countries.

It is important that significant further progress on reforming the international financial system is done quickly, as the risks and potential costs of not doing so are unacceptably large, especially for poor people in developing countries.

We must overcome any possible complacency on this matter, by remembering the man who neglected to fix his leaking roof in sunny times, and was then unable to do so when stormy weather came.

Given the complexity of the issues, I would like to focus the rest of my paper on better international information on markets and financial regulation, that is on international measures for crisis prevention. This is an area where, though action is urgent, there has been very little action, and even relatively little analysis.

II. Better International Information and Financial Regulation

1. Additional information on markets to developing countries

As pointed out above, better information to markets on developing countries has to be complemented by better information on international financial markets available to policy-makers, especially but not only in developing countries. Particularly during the crisis that started in Asia, emerging country policy-makers have found important limitations in the essential information available on the functioning of international capital and banking markets. The type of information required is particularly on almost day to day changes in the functioning of markets – and their key actors – globally and regionally.

The IMF has led the way in improving information – and its dissemination – on emerging markets economies, which is of particular use to markets. A parallel symmetric effort needs to be done to gather and provide timely information on market evolution to emerging markets' policy-makers. This task should perhaps be led by the BIS, and co-ordinated by the newly created Financial Stability Forum (FSF). Inputs from other institutions would be very valuable, for example, the IMF and the private sector (for example, the Institute of International Finance, IIF). Suggestions in the October 1998 G-22 Report of the Working Group on Transparency and Accountability did provide important elements for this task. These suggestions relate not just to better statistics on international banks' exposures, but also on "compiling data on international exposures of investment banks, hedge funds and other institutional investors". Furthermore, the growth of financial innovations, such as over-the-counter derivatives, while designed to facilitate the transfer of market risk and therefore enhance financial stability, have also made financial markets more complex and opaque. This has created difficulties in monitoring patterns of activity in these markets and the distribution of risks in the global financial system for market participants, regulators, central banks, and other authorities, including particularly those in developing countries. It would seem appropriate for major Central Banks and the BIS to attempt to improve registration of derivatives and institutions like hedge funds, by making it obligatory. Unfortunately, such initiatives to make reporting obligatory have until now been blocked, especially in the US Congress.

Given the speed with which markets move, it seems particularly important that the frequency with which relevant data is produced is very high (and possibly higher in times of market turbulence, when it becomes particularly crucial), and that dissemination is instant to all countries' Central Banks. Indeed, a special additional service could be provided by the BIS in which it would play the role of clearing house of information. For this purpose, it could draw not just on information it can gather directly from markets, but by collecting and centralising information on their markets that individual Central Banks have, and where the aggregate picture is not easily available to any individual Central Bank. This could possibly include both quantitative and qualitative information. Via the internet, the BIS could standardise the information requirements, collect the information, aggregate it, and disseminate it rapidly to all central banks, as well as to other relevant institutions. Such a service would be of the greatest usefulness to developing country policy-makers, especially immediately before and during crises; however, it would naturally also be very valuable to developed country policy-makers and international institutions (including the BIS itself) in handling crisis prevention and management.

2. Improved international financial regulation

1) The case for regulation

A strong case can be made that international financial regulation is welfare increasing. This is particularly true, if – as we discuss below – such regulation has explicit counter-cyclical elements, to compensate for inherent pro-cyclical behaviour by financial actors, that can also partly characterise traditional financial regulation.

Indeed, there is growing support for a view that the process of international financial intermediation has a second-best element, in which welfare for both source and recipient countries can be increased by regulatory changes (through measures in source and/or recipient countries), which would reduce excessive lending or investing. It is noteworthy that Chairman Alan Greenspan proposed – for the case of interbank lending – that it could be appropriate for either borrowing countries or lending ones to impose reserve requirements to "deter aberrant borrowing: sovereigns could charge an explicit premium, or could impose reserve requirements, earning low or even zero interest rates, on interbank liabilities. Increasing the capital charge on lending banks, instead of on borrowing banks, might also be effective"[1].

There is growing recognition that it may often be desirable to regulate excessive surges of potentially reversible capital flows in recipient countries. Indeed, an important part of the responsibility with discouraging excessive reversible inflows – as well as managing them – lies with the recipient countries. However, the experience of the 1990s, with very large scale of international funds – compared to the small size of developing country markets – leads to the question whether measures to discourage excessive short-term flows by recipient countries are sufficient to deal with capital surges and the risk of their reversal.

Aizenman and Turnovsky (1999) have formalised such analysis, by developing a rigorous model that analyses the impact via externalities of reserve requirements on international loans (both in lending and recipient countries) on the welfare of both categories of countries. Aizenman and Turnovsky op. cit. thus evaluate the macro-economic impact of reserve requirements in a second-best world, where there is moral hazard due to likely bail-outs on the lender's side and sovereign risk on the borrower's side; both generate large negative externalities on welfare. The general conclusion of their model is that the introduction of a reserve requirement in either source or recipient country reduces the risk of default and raises the welfare in both countries.

The aim of such regulatory changes is to help smooth capital flows to emerging markets, without discouraging them excessively. This is in contrast with views based on a belief that crises in emerging markets are due only to moral hazard, and that the appropriate way to combat such moral hazard is by scaling down the role of the IMF in providing financial packages before and during crises. The latter view has acquired some prominence in developed countries, particularly but not only in the US, in particular, the majority Meltzer Report to the US Congress took such views to the extreme. However, such reduction of the

[1] Remarks by Alan Greenspan before the 34th Annual Conference of the Federal Reserve Bank of Chicago, May 7th, 1998.

role of the IMF could either make crises even more costly and/or lead to a sharp reduction in private flows to developing countries. These are both highly undesirable effects which could significantly diminish welfare, particularly but not only in the developing economies, as well as undermine support for open economies and market-based economic policies in developing economies. Therefore, an approach based on better regulation is clearly better and more welfare-enhancing than one which cuts back the IMF.

2) Filling Gaps

The broad welfare case for applying reserve requirements in both source and recipient countries can also be applied to institutional investors and in particular to mutual funds, which became increasingly important in relation to banks in the 1990s. This growing importance occurred both within the developed countries, and particularly within the US – where mutual funds receive more than 50% of total deposits in the financial system – and in capital flows from developed to developing countries (see d'Arista and Griffith-Jones, 2000). The narrowing of differences between banks and institutional investors like mutual funds, and the fact that securities markets and thus mutual funds also have access to the lender of last resort – nationally in the US but more importantly in our context also internationally, due to the frequent rescue packages put together by the IMF in recent serious currency crises, suggests the importance of improving prudential standards for institutional investors such as mutual funds.

As regards portfolio flows to emerging markets, there is an important regulatory gap, as at present there is no regulatory framework internationally, for taking account of market or credit risks on flows originating in institutional investors, such as mutual funds (and more broadly for flows originating in non-bank institutions). This important regulatory gap needs to be filled, both to protect retail investors in developed countries and protect developing countries from the negative effects of excessively large and potentially reversible portfolio flows.

Institutional investors, like mutual funds, given the very liquid nature of their investments can play an important role in contributing to developing country currency crises. (For recent evidence, see Kaminsky, Schmukler and Lyon, 2000). It seems important, therefore, to introduce some counter-cyclical regulation to discourage excessive surges of portfolio flows. This could perhaps best be achieved by a variable risk-weighted cash requirement for institutional investors, such as mutual funds. These cash requirements would be placed as interest-bearing deposits in commercial banks. Introducing a dynamic risk-weighted cash requirement for mutual funds (and perhaps other institutional investors) is in the mainstream of current regulatory thinking and would require that standards be provided by relevant regulatory authorities and/or agreed internationally. The guidelines for macro-economic risk, which would determine the cash requirement, would take into account vulnerability variables as defined by the IMF and BIS (for a more detailed discussion of this proposal, see d' Arista and Griffith-Jones,1999).

The September 1998 Emerging Markets IOSCO Report on *Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets* has in fact described in some detail and evaluated rather positively the above proposal. This report emphasised that "there appears to be scope – and an urgent need for further work. This is very likely to require a multilateral effort – i.e. by regulators from both source and recipient countries in collaboration with the industry".

As regards HLIs, the FSF working group on HLIs rightly focussed on two problems.: systemic risk linked to high leverage and reduction of market and economic impact of collapse of unregulated HLIs. Particular emphasis was placed on HLI activities in small and medium sized open economies where the potential damage that can be caused by large and concentrated positions can seriously amplify market pressures.

As regards HLIS, the FSF Working Group considered formal direct regulation of currently unregulated institutions. This would include a licensing system, minimum capital and liquidity standards, large exposure limits, minimum standards for risk management, and even an enforcement regime with fines for transgressions.

Such regulation was seen to have several very desirable effects, (such as regular oversight over HLIS and reducing likelihood of disruptive market events), but due to what were seen as both philosophical and practical problems, the Working group did not recommend applying a system of direct regulation to currently unregulated HLIS at this stage, though it did not reject the possibility of establishing such a regime at a later stage. It emphasised that the failure to carry through their recommended measures (see Report *op. cit.*), would prompt such reconsideration.

The philosophical objection relates to the fact that direct regulation would not be aimed at investor protection (as investors are sufficiently wealthy or sophisticated to do their own due diligence), but on the mitigation of systemic risk. However, it could be argued that mitigation of systemic risk is also an increasingly valid regulatory aim. There were also practical objections, including how to avoid leakage through offshore centres. However, current efforts to improve and complete regulation in off-shore centres should help overcome those problems (see discussion of FSF Working Group Report on Offshore Centres). Other practical issues are more technical and more valid, including the need to adapt capital adequacy and large exposure rules to the specific risk profile of HLIS. This should be done in ways that any regulatory capital requirement did not adversely affect the efficiency and liquidity of markets in which HLIs are significant participants. This seems particularly important in a context when several large hedge funds have been wound down, which may diminish some of the negative impacts they had in recent crises, but could according to some observers – deprive markets of countrarian actors, with some useful roles to play in stopping the deepening crises.

3) Removing regulatory distortions and dampening exuberance of bank lending

As regards bank lending, there has firstly been concern that the 1988 Basle capital accord contributed to the build up of short-term bank lending and its reversal in East Asia and elsewhere, due to significantly lower capital adequacy requirements for short-term lending than for long-term lending. The new proposal published in June 1999 attempts to address this distortion by reducing somewhat (though perhaps not sufficiently) the differential between capital adequacy for short-term and other lending. However, the new Basle recommendations, though including many positive elements (see, for example, Cailloux and Griffith-Jones, 1999), also have suggestions that were widely seen as problematic. These included increasing the role of rating agencies to determine country weightings for capital adequacy, which could aggravate the pro-cyclical nature of bank lending, thus encouraging larger surges and larger reversals, – clearly an undesirable outcome.

There is important evidence that rating agencies act in a volatile and, especially, pro cyclical fashion. If that were the case, the reliance on ratings in the new system would exacerbate boom-bust cycles and could undermine the stability of the financial system. Indeed, as pointed by various authors., rating agencies failed to downgrade the East Asian countries before the crisis but then worsened it because they brought down the ratings as the crisis unfolded. Reisen and von Maltzan (1999) find that sovereign ratings lag rather than lead the market.

These problems should not, however, question the need for reforming the 1988 accord. The current system has fixed weights which do not adjust with the cycle. In the event of a recession the increased amounts of bad loans (which are usually not fully covered by provisions) will impact upon the lending bank's capital and can lead to decreased lending if the bank is already facing a relatively low capital asset ratio, and – as is likely in a recession – the bank is unable to raise new capital. This reinforces banks' own unwillingness to lend in a downturn. Both elements lower bank lending, which – in aggregate – further deepen the recession, and make banks' financial situation even more fragile.

4) Counter-cyclical elements in regulation

The answer thus may lie in the implementation of an explicit counter-cyclical mechanism which would, in boom periods, and in contrast to ratings, dampen excess bank lending. Counter-cyclical elements can also be introduced in regulating other actors (see above, for mutual funds). On the contrary, in periods of slowdown and of scarcity of finance the new mechanism should not further accentuate the decline in lending as exemplified by the 1997-1998 Asian crisis but rather encourage it.

There would be two linked objectives for introducing elements of counter-cyclical regulation. One would be to help smooth capital flows and the other would be to smooth the domestic impact of volatile capital flows on the domestic financial system and therefore on the real economy. Introducing counter-cyclical elements into regulation would help build a link between the more micro-economic risks on which regulators have tended to focus till recently and the macro-economic risks which are becoming increasingly important, both nationally and internationally[2]. Counter-cyclical elements in regulation related to bank lending could be applied, either internationally, nationally or at both levels.

Several mechanisms could be used to introduce a counter-cyclical element into regulation of bank lending. One mechanism would be to get the required capital ratio higher in times of boom, and to allow banks to use the additional cushion provided by the higher capital ratio, so they could sustain lending in times of recession at a lower capital asset ratio (when increased bad loans are likely to be reducing their capital). Some practical difficulties may arise in implementing such a mechanism, of which the most serious one may be getting international agreement on a general formula for cyclically adjusted capital asset ratios.

A second mechanism for introducing counter-cyclical elements in bank lending regulation is for regulators to encourage that higher general provisions be made for possible loan losses (i.e. subtracted from equity capital in the books of the bank) to cover normal cyclical risks (Turner, 2000). This would allow for provisions built up in good times to be used in bad times, without affecting reported capital. The way to ensure this would be to maintain higher general provisioning that applies to all loans. The main problem for this mechanism, according to Turner, op. Cit., may be that tax laws often limit the tax deductibility of precautionary provisioning; however, it is possible to change such tax laws, as indeed was done in the late eighties in the UK.

A third mechanism, relevant particularly for domestic bank lending, is for regulators to place caps on the value of assets (such as real estate or stocks and shares) to be acceptable as collateral, when the value of such assets has risen sharply in a boom and is at risk of declining sharply in a recession. Rules could be used such as averaging values for the last five years, or accepting only 50% of current prices in the peak period of a boom. The latter mechanism seems to have the least problems of implementation (indeed, reportedly it is already applied in some jurisdictions, e.g. Hong Kong).

[2] I thank Andrew Crockett for his suggestive remarks on this point.

A fourth possible counter-cyclical mechanism is that, as suggested by McKinnon and Pill, monetary authorities could monitor and try to limit or discourage lending for property, construction and personal consumption, as these items tend to increase substantially – and often even be a major factor – in booms. A possible implementation problem would be that it may be difficult to verify final use of credit, and such measures could be partially evaded.

Furthermore, regulators should be flexible in the downturn, particularly to allow banks to easily use cushions (e.g. of capital or of provisioning) in times of recession; it may even be advisable, if a recession is very serious, to allow ratios to fall below normally required levels, (to help sustain lending), in the understanding that they will be rebuilt as soon as the economy starts recovering. A tension may arise here between the regulatory concerns about individual bank liquidity and solvency and the macro-economic externalities of their actions, particularly in recessions.

Specific issues seem to require further study. How best can the distinction between a temporary boom and a permanent increase in growth be made? After what period of "boom", should regulatory changes be introduced? How large should such changes be? What are the best mechanisms through which counter-cyclical measures should be introduced (flexible capital adequacy ratios, higher provisioning against losses, more "realistic" pricing of collateral)? Should such measures be introduced for both international and domestic lending, or preferably for one of them? This paper provides only initial thoughts on these important issues.

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Comments and Discussion

Robert A. Blecker: I will begin my comment by signaling number of areas in which I agree with Dr. Griffith-Jones' arguments and I will conclude by mentioning one area in which I have some disagreement.

First, I think that Dr. Griffith-Jones is absolutely right that there has been a bias in international policy discussion, since the Asian Crisis, focusing on what the developing countries and emerging market countries need to do to reform their internal financial systems to make themselves less vulnerable. And too little attentions to industrial countries – the creditor nations – can do, and need to do to better regulate their capital outflows and to prevent volatile surges of capital flows in and out of emerging market that we witnessed in 1990s. Although, of course, the first area is very important, and one thing I have learned from my discussions with Koreans over last few days since I have been here is an appreciation of how much understanding there is here of need for internal reform. I have found out that much deeper and much of consensus view in Korea than I have expected.

In this area, the author has provided a number of important proposals, both in this paper and in some other works. Especially, for example, her call for risk weighted capital charges on overseas investment positions of mutual funds. I think it is very important that these sorts of measure which can enhance systemic stability included in the international negotiating agenda. And I think it will take pressures for non G-7 countries to do this, and it will also be important for those of us who live and work in the G-7 countries to add our voices.

This brings me to second point of agreement, which is the need for greater participation of developing countries in key policy negotiations and new institutions and fora that are developing such as the Financial Stability Forum. Of course, these first two recommendations complement each other because I think it is important for non G-7 countries to put pressure on industrial countries to do their share for preventing systemic instability. The other problem I think is the point about knowledge that Dr. Griffith-Jones mentioned which is very important. We cannot sit in Washington, Paris, or any other G-7 capital and know exactly what are the right standards and principles that country needs to uphold and that actually work in terms of financial systems, political systems, and economic needs of developing countries which themselves are very diverse. So that is another reason why it is essential to have this political input.

Now there are number of specific recommendations in this paper and again I urge you to read all other papers by Dr. Griffith-Jones which she has gone into some of these things in more detail. But a few of them that I would underline as being most important for our further discussions would be, first of all, the idea of imposing reserve requirements on international loans both in lending countries and borrowing countries. There is a substantial support actually for doing this in borrowing countries from a number of reports. Fred Bergsten was involved with this Council on Foreign Relations report and made that recommendation. And the notion of doing it in lending countries I think is something that has not received specific attention.

And more broadly improved prudential standards for institutional investors such as mutual fund where a lot of world's liquidity is in these sorts of institutions rather than in traditional banks and therefore they can be another source of instability so they also need to be more carefully monitored.

Thirdly, they need to regulate the highly leveraged institutions and make them transparent is another important point.

Fourthly, perhaps most controversial and most difficult to implement is this idea of changing nature of bank regulation, both internal bank procedures and government monitoring of bank so that it becomes less pro-cyclical and more anti-cyclical. In principle, it sounds like a good idea, but as the author candidly acknowledges, there are many difficulties in doing this in practice. And there are tradeoffs between goal of doing this, having more counter-cyclical banking regulations for purposes of macroeconomic stabilization and worries about destabilization of bank themselves and making them more likely to fail. That would be an important area for us to address in our deliberations of next few days for this group to consider.

Now, let me turn to the one point of which I would take somewhat different approach from the author and that is with regard to the International Monetary Fund. I think this paper takes too uncritical a view of the IMF and effects of its lending policies had in developing countries whether they have helped or not helped to prevent and to ameliorate financial crisis. The paper basically support continuation of virtually all present IMF lending facilities with enhanced resources of fund and expanded activities in several areas, especially regarding low income countries. For reasons that I will discuss in more detail tomorrow, I think the fund should be more focused on a core mission of financial stabilization and macroeconomic recovery. There should be more clear division of tasks between the Fund, the World Bank, and other more long-term development-oriented institutions. As Dr. Griffith-Jones said in the paper, I think we agreed on this, that there need to be reconsideration on how IMF conditionality is designed, and how to make more appropriate. But unfortunately, the paper does not say very much about that. I would urge the author, if she wants to make more convincing case for more resources for the Fund, she need to say much more about how those funds would be used. Certainly, coming from the country so called G-1, both on the left and right of the political spectrum, which is quite balanced at present, there have been a lot of concerns about how the funds go through the IMF are used. And it is very unlikely, politically, that there is going to be any increase in funding and even maintenance of present level without addressing these criticisms of how the fund is operated. The criticisms which come from some of the very same people that Dr. Griffith-Jones has cited such as Joseph Stiglitz, and many others.

On the point about channeling more fund into low income countries. I agree on the goal, the objective, but I think the question is that what is the right means. In my view, it would be more appropriate to do this through the World Bank or regional institutions rather than expanding the role of the IMF in these areas. I think it is not appropriate to have what we had in many poor areas of the world. Which is the IMF that supposed to a macroeconomic stabilization institution engaged in long-term micro-management of country's policies. One place I would agree with Meltzer commission has usurped the need to develop domestic policy making capabilities in many of the poor countries. Instead, they brings in advice made in Washington and that is why I think it would be better to get the Fund out of that kind of long term assistance. Although, of course, it should be available to handle short term crisis in the low income countries as well as middle income countries.

I would certainly not go as far as Meltzer commission in eviscerating the World Bank and shrinking the IMF. But I do think that the idea of having each one be more specialized and having less overlap of their functions to the point where each one in kind of stepping on the other one's toe is the good idea.

Again, the key point I think is that any notion of putting more fund into the IMF, and giving it greater ability to operate as a lender of last resort has to be balanced by reconsideration of way in which it lends and the kind of conditionality that it imposes. Also for moral hazard reasons, because if you simply have bigger lender of last resort, they can make a lot of big loans with not too many conditions, and moral hazard concerns can become important. We need to have balanced view on that issue.

Parkorn Vichyanond: Before any thing, I would like to mention that my comments are meant to be complimentary to Dr. Griffith-Jones' paper because as Professor Blecker has mentioned, her paper is very well written.

So, first one is about regulations. I do not question about the legitimacy of revising regulations but what I feel that the BIS and international community should be well aware about consequence of financial liberalization is that financial institutions functioning on overlapping basis have to be stipulated by functions, not by institutions.

Second point is about information. There is no question about release of more information but from my own experience in Thailand, I am afraid that the capital is moving very quickly and I am not sure whether information alone will be enough for the monetary authority to control and monitor the market. What I would suggest as an alternative channel for preventing crisis would be to control and uses of foreign capital flows. If we control uses of flows of foreign capital in particular cluster areas such as petrochemicals, steel, real estate, those bubble industries, I sense that it should have good impact upon capital flows instead of undertaking capital controls such as the case in Chile.

For small countries like Thailand which have very small foreign exchange reserves, the particular variable that we should pay attention to in the current scenario is investor confidence. The capital flow out of Thailand did amount to something like US$ 10 billion per day on month of May, 1997. At the time, the foreign exchange reserves at the central bank amounted to US$30 billion. So, the investor confidence should be handled very cautiously by way of announcement, imposition of constraints. Because of that concern, my institute did have some surveys on how investor confidence was determined. The factors were, first, political stability, second, confidence of economic management team, third, external accounts, fourth, efficiency and stability of financial system, fifth, foreign exchange reserve, sixth, asset quality of financial institutions and seventh, policy consistency.

Now, on regionalism that Dr. Griffith-Jones mentioned earlier. I fully agree about that and I would suggest two channels could come into help. One is about regional lender of last resort that would help amend the drawbacks in the IMF. If regional lender of last resort could be established, it should divide the functions. The regional lender of last resort should handle liquidity, the IMF should handle structural disequilibrium. Regional lender of last resort should be commercially oriented to prevent moral hazard whereas the IMF should be more fundamentally oriented. Another aspect of regionalism is the payment system such as bilateral payment arrangement, currency index. Those would help emerging countries certainly.

Finally, I would like to ask Dr. Griffith-Jones about changing tones of rules and regulations. I wonder whether that is possible in the international financial area now especially when economic cycles of different countries do not correspond to each other, and furthermore, when international community may not allow particular country to relax or tighten regulations in accordance to its economic environment.

General Discussion: Fred C. Bergsten commented on the question of the size and role of the IMF. He said that there is wide spread agreement in the U.S. and it is probably the one point where he and Dr. Blecker both disagree with Dr. Griffith-Jones' proposal. He pointed out both macro and micro issues.

The macro issue was the size of the fund. He said, one of the few things where there is bipartisan consensus in the U.S. is that smaller is better for the IMF because of moral hazard and other problems. He concluded, if this group felt from the standpoint of emerging market and want a bigger fund, it would be an important one to raise but tough one to take on.

The micro issue was more specific. Fred Bergsten pointed out that the majority of Meltzer commission proposed abolition of the poverty reduction and growth facility (PRGF) in the IMF. But those of the minority did not think that was good idea so they compromised on agreeing with the basic idea that the IMF should focus more directly on its core competency. Fred Bergsten, as he shared his experience in the political ground, proposed in the congressional hearing an idea to transfer poverty reduction facility from the IMF to the World Bank on the ground that poverty reduction is the basic function of the World Bank. He then tried to sell this idea to Horst Kohler, the new managing director of the IMF. Mr. Kohler initially accepted that but when he made his tour around the developing countries, he came back, particularly from Africa, with the strong view that the developing countries particularly the African countries wanted to keep the poverty reduction facilities in the IMF. Mr. Kohler wanted to respond to his developing countries membership and therefore changed his view and kept it.

Fred Bergsten concluded, the question for those who are looking at this from the standpoint of emerging market, is that which one makes better sense? It is not an easy question. It is important, interesting, and potentially highly operational question that Eminent Persons Group might want to look at.

In response to the issue of transferring the PRGF from the IMF to the World Bank, Dr. Griffith-Jones pointed out one big problem that there would be a risk of losing some of the resources because these are resources that have been approved by government, parliament, and particularly by US congress for facility in the Fund.

Capital Surges and Financial Opening in Emerging Economies: Policy Implications[1]

Ricardo Ffrench-Davis

I. Introduction

Purely financial factors have been changing in the world at a much faster pace than international trade and the globalization of production. During the 1970s and the 1980s many countries began to liberalize their financial sectors and to relax or eliminate foreign exchange regulations (Díaz-Alejandro, 1985; Devlin, 1989). This, together with the revolutionary innovations that have taken place in data–management and telecommunications technology, and the emergence of increasingly sophisticated financial techniques, contributed to a boom of international flows. Generally, the global financial boom worked in a framework of lax or non-existent regulations and supervision, and in which existing regulations were in fact procyclical (Ocampo, 1999; Griffith–Jones, 2000; ECLAC, 1999).

During the 1970s, a large supply of funds was made available to many developing nations; then, during the 1980s, there was a generalized severe binding shortage of financing, and particularly in Latin America, which became a net exporter of funds. Between 1991 and 1994, the region received a large capital surge again, experiencing another sharp reduction focused in Mexico and Argentina, and a generalized drop of portfolio flows in late 1994 and early 1995. The so-called tequila crisis was followed by a renewed access in 1996-97. In 1998-2000, Latin America was shocked by a new shortage of external financing, aggravated by a worsening of the terms of trade. The crisis originated in Asian countries was now the source of a new recessive macroeconomic adjustment in Latin American countries (LACs).

On all those occasions, the changes in external financing were supply-led,[2] were first expansive and then contractionary, and had a strong impact on the national economies on both the upswing and the downswing sides of the cycle. Up to 1996, the successful emerging economies of Asia appeared to be immune to the instability associated with capital surges, as illustrated by their performance during the tequila crisis. The recent events have shown that was

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[1] This paper makes some use of material prepared within the ECLAC research project on *Preventing financial crises in 'successful' emerging economies*, supported by the Ford Foundation. The views expressed herein are the sole responsibility of the author.

[2] There is well-documented evidence showing that these changes have originated, to a large extent, in the sources of supply. See Calvo (1998); Culpeper (1995); Griffith-Jones (1998).

not so anymore, and that some of the causes are common with those of Latin America. The new crisis provides a renewed opportunity to significantly improve the architecture of the international financial system, and to reform the domestic approach so to achieve sustainable macroeconomic equilibria and to enhance their contribution to growth.

It is extremely revealing that the modern crises have taken place in economies with high grading by risk agencies and with fiscal surpluses, and flows have been of the private-to-private type.

Section 1 sketches the three capital surges experienced by LACs since the 1970s. Section 2 reviews the main macroeconomic effects generated by capital inflows, emphasizing the analytical bases that explain the procyclical nature of surges. Section 3 compares the contrasting experiences of some Latin American nations in 1990-95 and 1996-2000. Section 4 outlines some policy lessons.

II. Three Capital Surges to Latin America

The growth of international capital markets since the mid-1960s is partly a reflection of the expansion of the world economy, including international trade, and the globalization of production. But, it is also associated with purely financial factors, in which changes have occurred at a much faster pace. During the 1970s and the 1980s, many countries began to liberalize their financial sectors and to relax or eliminate foreign exchange regulations (Díaz-Alejandro, 1985; Devlin, 1989). This, together with the revolutionary advances that have taken place in data-management and telecommunications technology, and the emergence of increasingly sophisticated financial techniques, contributed to a boom of financial flows.

Net capital inflows to Latin America averaged nearly 5% of GDP in both 1977-81, 1991-94, and 1996-97. During all three periods, the deficit on current account rose sharply, and exchange rates appreciated (see ECLAC, 1998; 2000); naturally, imports grew more rapidly than exports, and the stock of external liabilities rose steadily. Indeed, all these variables reflected a growing macroeconomic imbalance after a while,[3] in many cases anchored to one dominant "balance": that of a falling inflation associated to real exchange rate appreciation and climbing external deficits. Those recipient countries, which had larger deficits on current account, heavily financed with short-term liabilities, and exhibiting stronger appreciating exchange rates, tended to become increasingly more vulnerable to external creditors,[4] the outstanding case was that of Mexico in 1991-94. Creditors, given the high exposure of financial assets placed in the region, subsequently became more sensitive to any "bad news".

The dramatic increase of international financial flows has been more diversified during the current decade than it was during the 1970s. But the outcome is potentially more unstable, inasmuch as the trend has been to move from medium-term bank credit to investment in liquid stocks, bonds and deposits; a very high percentage of this supply of financing is of a short-term and liquid nature. Paradoxically, there has been a diversification toward volatility in the 1990s;

[3] Actual significant disequilibria, in a framework of repeated statements regarding the need to maintain macroeconomic equilibria, reveals an inadequate understanding of how to achieve equilibria, sustainable and consistent with development. See Ffrench-Davis (2000, ch. 6).

[4] See our advise, as early as in mid-1992, reproduced in Ffrench-Davis (2000, ch. 9).

the relative improvement after the "tequila crisis", with a rising share of FDI, [5]still included a significant proportion of volatile flows.

There has been a long process in the nineties of building a market for portfolio investment in emerging economies, with large flows in the process. Latin America was a receptive destination, and offered the expectation of high rates of return.

Why the high rates of return? Naturally the rate should tend to be higher in the "productive" sectors of the capital-scarce emerging economies. Beyond that, several conjunctural factors reinforced that outcome. Initially, prices of equity stocks and real estate were highly depressed. That allowed a 300% average rate of return (in current US dollars) in the stock markets of Latin America between late 1990 and September 1994 (see <Table 1>), with fast rising price/earnings ratios. After a sharp drop around the tequila crisis, with contagion to all Latin American stock markets, between March 1995 and June 1997 average prices boomed again, nearly duplicating. They were being pushed up directly by portfolio inflows.[6] Domestic interest rates were high as well, reflecting the binding external restriction predominating in 1990 and the repressive monetary policy in place (plus the short-termish bias of financial reforms implemented; see Ffrench-Davis, 2000, ch. 6). Finally, in a non-exhaustive list, the recovered supply of external financing generated a gradual exchange-rate appreciation (see <Table 2>) that also encouraged additional liquid inflows, by dealers operating with maturity terms within the horizon of expected continued appreciation of the domestic currency.

<Table 1> Latin America: Stock Exchange Prices, 1990-2000
(indices, July 1997=100)

	Dec-90	Sept-92	Sept-94	March-95	July-97	Aug-98	Dec-99	Sept-00
Argentina	13.4	46.9	78.2	53.5	100.0	53.4	86.7	73.9
Brazil	8.0	22.1	71.8	42.8	100.0	44.4	73.5	71.2
Chile	24.5	51.4	93.1	89.4	100.0	48.0	75.3	66.3
Colombia	16.6	65.0	113.1	96.3	100.0	49.9	44.9	28.6
Mexico	38.6	72.7	132.1	45.9	100.0	49.7	110.8	102.1
Peru			72.9	56.4	100.0	57.3	66.0	52.0
Venezuela	84.9	82.2	50.8	37.9	100.0	26.2	37.4	46.4
Latin America (7)[a]	21.7	44.6	92.5	52.3	100.0	47.2	84.0	77.7

Source: Based on IFC/Standard & Poor's, *Emerging Stock Market Review*, several issues.
[a] Averages are weighted by amount of transactions of the seven nations included. Values at the end of each period, expressed in current US dollars; distributed earnings are excluded. Selected dates correspond to peaks and minimum levels for the average.

[5] The well documented positive link between FDI and productive investment (see Ffrench-Davis and Reisen, 1998, ch. I), was weakened by the fact that, as shown by ECLAC figures, about 40% of FDI inflows in 1997-99 corresponded to acquisitions of Latin American firms instead of creation of new capacity.

[6] An outstanding feature of stock markets is that in significant cases they contribute a notably low share to capital formation (for the US see Stiglitz, 1994). In Chile the issue of new shares in the local stock market has represented in the peak years merely 4 to 6% of gross capital formation.

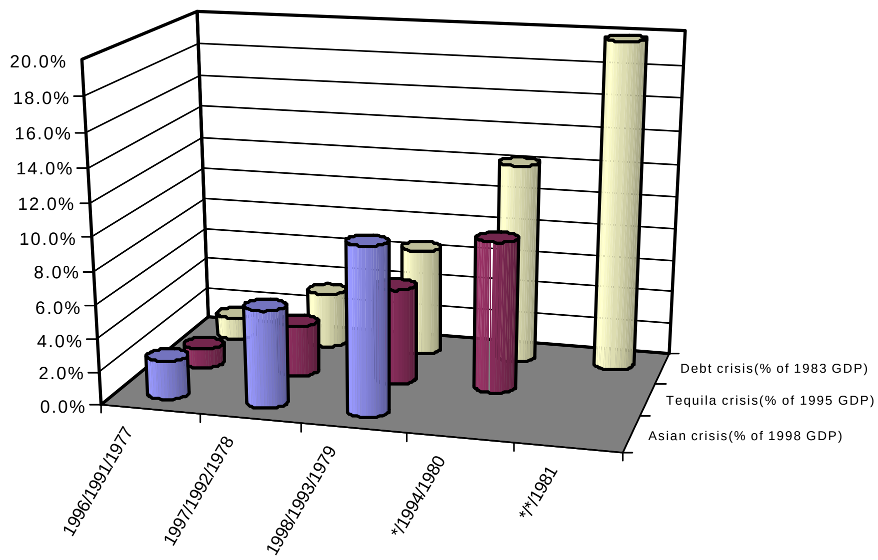
<Table 2> Latin America: Real Exchange Rates[a], 1987-2000
(indices, 1987-90=100)

	1987-90	1994 IV	1995 I	1997 III	1999 I	2000 II
Argentina	100.0	63.1	63.8	65.6	56.6	57.2
Brazil	100.0	74.3	71.5	64.4	102.8	93.6
Chile	100.0	96.4	97.1	80.2	85.8	87.3
Colombia	100.0	80.4	79.7	71.2	80.3	91.1
Mexico	100.0	75.9	116.3	81.4	81.9	71.2
Peru	100.0	59.3	59.9	56.0	64.5	63.6
Weighted average (18)	100.0	75.9	83.9	71.3	85.3	80.0

Source: Based on official figures processed by ECLAC.
[a] Quarterly averages of real exchange rate indices (main official) for each country with respect to the currencies of their main trading partners, weighted by the share of exports to those countries; inflated by external CPI and deflated by domestic CPI; for Brazil we weighted the Rio CPI index ($^2/_3$) and the new official series of inflation ($^1/_3$). Selected quarters correspond to peaks and minimum levels for the average of Latin America.

The deficits on current account rose persistently, and accumulated through time (see <Figure 1>). While in 1991 the actual stock of assets of the new investors in Latin America was evidently below the “desired” stock, in 1994 it was notably large. We had entered a *vulnerability zone*, with the economy growingly sensitive to bad political or economic news. The longer and deeper the permanence in that zone, the lower the probability to get away without a crisis.

<Figure 1>
Latin America: Accumulated deficit on Current Account as % of GDP in crises years



Source: Calculations of the author based on current figures of 18 LACs.

III. The Procyclical Macroeconomic Effects of Capital Surges in the 1990s

During the 1990s, capital inflows contributed to a recovery of economic activity, after the recession that still prevailed around 1990 in most LACs. When financial inflows recovered in the early 1990s, Argentina and Peru were two outstanding cases of capacity underutilization; in the opposite corner, the effective GDP of Chile and Mexico was close to their respective productive frontiers.

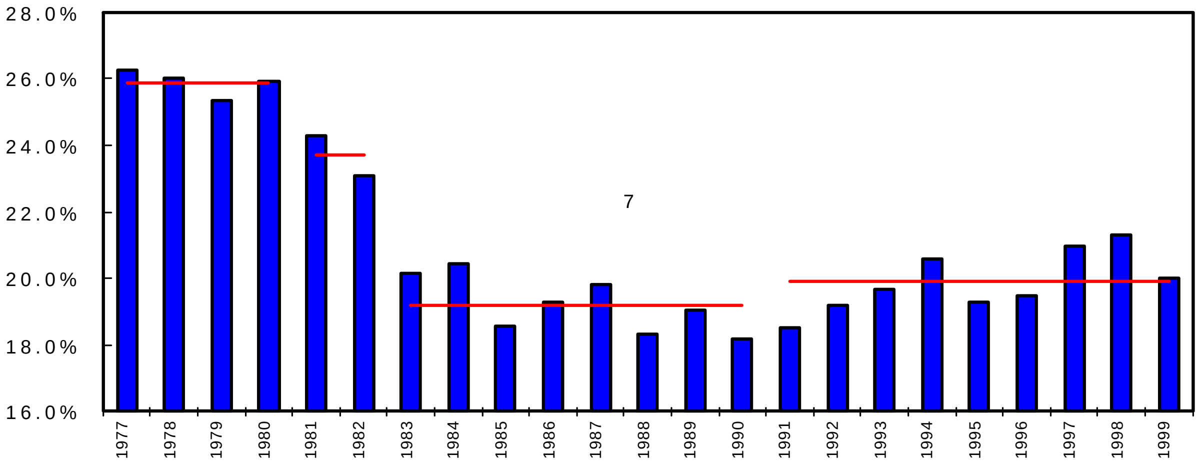
Annual GDP growth rose from 1.3% in the 1980s, to 4.1% between 1991 and 1994 and to 2.5% in 1995-99 (<Table 3>). This growth was meager, as compared to the three decades spanning between 1950 and 1980, Latin America had averaged a 5.5% growth per annum; domestic investment had been rising fast, as a source of that vigorous growth. Subsequently, in the 1980s there was a sharp drop of investment, 7 points of GDP, with only a mild recovery in the 1990s (see <Figure 2>). In fact, investment grew much less during this decade than the volume of capital inflows; thus, it suggests that a significant part of the external flows financed increased consumption, and consequently crowded-out domestic savings (Ffrench-Davis and Reisen, 1998); the crowding–out was notably strong in Argentina and Mexico, both having absorbed a large share of volatile inflows and channeled them into imported consumption.

<Table 3> Latin America: Gross Domestic Product, 1970-2000
(annual growth rates, %)

	1970-80	1981-89	1990	1991-94	1995	1996-97	1998-99	2000	1990-2000
Argentina	2,8	-0,7	-2,0	8,0	-2,9	6,7	0,4	1,0	3,7
Brazil	8,6	2,3	-4,6	2,8	4,2	3,0	0,5	4,0	2,0
Chile	2,5	3	3,3	7,5	9,1	6,9	1,5	5,6	5,8
Colombia	5,4	3,7	4,3	4,3	5,2	2,8	-2,1	3,0	2,8
Mexico	6,7	1,5	5,1	3,5	-6,1	6,1	4,3	6,6	3,6
Peru	3,9	-0,7	-6,0	5,1	8,6	5,4	1,0	4,5	3,6
Uruguay	3	0	0,0	4,4	-1,9	4,5	0,9	1,0	2,5
Latin America (19)	**5,6**	**1,3**	**-0,6**	**4,1**	**1,1**	**4,5**	**1,2**	**4,1**	**2,9**

Source: Calculations based on official figures for 19 countries processed by ECLAC; figures expressed in 1980 US$ for 1970-80, 1990 US$ for 1980-89 and in 1995 US$ for 1989-2000.

<Figure 2>
LATIN AMERICA: GROSS FIXED INVESTMENT, 1977-99
(% of GDP)



Source: based on figures processed by ECLAC, scaled to 1995 constant prices.

Actually, in general, the renewed financial inflows initially had a positive effect on economic activity in Latin America: thanks to a larger utilization of installed capacity, GDP increased beyond the expansion of the production frontier: about one third of the 4 % rate of annual GDP growth in 1991-94, corresponded to a larger rate of use of capacity. The phenomenon was particularly intense in countries such as Argentina and Peru in the first half of the 1990s. Subsequently, the strong recovery of Argentina and Mexico in 1996-97 rested to a significant degree on the underutilization created by their respective recessions in 1995. As a matter of fact, 1994 and 1997 were the only two years exhibiting growth of effective GDP close to the average of 1950–80. Again, the recovery of 1997 was short-lived, giving way to slower growth since mid-1998, and open recession in Argentina in 1999–2000.

An evident conclusion is that any serious research should control for the huge swings in the rate of capacity utilization, when measuring performance of policies, reform or productivity; otherwise, for instance, economic recovery can be confused with an increase in structural productivity. That has been a repeated misinterpretation by authorities and researchers, frequently very costly; but also it has underlined the behavior of consumers, explaining the destabilizing intertemporal adjustment of consumption.

The increased availability of financing removed the binding external constraint that had been responsible for the one-decade recession of the region. However, beyond contributing to overcome that constraint and to a move toward macroeconomic equilibria, after a while it led to an overshooting in several macroeconomic indicators. Gradually, effective output approached the production frontier; gradually the initially depreciated exchange rates rose and at some point started to become "appreciated,"[7] and so on in financial assets and real estate market prices. The accumulation of external liabilities (mostly liquid), made the economy more vulnerable to future negative external shocks.[8] <Tables 1>, <Table 2> and <Figure 1> show a similar story in 1991-94 and 1995-97, when the disequilibrating macroeconomic adjustments of 1976-81 were replicated (Ffrench-Davis, 2000, chap. 4).

Why debtors and/or creditors don't stop inflows before entering a vulnerability zone and inviting a crisis?

Among debtor countries we will distinguish three cases. Those with nominal pegs, the outstanding case being Argentina since 1991 with a currency board. Macroeconomic policy is passive and the conjuncture is determined by the external supply of finance. In an economy with huge underutilization of capacity and a capital surge, as was the case in 1991–94, passivity works well, until capacity approaches exhaustion or the surge softens or reverts; both did coincide in late 1994. The outcome tends to be intrinsically procyclical.

A second case is that of a flexible exchange rate. In the early 1990s, Mexico had flexibility within an asymmetric band, and allowed it to operate under the capital surge with an appreciating corner. Since the supply of funding was huge, the actual exchange rate remained at the most appreciated extreme of the band, and that extreme was appreciating in real terms. The outcome of Mexico shared with Argentina a significant real appreciation, but Mexico had no underutilization of capacity, so the capital surge leaked to a much larger degree towards excess imports and a large deficit on current account (Ros, 2000). The outcome was again procyclical.

[7] It should be recalled that several LACs were implementing sharp liberalization of import regimes *pari passu* with exchange-rate appreciation. See Ffrench-Davis (2000, ch. 3) and ECLAC (1998, ch. V).

[8] The process was similar to that in several East Asian countries, with a capital surge-cum-financial liberalization since the early 1990s. See Agosin (2000); Ariff and Ean (1999); Radelet and Sachs (1998); Shin and Wang (1999).

The standard assertion that exchange-rate "flexibility" can avoid disequilibria is at least misleading in these cycles built on capital surges.

The third case corresponds to a set of comprehensively active macroeconomic policies, of which Chile was the paradigmatic case in the first half of the 1990s, with an anticyclical outcome. Chile used a set of prudential countercyclical macroeconomic policies that were effective, making a significant difference (see Agosin and Ffrench-Davis, 2000; Le Fort and Lehmann, 2000).

In the majority of cases, authorities allowed the capital surges to move into their domestic economies, as illustrated by the data available and presented here. Most of them thought should do nothing or could do nothing, or preferred to "benefit a little longer" from the anchoring of the domestic CPI to international inflation. Most observers applauded the opening of capital accounts that was at work, and mistakenly took exchange rate appreciation as an equilibrating adjustment. However, after the explosion of the crisis, the consensus of observers was that disequilibria had been built, but there was little recognition of their notorious failure to foresee that the crisis was being built.

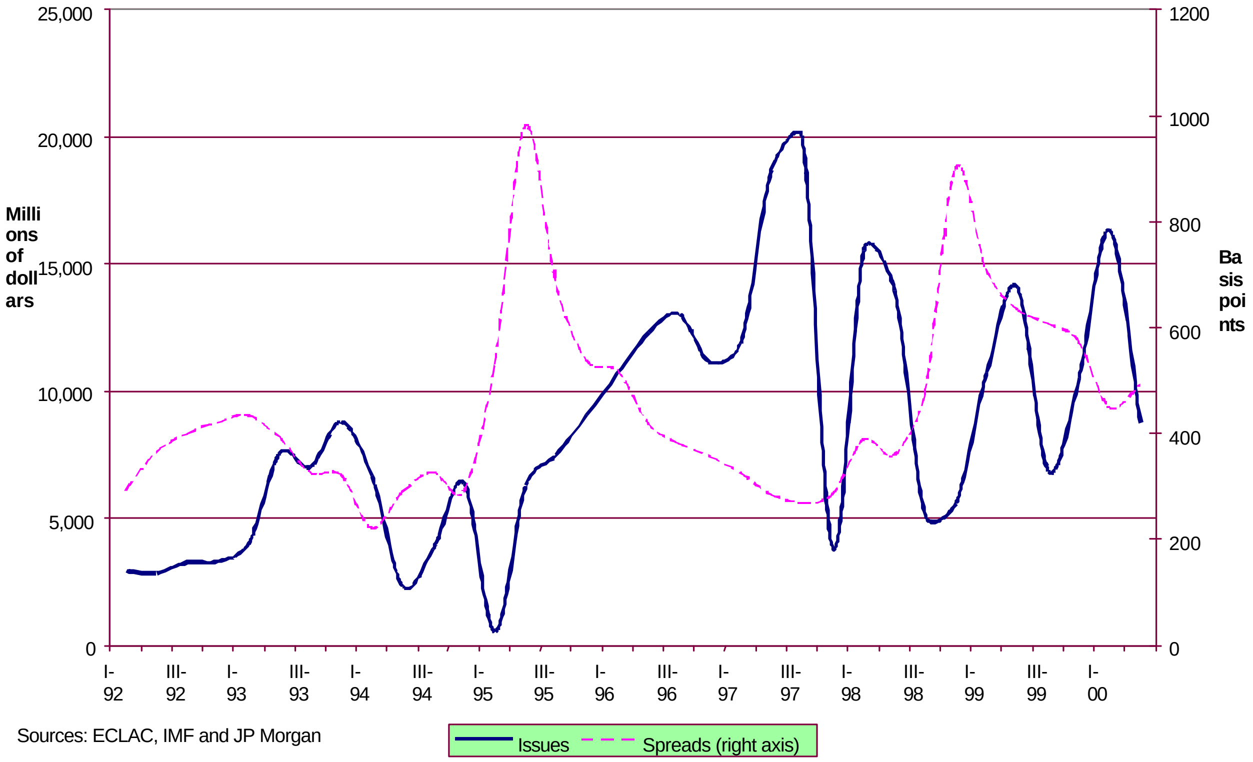
For a voluntary flow to take place there is need of willingness on both debtors and creditors. Then, why creditors did not act in due time to curve flows? The specific nature of agents prevailing in the creditor side is crucial. The conflictive segment of flows, that was predominant in the surges and busts, naturally works with short horizons. When creditors discover an emerging market, they naturally start out with a non-existent exposure. Then they generate a series of consecutive flows, which accumulate in rapidly increasing stocks. As said, the creditor's sensitivity with regard to bad news usually increases remarkably with the level of stocks placed in a country (or region), and with the degree of dependence of the debtor on additional flows (current account deficit plus refinancing of maturing or liquid liabilities). But, the most relevant feature is that, in the process of a series of capital inflows, most frequently takes place a significant increase in asset prices and exchange rates, accompanied with rising stocks of external liabilities. That was the fact in most LACs in 1991-94 and 1996-97. When that happens, after some while, the probability of reversal of expectations about their trend grows steeply.

The accumulation of stocks and a subsequent reversal of flows can be considered to be a "rational" behavior of individual suppliers, given the nature of predominant agents in the supply side.[9] Investors with short horizons are not concerned whether (long-term) fundamentals are being worsened with capital surges while they continue to bring inflows. What is relevant for them is that the crucial indicators –real estate, bond and stock prices, and exchange rates– can continue providing profits in the near term; thus, they will continue pouring money until expectations of near reversal of profitability start to build.

[9] Beyond that we face the already traditional issues of moral hazard, herd behavior, multiple equilibrium and transborder contagion.

It is quite relevant that during the three surges of the last quarter of a century, spreads in loans kept falling while the stock of liabilities was rising sharply: for 5-6 years in the seventies; 3-4 years before the tequila crisis, and a couple of years after the recovery following that crisis. This implies a downward sloping supply of external funding, what is evidently a destabilizing feature (see <Figure 3> for 1992-2000).

<Figure 3>
Latin America: International issues of bonds and spreads, 1992-2000



The most relevant issue is that "myopic by training" agents, specialized in microfinance have become to determine the macroeconomic conjuncture and policy design in emerging economies. The outcome, unsurprisingly, turns to be unsustainable macroeconomic imbalances, "wrong" or outlier macroprices, and undermined environment for productive investment (particularly in tradables). Then, what is "irrational", and evidently inefficient for resource allocation and total factor productivity, is that the domestic macroeconomy has become increasingly to be strongly influenced by experts in microfinance. There is need for macroeconomic authorities to take over their responsibility of making fundamentals prevail, so to achieve macroeconomic balances that are both sustainable and suitable for growth. That requires that they avoid entering vulnerability zones during economic booms-cum-capital surges (Ffrench–Davis and Ocampo, 2000).

IV. The Contrasting Cases of Mexico and Chile in 1990-95

Chile and Mexico were considered "stars" by financial markets in the early 1990s. Both faced a large supply of external financing in the various segments of international markets. At the outset of the decade, both chose divergent domestic policies with respect to capital inflows.

1. The tequila crisis[10]

The Mexican crisis which exploded in 1994 is a good example of the harm that can be caused when a country absorbs an excessive volume of capital inflows, giving way to a large stock of external liabilities, especially when the composition of such financing is short-term or liquid. Producers and consumers adjusted to a level of overall expenditure that growingly became much higher than potential GDP, between 1990 and 1994 the exchange-rate appreciated significantly and the external deficit rose sharply.[11] Thus, there was a maladjustment that would most likely have to be reverted in the future. Since the public sector was balanced, as in most modern financial crises associated with capital surges, the disequilibrium was located in the private sector; after a while the amounts involved became unsustainable. Then, a sharp cutback of financing on the part of creditors, forced Mexico into a highly recessive adjustment and a huge devaluation, despite the large package of international support it received in 1995 (Lustig, 1997). A 6.2% drop in GDP and of nearly 30% in capital formation occurred in Mexico in 1995.

It is wrong to say, as it is said surprisingly often, that the Mexican crisis of 1994 could not have been foreseen because of the concealment of information. While it is true that official information on international reserves was provided only sporadically, the key data concerning the exchange-rate appreciation, the high current account deficit, and the fact that it was financed with volatile resources, were available on a regular basis. Notwithstanding this, by 1993 praise of Mexican policies was generalized in financial institutions and media, enhanced by the incorporation of Mexico to two clubs of rich nations in 1994: NAFTA and the OECD.

However, the crucial problem was that neither those on the supply side nor those on the demand side paid enough attention to the available information until after the crisis erupted. Indeed, we must emphasize, for the most influential financial operators the more relevant variables are not related to the (long-term) fundamentals but to short term profitability. This explains why they may suddenly change their minds radically about the economic situation of a country whose fundamentals remain rather unchanged.

In 1995, the Mexican crisis did not have a widespread effect throughout the region, as it had in 1982. The Argentine economy, however, was seriously affected by the contagion. Although this did not lead to a currency crisis in the sense of a sharp exchange rate devaluation, as many operators had feared in 1995, Argentinean GDP fell between 2.9% and 5%, and investment diminished by 16 %; this recession was transmitted through trade to neighboring Uruguay. After peaking to 5.3% in 1994, the overall GDP growth rate of Latin America went down sharply in 1995, to a figure below the population increase, while the regional investment ratio also fell substantially. During 1995, in diverse countries, negative flows were observed in several segments of the supply of funds (especially bonds, deposits and to stock markets).

[10] For a recent comprehensive analysis, see Ros (2000).
[11] Despite the fact that expenditure exceeded GDP by 8% in 1992-94, production capacity was probably larger than actual GDP, with capacity underutilization in importables and exportables due to an excessively appreciated exchange rate. This, together with NAFTA membership, might explain the subsequent sizable response of exports to real devaluation in 1995.

Actually, capital outflows from stock markets were generalized across the region, with price drops in all of them (see <Table 1>).

Subsequently, the flow of funds reactivated vigorously once again, contributing to a 5.4% GDP growth (with 1994 the two largest since 1980). However, some of the same problems displayed in the 1991-94 recovery reappeared in 1996-97, and actually collected their bill in 1998-99. Nevertheless, the adjustment starting in 1998 took place in economies with a more moderate stock of volatile liabilities than in 1995, with healthier banking portfolios,[12] and with less overheated economies (see Ffrench-Davis, 2000, ch. 10). However, in all, the Asian crisis caught Latin America after most LACs had appreciated their exchange rates and their deficit on current account had risen. The same old story was returning to the scene, in circumstances that the international scenario was recessive, with worsened terms of trade, declining growth of trade and of access to finance, and rising spreads.

2. Chile, against the fashion in 1990-94

Chile displayed a performance opposite to that of Mexico in 1995-96, regardless of numerous similarities during the years prior to 1994. However, there was a most pronounced divergence in macroeconomic policies, related to the external sector and to the sustainability of macroequilibria.[13] In 1991-94, Chile and Mexico choose divergent roads with respect to the regulation of capital flows, exchange rate policy, prudential supervision of the financial system, and activism of macroeconomic policies in general.

Towards the end of the 1980s, both countries had already opened up their trade considerably; their fiscal budgets had improved substantially and both exhibited fiscal surpluses in the first half of the 1990s; privatization was well under way; annual inflation was around 20%, and the two countries had similar domestic savings rates. The reason why Chile performed notably better in 1995 is that, faced with an abundance of external funds in 1990-94, it deliberately followed a prudential policy, concerned with macroeconomic sustainability (Agosin and Ffrench-Davis, 2000). Instead of taking and spending all the large supply of external resources available, which would have led to a significant appreciation of the peso and to a rising deficit on current account, it chose to discourage short-term capital inflows. In 1991 a tax was imposed, and substantial non-interest-bearing reserves for external credit were required; the reserve requirement was subsequently extended to foreign currency deposits and investment in second hand stocks, while primary issues of ADRs and venture FDI capital were kept exempted;[14] FDI, loans and portfolio investment, had to be held in Chile for one year at least; the financial system was subject to relatively strict prudential regulation, including a selective supervision of assets and required provisioning, as well as restrictions and drastic penalties on operations with related parties. The set of measures adopted effectively discouraged speculative capital inflows (Agosin, 1998; Le Fort and Lehmann, 2000).

[12] After the banking crisis of Mexico and Argentina, following the "tequilazo", these and other countries introduced reforms to their financial reforms, which strengthened banking prudential regulation and supervision.

[13] There were also differences in macrosocial policies. Chilean policies in the return to democracy in the 1990s are summarized in Ffrench–Davis (2000, chap. 7).

[14] The rate of the reserve requirement, that had to be kept at the Central Bank for one full year, was reduced from 30% to 10% by the end of June 1998 and to zero in September, in order to accommodate to the new shortage of external financing associated to the Asian crisis. Authorities, like the President of the Central Bank, have reiterated that the policy tool is available for the next capital surge.

As a consequence, by late 1994, Chile had a moderate external deficit, high international reserves, a manageable short-term debt, a domestic savings rate that was rising instead of falling (the latter being the case in Mexico and Argentina), a level of domestic investment that since 1993 was the highest recorded in Chilean economic history (<figure 2>), and the exchange rate in 1990-94 was comparatively closer to equilibrium than that of most LACs, as reflected by a moderate deficit on current account: an average of 2.5% of GDP in 1990–95.

Policy was effective in Chile in achieving its targets of macroeconomic sustainability in most part of the 1990s. It also proved that macroeconomic sustainability is inconsistent with unmanaged capital surges or with a passive management. In fact, in 1996-97 the policy mix and the intensity with which it was applied remained unchanged, in spite of a new vigorous capital surge to most countries in the region, but particularly to Chile, a country immune to the tequila contagion and offering higher certitude of profitable investment. This new strong surge should have been met with increased restrictions on rising inflows. Being a market-based mechanism, that alters relative prices of capital flows, what happened was that inflows came in paying the cost of the reserve requirement, with no evidence of significant evasion (Agosin and Ffrench-Davis, 2000).

Consequently, despite heavy intervention in foreign exchange markets by the Central Bank, a sharp real outlier exchange-rate appreciation and rise of the deficit on current account took place: in 1996–97 it more than doubled to 5.7% of GDP as compared to 2.5% in the first half of the decade. It was a new proof of the need of a comprehensive set of policies; and the fact was that the intensity of the regulation of capital inflows becomes insufficient. The principal explanation of this policy weakening was that the authorities had become permeated to the overwhelming view that costly financial crises were over in the "new world economy". As a consequence, explicitly, the Central Bank had increased the size of what considered a sustainable external deficit. Only a few observers advised of the riskiness of a rising deficit.

Nonetheless, the benefits of the active regulation implemented in previous years, had left large international reserves, a rather low stock of foreign liabilities and a small share of volatile flows. Those strengths, that had been accumulated during a quinquenium, were only partially undermined by the excessive exchange-rate appreciation and high deficit on current account recorded in a couple of years: 1996–97.

The Asian crisis was felt first, principally, through trade. The fact is that the terms of trade of Chile worsened in the equivalent to 3% of GDP (in 1998 current prices), with reduced access to external markets, in a country that was selling one-third of its highly commodity-intensive exports in Asia. As a consequence, the authorities allowed a macroeconomic adjustment, with a sharp drop of aggregate demand since mid–1998. During the adjustment process, after putting for too long a break to market devaluating forces, within the crawling–band that had been in force during over a decade, the Central Bank liberalized completely the exchange rate.[15] In successive steps, with large swings, the rate recovered all the real appreciation it had experienced in 1996–97. Overall, the Chilean economy, after achieving an over 7% GDP growth in 1990–97, moderated to 4% in 1998 and decreased 1% in 1999. It was the first drop after the 14% collapse of 1982-83.

[15] During the process, before the exchange rate liberalization, the Central Bank lost a significant amount of reserves, with the corresponding direct effect on domestic liquidity: that generated a drop of 10% in aggregate demand and of 1% in GDP in 1999. The main outflowers of reserves were the private administrators of the reformed pension system, with outflows equivalent to 4.8% to GDP. This very procyclical behavior of this pension system becomes an extremely relevant issue for systematic evaluation.

In contrast, Mexico has been booming *pari–passu* the Asian crisis. After 1995 adopted a fully flexible exchange rate. However, like in the rest of the region, the Mexican peso appreciated with the capital surge of 1996–97. When the Asian crisis reached Latin America, Mexican exports suffered a shock in Eastern markets, but benefited from the boom in the US, where 84% of exports are directed; additionally, Mexico experienced a positive oil shock, in circumstances that oil proceeds represented one third of fiscal income. In all, Mexico has been rather unaffected by the persistent dryness of inflows to emerging economies in general.

One implication is that what happens in the domestic markets of an emerging economy depends, naturally, on the quality of local policies during the crisis, but more importantly depends on what is done before the crisis, in the typical boom periods that have preceded them.

But the other side of the coin is the economic environment abroad. The outcome depends on a set of variables which may reinforce the financial negative shock, like in Mexico in 1982 or Chile 1999, or may partially compensate it like in Mexico 1995, or more than compensate the negative shock, like in Mexico 1999 with the US pull–up.

3. Overoptimism in financial markets, 1996–97

Optimism regarding Latin America had returned to the international financial markets in 1996-97. Net capital inflows had climbed well over the pre-crisis levels. Composition improved, with a larger share of FDI. A dynamic growth of effective GDP for the region as a whole was observed since mid-1996 until mid 1998.

GDP recovery in Argentina and Mexico was particularly vigorous. With the sharp drop in both countries in 1995, there was a large gap between effective GDP and productive capacity. This enabled a significant reactivation to take place leading to a shortsighted complacent view of the effects of crises and of the capacity to recover. In fact, in both countries only during 1997 was GDP per capita approaching the levels achieved in 1994, while in Mexico average wages were in 1999 still 16% lower than in 1994. Costs for the real economy and equity are large and long-lasting. Rodrik (2000) has analyzed forcefully this issue, so relevant for consistency between market economies and sustainable democracy.

Since the GDP increase comprised a large recovery share, effective GDP was once again close to the production frontier. However, the frontier moved upward slowly, because productive investment was still low, while real exchange rates were retaking an appreciation path and the external deficit was rising fast. Consequently, as long as productive investment did not increase substantially, that rate of GDP growth was not sustainable. In fact, at the beginning of 1998 it was foreseen that the 5.4% growth of 1997 would moderate to around 4%. Latter on, with the intensification of the Asian crisis and its contagious effects, on finance and trade, the effective growth contracted to 2.1% in 1998 and closed near zero in 1999 (<Table 3>). Then the region was experiencing a new significant recessive adjustment, the second one in less than five years.[16]

[16] A recessive environment should never be identified by measuring actual GDP against the GDP of the previous period but against the production frontier in the present period. This is what firms, entrepreneurs and labor taste in the real economy.

V. Sequencing, Across-the-board Opening or Anticyclical Capital Account Opening?

The approach in fashion is an across-the-board opening of the capital account. Several virtues are granted to this approach.[17] We will cover two of them briefly, here. One is the belief that the presence of plentiful short-term inflows discourages macroeconomic mismanagement by domestic authorities. A second one is that a strict prudential supervision avoids the overborrowing syndrome.

A second approach proposes a sequential process, but concluding in a full opening in a rather close horizon in the future. What is deducted from the prior analysis in this paper, with what we are concluding, is that opening should be associated to the conjuncture prevailing in international capital markets: in periods of plentiful supply of liquid funding, emerging economies --while they remain in such condition, with per capita GDP notably below 20-25 thousand dollars-- should adopt a rather closed policy with respect to inflows, and viceversa.

1. Macroeconomic disequilibria led by short–term inflows

It is true that full opening of the capital account tends to deter domestic macroeconomic mismanagement in several cases of instability originated domestically; large fiscal deficits, permissive monetary policy, arbitrary fixing of the exchange rate at an outlier–appreciated level; it also punishes political instability.

However, alternatively, it can pose obstacles to necessary social reform: for instance, it can deter establishing taxes to finance efficient human investment; or capturing, legitimately, otherwise forgone economic rents from natural resources. But more to the point of the focus of this article, it is the fact that opening of the capital account can imply importing financial instability, with capital inflows leading to a worsening of macroeconomic fundamentals.

There is consensus that fundamentals must be a central actor for policy design. However there is a wide misunderstanding about the definition of "sound fundamentals". The conventional, incomplete, definition is what led to high positive grades for Chile just before the crisis of 1982, to Thailand in 1996, to Korea in 1996 and 1997, and to Mexico and Argentina in 1994. It is evident that, at least, something very "fundamental" was missing.

It has been the predominant practice, in times of booming flows, for recipient countries to be encouraged and praised by the international financial institutions and financial specialists to accept all the resources offered. Even, the typical situation has been that gradually the cost of external financing has fell during the boom period; then, actually, the market has operated with a downward sloping mid-run supply of funding. It was evident that all these EEs had moved into *vulnerability zones,* with a worsening of some crucial components of a comprehensive set of fundamentals, a worsening led by massive capital inflows and that would not had been feasible without those inflows.

Fundamentals include, among others, low inflation, fiscal surpluses, dynamic exports; but they should also include "sustainable" external deficits, "low" net liquid liabilities, "non-outlier" real exchange rates and transparency of the financial system.

Financial operators evidently fulfill a useful microeconomic function as intermediaries between savers and users of funds, as hedgers of risk, and as providers of liquidity. However, in

[17] A broader discussion is developed in Ffrench–Davis and Ocampo (2000).

practice, perhaps without wishing to do so, they have come to play a role that has significant macroeconomic implications. With their herd-prone expectations, they have contributed to intensify the financial flows towards "successful" countries, thus facilitating persistent rises in the stock of foreign financial assets and of equity stocks and real estate prices, and sharp exchange rate appreciation in the recipient markets. Apart from the poor quality of prudential supervision in these markets, these macroeconomic signals contribute to prolonging a process that appears, wrongly, to be efficient and sustainable (with good profits and loan guarantees, supported by the then high stock prices and low value in domestic currency of debt denominated in dollars). But in reality bubbles are being generated, which sooner or later will tend to burst.

In all cases, liquid and short–term flows appear to be consistently in the core of modern new financial crises.

2. Efficient prudential regulation and supervision to face external volatility

Lax or poor prudential regulation and supervision of domestic financial institutions obviously reinforces disequilibria. However, a strong regulation and supervision does not resolve *per se* the problem. First, usually, a significant share of capital inflows is not intermediated by domestic financial institutions; in Chile, before the 1982 crisis, nearly half of bank loans had been channeled via non–financial firms, notwithstanding the lax regulation of domestic banks; also Korea and Mexico in the 1990s, are cases at hand; with the specific diversification that has taken place in the supply, the significance of non-bank to non-bank flows has grown. Second, the sources of instability are inherent in the volatility of expectations that obviously also involve financial intermediaries and even, as we have seen, national authorities and IFIs. During booms, regulations are generally ineffective in reducing the strong incentive to lend, as overdue loans and provisions are low, prices and guarantees are biased upward, and the reinvestment of a high level of profits facilitate meeting the capital requirements necessary to increase lending. On the contrary, non-performing loans increase during crises, what carries rising provisions. That reduces the capacity to increase lending, as they bite into capital requirements, in a context in which low profits also reduce the funds available to increase the capital base of financial intermediaries.

3. Selective sequencing and flexible macroeconomic regulation

Across-the–board opening-up of the capital account has been premature and should have been postponed, moving only in a selective way, until a long term process in which other major reforms had been consolidated and new equilibrium prices had been established (Williamson, 1993). The lesson to be learned from this experience is that during structural adjustment, with open capital accounts (when international financing is abundant) the capital flows can increase too fast and have destabilizing macroeconomic and sectoral effects. Externalities and other imperfections of international capital markets give rise to frequent cycles of abundance and shortage of external financing (McKinnon, 1991; Rodrik, 1998; Wyplosz, 1998).

First, many emerging economies conducted deep trade reforms in the 1990s *pari passu* with exchange-rate appreciation. That real revaluation obviously tends to distort the allocation of investment, seriously weakening the structural mid–term objective of penetrating external markets with new exports (ECLAC, 1998; Ffrench–Davis, 2000, chap. 3; World Bank, 1998). As well, exchange rate instability is a significant deterrent to export diversification. Second, if productive investment capacity reacts with a lag and domestic financial markets remain incomplete and poorly supervised, capital surges cannot be absorbed efficiently in the domestic economy. Research show that they leak too much towards consumption (Uthoff and Titelman, 1998) and inefficient overinvestment such as in real estate, and thus they threaten the future stability of the flows themselves.

An inflexible commitment to indiscriminately opening the capital account is unwise, particularly in light of the crucial importance of macroeconomic stability, along with the disproportionate volume of the international capital markets compared with the small size of LACs markets. As long as market movements depend to a significant extent on short-term transactions and domestic securities markets remain shallow, there will be a risk of great instability in this new modality of linkages with the global economy. In fact, recent critical experiences of Argentina, Chile, Mexico, Korea and Thailand –to a lesser or greater degree– attest to the wisdom of discouraging the accumulation of large short-term and liquid financial liabilities (Rodrik and Velasco, 1999; Stiglitz, 2000; Wang and Shin, 2000). That can best be faced with domestic prudential macroeconomic regulations, suited to the intensity of the supply of funding.

4. The external environment

The "governance" of domestic and international financial markets is at the core of the future of the world economy. A common factor in recent crises has been the great volatility of the most rapidly growing segment of international financial markets: short-term and speculative funds. Successive waves of over-expansion, followed by financial panic, indicate that the market tends first to grow overshootingly and then to contract more than is justified by economic fundamentals. These features are inconsistent with a balanced and efficient globalization. More energy is being spent on resolving crises than on avoiding them. It is to be stressed that while there has been an obvious lack of appropriate prudential regulation of domestic financial markets in most of the emerging economies affected by the crises, there has been an even more notorious lack of appropriate international institutions to monitor such a sophisticated, but unstable, financial market (Blecker, 2000).

Instability has, even, been reflected in the exchange rates of the main world currencies. The pressures in fashion over LDCs, to adopt corner exchange rate policies, reflects a poor understanding of the source of instability and of their costly long-lasting effects. Efforts should be focussed in a very pragmatic approach making space for intermediate solutions (Frankel, 1999; Williamson, 2000; Wang and Yang, 2000).

In closing this paper, we would like to emphasize that the focus of attention should be the management of booms, rather than the crises; usually, the latter are the consequence of badly managed booms (ECLAC, 1999; Ocampo, 1999). Given that existing institutions and instruments have been ineffective in warning of impending turbulence and rather have tended to encourage unsustainable booms, it becomes particularly relevant to the design of an appropriate domestic regulatory framework and prudential macroeconomic policies, aimed at controlling booms before they become unsustainable. Noteworthy among such measures is the reserve requirement on financial inflows, within a comprehensive set of prudential stabilizing policies, that Chile used with success in times of capital surges.

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Comments and Discussion

Won-Am Park: Since Dr. Ffrench-Davis' paper was based on experience of Latin America, I will rather summarize what I have learned from this paper and then express my opinion from the Korean point of view.

He said that Latin America actually had several experiences of capital surges. He pointed out three capital surges to Latin America – 1981, 1991, 1997. He identified that three capital surges were similar and basically the changes in external finance was supply – led rather than domestically motivated, and patterns were almost like a boom-bust cycle. Based on observation, he raised a question why debtors do not stop throwing money from outside before the crisis, also, why don't their creditors take risk in investment in emerging market. Also, for the policy lesson, he moved to Argentina as a case of the nominal peg and Mexico as a case of flexible exchange rate, and also Chile for an active macroeconomic policy case. These all failed to deal with massive capital inflows, although Chilean performance was better than others.

So, Dr. Ffrench-Davis seems to say that there are inherent, systemic problems in the capital surges to emerging market and pointed out the inefficiency of the market of information problems. Confronted with these inherent problem, he seemed to rely on measures of capital control. That is the impression I derived from this paper.

Actually, from the Korean point of view, I get the impression that Korea might face same kind of destiny after financial integration. So far we had only one cycle of capital surge but we will have next capital surge and bust too. Then we may resort to capital control.

I am going to talk a little bit about how Korea got into the crisis. During 1996 Korea was quite sound, health and Korean government did quite a good job in capital management. We did not have any capital inflow problem although the real exchange rate showed little appreciation, not big appreciation. Also, already in 1996 and 1997, the government was concerned with financial sector weakness problem and Chaebol problem. Why the crisis happened? Is it sudden inflow of capital or domestic fundamental weaknesses. Korea had both symptoms. We had big inflow of capital and at the same time some indicators were warning the crisis. For example, domestic credit over GDP and M2 to foreign reserve indicators went up sharply.

There are certainly many indicators telling the financial crisis but the changes only happened after 1997. So it is hard to argue that these indicators are based on long term fundamental weaknesses.

How to cope with capital surges? Well known prescription is exchange rate regime and the other is domestic policy prescription of prudential regulation, healthy and sound macroeconomic policy especially emphasizing fiscal restraint. But I would like to emphasize that imperfection of market or may be international financial market for these problem. I think part of the responsibility should be taken by creditor side as well as emerging market. Both side has moral hazard but creditor side moral hazard is as important as debtor side moral hazard. So I want to emphasize the imperfection of the international financial market and boom-bust cycle happens because of that.

To cope with boom-bust cycle, Dr. Ffrench-Davis mentioned capital control measure which composed of two parts – unremunerated reserve requirement and minimum holding period. Both aspect should be respected to have capital controls effective.

There are objections about the effectiveness of control but many people have consensus that Chilean case of capital control has succeeded in lengthening maturity period, reducing stock market volatility. But there are some negative side of capital controls, they did not work to reduce the total capital inflow although there were some substitution between short term and long term. And also did not prevent appreciation in real exchange rate, interest rate volatility.

So, there are advantages and disadvantages in capital control measure and the policy suggestion of capital control should be carefully introduced for Korea.

Gordon de Brouwer: I agree with much of what Dr. Ffrench-Davis has said. I think he is exactly right that there are boom and bust cycle and capital flows are procyclical. They represent, in fact, first order market failure and if there is first order market failure you have first order reason for policy intervention.

I just want to add that there may be three caveats or cautions when thinking about intervention or control. First is that there is problem of calibration of control. By calibration what I mean is when you change pace or degree of control, do you have predictable effect on capital flows. The fundamental problem with capital flows especially in the emerging market is that there seems to be a binary on-off process. They are very hard to control. How can you expect an instrument to give you high degree of control over these inherently volatile flows of this phenomenon. The control issues is a bit like monetary policy, you increase interest rate a little bit you try to slow down the economy, you don't see anything, do a little bit more still nothing is evident, bit more, then everything collapses. So there is calibration problem, you don't have neat, predictable effects of the policy instrument on the things that you try to adjust. I think the same happens for capital control

Second caution or caveat comes to my mind is, what about changes in private behavior that are brought about by these experiences. Will these changes in private behavior themselves be stabilizing and can policy makers take advantage of this? I will take experience of Australia. Australia was forced to float the currency in Dec. 1993 because of speculative attack. Currency was fairly stable for couple of years, but by then the commodity price collapsed in mid 1980 and Australian dollar fell for 30-40%. It had devastating effect on her, on consumer household expectations, business sentiment at the time. It never happened before and people thought they will always have exchange rate stability. After that, for past fifteen years, the exchange rate varied 30-40% either depreciate or appreciate. But it did not effect consumer or business sentiment. The key thing was that people have learned to live with it. So that makes the authority much more relaxed. Another thing is also massively changed hedging behavior of household or corporations. When the currency collapsed in the mid 1980s, people did not hedge. But no one now for the past 15 years has had unhedged borrowings. It had major psychological impact on household and corporate behavior. It was the behavioral response which modified some of the worst aspect of volatility. Also, at the time there was deregulation. There was a view when you deregulate the banking sector, central bank, supervisory authority has to be totally off - sort of hands off approach. A number of corporations set up their treasury operations, manufacturing, particularly oil producing firms engaged in wide-spread foreign currency speculation. A number of them almost collapsed, the effect of that was people then realized that they have to manage foreign exchange rate risk within the corporation and supervision has to be effective. So what that means is that some of the fluctuations can still be problematic but you can get private response which can reduce the influence.

Final thing I want to say is that the aim of control is to minimize the instability that arise, but it is also to capture benefits that can arise from financial openness. When Australia embarked on this process, people did not know where it will take them. There was a lot of fear but in fact there have been amazing changes in terms of diversified asset base of Australians and it also provided many different alternative borrowing opportunities.

General Discussion: Dr. Il Sakong emphasized that we should also pay attention to the control on the outflow side like Malaysian way. He said, in times of emergency, we can have this system from inflow side as kind of precautionary way to prevent crisis and in terms of changing term structure, portfolio of the total debt, the Chilean scheme was successful. On the other hand, he pointed out, the outflow side control is very controversial and we, as a group, should give serious thought about it. Dr. Sakong suggested, with regard to capital outflow, the problem should be taken care of at both national level and global level. At the national level, sound financial system, good corporate governance structures should be emphasized while at the global level, the new structure should have mechanism to reduce short term capital inflow volatility.

Dr. Griffith-Jones commented that countries which have very high savings rate, as Asia, do have particular situation. She said, it is probably very hard to find efficient project, high productivity project. So, additional capital inflows will have great difficulty in going into high productivity investment and the margin of benefit will be highly restricted. She added, as Asian crisis has shown us, the fact that you have high savings rate does not necessarily protect you from crisis. Perhaps, this may imply that the capital account liberalization is rather problematic for high savings countries than for low savings countries.

International Standards and Regulations for Global Banking Industry: Emerging Market Perspectives

Khee-Giap Tan

I. Introductory Notes: Proliferation and Pragmatism of International Financial Architectures

After decades of rapid economic growth averaging 6% to 9% per annum for emerging market economies (EMEs) of East-Asia throughout the 1980s and 1990s, the colossal scale of the East Asian Financial Crisis (EAFC) which swept through EMEs in particular called for reexamination of the East Asian growth model. It has become apparent that, for both newly industrialized economies (NIEs) and EMEs of East Asia, the high efficiency of their export-driven and international trade-oriented manufacturing sector is not matched by the rapidly internationalized financial sector and the changing global financial landscape (Tan, 1997).

It is widely accepted that the malignancy of EAFC comes from the *twin crises* – referring to the capital account shortfall coupled with domestic credit contraction (Yoshitomi and Ohno, 1999). The vulnerable inefficient banking industry was further typified and exacerbated by the *double mismatches* – which is now widely known as the currency and maturity mismatches. It is also widely acknowledged that the EAFC which begun in July 1997 and affected regional economies for approximately 36 months in terms of economic growth, was essentially private-sector induced. However, we are of the view that the respective regulatory authorities clearly should be held responsible for the imbalance growth between the real and financial sectors as well as the ensuing system-wide and cross-border financial turmoil (Karigane, Tan and Yuihama, 2000).

Given the nature of the crisis and vulnerability of the banking industry, we view EAFC as essentially a crisis due to obsolete banking standards and regulations, ineffective regulatory supervision and inability to cope with rapid changing global financial landscape. These are important policy areas that EMEs need assistance from contributions and ideas put forward by international agencies and think tanks.

Following the popularization of the free market school in the 1980's, liberalization of financial sector, deregulation on financial services becomes the norm. Further integration of financial centers and rapid financial innovation in the 1990s meant more uncertainty in financial markets, volatility in capital flows across-border and complexity in risk management within the global banking industry. Since then, we have witnessed proliferation of financial architecture proposals by international agencies and a plethora of ideas by individual academics for reforming the global banking industry and advocating strengthening international standards for regulation and supervision. Amongst the major institutional effort and initiatives are as follows:

- "Supervision of Banks' Foreign Establishments" under the Basle Concordat in 1988, the "Basle Banking Supervision Committee" on 25 Core Principles in 1997 and the latest Basle Initiatives on New Capital Adequacy Framework to be implemented in 2001 by BIS
- the G-7 grouping consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States which first coined the term International Financial Architecture (IFA) in 1995 had set up a Financial Stability Forum (FSF) tasked with identifying and addressing vulnerabilities in the global financial system with three working groups to (a) recommend actions to reduce the destabilizing potential of highly-leveraged institutions, (b) evaluate measures to reduce the viability of capital flows and (c) evaluate the impact on global financial stability by market participants operating in offshore financial centers
- The European dominated G11 grouping which include G-7 members plus Belgium, Netherlands, Sweden and Switzerland, consisting of central bank governors and finance ministers mainly focuses on international financial matters such the Committee on Global Financial System to monitor and analyze evaporation of liquidity in 1998 and examine structural issues pertaining to settlement in over-the-counter derivatives and repos markets.
- The ac hoc G-22 grouping which consist of G-7 plus 15 newly industrialized economies emerging market economies formed three working groups in 1998 to (a) study options for increasing transparency and accountability, (b) strengthening financial systems and (c) sharing the burden of preventing and resolving financial crises with private sector.
- International Monetary Fund's (IMF) initiatives on Transparency, Standards and Surveillance in 1998 and launching of the Financial Sector Assessment Program (FSAP) jointly by the IMF and the World Bank in 1999.
- The Financial Services Agreement of the General Agreement on Trade and Services in 1995 by the World Trade Organization
- The Regional Economic Monitoring Unit established by Asian Development Bank (ADB) in 1999 to improve coordination between regulatory bodies and to introduce a system of peer review.
- Formation of Asian Policy Forum in 2000 to develop constructive dialogue amongst Asian policy makers and disseminate Asian voices to the world, which currently consists of 17 policy oriented research institutes representing 14 Asian economies with ADB Institute serving as the secretariat**.**
- Private sector entities such as the International Accounting Standards Committee, the International Federation of Accounts, the International Organization of Supreme Audit Institutions, the Committee of the International Bar Association and the International Corporate Governance Network, have done much reform work in areas as reflected by their organizational abbreviation in a decentralized approach only to be further recognized, harmonized and monitored by international financial organizations.

All the international effort cited above have something to say about international standards and regulations for the banking industry. Notwithstanding the broad agreement that the 1988 Basle Capital Accord has flaws, we do recognized that it has evolved to be widely regarded as a basis or model for international standards on supervision and regulation of the global banking industry. Certainly there exists no consensus on what alternative could or should replace it. In fact, we are of the view that dissimilar viewpoints from Asian think tanks, voices from NIEs, EMEs and intellectual perspectives from individual academics are also struggling to be heard as Basle Core Principles are being incorporated to the Basle Capital Accord for extended application to more economies.

Given the unrelenting international effort but slow progress made on the international financial architecture this far, the urgency of banking reform to affected economies require them to take national effort or seek regional initiatives from a smaller scale so as to protect themselves against future crises. Until a widely agreed global financial architecture takes shape, interim discussions by different quarters representing dissimilar interests would either contribute to a more solid architecture blueprint or at least exposed the problem nature of dissension and divergence.

The broad thrusts of our discussion in this paper are therefore to examine BIS as an institution and the review the existing capital adequacy framework. We also raise relevant issues on standards, regulations and supervision confronting regulatory authorities and banks pertaining to conditions and circumstances of EMEs. In particular, we wish to voice, develop and crystallize the so- called non G7 views that often lack international platforms and dialogues.

Section II of the paper provides critical discussion on harmonizing international standards and regulations for reforming the global banking industry. In part (i) we examining the potential of BIS as an institution for reforming global banking industry, briefly referring to her history, corporate structure and broad objectives. Part (ii) reviews the Basle Capital Accord in terms of its character, flaws and alternative models. Part (iii) looks beyond the Basle Core Principles and effective banking supervision in terms of its relevance, implementation difficulties. In section III, we highlight some aspects of the fundamental financial framework or measures which needs to be in place while EMEs contemplate on participating in the IFA reform. The paper concludes with some forward looking new challenges for regulatory authorities in the context of changing financial landscape which may exacerbate the current lopsided development in terms of effective banking supervision between banks in developed and developing economies.

II. Harmonizing International Standards and Regulations for Global Banking Industry

Almost three years through the East Asia financial turmoil, policy contradictions and retrogressive moves are beginning to manifest amongst regional regulatory authorities as governments struggle to protect their battered banking industry, economic aspiration and political survival. Firstly, market competition may now begin to be tempered with more regulations. Secondly, international financial activities may now be confronted with interventionist authorities. Thirdly, market efficiency is beginning to be hampered by restraint on information flows and transparency. Fourthly, accessibility to financial markets may now be delayed as momentum for greater opening slows down under the name of prudence and stability (Lee and Tan, 1999).

> *If Bank for International Settlements (BIS) is responsible for "promoting cooperation amongst central banks, provide additional instruments for international financial activities, and serving as the trustee or go between for international financial settlements" as enshrined in item 3 of her banking constitution, then clearly BIS can and needs to do much more. We think more questions about BIS should be raised even when immediate answers can not be expected.*

1. Bank For International Settlements' Institutional Missions

As for the BIS, are there inherent difficulties in implementing the awesome task assigned? Is the organization structure of BIS ideal for carrying out her entrusted tasks? What exactly are or should be the objectives of BIS? These are paramount questions and issues to be answered and understood before we even review the terms of reference for the Committee on Banking Regulations and Supervisory Practices at BIS. We need to examine further the context which give rise to the Basle Capital Accord and the Basle Core Principles.

We are not quite clear what are the prime objectives of BIS in her role as the coordinator for central banks? Is BIS trying to prevent widespread bank closures from member economies, or is BIS concerns with the shock caused by its to impact to member economies? Is BIS ultimately concern or committed to the interest of depositors from global banking industry? What is the role of BIS in helping to ensure the transparent management of the large pool of national reserves of central banks A clear mission statement would certainly allow us to contemplate on the tasks and duties BIS can shoulder as one of the prime international agency.

To be an widely accepted and effective international agency, BIS needs to be more open on participation in her Board of Directors in terms of voting right allocation and should also seriously review her membership structure which is currently dominated by European interests. The core of the matter is that BIS must widen and spread her membership representation further if she is serious about her greater role as an international agency.

However one should not be too pessimistic about the acceptance of common core international standards and regulations for the global banking industry as past records revealed that even developed economies such as the Europeans members and the United States took a while to accept BIS role. What is more crucial is not the time taken for initiatives to be accepted but rather it is the effectiveness and relevance of the standards and regulations that matters.

2. The Basle Capital Accord: Its Character, Flaws and Relevance

Easing supervisory burdens and the creation of level playing field for banks are paramount objectives for regulating capital standards and it should lead to more but not less financial market stability. All effort to streamline regulation so as to reduce competitive disadvantages faced by banks and optimizing cost-efficiency for regulatory authorities are to be welcome. Under the 1988 Basle Agreement on International Capital Standard or the Basle Capital Accord (BCA), sources of bank capital are divided into two tiers:

Tier 1 capital includes common stock and surplus, undivided profit, qualifying non-cumulative perpetual stocks, minority interest in the equity account of consolidated subsidiaries and selected identifiable intangible assets less good will and other intangible assets.

Tier 2 capital includes the allowance for loan and lease losses, subordinated debt capital instruments, mandatory convertible debt, intermediate-term preferred stock, cumulative perpetual preferred stock with unpaid dividends, and equity notes an other long-term capital instrument that combines both debt and equity features.

Hence the minimum Basle Capital Adequacy Ratio (CAR) include:

(1) ratio of Tier 1 to risk-weighted assets must be at least 4%, and
(2) ratio of total capital (the sum of Tier 1 and Tier 2 capital) to total risk weighted assets must be at least 8%, with the amount of Tier 2 capital limited to 100% of Tier 1 capital. Hence under the Basle Capital Accord, shareholders are supposed to re- capitalize the bank should performance causes capital to fall below this minimum requirements and failure to do so called for liquidation of the bank by the regulating authorities.

On conceptual rationale, it is assumed that the 8% minimum CAR helps to protect the safety and soundness of individual institutions and the financial system. CAR is supposed to be "socially useful" when being monitored by an impartial regulatory authority so long one does not subscript to an extreme free market point of view. In terms of the appropriate levels of capital, right form the outset, the BCA conceded that the 8% CAR as a technical tool is at best arbitrary and the "correct" level of capital is impossible to be established for any single financial institution without disagreement. Nevertheless it is ambitiously assumed that a lower bound optimal level consistent with the interests of the institution and supervisory objectives exists through which a mechanical formula can be accurately estimated.

Retrospectively, it is being widely acknowledged by now that the usefulness or the relevance of mechanical formulas are rather limited when dealing with evolving financial banking activities which involve informal criteria, social determinants, unconventional practices, different economic conditions and unique institutional features. In Asian economies where financial systems and banking sectors are less mature or even rudimentary, such widely prevailing phenomena mentioned would render the static formulas ineffective if not irrelevant. Considerable costs and unacceptable complexity are involved if formulas would to be rendered frequent revisions to keep pace and reflect with such phenomena and their changes.

In the aftermath of the EAFC, many quarters redirected again their attention to the character of BCA under the so-called one-size-fit-all approach. Several areas if inconsistency can indeed be identified (Frankel 1998). Firstly, it implicitly presumed signatory countries had compatible institutional arrangement across all banks in different economies that clearly are not true. When we look at the financial paralysis of financial institutions that cracked during the EAFC, the naked nature of the disaster is shocking.

Secondly, the BCA is an incomplete agreement that affords considerable discretion to national supervisory authorities. Disparate implementations of prompt corrective action and no guidance on closure procedure for banks that are unable to meet the minimum 8% CAR. Since there is no formal enforcement mechanism for prompt corrective action, enlargement of rogue signatory banks from EMEs can further disrupt the efficiency of global inter-bank markets.

Thirdly, CAR is indeed a blunt measure merely to cushion default risk since it does not take into account of credit risks, portfolio risks, operational risk, legal risk, country risk, valuation risk, concentration risk and value-at-risk estimates. However, technically there is a lack of consensus as to how such risks can be factored into an objective calculation and given the general difficulties in its implementation even if such formulae can be arrived at. If such are the prevailing difficulties and complexity for regulatory authorities and banking institutions in developed economies, it will be a tall order to expect it from EMEs.

Fourthly, perhaps the problem is not just on the lack of dynamics and crude structure of CAR itself, but rather it is concerning the attitude and aptitude of financial institutions in the context of the capital management that regulating authorities ought to focus on rather than mechanical formulas. For EMEs, focusing on how bank risks can be identified, measure, monitor and managed is more meaningful then just providing banks with mechanical formulas. However, avoiding mechanical formulas is potentially difficult since enhancing attitude and aptitude on capital management by regulatory authorities seem quite fuzzy since it involves discretion.

Finally, it has been widely acknowledged that the usefulness or the relevance of mechanical formulas are rather limited when dealing with evolving financial banking activities which involve informal criteria, social determinants, unconventional practices, different economic conditions and unique institutional features. In Asian economies where financial systems and banking sectors are less mature or even rudimentary, such widely prevailing phenomena mentioned would render the static formulas ineffective if not irrelevant. Considerable costs and unacceptable complexity are involved if formulas would to be rendered frequent revisions to keep pace and reflect with such phenomena and their changes.

Four alternatives have recently been suggested, advocating doing away with mechanical formulas on capital requirements. Under the “pre-commitment approach” (Kupiec and O’Brien, 1995) whereby banks prior to each time period pre-commit a fix quantum of capital reflecting market risk. At the end of the specified period should losses exceed the pre-commit amount, penalty in terms of monetary fines, supervisory disclosures or any other form deemed suitable would be imposed. Advantages of such an approach are that it has greater flexibility in terms of capital requirements, less intrusive to businesses, less regulatory distortion and less knowledge demanding to the regulatory authority. While such an approach circumvents the need for mechanical formulas, it requires the design of penalty formulae that involves supervisory discretion.

On the other side of the spectrum we also have the “self-regulating approach” proposed by the G-30 essentially leaves the development of regulatory strategies to the major but a small group of market players. However, such an market discipline approach in the absence of administrative sanctions to enforce standards presupposes high degree of transparency, and may lead to divergence of interest between individual players and the industry which may give rise to competitive distortion at the expense of smaller players.

A middle ground idea known as the "supervisory approach" (Estrella, 1995) under which banks are initially accountable for determining its won appropriate level of capital in accordance to the complexity of their business activities, monitored by the regulatory authority while limiting the reliance on the mechanical formulas to a simple well-defined role as capital levels benchmarking and cushion bank default. There are substantial synergies under this approach in terms of supervisory review of risk management activities since this itself form part of the bank examinations. Other advantages being that the regulatory authority looks at the process rather than the mechanical formulas and can ensure consistency with public goals of system safety and soundness. Unfortunately, such supervisory approach demands high human resource investment from both banks and the regulating authority.

There are those who advocate for the implementation of appropriately risk-adjusted deposit insurance premiums (John *et al.*, 1995) to avoid the distorting consequences of resource allocation associating with imposition of CAR. It is argued that such measure would encourage bank owners to put in place optimal management compensation structures and hence induced bank managers to avoid taking risks beyond those that are optimal for an all-equity-financed bank. Theoretically attractive as it may, experience of United States and European countries suggest that such an approach is politically difficult, more so we supposed for EMEs since risk difference differ more widely among banks if compared to their counter part from more mature or developed economies.

3. Beyond Basle Core Principles and Effective Banking Supervision

All four alternate approaches highlighted are no doubt thought-provoking ideas. However, when supervisory discretion, market transparency and technical complexity are involved, EMEs may do better by improving upon the mechanical formulas on capital requirements. We are of the view that the Basle Capital Accord can be modernized, adapted and expanded in order to stay relevance, at worst to serve as a conservative benchmark to cushion banks against risks that are difficult to measure. It can then serve to protect public interest against bank failures whose costs are ultimately borne by taxpayers. It is in this spirit that the 1997 Basle Core Principles and new capital adequacy framework evolve.

The Basle Core Principles for Effective Banking Supervision being set up in September 1997 is indeed one of the most important supervision documents for global banking industry, notwithstanding that it is still essentially "core principles" that are yet to be refined and broaden. The content of the 25 Basle Core Principles (BCP) can be categorized as follows:

BCP 1	Regulatory authority must recognize that preconditions for effective banking supervision include explicit regulatory objectives, clear supervisory responsibility, sufficient resources, appropriate legal framework, information confidentiality and sharing between the authority and banks.

BCP 2 to 5	Regulatory authority should set proper procedures and transparent criteria for licensing of banks, be stringent on the usage of the term "bank" and setting criteria on examining major acquisitions and investment plans by banks so as to ensure excessive risks brought by its subsidiaries or institutional structure would not undermine supervisory efficiency
BCP 6	Regulatory authority should ensure that the minimum CAR adopted for the banking industry should not be lower or less conservative than the 1988 BCA and its 1996 amendment.
BCP 7 to 8	Regulatory authority should independently assess and monitor banks' lending procedures, investment exposures, assets quality and provision made for loan losses.
BCP 9	Regulatory authority should set up comprehensive information systems to identify the extend of banks' assets concentration risk and setting maximum exposure allowable on a single or group borrowers.
BCP 10	Regulatory authority should supervise, control and dissolve risks resulted from connected lending activities and ensures banks lend to enterprises or individuals based on commercial or business considerations.
BCP 11 to 15	Regulatory authority should encourage banks to set up internal models to measure market risks and adopt control procedures that are consistent with their respective business nature and scale.
BCP 16 to 20	Regulatory authority should consolidate supervisory activities that include on-side and off-side inspections, maintain regular contacts with banks' core management and verify their business health through both external and internal auditing.
BCP 21	Regulatory authority should follow consistent accounting procedures and tradition in order to maintain complete accounting records so as to truly and impartially verify banks' financial conditions and profitability
BCP 22	Regulatory authority should adopt corrective actions for banks which are unable to meet the minimum 8 % CAR or when depositors interests are at stake by suggestion to withdraw or even canceling business license.
BCP 23 to 25	Regulatory authority should promote global coordination and consolidation by ensuring it banks foreign establishments follow prudent business principles and standards, establishing contacts with the hosting regulatory authorities through information exchanges.

While there is no difficulty to recognize that the 1997 BCP is an improvement over the 1988 BCA. It is a general but not detailed supervisory document based on a list of core principles for guiding global banking industry. As for BCP 10 regarding connected lending and BCP 9 on maximum exposure to a single or group borrowers, as recognized by Caprio and Honohan (1999) who argue that the underlying causes of banking problems in EMEs go beyond supervised capital requirements. Bad banking practices and political interference were identified as underlying sources of weakness. A general advocating of BCP 10 and BCP 9 are unlikely to dissuade connected lending and excessive exposures to single individual or group borrowers which were known to be notorious prior to EAFC. We do realize that the problems of nepotism and cronyism in EMEs can be rather difficult to establish legally. A pragmatic prudential safeguard is really to entice voluntary participation from banks to join the early surveillance scheme, peer review and greater disclosure program by way of incentive designs. By way of enticing voluntary participation as one of the qualifying conditions for joining a regional financial arrangement such as the proposed Asian Monetary Fund (AMF) could be more fruitful.

For instance the BCP 22 concerning timely corrective actions by the regulatory authority may not be so widely accepted and appropriate for EMEs. Considering the case of swift closures of banks and financial institutions in Indonesia and Thailand, as contrast to the non-closure approach adopted by the Malaysian authorities, which nevertheless constitute to a negligible proportion of the total outstanding bad debts in those countries. In fact prompt corrective actions upon firm recommendation by IMF to withdraw licenses had significantly undermined the fragile public faith with the financial system which further triggered widespread bank panic and hence exacerbated bank runs.

While no one would argue with BCP 6 which renders greater flexibility to regulatory authorities in setting their CARs, the requirements from BCP 11 to 15 to keep up with a sophisticated risk management systems for banks can be technically and operationally extremely demanding for EMEs. Failing to master BCP 11 to 15 and without the enforcement mechanism for corrective action under BCP 22, BCP 23 to 25 which meant to enhance global consolidation and cooperation may be hard to achieve. This is because enlargement of rogue signatory banks from EMEs risks the transfer of rogue national banking system to further disrupt the efficiency of global banking industry.

The Basle Committee in consultation with representatives from G-10 member countries and 9 EMEs drafted the 1997 BCP. Can we reasonably expect a comprehensive treatment on all relevant core principles for banking supervision from such selected representations and expected it to be endorsed by all countries? In particular, to many EMEs whose basic essential financial infrastructures are still not in place, where the regulatory philosophies are still not in tune, whose legal framework are still not in sight, whose banking industry is still not in shape and whose economies simply are in tatters? From the EMEs perspective, we ought to identify the sine quo non and correct sequencing as to what must first be put right before proceeding to those by and large uncontestable but not necessarily pragmatic core principles.

III. Reforming Domestic Financial Framework in EMEs: Some Observations, Issues at Stake and Policy Implications

Assuming the objectives of safety and soundness for global banking industry can be achieved through close adherence to BCP, there are concerns from EMEs that too stringent or high degree of supervision and harmonization of standards may stifle the ability to raise capital hence slow growth momentum. As there are a certain segment of investors who are not risk adverse would always seek for high return opportunities in EMEs especially during early stage of economic development. There is also the associated risk of greater institutional divide between banks in developed and emerging markets given the high costs of regulatory reform and infrastructure upgrading for the latter which started with a lower corpus of capital.

The vicious cycle is such that banks from EMEs due to their inability to swiftly adopt higher standards will now be marginalized in the global market place while banks from developed financial markets centers will strengthen their competitive edge. To cope with such challenges, the priority for EMEs is therefore to revamp basic financial and legal framework, strengthen markets structure, incorporating business incentives and sequence financial policies. Shaping and acceptance of IFA by international agencies are likely to take time. Designing one's national financial architecture would be a small urgent step to take.

1. Enhancing Bank Disclosure, Public Accountability and Supervisory Transparency

According to a recent report by Singapore's 1998 Committee on Banking Disclosure, the international comparative analysis revealed that the United States and the United Kingdom are leading the best financial disclosure practices followed by the European counterparts such as Germany, Luxembourg and Switzerland. Australia, Japan, Singapore and Hong Kong are grouped under the third category for bench marking within the Asia-pacific region while the EMEs still have a long way to go. The Committee on Banking Disclosure had made several recommendations which encompass undisclosed reserves, accounting policies, profit and loss account, balance sheet coverage on assets, liabilities and shareholders' equity, off-balance sheet, supplementary information, financial review, equity accounting and reporting requirements.

One of the policy mistakes that many central banks committed during the early stage of the currency turmoil is the failed attempt to shore up their local currency value through market intervention which quickly depleted the precious and much needed foreign exchange reserves. Central banking discipline and public accountability can and should be reinstated or strengthen further by setting up a separate government supervised investment company to better manage foreign reserves based on optimal long term yields. Leaving the central bank instead with only working capital to "smooth" the shorter-term exchange rate fluctuation under a preferred option of a basket of trade-weighted-managed float exchange regime.

The argument that ultimate control on central banking discipline and public accountability may still lie with the quality of government is well taken. However, setting aside the accumulated reserves on longer-term investment portfolio may make it at least administratively less fluid for easy and non-transparent decision to be made without public accountability. In the event of temptation to easy option or unjust monetary policy being adopted by the central bank, investment in longer-term bonds or positions in the less liquid property investment may discourage temptation to easy policy options.

If financial safety and soundness are paramount objectives for supervision, then the regulatory authority must contemplate beyond supervisory transparency. In the aftermath of EAFC, three areas pertaining to core competence, instituted corporate governance and sector-specific regulated lending are worth considering. On core competence, the regulatory authority should maintain that banks should not venture into non-banking related businesses such as manufacturing, property development or other non-financial services. Such prudent directives will spare the central bank from having to supervise or manage non-bank activities during bank failure.

As for instituted good corporate governance, nominated members for Board of Directorship would have to be approved by the regulatory authority on the basis of professionalism and contribution. Bank failures are quite different from failure of corporations in that depositors' interests are at stake apart from the usual losses in jobs and shareholders fund. Guidelines on sector-specific regulated lending are particularly useful in EMEs though it was not widely recognized prior to the 1997 EAFC. Such guidelines are dissimilar to industrial policy or targeted lending since it restrict rather than direct fund to usually property and equity stock sector. In rapid growing EMEs, it is not uncommon to see such sectors being pushed to unacceptable levels by risk-taking-high-returns seeking investors. Clearly in the context of EMEs, preemptive moves would have to be initiated by the regulatory authority instead of waiting for corrections through market discipline.

2. Coping with Capital Flows, Guarding Against Market Manipulation and Maintaining Exchange Rate Stability

Reasons for capital flows are due mainly to changes in economic fundamentals, market imperfections and official policies, and in recent years the active financial innovations and growth of the hedge fund industry within an increasingly integrated global financial community. Effective supervision on international financial intermediation is amongst one of the biggest challenges to central banks. Capital controls are unlikely to eliminate completely capital flows although these rules are amongst the most important impediments to market accessibility. Very often capital controls are further reinforced by barrier to entry set on foreign financial intermediaries either in terms of ownership, taxation or financial participation.

A comprehensive capital controls would enable the local economy to be insulated from global monetary market forces such as interest rate and exchange rate influences. Hence countries are able to pursuit independent monetary or/and fiscal policies in relative isolation from external developments. In the light of the recent currency turmoil, resistance to capital controls has been softening following the Chilean and Malaysian experiences and policy sentiments for greater financial market openness have also been weakened considerably at least in the short run. Speedy transmission of external financial shocks and contagious systemic consequences are often cited as justification for controls. According to Fisher and Reisen (1993) and recent studies by Edward (1999) provide a thorough account of country experiences on capital and exchange controls, which they concluded to be largely ineffective.

One of the important system features that appears to have exacerbated the Asian currency turmoil must be the rigidity of the foreign exchange regime that were virtually linked to the US dollar as were the case of Thailand, Indonesia and Malaysia. For an outward export-oriented economy, adoption of a trade-weighted basket managed-float exchange rate regime may be a more market-determined system. Under such a regime, a reasonable level of foreign exchange reserves often valued to be worth several months of imports that might well be a prerequisite to exchange rate "smoothing". The essence of the managed-float exchange rate regime is to allow the value of the local currency to "float" with market forces vis-à-vis the currencies of trading partners and the central bank only comes in to "smooth" the exchange rate whenever volatile movements occur.

Non-internationalization of the local currency could turn out to be the most significant policy safeguard to financial stability if the managed-float exchange rate regime is to be effectively "smooth". Regulatory measures to ensure non-internationalization of the local currency must be in place and monitor closely. Such policy is of particular relevant to an emerging economy whose exchange rate movements may be intimately linked to the rate and the stage of the economic development. Under the non-internationalization policy, flows of capital may not be hindered but restrictive usage of local currency to non-residents and its circulation beyond the national geographical boundary is to be disallowed. As the economy matures and it size expands, gradual internationalization of the local currency can then slowly be introduced as governed by the degree of openness to trade and flows of foreign direct investment.

Those advocate for sequencing of stabilization and structural reforms advise delaying dismantling of capital controls for fear of capital inflows and swift real appreciation of exchange rate, thus remove protection for tradable sector. Capital controls therefore should be retained when an economy is undergoing major stabilization and liberalization reforms to avoid sudden attempt for foreigners to increase their claims on the reformed economy. However, some quarters strongly argue that capital account liberalization should be sequence first to reduce structural adjustment costs by relying on foreign capital during transition. Early capital account liberalization may serve to expedite reform plans and avoid vested interests and political constraints that are resisting reform.

Under the political economy of liberalization thesis, the disillusionment about the effectiveness of capital controls justified dismantling of controls. Growing trade integration and the increased presence of multinational corporations produce closer financial links and opening up ways for circumventing existing controls. The imposition of capital controls can generate uncertainty about further tightening and thus stem capital inflows and induce capital outflows. Those who questioned the effectiveness of capital controls generally suspect that controls often become another convenient or the most attractive channel for corruption. As regard to the perceived negative impact alleged to have caused by the activities of the high profile hedge fund mangers, one suggestion that comes out of the global concern for the fluid activities of hedge funds is to monitor through the risk profile of banks. However, given that there exists no standard definition to date on hedge funds, it is indeed quite difficult to legislate and implement rules to regulate them. However, this should not stop the supervisors from "closely monitoring" their activities.

3. Policy Over-Spill, Contagion Effect and Regional Central Banking Coordination

One of the clear lessons which have immerged from the currency turmoil being that central banks in fast growing economies probably have to include assets inflation explicitly as amongst the central banking policy objectives as Monetary Authority of Singapore had already done since 1995. The other experience that came out strongly through the currency crisis is the pursuing of unsustainable growth policy which led to macro economic imbalances tend to attract excessive capital inflows or/and volatile capital outflows. Indeed Blinder (1997) discusses on what central bankers could learn from academics and vice versa.

Sudden policy measures by the central banking authority of the affected country may have the over-spilling effect to the neighboring economies as capital mobility intensifies. A case in point would be the strong measure of imposing reserve cost on the vostro ringgit account in by BNM in the early 1990s had led to excessive capital outflows seeking sanctuary in the Singapore markets. Similarly, in the Singapore markets, the excessive short speculation on ringgit by foreign exchange dealers coupled with rumors on the impending imposition of exchange controls had resulted in the extremely high shorter-term interest rates on the Malaysian currency. Such financial activities and interest rate differential in turn had exacerbated the exodus of ringgit deposits from Malaysia thus causing domestic fund shortages. These are circumstances that policy coordination clearly exists amongst central banks. It is therefore paramount and pertinent for policy authorities to be careful so as not to create economic conditions and political environment that tend to attract financial speculations

4. Changing Financial Landscape in the Global Banking Industry: An Omnibus Act to Streamline Supervision

The global banking industry has gone through a series of lending excesses over the past three decades which include the international bad debts of the 1970s, energy and real estate crisis of the 1980s and Asian emerging markets of the 1990s. For the year 2000 and beyond or the new Millennium, ways are cleared to erase financial barriers in creation of financial supermarkets. This significant US financial sector reform is supposed to lead to major improvements in financial services, promote financial innovations, lower capital costs, greater variety of financial products for consumers and strengthen international competitiveness. Historic legislation looks set to be passed soon by US law makers to repeal the 1933 Glass-Steagall Act and the 1956 Bank Holding Company Act.

Intensified competition worldwide had led to a series of mergers and acquisitions (M&A) which begun in US and subsequently took place amongst European and Japanese banks. The Financial Service Modernization Act of 1999 would set the train of M&A moving across bank and non-bank financial institutions and produces vast service-based conglomerates. The major rationales for M&A are essentially due to over capacity, to realize costs saving, greater business synergies, allowing cross selling of services and of paramount importance, Web-based Internet technology-driven consolidation.

Over capacity in the banking industry leads to lowering of lending criteria, irrational pricing of credits which can weaken the financial system. M&A will therefore necessarily mean substantial loss of jobs at least in the shorter-term, further investment and super-heading the new technology advancement, responding to demand for specialists in newer businesses under a new competitive environment and coping with the mammoth task of business consolidation and management restructuring. From the investors or consumers' perspective, intensified competition had led to increasing emphasis for high growth/high yield instruments. Given the Asian economic crisis and financial paralysis, the global interest rate environment has remained benign. Greater financial deregulation worldwide and freer flows of financial information enhance financial innovations and cross-border financial investments.

Notwithstanding the Asian currency turmoil whose recovery momentum and strength are faster than expectation, wealth accumulation in Asia after prolonged years of growth have significantly changed investors' expectation towards the returns of Western traditional pension funds. In meeting these more sophisticated demand by the new high net-worth Asian individuals, commercials banks are shifting their traditional financial intermediation of deposits taking-corporate lending businesses emphasis to investment portfolios, fund managing and private banking. Hence we saw the rapid growth of "target" funds, boutique fund managers and private banking facelift with very tailored-made structured financial products to cater for individual investor's requirements and expectations (Lee, 1999 and 2000).

Such changing landscape in the global banking industry is changing the approach in which central bankers think about supervision in view of the worldwide trends of convergence amongst financial institutions and blurring of product boundaries. It is therefore rather logical to look into the model of an omnibus Act to streamline and consolidate the existing supervisory role and regulating structure and financial service legislation which is deemed to be more cost effective and prevent regulatory arbitrage. Examples of possible changes include a single authorization or license for all financial institutions and a bottom-up approach where capital is required for different regulated activities within a financial institution (Koh, 2000).

5. Potential of Online Financial Services and its Implications to Regulating Authorities

As the demarcating lines between bank and non-bank financial institutions such as securities firms and insurance companies are blurring, competition and market encroaching from non-bank financial institutions, which are also strong branded market players, to commercial banks in terms of the traditional financial intermediation are intensifying. Web-based Online financial services (OFS) with Virtual Branch and specialist services outsourcing such as mortgage processing companies are becoming new marketing and sales channels where contracting or closure of brick-and mortar branch network are to be expected.

According to the 1999 annual survey on Asian CEO issued by the World Economic Forum and Pricewaterhouse Coopers revealed that half of the respondents believe that the financial industry will be most significantly impacted by the Internet over the next two years. About 42% of the respondents, as compared to 35% in 1998, do not rule out government regulation of Internet of some kind. In 65% of the Asian CEOs, as compared to 70% last year, agree that Internet access, transaction and use should not be taxed. No doubt the potential of e-banking is written on the wall, however, the two issues concerning government regulations and imposition of taxes on Internet activities are rather controversial and debatable which we shall revisit later. It is hardly surprising that CEOs, financial experts and policy makers are basically upbeat or at times even over anticipatory about the potential of OFS.

If we just look at the exponential growth of the Internet users worldwide since the middle of 1990s, it is indeed a business phenomenon that we have not witnessed or encountered (Tan, 1999 <table 1>). The filtering of Internet banking through to main stream commercial banking is a fairy new phenomenon. Amongst the top ten banks from the United States, Wells Fargo Bank began to provide full range internet-based on-line banking services in 1995, followed by First Union Bank and Bank of America in 1996 and Citicorp and Banc One as recent as 1997. Surprisingly until 1998, major financial institutions such as JP Morgan, Bankers Trust, Chase and First Chicago CND are yet to move into this new medium of financial services. In late September 1999, for the first time ever, a revolution in institutional financial management called CFOWeb.com was launched in the United States. It is an international network created exclusively for chief financial officers, treasurers and fund managers which provide direct access to international capital markets with more choices, increased resources and lower costs than were ever before possible. CFOsWeb.com offers a complete array of innovative online tools and services that let you manage your portfolios, determine fair market valuations, process a trade or satisfy FASB and regulatory reporting requirements, all in Internet time.

In Asia, Hong Kong and Singapore are amongst the leaders in the provision of OFS. According to the Hong Kong Monetary Authority, as of October 1999, there are already five banks in Hong Kong providing Internet banking (i.e. Heng Seng Bank, Cititcorp, East Asia Bank, Wing Long Bank and Tao Hang Bank) although not all five are involved in full range Internet-based on-line services). Twelve banks are currently planning to launch financial services through Internet and twenty banks have expressed interest to participate in such a new medium. In Singapore, OFS including commercial banking, securities brokerage services and insurance services have been gaining momentum over the recent years. On Internet banking, almost all the major local banks and securities firms (such as Development Bank of Singapore, Overseas Chinese Banking Corporation, United Overseas Bank, Overseas Union Bank and KeppelTatlee Bank) and most foreign full license banks (such as CITIBank and AMRO Bank) are already involved in Internet banking. Malaysia, India, Indonesia and Vietnam have at least on major bank already tapping the Internet to offer financial services, Philippines will follow suit shortly

For effective banking supervision, the central banking authorities ought to seriously take into account the following reality and impact of e-banking:

The America Banking Association estimated in 1996 that an online financial transaction cost $.01, an ATM transaction costs $.27, a telephone transaction costs $.54 and a branch transaction costs $1.07. Although duplication of delivery or access channels may actually increase costs at least in the short run. Justifying Internet development based on short term cost saving may be unrealistic since changing of consumers' habit may take time. There will be a fundamental shift of power to consumers through information accessibility.

Embracing Internet could destroy basic business and pricing model since it reduces barrier and moves closer to perfect competition. Cannibalization of existing businesses such as the traditional brokerage services are to be expected. Use of physical cash is unlikely to disappear and face-to-face approach to banking services will continue for quite some time.

Low confidence in terms of data confidentiality, system security and lack of legal precedent, unclear tax treatment to financial transactions and trading in uncharted territory may discourage participation. Shifting from branded financial products or services to information based banking. Disintermediation of traditional roles and channels would take place and rapid advances in technology may render correct infrastructure investment obsolete.

On foundation building in the longer term, the biggest challenge within the knowledge based information society for any economy is still to educate and upgrade the profile of the population workforce which is an expensive long term process and need carefully thought out strategies. Although building of physical information infrastructure for wealthy nation in theory can be done in a single stroke, such move would be unwise if Internet-specific laws, provision on data security, intellectual property rights and privacy policy are not being considered simultaneously.

On managing changes during the transition, incremental up grading or the evolution pace towards establishing a comprehensive Electronic Data Interchange would lead to smooth leap for more advance information infrastructure. A consistent government initiated regulatory institution would be needed to push through certain sub-sectors where market forces are weak to ensure general accessibility and affordable access.

On mapping future strategies to maintain a competitive edge, rapid advances in the Internet technology calls for convergence of telecommunication, media and information technology sectors. Forming of an international advisory group to super-head strategic information infrastructure planning and identification of market stimulants would be paramount. Individual government, taking into account of the social and cultural aspects, may wish to decide subjectively the degree of liberalism that would be allowed to filter through by way of “Internet censorship”.

IV. Concluding Remarks: Some Lessons, Suggestions and Issues for Thought

In as far as the revision effort on the New Basle Capital Accord based on three pillars, namely minimum capital requirements, supervisory review and market discipline, the countdown to completion are as follows:

June 1999	First consultative package on the new accord
Jan 2001	Second consultative package on the new accord
End May 2001	Deadline for comments
End December 2001	Publication of the new accord
2004	Implementation of the New Basle Capital Accord

The announced goals of the Basle Capital Accord 2004 is to deliver a more risk-sensitive methodology, a more risk-differentiated view of bank assets, rewards people who are good bankers by letting banks hold less reserves for lower risk loans but require fuller disclosure. Thus scrapping the "one-size-fit-all" approach, banks are expected to develop their own internal risk management system. Banks that do not have their own risk assessment system will need to rely on an external credit assessment institution that meets strict standards. However, bankers around the world continue to doubt that any agreement could be at all reached as to how these risks can be measured at a practical level.

Since any system of international standards, prudential regulations and sound supervision are likely to be evolving with changing financial landscape, four general reminder underlying any future proposed changes are being raised by Chairman of the Federal Reserves Bank of United States as follows (Greenspan, 1998):

(1) A reasonable principle for setting regulatory soundness standards is to act much as the market would if there were no safety net and all market participants were fully informed
(2) Continue linking strong supervisory analysis and judgement with rational regulatory standards
(3) Continue to plan for a successor to the simple risk-weighting approach to capital requirements embodied within the current regulatory standards, and
(4) The Basle Standard and the Bank examination process, even structured in optimal fashion, are a second line of support for bank soundness. Supervision and regulation can never be a substitute for a bank's own internal scrutiny of its counter-parties and for the market's scrutiny of the bank.

In the light of these mounting difficulties, there have been numerous calls for harmonizing and enforcing common standards and regulations on global banking industry by erecting yet more international institutions to act as global policemen. Suggestions such as a World Monetary Authority, an International Federal Deposit Insurance Corporation, a Global Financial Regulator, an International Bankruptcy Court, an International Financial Crisis Manager and a "deep pocket" International Lender of Last Resort had been mentioned (Rogoff, 1999). However, we propose a regional approach towards core principles for effective banking supervision, which are consistent with the Basle Initiatives 2001. Such regional initiatives that involve in particular proper supervisory agency, capital regulations, criteria for licensing banks, lending procedures, information-reporting systems, risk management profiles, accounting standard, timely corrective actions, consolidation and co-operations amongst banks. Since these are rather crucial yet sensitive core principles to be upheld, the regional approach can begin from East Asia or even within ASEAN.

Given the recent trends of convergence within the global banking industry, for efficiency and streamlining of regulation, an Omnibus Act for all financial institutions may be the inevitable way forward. The ongoing developments of Internet driven-online financial services do pose serious challenges to central banking authorities in terms of effective banking supervision. The more fruitful approach is perhaps not to attempt to regulate or control these activities but we should allow the market to dictate instead. However, to effective monitoring their impact on financial services and financial institutions would call for a more comprehensive financial information system. In this sense we may concur with some market observers that "it is a fallacy to speak of the wisdom of the market place" at all times especially where efficiency of the market place prevails through regulations and institutions set up by the international policy authorities and financial agencies.

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Comments and Discussion

Stephany Griffith-Jones: I found this paper interesting and have some new points but I also find some important gap. Perhaps the best way to change it is to take out 'the emerging market perspective' because I found many aspects from developed countries or countries which is exactly on the threshold of developed country, like Singapore, in fact.

Tan said main part of the architecture is domestic financial framework. The developing countries would say, quite contrarily, "we have been forced to make compliance of standards because that implies no cost for the G-7 and implies a lot to us." The ranges of standards are too big, it is about sixties. The developing countries need to prioritize to have adequate timing. That is to give enough time for developing countries to develop these institutions because we are talking about proper institutions which have taken very long in advanced countries. Lack of participation of developing countries in defining the standards has also been the problem. Another thing is lack of clearance of the benefits the developing countries would get if they implement the standards. I think these should be added here.

What I liked very much about the paper, is the regional perspective. This was very Asian response and I think it is very positive one. With this idea, you would have regional standard setting which, therefore, would help overcome the problem of 'one-size-fits-all.' But it has to be complementary and consistent with the work of BIS and others because it would be even worse for developing countries if there are two sets of standards. I think the fact that you have taken an initiative within Asia on this would be very helpful in making more flexible and softening of position which are very rigid.

Most specifically, the paper said the BIS does not have clear objective. But it seems to me that the BIS very clearly have objectives. I think it is true that the membership is mainly G-7 but they have made an effort since 1996 to incorporate key emerging market into them. The characteristic of the BIS, which many of us appreciate and which we don't stress enough, is that it is not based in Washington. Therefore, it is far more pragmatic, far less ideological and little bit further from U.S. treasury. And because it is consist of central bankers, it has a lot of concerns with systemic risks. So I think Tan has been a little bit harsh on the BIS.

One aspect that I was surprised that Tan did not mention at all is revision of capital adequacy ratio. Now, there is big discussion about how it should be revised. I think it would be very interesting if we have developing country perspective on this.

To finish with the positive note, the issue of role which regional standard setting could play as an interlocutor for the BIS, Basel committee, and for the IMF indeed is very positive and constructive one.

Yunjong Wang: I would like to say similar point to Griffith-Jones'. One is Basel capital adequacy ratio. It has been revised in 1998 and now the debate is going on for another revision. I think we need some revision, particularly about the short term versus long term. It has not been changed much.

I also agree that one-size-fits-all approach is not relevant and we might introduce Asian BIS and standards. In addition, if this kind of approach is not viable, let's think about trade negotiation, particularly in the WTO. There are a lot of standards coming out, but they go through very arduous process, almost 7 years in the Uruguay Round. But there is no process for negotiation in defining and implementing financial standards. If we need some standards, we also need negotiation for it.

I would like to point out the three factors. First, free-standing, not the ready made standard should be adopted and incorporated to the system. This is the key factor because ready made adoption is not compatible with the existing system. Second is about cognitive institution, which means that the application and implementation should be determined by the perceptions of users in the developing countries. Third one is an effective law enforcement. It should be functional but voluntary compliance. If it is not compatible or attractive then nobody will want to comply with the standards. I observe that the IMF tried to link these kind of enforcement mechanism to the CCL so that only qualified, eligible countries can be rescued. But this is a very dangerous idea. If we adopt this kind of system, only few countries will be saved from contagious shock.

General Discussion: Tan added Singaporean view that they think these core principles are not rules but only guidelines. In that sense, it is very nice to have core principles that are not binding as the IMF conditionality, so that we have the flexibility not to follow if we don’t want to. Tan agreed that these core principles are highly ideal and argued that within some of the core principles we can define several steps we should go forward.

Tan also mentioned about the new capital adequacy framework that we are to implement by year 2001. He pointed out that Singaporean experience with the BIS was not very good. As the BIS openly conceded that they don’t have expertise in rating banks, that is the reason the BIS is outsourcing from ratings agencies such as Moody’s, S&P. He continued that it is likely that the new adequacy framework would not make any difference.

He suggested that within the 25 core principles as ideal, we should refine the core principles and attach principles as prerequisite. Then alternative rating agency is what we ought to suggest in this group. He pointed out that it is not realistic for emerging market economies or banks to set up their own standards and it would be better to have central banks to give certain guideline to banking industry, rather than resorting to market discipline.

The IMF in a New Financial Architecture: An Evaluation of Alternative Proposals

Robert A. Blecker

I. Introduction

The 1997-99 financial crisis in Asia, Russia, and Brazil brought an unusual amount of public attention and professional criticism to the International Monetary Fund (IMF), an institution which had previously operated mostly behind-the-scenes and without much public awareness of its role. Dissatisfaction with the IMF's response to the crisis led to a number of radical proposals for either transforming the IMF itself (including some calls for abolishing it), or else supplanting it with another type of international financial institution, such as an international central bank or world financial authority.[1] Although the end of the financial crisis in mid-1999 led to a lesser sense of urgency about the need for major institutional innovations, reform of the IMF remains very much on the agenda for transforming the international financial architecture.

This paper will review and evaluate some of the key proposals for IMF reform that have been made in recent years. Although most of these proposals have come from the United States, any such changes would have profound effects on the developing nations and emerging market economies. It is therefore hoped that a critical discussion of these alternative proposals will provide useful background for those who wish to promote emerging market (EM) perspectives on international financial institutions. To facilitate the comparison of G-7 and EM perspectives, this paper will use the policy recommendations of the Asian Policy Forum[2] (2000) for preventing future capital account crises as an example of EM views which can be contrasted with the proposals being developed in the US.

In this discussion, it is important to realize that experts in the G-7 countries and even the "G-1" (i.e., the US) do not hold monolithic views about the IMF or the international financial architecture generally. On the contrary, there is wide-ranging disagreement within the G-7 as a whole and within the US in particular over the right direction for global financial reform and the future role of the IMF. By taking account of these differing perspectives, advocates of the interests of the EM countries can identify the proposals that would be of most benefit to those countries. At the same time, the non G-7 countries are also not a homogeneous bloc. The non G-7 countries differ enormously in levels of development and internal structures. They also have diverse interests and perspectives internally. For this reason, any discussion of global financial reform proposals must be sensitive to the developing countries' different needs and aspirations as well as to the goals and interests of different groups within those countries.

The discussion in this paper will be organized into three main areas of contention: (1) what should be the proper mission and scope of the IMF as an institution; (2) whether there

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[1] See Blecker (1999) for a broad survey of such proposals and Eatwell and Taylor (2000) for the case for a World Financial Authority. For other critical discussions of international financial reform proposals, see Eichengreen (1999), Goldstein (2000), and Rogoff (1999).

[2] The Asian Policy Forum (APF) is a group of 17 research institutes from 14 Asian economies, with the Asian Development Bank Institute functioning in a coordinating role.

should be some kind of pre-qualification for IMF assistance, and if so how should it be structured; and (3) what kind of policy "conditionality," if any, should accompany the IMF's short-term lending. This analysis will be accompanied by brief discussions of several specific issues in the IMF reform debate, including social dimensions, burden sharing, exchange rate policy, capital market liberalization, and governance of the IMF itself. But first, the next section begins with a summary of some of the leading reform proposals for the IMF in the US and a discussion of how they compare with the proposals of the Asian Policy Forum.

II. Major Reform Proposals

Two major reports analyzing the performance of the IMF and suggesting needed reforms have been issued in the US since late 1999. One is the Council on Foreign Relations (1999) report on "Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture Report of an Independent Task Force," which was published by the Institute for International Economics (IIE) in September 1999 (hereafter referred to as the "CFR report"). The second is the report of the International Financial Institution Advisory Commission (2000), which was appointed by the U.S. Congress as a condition of the $18 billion IMF funding increase in 1998, and which is commonly known as the "Meltzer Commission" after its chair, Allan H. Meltzer. Both of these groups included many notable economists, business leaders, and policy makers representing a diversity of views, and each group's report included a number of dissents along with a statement of majority views. This section will begin by discussing these two reports in detail and will then turn to a discussion of alternative views.

The CFR task force was directed by IIE fellow and former IMF Deputy Director of Research Morris Goldstein,[3] and included numerous prominent individuals in the international financial arena.[4] The task force majority made six key recommendations:[5]

(1) the IMF should lend on more favorable terms to countries that meet certain standards of financial reform and adopt sound macroeconomic policies in order to reduce their vulnerability to financial crises, and should issue public "standards reports" on member countries as well as publish its Article IV economic assessments;
(2) the IMF should advise emerging economies with fragile financial sectors that liberalize capital inflows to impose Chilean-style restrictions on short-term inflows in order to moderate boom-bust cycles in capital flows and encourage more long-term inflows;
(3) the IMF should encourage greater burden sharing by international creditors and greater market discipline for investors through a variety of means including collective action clauses in government bonds,[6] improved deposit insurance for

[3] A new study of IMF policy by Goldstein (2000) was published too late to receive extensive comment in this paper, although some specific points from this study are cited below. Goldstein largely defends the recommendations of the CFR report, which he directed, as compared with those of the Meltzer Commission and other views.
[4] Other notable task force members included C. Fred Bergsten, Barry Eichengreen, Martin Feldstein, Carla Hills, Paul Krugman, Peter Peterson, William Rhodes, George Soros, Laura Tyson, and Paul Volcker. Hills and Peterson served as co-chairs. See the CFR report for a complete list of members.
[5] A seventh, less substantive recommendation is to convene an international meeting of finance ministers from developing countries as well as industrialized countries in order to build political momentum for reform.
[6] Many emerging market governments are concerned that such collective action clauses would be seen as an admission of financial fragility and hence would induce lenders to charge them higher risk premiums (spreads).

bank depositors, mandatory rescheduling of unserviceable debts, and possible temporary halts in debt payments during crises;

(4) the IMF should refuse to support adjustable peg exchange rates, and should instead encourage countries to adopt either flexible rates (including managed floats without explicit targets) or permanently fixed rates (e.g., currency boards or dollarization);

(5) the IMF should provide smaller rescue packages in cases of country-specific crises due to unsustainable domestic policies, while creating new facilities for additional lending with less conditionality than present programs in cases of systemic crises or contagion effects; and

(6) the IMF should be re-focused on its core area of competence, which is in regard to monetary and fiscal policies, exchange rate policies, and banking and financial-sector surveillance and reform, and its conditionality should be restricted to these types of policies; development and anti-poverty assistance should be handled by other organizations such as the World Bank.

Several members of the task force dissented on various of these recommendations and some of their alternative views will be discussed below.

The Meltzer Commission included a number of prominent economic critics of the IMF, such as Charles Calomiris and Jeffrey Sachs as well as Chairman Meltzer. The Commission's majority report, issued in March 2000, was scathing in its criticism of the IMF:

> The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations. Its system of short-term crisis management is too costly, its responses too slow, its advice often incorrect, and its efforts to influence policy and practice too intrusive.... Countries often face a long list of conditions that, if followed, would restrict the role of national political institutions and the development of responsible, democratic institutions. (pp. 17-18)

The report also charges that the IMF unnecessarily prolonged the 1980s debt crisis, causing massive economic losses and suffering, and that its interventions have "protected U.S. and other foreign banks, financial institutions, and some investors at great cost to the citizens of the indebted countries" (p. 50).

The Republican-led majority of the Meltzer Commission (joined by a few Democrats, most notably Sachs) called for drastically reducing both the scope of IMF intervention and the role of the World Bank in development finance, with a more strict separation between the missions of the two Bretton Woods institutions. The IMF would be restricted to short-term lending to developing countries in financial crises, plus certain informational and evaluative functions (i.e., gathering and disseminating economic and financial data and assessing countries' compliance with financial reform objectives). The Fund would cease lending for long-term development assistance, structural transformation, and poverty reduction. The World Bank would be transformed into a World Development Agency with a reduced mission of making grants (not loans) to poor countries for the provision of public goods, especially in sub-Saharan Africa and other regions lacking well-functioning regional financial institutions, while development finance in Asia and Latin America would be turned over exclusively to regional development banks. The majority report advocates abolishing all public development assistance to countries with access to private capital markets (as

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To address this problem, the CFR report recommends that all member governments, including those of the industrialized countries, should include collective action clauses in their government bonds.

indicated by an investment grade international bond rating) or with per capita incomes above US$4,000.

The majority of the Meltzer Commission supported some of the CFR task force's recommendations for the IMF, including a narrower focus on crisis management and prevention and a prohibition of IMF support for the defense of adjustable peg exchange rates. But the Meltzer majority report went much further in advocating radical restrictions on the IMF's policies and procedures, especially:

(1) the IMF would only be allowed to lend to developing countries and transition economies, not to industrialized nations, and all loans would be very short-term (maximum 120 days) at penalty interest rates;
(2) the IMF would no longer impose any policy conditionality as part of its lending activities, but instead would require countries to pre-qualify for assistance by meeting a strict set of financial and macroeconomic conditions with a five-year phase-in period;
(3) the preconditions for IMF assistance would include: allowing free entry and operation of foreign financial institutions, publishing complete information on countries' outstanding public debt liabilities, adequate bank capitalization, and a vaguely defined "proper fiscal requirement" to avoid large budget deficits, plus the avoidance of intermediate exchange rate regimes (adjustable pegs); and
(4) the only other functions that the IMF would retain would be "to collect and publish financial and economic data from member countries" and "to provide advice (but not impose conditions) relating to economic policy as part of regular 'Article IV' consultations" (p. 43).

The Meltzer Commission majority did not make any specific recommendations for debt rescheduling efforts or domestic financial system reform in emerging market countries, and seems to count on a reduced IMF role in bail-outs to effectively subject lenders to greater market discipline and to reduce moral hazard.

Several members of the Meltzer Commission issued heated dissents. A minority report written by C. Fred Bergsten and signed by several Democrats called for more limited reforms and larger global roles for both the IMF and World Bank. Bergsten's dissent defends the IMF as having played a positive role in ameliorating the recent financial crises and supports a more traditional approach to conditionality focused on monetary and fiscal policies, in place of the majority's proposal for pre-qualification. Among other things, the dissenting statement also opposes the majority's call for charging penalty interest rates on IMF loans and rejects the majority's blanket opposition to all types of managed exchange rates. The Bergsten dissent also rejects the radical changes at the World Bank proposed by the Commission majority.

The Meltzer Commission did reach unanimous agreement on two points, however:

(1) all of the international financial institutions (IFIs), including the IMF, should completely write off all debts of the highly indebted poor countries (HIPCs) provided that they implement "an effective economic and social development strategy in conjunction with the World Bank and the regional development institutions"; and
(2) the IMF should only make loans to provide short-term liquidity in crisis situations and should cease all long-term lending programs. (p. 4)

It should be noted that debt cancellation for the poorest countries is an essential step for releasing those countries from continuous IMF tutelage, as advocated by the Commission majority.

Earlier, in December 1999, US Treasury Secretary Lawrence Summers launched a preemptive strike against the expected conclusions of the Meltzer Commission. Summers

(1999) announced his own vision for more limited IMF reform, including: making member countries' financial information publicly available to private markets; paying more attention to financial vulnerability instead of just traditional macroeconomic policy fundamentals; restricting the IMF's role in bailouts with more efforts to keep private investors "bailed-in" and to arrange orderly debt reorganizations; putting greater emphasis on restoring growth in the design of conditionality; limiting conditionality to directly relevant economic and financial conditions; restricting the IMF to short-term, emergency lending in emerging markets, but allowing it to support the World Bank's anti-poverty efforts in the poorest countries; and institutional reform including a more representative governing structure, internal transparency, and openness to outside scrutiny and input.

More strident criticisms of the IMF have come from former World Bank Chief Economist Joseph Stiglitz, who published a stinging critique of the IMF's policies during the recent Asian crisis after he was forced out from the World Bank.[7] Stiglitz charged that the IMF prescribed inappropriate and counterproductive austerity policies for the Asian crisis countries as conditions of its bailout loans. He argued that the IMF applied misspecified economic models that ignored important characteristics of the Asian financial systems, such as the high debt levels of firms that made them extremely vulnerable to interest rate increases. He also claimed that the IMF was secretive, undemocratic, and unresponsive to outside criticism—even from its sister Bretton Woods institution, the World Bank. Stiglitz's critique of the IMF supplements that of many other leading academic experts (such as Martin Feldstein, Paul Krugman, Ajit Singh, Lance Taylor, and Robert Wade, in addition to Sachs),[8] but Stiglitz is unique in being an "insider" (albeit across the street at the World Bank) who ended up joining the "outsider" critics.

Regarding the political "outsiders," it is more difficult to obtain a definitive statement of their views since there is no single authoritative source, and there is much disagreement on priorities among different non-governmental organizations (NGOs).[9] Many of the more detailed proposals from these groups are directed more toward the World Trade Organization (WTO) or World Bank, rather than the IMF.[10] Indeed, many of these organizations seem uncomfortable talking about the technical economic and financial issues that have to be addressed by the Fund, such as exchange rate policies, banking regulation, or fiscal and monetary policies. Hence, there tends to be an emphasis among these groups on more political demands, such as calling for greater transparency, accountability, and democratic decision-making in all of these institutions. Among other things, the NGO groups tend to distrust governments, both in the G-7 and non-G-7 countries, and therefore seek direct input from "civil society" groups, labor unions, and environmental organizations into policy-making at all of the IFIs.

With regard to economic policies, perhaps the most specific recommendations that come from these advocacy groups are calls for new forms of IMF program assessment that would emphasize a broader set of objectives than simple financial stabilization *per se*. For example, a recent report from a group called the "Center of Concern" in Washington urges both the World Bank and the IMF to take account of the following social impacts in designing and evaluating their programs:

> Is adjustment reducing poverty and inequality? Are export incentives depleting the natural resource base? Are adjustment monies being recycled to service unpayable

[7] See Stiglitz (2000).
[8] See Blecker (1999) for a survey of these views.
[9] Since I discuss the views of the US labor movement in a separate section below, in this paragraph I refer mainly to non-labor NGO groups.
[10] See Alexander (1999) for a typical set of policy recommendations of the type described in this paragraph.

> debt? Are labor flexibility provisions undermining the rights of workers? Would privatization reduce access by the poor to basic education and health services?[11]

The Center of Concern recommends that the Bank and Fund "conduct Dynamic Assessments of loan operations in order to help ensure *positive benefits* to vulnerable social groups and eco-systems."[12] Another report from the same organization calls for

> A switch in adjustment program priorities that would result in income and employment *benefits* for low-income and marginalized groups and women, hence, minimizing the need for safety nets.[13]

How exactly the IMF could ensure positive gains for such groups in the midst of a financial crisis is, needless to say, not explained. Unfortunately, such wishful thinking about costless adjustment strategies permeates the economic recommendations in such reports. Nevertheless, concerns over the social and distributional effects of IMF policies is legitimate and the issue of how best to address these concerns is discussed further below.

The more radical anti-globalization protestors have, ironically, been even more vague in their demands about the IMF (except for those who simply call for abolishing it, which is at least a specific demand). Many protestors are deeply skeptical of the sorts of reforms sought by the NGOs, which are felt to be too easily co-opted by the Fund and other IFIs through "window-dressing" changes, such as posting documents on the internet or inviting NGO representatives to have dialogues with institutional officials. Some of the protest groups have endorsed certain particular demands, such as calling for 100% debt relief for the HIPC countries without having to comply with IMF policy conditions, or prohibiting the IFIs from requiring user fees for primary health care and education in their structural adjustment programs. But to date, the protestors have largely failed to put forward a positive vision of either how to change the IMF or else how to manage the global financial system without it.

A study that makes a number of specific proposals for "fundamental reform of the IMF" is a book by this author, *Taming Global Finance*, which was published by the Economic Policy Institute (EPI), a Washington think-tank (Blecker 1999).[14] My recommendations included:

- The IMF's mission should not be narrowly conceived as financial stability for its own sake, but rather financial stability should be sought as a means to the larger ends of macroeconomic prosperity and social equity.
- The IMF should not promote policies that encourage global deflation through the repression of aggregate demand and real wages in numerous countries simultaneously, as it did in the 1997-98 Asian crisis. Rather, the IMF should encourage member countries and especially the leading G-7 economies to inject adequate demand-side stimuli during systemic crises (e.g., through fiscal expansion or interest rate reductions) in order to prevent a global downturn.
- Since IMF policies inevitably have distributional consequences, it should take measures to ensure against exacerbating poverty and inequality in the design of its stabilization programs and conditionality. Core labor rights should be included along with other forms of social and economic standards (e.g., financial transparency, banking regulation, and environmental protection) in a broader

[11] Alexander and Grusky (2000), p. 33.
[12] *Ibid*., p. 34, italics added.
[13] Alexander (1999, p. 26), italics added.
[14] These proposals draw upon the ideas of Calomiris (1998), Feldstein (1998), Sachs (1998), Taylor (1998), Wade and Veneroso (1998), and other IMF critics.

vision of the types of reforms that developing and transition economies need to adopt in order to pre-qualify for international financial assistance.

- The IMF needs to be more open, transparent, democratic, and accountable. The IMF should publish more of its internal documents and country evaluations in order to make known the basis for its decisions and advice. All member countries should have more proportional representation in IMF decision-making. Outside peer review of IMF programs and policies should be conducted and the Fund needs to reevaluate its own policies and procedures in the face of outside criticism.
- The IMF should abandon its blanket support of capital market liberalization and allow developing countries and transition economies to maintain reasonable and appropriate capital controls (both inward and outward) as necessary to stabilize their finances and promote sustainable growth and more equitable development. Many countries may legitimately wish to postpone or limit capital market liberalization until their domestic regulatory and surveillance capacity are improved. Countries that do open their capital markets should use Chilean-style reserve deposits on short-term capital inflows.
- IMF loans should be rapidly disbursed to countries in crisis with minimal conditionality directly related to the conditions that fostered the crisis. The IMF should abandon its one-size-fits-all macroeconomic models and investigate the specific circumstances that fostered a crisis in a particular country, paying attention to the microeconomic structure of financial markets as well as any macroeconomic policy inconsistencies. The IMF should consult with member country economists and knowledgeable country experts in formulating stabilization plans, rather than imposing plans developed solely by its own staff. Conditionality for short-term lending should not include conditions related to long-term, structural reforms, and unrelated to the direct causes of the immediate crisis.
- Austerity measures such as fiscal cutbacks, monetary restraint, or increased interest rates should be used only to the *minimum* extent necessary to solve a *particular* balance of payments problem, and only if they respond to specific sources of a country's balance of payments disequilibrium and will not cause undue domestic economic hardship. Fiscal austerity should not be required in countries without large budget deficits, and interest rate increases should be avoided in countries where they could destabilize highly leveraged debt positions of business firms. Making creditors bear a larger share of the adjustment burden (e.g., through an international bankruptcy procedure) can reduce the need for austerity measures. Adjustment policies should be designed to get growth re-started as quickly as possible. Countries should be allowed and even *encouraged* to use temporary capital controls (like the Malaysian exchange controls) and to suspend payments to foreign creditors temporarily in crisis situations.

The *Policy Recommendations* of the Asian Policy Forum (APF) are, as noted earlier, not specifically addressed to changing the IMF. However, these recommendations include a number of proposals that are also included in some of the US proposals for IMF reform reviewed above, as well as some additional proposals reflecting distinctively non G-7 perspectives. The four main proposals that are shared with some of the US groups are:

- Managed floating exchange rates based on real exchange rate targets with a trade-weighted basket of foreign currencies, with nominal targets adjusted for inflation differentials; this is similar to the views of Bergsten's dissents to the CFR and Meltzer reports, as well as to Blecker (1999), but contrary to the CFR and Meltzer majority views favoring the "corner solutions" of either permanently fixed or freely floating rates.

- Discouraging volatile short-term capital inflows by using unremunerated reserve requirements and minimum holding periods, similar to some of the recommendations of the CFR report and Blecker (1999), and also endorsed by Eichengreen (1999).
- Measures to bail-in private creditors and to facilitate orderly debt relief and restructuring, including collective action clauses in bond contracts allowing for (1) collective representation of creditors, (2) majority action to alter payments terms, and (3) sharing of payments among creditors; all of which is also endorsed by the CFR report but not by the Meltzer Commission majority.
- Enforcing best practices in prudential regulation and banking supervision, along with public disclosure requirements for banks, non-bank financial institutions, and the corporate sector; this is consistent with virtually all official and unofficial G-7 views of a new financial architecture and is specifically endorsed by the CFR report, the Meltzer Commission, Eichengreen (1999), and Blecker (1999), among many others.

In addition, the APF makes four other recommendations which are either not emphasized by or not endorsed by many groups in the G-7 countries. These include the following:

- Developing more liquid domestic capital markets, especially corporate bond markets, in order to lessen dependence on bank finance of investment; this is not contrary to any G-7 proposals, but few G-7 organizations have emphasized the importance of such a transformation for the Asian emerging market economies;
- Small emerging market economies should be allowed to restrict holdings of domestic currency by non-residents, including possibly freezing non-resident use of domestic currency holdings in crisis conditions, in order to discouraging speculative attacks; this is not accepted by many G-7 groups or by most of the US reports on IMF reform cited here, although it is partly consistent with the endorsement of Malaysia's foreign exchange restrictions in my previous study (Blecker 1999) and with the CFR report's endorsement of temporary payments suspensions.
- The Asian economies should create a Regional Financial Arrangement (RFA) that would mobilize regional financial resources for lender-of-last-resort interventions and also provide surveillance of financial reforms and macroeconomic policies in the Asian economies, as a supplement to the IMF's role in these areas; regional institutions of this type are endorsed by Blecker (1999) but not in either the Meltzer or CFR reports.[15]
- Finally, for countries that have not substantially opened their capital accounts, the APF continues to endorse adjustable peg exchange rates, although it advises such countries to prepare for eventual capital market liberalization through prior reforms such as sound macroeconomic policies and strengthened banking systems; the continuation of adjustable pegs is not endorsed by any of the major US reports or even in the dissents, which tend to favor other types of managed exchange rates such as crawling bands, but the idea of preparing for capital market

[15] The Meltzer Commission majority report endorses regional institutions for long-term development lending, but not for short-term lender-of-last-resort intervention. Regional efforts at solving the Asian crisis in the fall of 1997 were strongly discouraged by the US Treasury and IMF. Mead and Schwenninger (2000) have endorsed the creation of regional central banks, which would not only function as local lenders-of-last-resort but would also issue regional currencies in lieu of national currencies.

liberalization through prior internal reforms is consistent with the new emphasis on "orderly" or properly sequenced capital market liberalization now being advocated by the IMF and US Treasury as well as with most of the academic literature on financial liberalization.

This, then, is the political context in which IMF reform is currently being considered and the range of ideas that are included in the reform debate. In order to evaluate these proposals, I shall organize the discussion around a series of issues, beginning with the basic question of the scope and mission of the IMF as an institution.

III. The IMF's Role and Mission

The first and most fundamental issue is how the IMF's role and mission should defined, and whether it should be given more limited or more expansive responsibilities. As all observers agree, the IMF has evolved from its original role as an institution that lent to countries (mostly industrialized countries) with short-term balance-of-payments problems under the Bretton Woods system of adjustable pegged exchange rates during the 1944-73 period. Since the demise of the Bretton Woods exchange rate system in 1973, the IMF has turned into a multi-faceted organization, which lends to developing countries and emerging markets with short-term balance of payments problems, and also engages in long-term conditional development lending (to support structural adjustment programs), various forms of policy monitoring and advising (e.g., banking sector reform and labor market flexibility), and new types of specially targeted lending (e.g., poverty reduction and contingent credit lines). Through these various channels, the IMF has assumed the role of dictating economic policies in a wide range of areas to a large number of countries. As a general rule, IMF intervention in the emerging market countries is sporadic in response to short-term crises, while IMF intervention in poorer, less developed countries has often been for prolonged periods of time (e.g., decades)—generally without noticeable long-term improvement in those countries' economic welfare.

There is a broad consensus in most of the reports and studies surveyed above that the IMF should have a more narrowly defined mission, with less overlap with the World Bank and other development agencies. The Meltzer Commission majority recommends a narrower and more streamlined IMF that would function mainly as a "quasi lender of last resort" to emerging economies that are fundamentally solvent. The IMF would only be allowed to make short-term loans in response to liquidity crises in these countries, and would no longer be allowed to lend to industrialized countries or to engage in long-term development lending.

> Transformation of the IMF into a source of long-term conditional loans has made poorer nations increasingly dependent on the IMF and has given the IMF a degree of influence over member countries' policymaking that is unprecedented for a multilateral institution. Some agreements between the IMF and its members specify scores of required policies as conditions for continued funding. These programs have not ensured economic progress. They have undermined national sovereignty and often hindered the development of responsible, democratic institutions.... (pp. 28-29).

The CFR report agrees that the IMF should give up its long-term development and anti-poverty assistance functions, although it would place less restrictions on the countries to which the IMF could lend (e.g., it would not rule out future loans to industrialized member countries) or the conditions under which it would make loans (more on this below). But both reports concur that the IMF should be more focused on a core set of responsibilities related to financial stability, macroeconomic policy, and country monitoring.

Ironically, virtually the only groups that seek an even broader mission for the IMF are some of the socially oriented NGOs. Some of their demands would require the IMF to become much more deeply involved than it is at present in activities such as long-term poverty reduction, social and environmental impact assessment, extensive consultations with civil society groups, design of "social safety nets," and so on.[16] These groups offer no explanation of how a bastion of conservative financial management like the IMF could be transformed into a global social service agency, or why they want it (as opposed to other, more specialized agencies) to become one. Ironically, many of these same groups often have little to say about IMF's core function of helping countries correct balance of payments problems, and offer few concrete suggestions on how Fund-sponsored balance of payments adjustment could be made more consistent with social objectives (while still being effective in stabilizing the balance of payments).

I think that the case for shrinking the role and narrowing the mission of the IMF to core financial and macroeconomic objectives is overwhelming. There is no evidence that the IMF has been successful as a long-term development or anti-poverty agency, nor any reason to expect it to become so. If anything, the IMF's financially-oriented policy approach—with its emphasis on fiscal restraint, inflation control, and investment liberalization—has often proven inimical to promoting the type of equitable economic growth without which long-run development and poverty reduction cannot take place. Moreover, if the IMF is distracted by too many responsibilities, it can only be hindered from achieving what should be its core objective of preventing financial crises from occurring and lessening their socially harmful consequences when they do occur. Although the IMF has much room for improvement in regard to crisis prevention and management, it will be less likely to make the necessary improvements in those areas if it is also juggling a wide range of other policy initiatives at the same time.

Anti-poverty support and long-term development assistance for poor countries should be carried out by a specialized and competent set of international institutions, not by an organization whose main concern and expertise is in the area of financial stability and macroeconomic policy. Just as we do not expect a central bank or treasury department to be in charge of social welfare, environmental, or labor policies within a country, it makes no sense to expect an international lender-of-last resort to assume such functions internationally. As the Meltzer Commission notes, the addition of the Poverty Reduction and Growth Facility to the IMF's programs makes the IMF "responsible for monitoring and setting conditions for virtually all aspects of developing countries' economic and social policies" (p. 37). Although a full discussion of proposals for the World Bank would be beyond the scope of this paper, suffice it to say that it (along with regional development banks) is a more reasonable candidate for overseeing long-term development and anti-poverty efforts in developing countries—and that the Meltzer Commission majority's proposals for truncating the functions of the World Bank go too far and would eviscerate its ability to pursue these goals.[17]

It is important, however, not to go too far in narrowing the scope of the IMF's mission. As the CFR report reminds us,

> *financial stability is not an end in itself but rather a means to broadly shared prosperity and ... it is a fantasy to believe that financial stability can be maintained*

[16] See, e.g., Alexander (1999).
[17] See dissenting statement of C. Fred Bergsten et al. and separate dissenting statement of Jerome Levinson in the Meltzer Commission report.

without attention to the social aspects of development. (italics in original)[18]

The IMF's mission should therefore be to promote financial stability as a means to the larger ends of sustainable and equitable economic growth. This is similar to the role originally foreseen for the Fund by John Maynard Keynes and Harry Dexter White in the 1940s, albeit in the changed circumstances of the 2000s. Too often in the past the IMF has prioritized only a narrow vision of financial stability—essentially, whatever pleases financial markets and foreign lenders—at the expense of sacrificing economic growth and employment objectives in the country nominally receiving its assistance. All too often, IMF policies have been successful in the narrow sense of stopping a balance of payments crisis and stabilizing a nation's currency, at the cost of provoking a prolonged period of depressed economic activity, fallen real wages, heightened inequality, and stagnant growth. In effect, IMF "bail-outs" often rescue the creditors rather than the debtors, with the adjustment burden falling hardest on the poorest and most vulnerable members of the debtor societies who had no part in creating the financial crisis in the first place.

The purpose of financial markets is supposed to be to finance real economic activity by serving as intermediaries between ultimate savers and ultimate investors (i.e., business firms accumulating productive capital). If "confidence" is restored in ways that do not facilitate the recovery of productive investment and real growth, then the financial stabilization has been misdirected. Moreover, it is in regard to growth and employment effects that the distributional impact of IMF policies must be assessed. Equity concerns arise naturally in the context of how the gains from growth (or the costs of adjustment) are shared among different groups in a society. Alternative economic stabilization and growth policies inevitably have distributional implications and, as a result, the impact of IMF policies (like any other macroeconomic policies) cannot be distributionally neutral. To pretend otherwise is to obscure the fact that certain types of stabilization policies can be biased in the direction of exacerbating inequality by distributing the costs of adjustment widely while bailing out those wealthy interests (including foreign investors) who were most responsible for causing a crisis in the first place. As a consequence, equity issues cannot be ignored in framing the IMF's mission, which should be to promote *equitable* growth and *widely shared* prosperity. This does not mean that the IMF must convert itself into an anti-poverty or development agency, but it should imply that IMF policies be designed in ways that enhance these goals rather than protecting elite interests at the expense of the rest of society (or, foreign creditors at the expense of domestic citizens).

Finally, there is no principled reason to exclude all industrialized countries from the scope of future IMF lending. It is true that few industrialized countries are likely to need IMF loans in view of the general switch to floating exchange rates since 1973. The Meltzer Commission majority is certainly correct in observing that "the central banks of *large*, industrial countries should continue to function as lenders of last resort for their own currencies and financial systems" (p. 44, italics added). But it is not inconceivable that smaller industrial countries might require IMF assistance in a future global financial crisis, and it seems foolish to rule out the possible need to respond to such an eventuality *ex ante*.

[18] The CFR report was downloaded by the author from the internet (see References). Therefore, page numbers are not given for quotes from this report. Quotes can be located and verified by searching the downloaded report.

IV. Pre-qualification and the "Good Housekeeping Club"

A common element in both the CFR report and the Meltzer Commission majority report is the notion of requiring countries to meet certain standards in order to pre-qualify for borrowing privileges at the IMF. The CFR task force refers to this as "joining the 'good housekeeping club.'" The notion of pre-qualification is consistent with an IMF mission that includes promoting financial stability and sustainable growth. Since under normal circumstances the IMF can only influence policies in a country that has already come to it for assistance in a crisis situation, the goal of preventing financial crises can only be addressed if the IMF gains some leverage over countries' financial policies *before* a crisis erupts. Hence, inducing countries to meet sensible pre-qualification standards could help to make both individual countries and the global economy more immune to financial crises.

However, the two reports differ strongly on the nature of the standards that countries would have to meet and the benefits that they would receive from pre-qualification. The Meltzer Commission majority would require countries to prequalify only with certain particular types of financial sector "reforms," including complete openness to foreign financial institutions as well as transparency measures and increased bank capitalization standards. In addition, countries would have to maintain pre-approved macroeconomic policies including no "irresponsible" budget deficits and no managed or pegged exchange rates (only the "corner solutions" of freely floating or rigidly fixed nominal rates would be allowed). After a five-year phase-in period, only countries that prequalified in this way would be eligible for any IMF loans. The loans would then have no specific policy conditionality attached and could be rapidly disbursed, but they would be very short-term with penalty rates (i.e., above-market interest rates) and would be secured by a priority claim on the borrowing country's assets.[19] Thus, in the Meltzer Commission's view, countries would have to pre-qualify in order to receive any IMF assistance at all, and even then would have to pay penalty rates for IMF loans, but the loans would be as large as needed to stop a speculative run and would have not other conditionality attached.

The Meltzer Commission majority's view of pre-qualification for lender-of-last-resort assistance from the IMF is based on a curious revival of a 19th-century view of lender-of-last-resort intervention in banking due to Bagehot (1873), which has never found much practical application anywhere. As one critic notes:

> Purists like Meltzer ... [argue] that a true lender of last resort must employ the classic Bagehot rules: Lend freely, to temporarily illiquid but solvent banks, at penalty rates, and using collateral that would be good under noncrisis circumstances. But this claim is naïve. Most modern lenders of last resort do not scrupulously follow any of Bagehot's time-honored prescriptions.... They are often gamed into rescuing institutions that are permanently insolvent, not just temporarily so. They seldom charge significant penalties, precisely because they are trying to strengthen the troubled bank's balance sheet. And whereas Bagehot would have lenders of last resort require collateral that would be good under ordinary circumstances, this advice is not always practical. It is often very hard to assess the value of highly specialized liquid assets in times of crisis.[20]

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[19] This idea of a "priority claim" is intended to substitute for the use of collateral in the original Bagehot (1873) approach to lender-of-last intervention, which is discussed further below.

[20] Rogoff (1999, p. 29, references omitted). Rogoff is referring to Meltzer's own views, as expressed in 1998 Congressional testimony, but these same views seem to have been enshrined in the Commission majority report.

It seems extremely dubious to insist that the IMF should be required to apply highly theoretical standards for lender-of-last-resort intervention internationally that are not followed in practice by ordinary central banks inside individual countries.

Goldstein (2000) observes that the motivation for the penalty interest rates in the Meltzer-Bagehot approach is to discourage countries from borrowing from the lender of last resort in order to reduce moral hazard problems. However, Goldstein points out that "we don't observe emerging economies tripping over themselves in a rush to come to the IMF at the first sign of balance-of-payments trouble. Instead, ... countries come to the Fund late in the game." Thus, he concludes that the IMF's non-penalty interest rates (which are undoubtedly lower than the rates that countries could get in private markets during a crisis, assuming they could get any funds at all) are not fostering overuse of IMF lending facilities. Furthermore, Goldstein points out that the policy conditionality attached to IMF loans effectively raises their social cost to countries, over and above the explicit interest costs. Although the Meltzer Commission majority would abolish such conditionality, Goldstein (like the CFR task force) supports a modified version of conditionality and argues that other reforms (e.g., reducing the size of IMF loans and shortening their maturity and repayment periods) are better ways of dealing with moral hazard concerns.[21]

In contrast, the CFR report offers a positive incentive for pre-qualification: countries that meet the "good housekeeping" standards would receive loans on more favorable terms than other countries—not loans at penalty rates. In other words, the CFR task force would rely on "carrots" rather than "sticks." It seems more sensible (and politically realistic) to offer positive incentives for countries to want to meet the pre-qualification standards, rather than threatening to cut them off entirely if they don't—and then penalizing them anyway. Although the CFR report is not very specific on what "more favorable terms" means, it could refer to lower-than-market interest rates or less stringent conditionality (possibly even no conditionality) with more rapid disbursement of funds.

There are several problems with these pre-qualification schemes, however. First, it is not credible that strict pre-qualification requirements will be enforced in a crisis involving an important country or a possible systemic threat. This problem of credibility is especially severe in the case of the Meltzer Commission approach, in which countries that fail to pre-qualify would be cut off from IMF lending altogether. In a crisis situation involving one or more major countries that have not pre-qualified, there will inevitably be a pressure to bail out the affected countries anyway—especially if the crisis appears to be systemic. Who will care if country X has opened itself up to foreign banks or if country Y has imposed Chilean-style reserve requirements on short-term capital inflows, if a collapse of its financial system could contribute to a global economic meltdown?

In fact, the Meltzer majority report recognizes this problem when it writes, "*Except in unusual circumstances,* where the crisis poses a threat to the global economy, loans would be made only to countries in crisis that have met pre-conditions that establish financial soundness" (p. 7, italics added).[22] However, this is a loophole big enough to drive a Mack Truck through. The more reckless a country is in its financial policies, and the greater the threat it poses to global stability, the more it can hope to obtain an "unusual circumstances"

[21] The Meltzer Commission majority supports very strict time limits on IMF loans, i.e., a maximum of 120 days for repayment. Goldstein argues, convincingly, that such an arbitrary restriction is inappropriate in many crisis situations. However, the Meltzer majority also supports very large IMF loans to countries that meet its prequalification criteria, far in excess of the amounts of funds used in the recent financial crises. Goldstein rightly regards these large loan amounts, with no policy conditionality, as unrealistic.

[22] This qualification also appears on p. 43 (except that the word "crisis" is replaced by "crises"). However, in somewhat contradictory fashion, the report also says that in the case of "extraordinary events," countries would have to rely on "vehicles other than the IMF" (p. 47).

exception that would allow it to borrow without having pre-qualified. And one can be sure that the political pressures to grant such an exception will often be overwhelming, especially if a country is considered "too big to fail." Thus, the Meltzer approach could actually lead to greater financial instability, if it induced many countries to avoid taking the necessary steps to reform their own financial systems. The CFR approach, in contrast, is much more likely to be credible, since it only requires that countries that fail to pre-qualify would receive loans on less favorable terms, not that they would be prohibited from borrowing from the IMF at all.

A second objection is that no eligible countries would seek to pre-qualify anyway. Borrowing countries fear that any announcement that they would try to pre-qualify would send the wrong signal to financial markets (i.e., that they are not creditworthy borrowers) and hence could lead to a cut-off of lending or at least increased borrowing costs. Furthermore, any country that succeeded in pre-qualifying would run the risk of subsequently failing to meet the criteria and being removed from the "good housekeeping" list, a circumstance that would be virtually guaranteed to spark an investor panic and a withdrawal of lending. Finally, most countries would not be willing to tolerate the degree of IMF control and supervision that would be required to monitor a prequalification agreement. These are all serious concerns, especially in light of the fact that the IMF's one existing pre-qualification scheme — the contingent credit line (CCL) — has yet to find any takers.

In part, the disagreement over pre-qualification schemes is political. All of the proposals for pre-qualification have come from the United States. Developing and emerging market nations are naturally reluctant to agree to US-defined standards of "good housekeeping." Moreover, they have enough experience with the fickle whims of international investors to be wary of any policy announcements that could undermine confidence in their economies.

Nevertheless, pre-qualification makes sense in principle as a means of inducing the enactment of reforms that can prevent future financial crises or make them less severe when they occur. This can be of benefit both to the individual countries that pre-qualify as well as for global systemic stability. What is required, then, is to design pre-qualification in a way that addresses the legitimate concerns of developing and emerging market countries. This in turn requires action in two areas: first, removing the stigma of pre-qualifying, and second, designing appropriate and flexible pre-qualification criteria that the countries can accept and which are not simply dictated by the US or IMF staff. These two problems can be addressed simultaneously by engaging a large number of leading emerging market nations in the negotiation of pre-qualification standards, and having them commit to pre-qualify jointly and simultaneously so that no individual nation is seen as admitting some sort of country-specific problem when it seeks pre-qualification. Also, pre-qualification criteria should be focused on reforms that are likely to be permanent (e.g., banking reform legislation), rather than short-term macro policies that could easily be reversed (e.g., specific fiscal targets), in order to reduce the risk of pre-qualified countries later becoming unqualified.

In regard to the content of the pre-qualification standards, the only areas on which the Meltzer and CFR majority reports concur are in regard to transparency and disclosure requirements, sound macroeconomic policies (avoiding large budget deficits), and exchange rate policies (discouraging adjustable pegs). Otherwise, the CFR task force's notion of "good housekeeping" appears to be more carefully targeted on policies that could directly help to avoid future financial crises, such as: careful debt management that discourages large short-term obligations in foreign currencies; compliance with international standards for disclosure of financial and economic data; improved prudential regulation of domestic banks and other financial institutions; the maintenance of adequate foreign exchange reserves by central banks; creating systems of deposit insurance for small depositors that shift the burden of bank failures onto private shareholders and uninsured large creditors; and including collective action clauses in government bond contracts in order to facilitate debt rescheduling. This is a much more comprehensive and relevant set of steps that a country can take to avoid financial crises, compared with the Meltzer Commission's narrow focus on adequate bank capitalization and allowing foreign ownership of financial institutions.

However, there is one area of pre-qualification in which the Meltzer Commission is stronger than the CFR task force, namely transparency standards. The Commission majority would require that "every country that borrows from the IMF must publish regularly the maturity structure of its outstanding sovereign and guaranteed debt and off-balance-sheet liabilities in a timely manner" (p. 45, bold omitted). This would give lenders "accurate information on the size of short-term liabilities," which they could use "to assess properly the risks that they undertake" (*ibid*.). This is more specific and demanding than the CFR report's general admonition for countries in the "good housekeeping club" to comply with "international standards for good public disclosure of economic and financial data." It also seems prudent in regard to increasing the amount of information available to creditors so that they can make a proper risk assessment before investing in a particular market.

If one puts together the CFR report's good housekeeping standards and the more reasonable parts of the Meltzer Commission's recommendations, what one has is a set of steps that countries with liberalized financial markets can take in order to insure themselves against excessive risk-taking and the build-up of unsustainable financial positions. In effect, then, pre-qualification along these lines simply requires countries with open capital markets to take the requisite safety measures that they should take in order to protect against undue financial volatility. Whether emerging market countries agree to accept pre-qualification standards or not, it is important that they move in the directions indicated by the pre-qualification proposals (especially those of the CFR) if they want to maintain open short-term capital markets. Countries that are unwilling or unable to take such measures should keep their financial markets closed to short-term capital inflows, and the IMF should not pressure them to open those markets unless and until they have put in place adequate prudential standards and regulations. It should not be an acceptable option for countries to open their capital markets to short-term financial flows while failing to take the steps needed to avert the risk of financial crisis, and the IMF should no longer support that option or bailout countries that choose it.

At the same time, the point about needing to engage eligible countries in the negotiation of pre-qualification standards and overcoming their fears of financial market reactions needs to be borne in mind. It makes no sense to construct a comprehensive set of standards that no country will be willing or able to meet. Thus, instead of the IMF dictating pre-qualification criteria, it should rather establish a broadly inclusive negotiating process that can arrive at a set of realistic and appropriate standards that countries are willing to agree to, and which can then serve as the basis for a more positive attitude toward pre-qualification on the part of both borrowing countries and international lenders. For this reason, I do not endorse a specific set of pre-qualification criteria here, but rather suggest that the standards be established through negotiations among all the affected countries.

Before leaving this topic, the Meltzer Commission's proposal for including freedom of entry for foreign banks as a pre-qualification criterion deserves special critical comment. The Commission majority report claims that this will enhance financial stability because foreign financial institutions hold more diverse portfolios of loans than their domestic counterparts, and hence help to diversify risk on an international scale. The Meltzer view also seems to assume that foreign banks will self-regulate themselves better than national banks.

However, the Meltzer majority view does not take into account the potential negative consequences of foreign multinational banks on domestic banks, small national firms, and the distribution of credit in emerging market countries. As Christian Weller concludes from several studies of multinational banking in the transition economies,

> In their operations, MNBs [multinational banks] focus on a select range of activities for a small circle of clients.... MNB clients are usually MNCs [multinational corporations] or large domestic corporations engaged in international transactions. In addition, MNBs also provide services for high-income earners, or what [are] referred to as high net-worth individuals.... Retail banking services, such as small checking and savings accounts, mortgages, or small business loans, are rarely emphasized by MNBs, despite their claims to the contrary.... [as a result], increased competition from MNBs leads domestic banks to reduce their loan exposure.... The fact that domestic banks lower their credit exposure is driven by the fact that MNBs "cherry pick" the best customers, leaving domestic banks with borrowers of lesser quality. As a result, both the costs and credit risks at domestic banks increase, while good, low-cost customers move to MNBs.[23]

In light of these problems, it seems inappropriate to force countries to accept foreign banks and multinational financial institutions as a pre-condition for receiving IMF assistance or even as part of "good housekeeping" standards for loans on more favorable terms. This is not to say that openness to foreign banks is necessarily bad. Foreign ownership can sometimes play a positive role, especially for recapitalizing banks with weak balance sheets (similar to allowing bigger banks to buy up failed smaller banks within a country). The point, rather, is that allowing free entry for foreign banks creates costs as well as benefits, both of which have to be weighed by national policy makers. The issue of openness to foreign financial institutions, along with other aspects of financial liberalization, should be considered in light of how it would contribute to domestic economic development goals, including distributional issues as well as financial stability. This should be an issue for individual countries to decide — not something imposed by the IMF, and certainly not a pre-qualification standard for IMF assistance.

V. Social Dimensions and Labor Rights

One of the thorniest controversies about the IMF is whether it should incorporate various sorts of social standards into its lending conditions and country programs. As noted earlier, many NGO critics have proposed injecting a variety of social standards into IMF policy, including human rights, labor rights, environmental protection, poverty reduction, and distributional equity. From a political perspective, recent history in the US suggests that broad-based support for funding the IFIs may be contingent on greater attention to these social dimensions of international trade, investment, and finance. Hence, those who are concerned about IMF reform from an emerging market perspective need to take these issues seriously and not simply dismiss them out-of-hand as disguised protectionism. The discussion in this section will focus mainly on labor rights, which have received the most attention in regard to the IMF, although the same principles apply to other social concerns.

Two dissenters — one each on the CFR task force and Meltzer Commission — issued separate statements calling for the promotion of labor rights within all the IFIs. Ray Marshall argued in a CFR dissent that international institutions should avoid encouraging global

[23] Weller (2000a, pp. 3-4), which summarizes the results of research published separately in Weller (1999, 2000b, 2000c) and Weller and Scher (1999).

competition based on low wages and substandard working conditions, and that respect for human rights and democratic freedom is essential to the success of economic reform:

> Core labor standards are important because global economic integration has caused the basic economic and equity rationales for labor standards to apply to international as well as domestic markets. The equity rationale is to protect workers, especially the most vulnerable, from exploitation and the most adverse consequences of competitive markets. The economic efficiency rationale is to cause competition to improve efficiency, not to depress basic labor standards.[24]

Marshall called for the formation of a joint working group of the World Bank, IMF, and International Labor Organization (ILO) to explore the links between core labor standards[25] and international financial transactions, and also supported the Clinton administration's demand for the formation of a WTO working party on international labor standards.

On the Meltzer Commission, Jerome Levinson argued that the global economy requires a "new social compact ... that balances minimum standards of equity with economic efficiency criteria and national sovereignty."[26] He noted that the IMF and other IFIs have promoted labor market "flexibility" in the name of economic reform, and argued that such flexibility can weaken workers' bargaining power and lead to a more unequal distribution of income unless balanced by an offsetting enforcement of core labor rights. Specifically, Levinson called for the U.S. representatives at all the IFIs to vote against any financing "for countries that are egregious abusers of core worker rights," where core worker rights are defined as including the right to freedom of association (i.e., to form independent trade unions) and the right to collective bargaining.[27]

In evaluating these arguments, it is important to bear in mind that IMF policies inevitably have profound social and distributional effects, including impacts on labor, poverty, inequality, and the environment, as well as on more standard macroeconomic and financial indicators. In this respect, the critics have a valid point about the need for the IMF to avoid fostering undue harm in these areas. The question, however, is how such concerns should be addressed operationally: as part of pre-qualification criteria, as part of lending conditionality, or in some other way? Addressing this question is vital for considering how social concerns can be institutionalized in the IMF's operations.

In the pre-qualification approach, social standards such as core labor rights could be added to the definition of what it means for a country to belong to the "good housekeeping club." Respect for human rights, including core labor rights, makes a positive contribution to the economic objective of promoting rapid, sustainable, and equitable economic growth. A country with social stability guaranteed by the respect for human and labor rights is also less likely to have a political meltdown in the event of a financial downturn (as one can see, for example, by comparing the outcomes of the Asian crisis in Indonesia and Korea). Democratic freedoms give workers and other citizens the ability to influence national policymaking in ways that can counteract the otherwise overwhelming pressures from corporate and financial interests, and thus lead to a more balanced approach to economic policymaking. One researcher has found empirical evidence that (i) improvements in countries' labor standards are associated with increased subsequent growth rates; (ii) higher labor standards are

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[24] Dissent of Ray Marshall, CFR Report (see note 18 above regarding page citations to this report).
[25] Marshall defines core labor standards as including the right to free association, collective bargaining, strike, workplace safety, minimum wages, prohibition on forced labor, and limits on child labor.
[26] Separate Dissenting Statement of Jerome I. Levinson, in *Report of the International Financial Institution Advisory Commission,* p. 172.
[27] *Ibid*, p. 133. Note that this is somewhat more narrow than Marshall's definition (see note 25, above).

associated with greater democracy, reduced corruption, and more secure contracts; and (iii) higher labor standards are associated with higher per capita GDP, even after controlling for other economic and political factors.[28] Thus, if the IMF's mission is to promote equitable and sustained long-term growth, it makes sense in principle to incorporate labor rights and other human rights into the set of criteria that countries should follow in order to pre-qualify for preferential IMF lending.

A common argument against including such social standards in international agreements is that they interfere with national "sovereignty" in these areas. It is important to dispense with this argument, which is simply a "red herring." All international agreements and institutions, insofar as they have any binding authority over member countries, necessarily interfere with sovereignty. This is true whether in regard to trade barriers, investment rules, intellectual property rights, banking standards, industrial subsidies, or any other subject of current international agreements. There is no principled reason why "sovereignty" should be respected in regard to, say, violations of core labor rights (e.g., child labor laws and freedom of association), but not in regard to, say, violations of intellectual property rights (e.g., copyrights and patents).

The conditions under which goods are produced affect international trade and investment just as much as the conditions under which the goods are sold. Moreover, there are citizen groups and labor organizations in many developing countries which would like to see these types of social standards enforced, even if their governments or employers do not. Thus, the most common argument against including social issues in international agreements or institutional criteria is simply indefensible. In fact, many countries around the world are signatories to the International Labor Organization (ILO) conventions that define core labor rights, and for these countries respect for those rights is something they have already agreed to maintain.

However, adding social dimensions into the IMF's pre-qualification criteria could worsen the problem of asking the IMF to do too much and stretching its mission in too many directions. It also increases the probability that many governments will simply refuse to meet the pre-qualification requirements, preferring to take the risk of less favorable treatment from the IMF in exchange for preserving greater autonomy over domestic financial and social policies. The more conditions that are attached to any pre-qualification scheme, the less likely it is that countries will choose to meet them. Most countries have refused to negotiate over labor rights in the WTO (where they are more closely linked to trade issues) already, and few would be willing to include them in pre-qualification criteria at the IMF in the foreseeable future. The end result would then be to leave the global financial system more vulnerable to future crises, without promoting the social objectives anyway.

These are genuine problems, as distinct from an abstract (and inconsistent) insistence on preserving "sovereignty." Yet, to leave out these other dimensions of pre-qualification creates another risk, which is that IMF policies could continue to be biased in directions that unduly lower wages, worsen inequality, injure the poor, and hurt the environment. Thus, it seems critical to find a way out of this impasse. Some solutions can be found in redesigning the conditionality attached to short-term IMF lending, as discussed in the next section. But it is also important to think about alternative ways to incorporate social standards into the IMF's policy deliberations.

One principle should be that the IMF, given its narrower mission as defined above, should not take the lead on social and environmental standards. Rather, as these issues are negotiated in other, more appropriate fora, such as the WTO and World Bank, compliance with internationally accepted social rights and standards could become integrated into the

[28] See Palley (1999, 2000a, 2000b).

IMF's pre-qualification criteria. A second and related suggestion is that the IMF should count on other specialized, independent agencies to assist it in judging whether countries meet non-financial or non-economic types of social standards. For example, the ILO should be consulted in regard to whether countries meet internationally accepted core labor rights. The World Bank might be able to play a similar role in regard to social safety nets policies, provided that it developed a more credible oversight capability in this area than it has to date. No international environmental agency yet exists, but as international agreements are reached in this area they may establish an institutional framework that could determine standards for the IMF and other IFIs.

A third principle is the need to engage civil society groups from developing countries (e.g., labor unions, community organizations, and environmental groups) as well as developing country governments in the negotiation of internationally accepted social standards in these areas, so that they are not seen as disguised forms of protectionism imposed by interest groups in the industrialized nations. For example, independent labor unions in developing countries, where those exist, could help to negotiate core labor rights that all countries should agree to respect, while leaving other issues of labor standards (e.g., minimum wages) for individual countries to decide. Such consultations and social criteria make more sense as part of long-term pre-qualification for preferential IMF lending, rather than as part of short-term crisis relief efforts in which it is imperative to move quickly and flexibly.

If it turns out to be politically premature to inject social standards and labor rights into the pre-qualification criteria for preferential IMF lending, in the sense that no international agreement can be reached in this area, then there are other, fall-back approaches that can be used to try to achieve some of the same objectives. For example, if the IMF and World Bank's promotion of labor market flexibility is undermining workers' bargaining strength vis-à-vis employers, and if it is not politically feasible to make respect for core labor rights a condition for IMF assistance solution, then an alternative solution is to get the IMF out of the business of dictating labor market policies altogether, i.e., ban it from promoting labor market flexibility. Furthermore, even within a more narrow conception of its mission, the IMF can reasonably be asked to protect workers and poor people from unnecessary injury by trying to minimize (rather than exacerbate) the negative income and employment effects of financial crises, through the redesign of conditionality in stabilization programs (as discussed in the next section).

Also, although this may only be feasible on an *ad hoc* basis, it may sometimes make sense simply to deny IMF assistance altogether to a country whose government is engaging in egregious violations of basic human rights, such as when the IMF cut off lending to Indonesia in response to gross human rights violations in East Timor in 1999. This principle could be extended to encompass gross violations of core labor rights. The difficulty lies in deciding where to draw the line, i.e., when are abuses of human or labor rights so "egregious" (to use Levinson's term) that the IMF should cut off lending. Still, such *ad hoc* actions, while falling short of ideal, long-term solutions, establish important precedents for transforming the IMF into a more socially responsible institution.

Finally, one suggestion that might be less objectionable than including labor rights in pre-qualification criteria would be to include respect for internationally recognized labor standards (i.e., ILO conventions) in the IMF's Article IV reviews and its new surveillance reports.[29] The Fund would not make its own judgments in this area, but would simply report the findings of an independent international agency (i.e., the ILO) on compliance with internationally accepted labor rights along with its findings on compliance with other types of

[29] This suggestion comes from private conversations with labor movement activists in the US.

international standards. This would hopefully put pressure on member countries to comply, and would at least elevate respect for labor rights and standards onto a more equal plane with other types of international economic and social norms.

VI. Conditionality in Short-Term Lending

The conditions attached to IMF program lending — which countries agree to uphold in so-called "letters of intent" — lie at the heart of the controversy about the Fund's policies and their impact. By setting excessive, unnecessary, or unreasonable conditions for its loans, the IMF has frequently abused or misused its authority in the past. Just as an example, Indonesia was required to meet 140 conditions for its bailout in 1997-98, many of them patently unrelated to its financial crisis (e.g., eliminating price controls on cement and protections for dairy farmers).[30] Several of the Asian crisis countries in 1997-98 were required to reduce their budget deficits, when they never had excessive budget deficits in the first place and fiscal profligacy was not a cause of their financial crises. These countries were also advised to raise interest rates sharply, without regard to the effects this would have on domestic firms in financial systems that rely heavily on bank debt to finance working capital and productive investment. Thus, any effort to reform the IMF must focus squarely on changing the nature and content of its conditionality. Moreover, as noted above, changing conditionality can provide an effective way of addressing social criticisms of IMF policies if it is not possible to include social dimensions in pre-qualification criteria.

One of the most radical ideas in the Meltzer Commission majority report is the proposal to abolish conditionality for IMF lending. Lender-of-last resort loans would be given without any strings attached, but only (as discussed above) at penalty interest rates for very short-term periods to countries that pre-qualified. For reasons discussed earlier, it is not credible that that IMF will only lend to countries that pre-qualify. Moreover, other IMF members are unlikely to allow funds to be disbursed to countries with no idea of how the funds will be used to help the borrowers escape from their payments difficulties. Thus, while the Meltzer proposal is attractive in regard to being able to disburse funds quickly in a crisis situation, it is probably not realistic. Moreover, would not be responsible for the IMF to disburse very large amounts of money with no sense of how a country will solve its payments imbalances or ensure repayment of the loan.

In keeping with the CFR task force's approach of using positive incentives to get countries to join the "good housekeeping club," countries that pre-qualify could certainly be promised easier terms for their conditionality. This seems more realistic and more likely to encourage countries to cooperate than the Meltzer Commission's approach. However, the CFR task force was remarkably unspecific on how conditionality should be changed, except to imply that it should be more narrowly focused on fiscal and monetary policies, exchange rates, and financial-sector conditions, and should avoid requiring longer-term structural reforms as a condition for short-term stabilization loans. The CFR report states that countries should maintain "sound macroeconomic policies" without saying what those are, what their distributional impact would be, or how they guarantee against financial speculation and crises.

The CFR report states, with perhaps unintended irony, that

> The International Monetary Fund was created to help countries tackle balance of payments problems *without* resorting to draconian austerity measures, beggar-thy-

[30] See Kahn (2000).

> neighbor exchange rate policies, and trade barriers. This remains an extremely important goal. (italics added)

Yet at least the first two of these (draconian austerity and competitive devaluations) have often been the result of IMF conditionality in recent crisis situations. Summers (1999) at least acknowledges that conditionality may have leaned too heavily in the direction of austerity in the past, but offers few specifics on how it should be changed.

A number of proposals for reforming conditionality are discussed in my EPI study, *Taming Global Finance* (Blecker 1999). I argued that IMF loans should be rapidly disbursed to countries in crisis with minimal conditionality directly related to the conditions that fostered the crisis. A crisis situation is not the time to insist upon, say, fundamental banking reform, trade liberalization, labor market flexibility, or other structural changes. The IMF should abandon its one-size-fits-all macroeconomic models and investigate the specific circumstances that fostered a crisis in a particular country, paying attention to the microeconomic structure of financial markets as well as any macroeconomic policy inconsistencies. The IMF should consult with member country economists and knowledgeable country experts in formulating stabilization plans, rather than imposing plans developed solely by its own staff.[31]

Austerity measures such as fiscal cutbacks, monetary restraint, or increased interest rates should be used only to the minimum extent necessary to solve a particular balance of payments problem, and only if they respond to specific sources of a country's balance of payments disequilibrium and will not cause undue domestic economic hardship. For example, fiscal austerity should not be required in countries without large budget deficits, and interest rate increases should be avoided in countries where they could destabilize highly leveraged debt positions of business firms. I also argue that reforms in other areas, such as allowing Malaysian-style temporary restrictions on foreign exchange transactions to avert a speculative run and capital outflow controls to avoid capital flight, and making creditors bear a larger share of the adjustment burden (e.g., through an international bankruptcy procedure), can minimize the need for painful austerity measures in order to stabilize a country's balance of payments. In general, macroeconomic adjustment policies should be designed to get growth re-started as quickly as possible, rather than imposing a prolong period of austerity, recognizing that capital inflows (especially of the long-term variety) will respond more positively to good market prospects than to high interest rates in an uncertain environment. What Krugman (1998) calls the "confidence game" — i.e., raising interest rates to astronomical levels in order to placate foreign investors, while depressing the domestic economy — should be avoided. Rather, countries should be allowed and even *encouraged* to use temporary capital controls (like the Malaysian exchange controls[32]) and to suspend payments to foreign creditors temporarily in crisis situations if necessary in order to stop the financial bleeding and stabilize the real economy, without having to unduly repress domestic income and employment.[33]

Insofar as IMF lending conditions have detrimental side-effects on poverty, the environment, or other social concerns, those conditions may need to be modified accordingly.

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[31] Legally, of course, the IMF never imposes an agreement; rather, from a legal viewpoint, a country signs a "Letter of Intent" in which it voluntarily agrees to a certain set of conditions. In reality, however, countries have usually been forced to accept stabilization plans developed by IMF staffers, often with little experience in or knowledge of the country's economy.

[32] On the effectiveness of Malaysia's capital controls see Edison and Reinhart (2000).

[33] There is considerable support for temporary suspensions of payments to foreign creditors in the academic literature on financial crises, based on the analogy to allowing banks to suspend withdrawals in order to prevent a domestic bank run. See Rogoff (1999).

For example, if countries are reducing their social welfare spending in order to meet fiscal policy targets, the fiscal policy conditionality in IMF agreements should stipulate that governments may not balance their budgets through cuts in needed social spending (i.e., they would have to raise taxes, preferably on wealthy taxpayers, or cut wasteful expenditures such as military budgets). Another solution could be to place less attention on budget deficits *per se*, especially in cases like East Asia where they were not part of the problem to begin with. Such modifications of conditionality are preferable to having the IMF make additional loans for "poverty reduction" with one hand while worsening poverty through inappropriate conditionality with the other hand.

One thing that should not be done in short-term lending conditionality is to attach conditions related to long-term, structural reforms. For example, it is not credible to insist on long-term banking reforms as a condition for short-term crisis lending which, in order to be effective, has to be disbursed rapidly.[34] The 140 conditions required for Indonesia's bailout in 1997-98, cited earlier, is an example of the overly intrusive sort of conditionality that should be banished. By the same logic, however, it is not reasonable to insist that countries promise to improve their respect for labor rights in order to obtain a short-term loan, or to deny credit to countries that fail to meet social criteria in the midst of a crisis, if such restrictions would only inhibit the IMF's ability to put out financial fires when they occur (and provided, of course, that IMF conditionality is reformed in other ways so that it does not disproportionately injure workers or worsen poverty). Similarly, whatever the advantages or disadvantages of labor market flexibility, a short-term crisis situation is not the time to force such policies on a country. If any of long-term structural reforms are to be included in IMF lending policies, they should be incorporated via pre-qualification criteria with a reasonable phase-in period, rather than imposed suddenly in the midst of a crisis.

Several of the recent reports on the IMF recommend that it distinguish in its lending policies between more or less serious crisis situations or different types of borrowers. For example, the CFR report argues that only small loans should be extended in individual "country" crises, while larger loans should be made in "systemic" crises in which there are international contagion effects —and only when a super-majority of creditor countries designate a crisis as "systemic." In a somewhat different vein, the Meltzer Commission urges the IMF to make a sharp distinction between countries that are fundamentally solvent and are merely temporarily illiquid due to a crisis (which would receive loans), and countries that are fundamentally insolvent (which would not receive loans). The APF's *Policy Recommendations* are specifically focused on preventing "capital account crises," rather than traditional current account crises. And a large theoretical and empirical literature has tried to separate out "bad policy fundamentals" from other causes of crises, such as market psychology (self-fulfilling prophecies of speculators) and contagion effects (panics that spill over from other countries).[35]

In principle, these are vital distinctions to make and they should definitely influence the amount, terms, and conditions of IMF lending. The Fund should lend generously and with fewer conditions to countries that fall victim to systemic crises, which are merely illiquid (and not insolvent), and which do not have policy fundamentals bad enough to cause a crisis on their own.[36] The Fund should lend lesser amounts and with more conditions to countries that have individual crises as a result of demonstrable policy mismanagement, with no systematic repercussions or contagion effects. If the pre-qualification criteria are successful,

[34] See Calomiris (1998).
[35] See Blecker (1999) for a critical survey.
[36] There is some evidence that contagion effects are rational in the sense that they are felt mainly in countries with weaker economic and financial conditions. Nevertheless, in many cases these conditions would not be serious enough to spark a crisis in the absence of contagion from other countries.

countries that have pre-qualified will generally be able to avoid the latter type of crisis, but still might need assistance in the former type. Countries that fail to pre-qualify will often be vulnerable to both kinds of crises and may need stricter conditionality when they do borrow from the Fund.

In practice, however, it is not always easy or possible to make such clear distinctions. For example, the Thai crisis of 1997 was partly a product of speculative capital inflows that were overinvested in certain sectors of the domestic economy based on unduly euphoric expectations and poor risk assessment. Yet Thailand was also characterized by some traditional signs of an old-fashioned balance-of-payments crisis, such as an overvalued currency, large current account deficits, and a misguided effort to defend a pegged exchange rate. The two sides of the balance of payments (current and capital transactions) are closely related and one cannot always say which one is determining the other. Also, when the Thai crisis broke out it was not immediately apparent that it would be anything more than another individual country crisis. Only a few months later did it become obvious that it had ignited a systemic crisis in Asia and beyond. Other emerging market economies suffered contagion effects as international investors panicked, but the worst crises occurred in countries where either the policy fundamentals were truly unsound (e.g., Russia) or else financial systems had obvious (at least in retrospect) vulnerabilities (e.g., Korea). Similarly, judgments about whether an economy is fundamentally solvent or merely illiquid can also be difficult to make, especially in the midst of a crisis, and even the meaning of “insolvency” for a national economy is hard to define.

The point of this discussion is not that the IMF should not try to make such distinctions. The Fund has to make such judgment calls in order to decide how much to lend a particular country and on what terms. The point, rather, is that it is not helpful to try to lay down hard-and-fast rules for distinguishing between different types of borrowers and crises when such rules may be difficult if not impossible to implement during an actual crisis situation. There is a need for the IMF to retain enough flexibility to respond to changing conditions and, in some situations, to increase lending when a crisis worsens beyond original expectations, while in other cases refusing to lend more when it becomes clear that a country is failing to take reasonable steps to solve its own (immediate) financial problems.

VII. Moral Hazard and Burden Sharing

Both the CFR report and Meltzer Commission stress the alleged importance of moral hazard problems as a motivation for many of their recommendations. The Meltzer majority report says flatly that, “The importance of the moral hazard problem cannot be overstated” (p. 33). This is the basis for many of the Commission’s recommendations, such as the charging of penalty interest rates and the very short maturities (120 days maximum) for IMF loans, which are intended to discourage recourse to the IMF and hence to dissuade creditors from expecting generous IMF bailouts. A concern over moral hazard also motivates many of the CFR report’s recommendations. For example, the CFR’s various ideas about burden sharing, such as requiring collective action clauses in government bond contracts and requiring countries to adopt deposit insurance systems for their banks, are justified by a claim that they will reduce moral hazard by forcing uninsured creditors to bear more of the risks in cases of debt crises or banking crises. The CFR report also endorses smaller rescue packages for individual country crises (as distinct from systemic crises—see above) as a means of reducing investors’ expectations of counting on generous bailouts.

Moral hazard is a general problem in any type of insurance system, including the provision of lender-of-last-resort assistance to financially troubled institutions or countries.

However, there is reason to believe that the extent of this problem in IMF lending has been exaggerated in some of these analyses. There is no evidence that the IMF's bailout of Mexico had any significant effect in inducing excessive investment in Thailand or other Asian countries. A recent study finds that the spreads on emerging market bonds increased after the Mexican crisis, after controlling for the effects of domestic economic fundamentals and global financial conditions.[37] This finding is inconsistent with the moral hazard hypothesis, which would imply that investors were lulled into ignoring risk by expectations of IMF bailouts.

Most studies of the Asian crisis have concluded that investors ignored risk for other reasons, such as optimism about long-run growth prospects and confidence in exchange rate pegs (not to mention continued assurances from the IMF and other IFIs that the Asian countries had exemplary financial, trade, and macroeconomic policies).[38] There is also ample evidence that some of the excessive capital inflows were due to speculative bubbles in asset markets, such as Thai real estate, which were unrelated to expectations of IMF bailouts. Perhaps the only case in which moral hazard was definitely a problem was in Russia, where investors who bought highly risky government bonds were confident that the Yeltsin government would be bailed out for geopolitical reasons ("too nuclear to fail"). But aside from such special cases, there is no evidence that expectations of large and generous IMF bailouts were a major causal factor in most of the recent financial crises.

Thus, the importance of the moral hazard problem in the Asian crisis *has* been vastly overstated. Nevertheless, as the Russian case makes clear, it is a potential problem especially when proper lending criteria are not followed, and it is certainly true that large rescue packages that effectively bail out uninsured creditors who took excessive risks could invite moral hazard problems in the future. Thus, it still makes sense to consider the *potential* for moral hazard problems in designing IMF lending policies.

In addition, there are *other* reasons to support greater burden sharing by creditors even if moral hazard concerns have been exaggerated. The most important reasons are equity concerns. A major problem with IMF lending in the 1990s has been that it tended to benefit disproportionately the wealthy creditors in the rich countries (especially large banks, rather than bondholders), who were effectively bailout out from the consequences of their own flawed lending strategies in the emerging market countries. Meanwhile, the costs of adjustment were imposed on workers, the poor, and the environment in the debtor countries, as well as on workers and farmers in the US. US manufacturing workers lost jobs due to increased import competition from countries that suddenly had excess capacity and undervalued currencies, while farmers and other exporters faced falling demand and declining prices due to weak Asian markets. The greatest suffering of all was felt by workers, small entrepreneurs, and poor people in the crisis countries, who were faced with conditions that can only be described as a severe depression.

As the CFR report acknowledges, there was a "perception that Wall Street—and particularly, large banks—was benefiting much more from official rescue packages than was Main Street."[39] But this was more than a perception, it was a reality. Indeed, much of the negative impact of IMF intervention on workers and the environment that has led to so many demands for the Fund to enforce labor rights and environmental standards could be avoided if the Fund simply made sure that a much higher proportion of the adjustment burden was

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[37] See Zhang (1999). This study did not include Russia, where moral hazard was likely to be significant for special reasons discussed below.

[38] See, e.g., Taylor (1998). Blecker (1999) provides further discussion of this issue and additional citations.

[39] The Wall Street versus Main Street metaphor was used previously by Palley (1998), who is not cited by the CFR report.

shifted onto creditors. This, and not a theoretical concern over moral hazard, is the right reason to support greater burden sharing in IMF rescue packages.

VIII. Exchange Rates

Both the Meltzer Commission and the CFR task force majority reports call for the IMF to abandon its traditional willingness to support "adjustable peg" exchange rates. Recent experience has shown that such pegged exchange rates invite speculative attacks whenever investors perceive that the pegs are significantly out of line with economic fundamentals or when short-term, foreign-currency debt obligations exceed a country's foreign exchange reserves. In such cases, speculation becomes a "one-way bet" for investors who short the currency under attack, and the expectation of a devaluation becomes a "self-fulfilling prophecy." Such speculative attacks are only feasible for as long as the central bank persists in trying to defend the peg by selling foreign exchange reserves at the official, artificially cheap pegged rate.

Certainly, pegged exchange rates that are allowed to become glaringly inconsistent with underlying economic fundamentals, or which become so overvalued as to foster severe payments disequilibria (e.g., large current account deficits), should not be supported by the IMF. The IMF's support for Brazil's failed effort to prevent a devaluation of the real in late 1998 and early 1999 is a notorious case in point, which may have been due to political pressures rather than the economic merits of the policy.[40] The IMF should certainly discourage countries from allowing their currencies to become severely overvalued, like the Mexican peso in 1993-94 or the Thai baht in 1996-97, such as through publishing country reports that publicly expose exchange rate misalignments before they become too serious. This is clearly an area in which "early warning signals" are appropriate.

The argument for the two extremes of rigidly fixed or freely floating exchange rates (the so-called "corner solutions") is that adopting an exchange rate policy that ties the hands of policy makers is necessary to prevent them from creating a situation that makes an attack feasible. At one extreme, if the exchange rate is freely floating and the central bank never intervenes to influence it, then there is no officially pegged rate for speculators to attack and no possibility of draining the country's reserves through one-way bets. At the other extreme, if there is a rigidly fixed exchange rate maintained by a currency board or through "dollarization" (i.e., adopting a foreign currency as domestic money), then monetary policy is forced to be consistent with the fixed rate and there is no possibility of a disequilibrium that speculators could exploit (assuming that investors do not perceive any possibility of the country abandoning the fixed rate).

While the logic of this argument is clear, it is not at all clear that the middle ground of managed exchange rates should be abandoned entirely, or that the IMF should force all

[40] The Clinton administration was interested in supporting the re-election bid of Brazilian President Fernando Henrique Cardoso, and this undoubtedly led the Treasury to pressure the IMF to support an exchange rate policy that was widely believed by independent observers to be unsustainable. Among other things, both the US and IMF felt that Cardoso would be more compliant with their demands, such as for fiscal deficit reduction, than the other party's candidate. Officials such as US Treasury Secretary Summers and IMF chief economist Stanley Fischer surely must have realized that Brazil's effort to defend its peg was likely to fail, and that the hard currency they were using to assist the Brazilian government in this doomed effort was going directly to bail out foreign banks and investors rather than benefiting Brazil's domestic economy. However, in this case it is also true that the IMF's agreement to support Brazil's currency peg was consistent with the wishes of the incumbent Brazilian government, as discussed further below. The fact that the effects of the Brazilian devaluation on the domestic economy turned out to be milder than anticipated can be cited in defense of the IMF's policy, although it can also be cited as proving that the devaluation should have been undertaken sooner.

countries into one of the two corner solutions as a pre-condition for its assistance. Both of the extreme exchange rate regimes are far from problem-free. Each of these regimes ties the hands of policy makers in ways that may be contrary to a nation's economic interests and even to financial stability. On the one side, a rigidly fixed rate prevents the government from ever using the exchange rate as a means for international payments adjustment, and as a result the entire adjustment burden is shifted to the domestic economy via potentially negative price and income effects (i.e., deflation and recession/depression). This can be a very steep price to pay for eliminating the possibility of speculative attacks, which could be eliminated through other means (e.g., improved policy fundamentals and better debt management). On the other side, freely floating rates are subject to wide and persistent swings, which can undermine real economic activity and long-term growth. In a boom, currencies can over-appreciate as a result of speculative bubbles, leading to contraction of tradable goods industries, while in a downturn a currency can collapse due to a panic leading to sharp increases in import costs and foreign debt service burdens. Such instability in currency values increases risks for investors, forcing them to devote resources to hedging strategies and increasing borrowing costs for productive enterprises.

Given these problems, it is no wonder that in practice the majority of developing countries have avoided the corner solutions and still search for viable intermediate alternatives. In fact, there are many other "intermediate regimes" besides adjustable pegs, such as managed floats which target stable real exchange rates and Williamson's wide crawling bands that automatically adjust for inflation differentials.[41] These types of exchange rate policies are not as vulnerable as adjustable pegs to the threat of speculative attacks, and, if properly designed and managed, can provide an optimal balance between the need for flexibility in nominal exchange rates and the desire for greater stability in real exchange rates. It would make more sense for the IMF to assist countries in finding and implementing such viable intermediate exchange rate regimes, rather than to insist that they follow extreme exchange rate policies that risk causing other sorts of problems for developing economies. The Meltzer Commission is right when it says that "Stabilizing policies are more important than the choice of exchange-rate regime" (p. 49), but it fails to recognize the implication that intermediate exchange rate regimes can be successful when accompanied by consistent and sustainable macroeconomic and financial policies.

Moreover, the argument that speculation will inevitably bring down a pegged exchange rate assumes that a country's capital market and foreign exchange markets must be open enough to allow such speculation to take place. Countries like China, India, and Taiwan that never opened their capital markets to financial speculators in the first place naturally escaped the worst effects of the 1997-98 Asian crisis—and helped to stabilize the rest of the region in the process. Rather than insisting on wide-open capital markets and extreme exchange rate policies, the IMF should allow countries to choose the equally feasible alternative of selectively closed capital markets (e.g., markets that are open only to long-term inflows) and managed exchange rates.

The APF's *Policy Recommendations* suggest that there is no reason to require countries that maintain extensive capital controls to abandon adjustable pegs, as long as those countries adopt a consistent set of sustainable macroeconomic policies and make efforts to improve the soundness of their domestic banking systems. While this is true in principle, history suggests that it is often hard to keep pegged exchange rates consistent with underlying policy fundamentals over time, and hence it would be better to encourage such countries to move toward other forms of managed exchange rates such as crawling bands. Alternatively, countries that use adjustable pegs need to realize that frequent, small adjustments to keep up

[41] See Williamson (2000) and Frankel (1999) for defenses of intermediate exchange rate regimes.

with inflation differentials may be needed in order to avoid a drift into chronic overvaluation, which sows the seeds for a major crisis when the inevitable maxi-devaluation occurs.

Finally, the CFR dissent that calls for efforts to stabilize the G-3 (dollar, euro, yen) exchange rates should be supported. The wide and persistent swings in these currencies, often due to self-fulfilling expectations of speculators rather than to economic fundamentals, are an example of the problems that result from purely floating exchange rates (with only sporadic intervention). Furthermore, the instability in these exchange rates adversely affects the ability of developing countries and emerging markets to stabilize their own currencies, avoid balance of payments disequilibria, and maintain acceptable growth rates. However, the IMF is probably not the right forum in which to promote G-3 currency stabilization, since the IMF has little leverage over the major industrialized nations. Negotiations among the finance ministries and central banks of the three currency blocs are required in order to agree on target zones or crawling bands and to coordinate fiscal and monetary policies in order to support them. Serious attention should also be given to John Grieve Smith's (1997) proposal for an International Stabilization Fund that would have adequate resources for intervening to support the G-3 currency targets.[42]

IX. Governance Issues and Political Compromises

Last but not least is the need to transform the IMF itself as an institution. There is widespread agreement among many critics about the need for a more equitable allocation of voting rights among member countries, greater openness to outside evaluation and peer review of IMF programs, more reliance on in-country experts rather than "missions" sent from headquarters in Washington, and increased input from affected civil society groups in all countries. Beyond that, the IMF needs to be made independent from what Jagdish Bhagwati aptly called the "Wall Street-Treasury Complex." As the Meltzer Commission forcefully argues, "The IMF should not be used as a 'slush fund' to satisfy decisions of the G-7 finance ministers or other groups of powerful members" (p. 48). It should no longer be possible for the US to hand-pick a European executive director while keeping a US economist in place as the chief economist (and, simultaneously, getting the American president of the World Bank to force out his own chief economist and drive another top Bank economist to resign because of their independent views[43]).

While it is easy to advocate such political reforms, it is much more difficult to implement them. It is easy to say whose votes should be increased, but much more difficult to get those who currently have larger quotas to agree to reduce their proportionally greater voting rights. In particular, any effort to reduce US influence would not help in getting the US Congress to look favorably upon funding for the IMF and other international organizations. There are also some developing countries (e.g., Middle Eastern oil exporters) whose quotas are out of proportion to their current economic size relative to other nations whose economies have grown rapidly (e.g., in East Asia), but the former are unwilling to yield their positions. Since any reallocation of quotas and votes is seen as a zero-sum game politically, it is difficult to get any movement in this direction. Still, quota reform has to be a top priority for emerging market countries, who receive the brunt of the IMF's advice while

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[42] This proposal was originally intended for the G-7 currencies prior to the creation of the euro, but it would now make more sense to reformulate it as a proposal for the G-3 currencies with the possible additional inclusion of the UK pound.

[43] I am referring to the resignations of Joseph Stiglitz, whose critical views were discussed earlier, and Ravi Kanbur, who refused to endorse the Treasury's policy views on poverty reduction in the World Bank's annual *World Development Report 2000-01*.

having little input into the design of its policies. Quotas should be increased for those countries in proportion to their current weight in the global economy and a formula should be established for automatically changing quotas as international conditions change.

One difficulty that is rarely discussed in public, but which needs to be addressed, is the potential for conflicts between more democratic governance and other reform objectives. For example, giving most member countries (especially non-G-7 countries, who are the likely borrowers) greater voting rights and more influence over IMF decisions could weaken efforts to adopt strong prequalification criteria or to promote more sustainable exchange rate policies, if the governments that got more influence were resistant to taking such measures. Already, proposals for publishing more of the IMF's internal documents and country evaluations have run into objections from member governments that do not wish to have their policies subject to greater scrutiny. Many governments resist ideas like early warning signals and collective action clauses[44] out of fear of reducing foreign investors' confidence and raising their borrowing costs. As another example, the IMF's support for Brazil's failed effort to defend its currency peg in 1998-99 was consistent with the wishes of Brazil's own government. Unfortunately, many discussions of democratizing the IMF have failed to confront these sorts of potential conflicts between governance reform and other desired changes in IMF policies.

There is no simple way out of this dilemma. However, one compromise could be to forge a link between the types of economic and financial reforms that emerging market countries are being asked to adopt and the kinds of governance reforms that those countries desire at the IMF itself. That is, one could link a country's willingness to join the "good housekeeping club" via best-practice financial supervision and other types of economic reforms, as discussed earlier, with the country obtaining a larger quota and winning greater voting rights at the Fund. As part of this process, it is essential that the definition of "good housekeeping" continue to be a subject for discussion among all countries, both G-7 and non-G-7, and among various interest groups and social constituencies as well as among finance ministries and central bankers.

X. Conclusions

To date, the IMF itself has made only minimal responses to most of the calls for radical changes in its policies and procedures. The IMF has taken some steps toward greater transparency, such as by making more internal documents and country information public (including through a much improved website). The IMF has admitted some mistakes in its initial responses to the Asian crisis, especially in regard to imposing unnecessarily harsh fiscal austerity in countries such as Korea. According to press reports, the Fund decided at the Prague meetings in September 2000 "to cut back slightly its long-term and repeat lending to countries so it could refocus its resource and attention o its role as lender of last resort when the next global cash crisis hits."[45] The IMF is also now advising countries to avoid pegged exchange rates, although as recently as the winter of 1998-99 it was pouring billions of dollars into Brazil in a futile effort to defend that country's currency peg.[46] The Fund also

[44] At the same time, the US may be unwilling to push for such a requirement due to objections from powerful Wall Street financial interests. It is interesting to note that the only member of the CFR task force who dissented from its recommendation for collective action clauses in bond contracts and other burden-sharing measures was William R. Rhodes, Vice Chairman of Citigroup/Citicorp/Citibank.
[45] Pearlstein (2000, p. A34).
[46] The Brazilian case is discussed further below.

claims that it will no longer require budget cuts in social spending for the poor as part of its stabilization programs.

Nevertheless, the IMF is resisting more fundamental types of changes such as those discussed here. Moreover, the IMF is generally backed in its resistance by the US Treasury. The Treasury is extremely cautious even about some of the more moderate proposals that came out of the CFR task force and the Meltzer Commission, such as requiring collective action clauses in government bonds or publishing mandatory reports on member countries' financial conditions and standards. At the same time, many other member governments are also resistant to some of these same reforms, and part of the US Treasury's reluctance to promote them may stem from concern over a lack of international political support as well as from doubts about their likely effectiveness. If the international financial system is to be more stable in the 21st century than it was at the end of the 20th, it is imperative that this political logjam be broken and that the IMF be transformed into a more effective and responsive international lender of last resort.

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Comments and Discussion

Kwang-Woo Jun: Based on a review and comparison of major proposals put forward so far, Dr. Blecker recommended set of changes for revamping the IMF. In short, I concur with many of his observations and suggestions. In the end, however, I should say that the value and efficacy of the paper's recommendations need to be judged against realism and fairness among many other factors.

Let me respond to specific points that Dr. Blecker highlighted in his paper. First, the paper's first key suggestion is to have the IMF mandate more narrowed and focused promotion of financial stability. I agree with this view in principle and I also support the notion that long term development lending will be better left in the World Bank and the Fund should avoid micro-management of national economic policy. Having said that, we may have to admit that achieving financial stability does not come in isolation of broad macroeconomic stability. Indeed, we are witnessing increasing interaction between real and financial sectors. That suggests some room for the Fund's role in bigger picture. In fact, one of the lessons we have learned from Asian crisis is that there is very close link between financial stability and sustainable growth.

Second point deals with so called pre-qualification issues relating to the Fund's financial assistance. Here, I don't disagree with author's view about targetted pre-qualification criteria but I would think that such criteria should not be so stringent and must leave room for flexibility to reflect on country's specific circumstances. I may also say that if country meets all the tough pre-qualification criteria, it will be highly unlikely for such country to require emergency lending after all. So there is some inherent contradiction.

Third, concerning conditionalit, I subscribe to the proposal that the conditionality will be limited in scope and tailored to specific circumstances. It is also very sensible to link the Fund's policy prescriptions to the root causes of the problem. That is to say, as you mentioned in your paper, one-size-fits-all policy conditionality will be a recipe for disaster. That conditionality should be imposed in the manner that is least disruptive to the effected economy.

The next point that I would like to touch upon has to do with exchange rate regime. Clearly, maintaining flexible exchange rate system is crucial to ensure stability in foreign exchange market and to avoid speculative attack under liberalized capital account environment. However, I am not sure if the Fund should impose any particular regime on the recipient country as a prerequisite for the IMF credit – the point that the paper appears to support.

In addition, I would also like to strengthen the proposition of G-7 currencies. The advanced countries must ensure the equilibrium in the anchor currencies to promote stability in exchange rate market in small open economies. As we know, in these days, continued weakness in Euro creates instability in global foreign exchange market which is not a good news for small guys.

Next subject is on burden sharing, in fact, this issue goes well beyond the topic of IFI reform as it constitutes the core of the new international financial architecture in a broader context. As we all agree, for every dollar of reckless borrowing, there is equal amount of reckless lending. Hence, I fully support the veil in concept calling for more active and equitable creditor responsibility not only in crisis resolution but also in crisis prevention. The IMF must play active facilitator role in having creditor veiled in and an honest intermediary for effective debt restructuring.

Then here comes the issue of liberalization of capital account. I strongly believe that the capital account liberalization should proceed prudently and sequentially, so as to minimize its potential adverse effects on domestic markets and external vulnerabilities in emerging markets. Nevertheless, the paper's contention that the IMF should stop promoting capital market liberalization seems too strong. I am of the view that by and large, that capital flows provide more goods than harm for capital importing emerging market countries as long as they are properly used and managed.

Last but not least, the author's point on the need to enhance the Fund's transparency, accountability, and equity is well taken. In this context, I would like to raise one specific comment concerning the IMF's existing quota system. The present quota system is clearly outdated and fails to reflect the true economic standing of many of non G-7 countries, including Korea. Although, the G-20 forum, which was held in Berlin last December, serves the purpose of promoting wider dialogue on international financial issues, the improvement in the Fund's quota system will help further balance representation at IFIs with adequate voice of emerging market economies on global issues

General Discussion: Blecker responded to Jun's comment and concluded the session. He started with Jun's comment saying that if a country meets all the pre-qualification criteria outlined in the paper it will probably not have financial crisis and it would not need the IMF assistance. Blecker responded that he thinks that is intentional. He said, the idea is of inoculation against the disease. If we take a shot then we immunize ourselves with all these measures and it would be unlikely that we would have at least a standard kind of balance of payment crisis. He continues, if we put it in another way, if we met all these criteria and still have crisis anyway, it would then be pretty clear that it was pure contagion effect, herd behavior, or something of that nature. He pointed out that the idea therefore is that if we have done all these things, and we make sure that our fundamentals are not out of equilibrium or out of line. And if we get hit by some kind of speculative attack or speculative crisis anyway, then we can be sure that is the type of crisis it is and respond appropriately with very mild conditionality, very rapid injection of large amounts of fund with low interest rate because at that point you only want to beat the speculators.

In that regard, he pointed out that Meltzer report is especially problematic because their list of pre-qualification criteria is really not appropriate. It includes something like rights for foreign banks, but it excludes very important things such as burden sharing, ways of ensuring veiling in and so on. He argued that in fact, even if we met the Meltzer criteria, we would really not have inoculated ourselves properly. Blecker suggested his view that from the disease of financial contagion and yet, they will give large amount of money with no conditionality anyway. He concluded, there is important difference there and some of the other perspectives.

Bleacker also mentioned on the capital account liberalization. He continued that if we take account of what we have said earlier about country starting in different places in terms of income levels, institutional capability, internal financial development, may be in the long run we will all have open capital market subject to various kinds of regulations. But he added, as a matter of reality, that many developing countries are not really prepared for this. He pointed out that the notion that everybody, everywhere should be establishing capital market liberalization as a goal soon to be achieved may be premature. He concluded that we need to distinguish between the long term goal and what makes sense in each country's own situation.

Private Sector Involvement : A Korean Perspective

Won-Am Park

I. Introduction

As the Asian crisis that originated in Thailand quickly caught Korea with the rundown of foreign reserves, it was inevitable that she requested IMF loans on November 21, 1997. Korea's current account deficit was maintained at a modest level and the external debt as a ratio of GDP was also low, compared to other Asian countries. But the bulk of the external debt was short-term inter-bank loans so that Korea had to rely on IMF loans to cope with the depletion of foreign reserves due to capital outflows. The IMF approved a stand-by arrangement with Korea on December 4, 1997, providing very large official financing plan of $58.4 billion together with the program of structural adjustment.

Despite the implementation of the IMF program and the immediate injection of $10 billion, the economic situation in Korea did not improve but worsened. The official reserves continued to diminish and the value of the Korean won plummeted in late December. The usable official reserves that excluded deposits at offshore subsidiaries of domestic financial institutions reached around $4 billion on December 18, 1997. The depletion of foreign reserves would have driven Korea to the suspension of debt payments. Korea was situated in effective standstills in late December 1997. During the week between Christmas and New Year, emergency talks took place between the creditor banks and the new Kim administration with the moral suasion of the G-7 governments and central banks. The major creditors of the US, Japanese and European banks agreed to maintain credit lines through March 1998. On January 28, 1998, Korea reached an agreement with a committee of foreign banks on the principles of maturity extensions. The final debt-restructuring agreement was signed on March 31, 1998, with 134 creditor banks from 32 countries. Debt of $22 billion was converted into government-guaranteed bonds due to mature in one to three years and a spread of 225 to 275 basis points. On April 8, 1998, the Korean government was able to issue global bonds worth $4 billion with maturities of five and ten years and spreads of 345 to 355 basis points. It took almost five months before Korea regained access to the international financial market after having requested the IMF loans.

The debt restructuring in Korea was similar to that in Thailand and Indonesia in that they were all concerned about the rollover of their short-term debt. At a closer look, however, they differed because the debtors were different (Lane et al., 1999). In Thailand, the bulk of short-term debt was owed by foreign bank branches and subsidiaries, mostly Japanese. It was owed by domestic financial institutions in Korea and by private corporations in Indonesia. Overall, debt restructuring in these three countries was different in nature from that in other countries such as Pakistan, Ecuador, Romania and Ukraine; the former involved bank loans, while the latter bonded debt.

Many questions can be raised regarding the IMF program financing and debt restructuring implemented in these countries, but this paper focuses on the following questions that are related to private sector involvement in the Korean financial crisis. Why did the IMF program financing not restore the market confidence at the initial stage? Why was the debt restructuring delayed until late December? Were the IMF program financing and debt restructuring by the private sector appropriate for resolving the financial crisis? To answer these questions, we must understand the causes of the crisis, solvency of debt, tools for private sector involvement and the like.

This paper reviews the IMF-supported program in Korea with attention paid to the role of the private creditors and suggests ways of private sector involvement (PSI). Section 2 summarizes recent progress on the private sector involvement in forestalling and resolving financial crises. Section 3 discusses Korea's suggestion for PSI proposed at the G-20 Meeting in early 1999. Section 4 evaluates the IMF program financing and debt rescheduling from the viewpoint of PSI. Section 5 concludes the paper.

II. Progress on the Private Sector Involvement in Forestalling and Resolving Financial Crises

The private sector involvement in the prevention and resolution of the crisis is currently one of the core agendas in the new international financial architecture. The international debt crisis in the 1980s aroused concerns about the ways to "bail in" rather than to "bail out" the private sector or to "share the burden" between the official sector and private creditors, which led to the Brady Plan for debt reduction. The Mexican crisis in 1995 further magnified the need to bail in the private sector, as private creditors were bailed out through the injection of huge amount of official financing. Although the immediate bailout of private investors was effective to subdue the financial panic, concerns about the private sector's moral hazard elevated the need to bail in the private sector. The 1996 G-10 report, so called Rey Report, was prepared after the Mexican crisis to recommend collective action clauses, IMF lending into arrears and appropriate PSI, but they were not implemented.[1]

The financial crises in Asia and transitional socialist economies created the momentum to reconsider the international financial architecture and revive the discussions on PSI. The October 1998 report of the G-22 Group included PSI in crisis prevention and resolution to the new architecture. Then the formal G-7 doctrine in which PSI resurged as one of the core issues was developed in early 1999 in preparation of the July 1999 Cologne G-7 Summit. The June 1999 G-7 report included a section on the new G-7 PSI framework characterized as a "case-by-case approach with principles and tools." The case-by-case approach was adopted because the rigid rules to guide PSI were not able to encompass complexity and novelty of each case of crisis, but a set of principles and tools were provided to make PSI transparent and guide the PSI policy.

The five basic principles of case-by-case approach are as follows:

- The approach to crisis resolution must not undermine the obligation of countries to meet their debts in full and on time;
- Market discipline will work only if creditors bear the consequences of the risks that they take;
- In a crisis reducing net debt payments to the private sector can potentially contribute to meeting a country's immediate financing needs and reducing the amount of finance to be provided by the official sector;
- No category of private creditors should be regarded as inherently privileged relative to others in a similar position; and
- The aim of crisis management wherever possible should be to achieve cooperative solutions negotiated between the debtor country and its creditors, building on effective dialogues established in advance.

[1] The terminology of private sector involvement (PSI) connotes the voluntary and cooperative nature of "bail-ins" of private sector creditors during crises. More recently the IMF uses the term "constructive engagement" to stress the need for voluntary and market-based approach to PSI.

The eight tools for PSI were listed. The tool should link the provision of official support to the policy program by the debtor, the new funds from private markets, the maintenance of exposures by private creditors and efforts to restructure debt by the debtor. The flexible approach to the Paris Club comparability, reserve floor to ensure the contribution of the private sector, lending into arrears, capital controls and standstills were recommended as policy tools.

The G-7 also called on the IMF to develop the PSI framework and assume the lead in the actual implementation. The IMF discussed the following measures for crisis prevention and ex ante measures that can be implemented and in extreme situations to facilitate crisis resolution (IMF, 1999a, 1999b).

Prevention

- Improving the environment for private sector decision-making that includes the elimination of any regulatory bias toward short-term inter-bank credit lines, improvement of standards and transparency
- Strengthening ability to assess and manage external vulnerability
- Dialogues of debtors with their creditors
- Assessment of vulnerabilities in Fund surveillance

Ex Ante Measures

- Contingent financing arrangements from commercial banks
- Embedding call options in inter-bank lines
- Debt-service insurance through the use of structured notes
- Official enhancements of new debt, and in particular the use of partial guarantees from multilateral and bilateral creditors
- A concerted rollover and restructuring of inter-bank lines including the enhancement of the role of creditor's committees
- Bankruptcy procedures for corporations
- Modification of sovereign bond contract including representation provisions

Extreme Situations

- Default on sovereign obligations or the imposition of exchange controls leading to an interruption in non-sovereign debt service in extreme cases
- Temporary stays on creditor litigation

As the IMF plays a central role in the application of the "case-by-case approach with principles and tools" laid out in the Cologne Summit, the G-7 agreed on a set of "operational guidelines" for PSI at the IMF/WB meeting in April 2000 to provide clearer directions to the IMF. These guidelines were reaffirmed as part of the Finance Ministers Communique prepared for the July 2000 G-7 summit in Fukuoka, Japan.

The salient features of the operational guidelines for PSI annexed to the April 2000 G-7 document and redressed in the Fukuoka summit are as follows. First, they paid more attention to crisis prevention measures of a strong and continuous dialogue between debtors and creditors. Second, they agreed to facilitate the use of collective action clauses in international bonds. Third, crisis resolution should be based on the IMF's assessment of a country's underlying payment capacity and prospects of regaining market access. Fourth, all

IMF programs need to include analysis of the country's medium-term debt and balance of payments profile, including a section explaining the assumptions taken about the sources of private finance.

Three cases of the private finance in the IMF programs are identified: combination of official financing and policy adjustment; voluntary approach to creditor coordination problem; and debt restructuring or debt reduction. In the case of debt restructuring or debt reduction, the further guidelines were provided including the IMF lending into arrears.[2]

There are many focal points on the recent progress in PSI. First, the case-by-case approach with principles and tools is so often far from the rule-based approach that it could create the time inconsistency problem such as moral hazard. However, the rigid rule such as the monetary growth rule could be worse than the less rigid and somewhat flexible rule such as the Greenspun's monetary rule. The case-by-case approach that considers complexity and novelty of each crisis could play the positive role in involving the private sector by providing constructive ambiguity. In fact, opinions of the advanced countries on the PSI framework are divided. The U.S. and Japan support the case-by-case approach, while the European countries, Canada and Australia support the rule-based approach.

Second, the moral hazard of debtors complicates the PSI framework. If the moral hazard of debtors is more serious than that of creditors, then PSI would not resolve the crisis but revive the crisis. The PSI assumes the significance of the moral hazard on the part of the creditors

Third, the use of collective action clauses that has been recommended as one of operational guidelines and more rule-based approach for PSI in the Fukuoka summit poses questions on its effectiveness. The collective action clauses could facilitate PSI by providing the rule for resolving the collective action problem. However, many arguments have been raised against the collective action clauses.

Fourth, the standstills or capital controls that have been recommended as one of eight tools for PSI in the Cologne summit bring both benefits and costs. The implementation of the standstills could facilitate a voluntary agreement between the creditors and debtors, but it could also trigger the rush to the exits in the form of capital outflows and contagion.

The following section examines Korea's suggestion for PSI, but it is mostly devoted to the discussions on the focal points introduced in the above.

III. Korea's Suggestion for the Private Sector Involvement

Korea has learned from the financial crisis many lessons on the causes of the crisis, rescue programs with policy adjustment, and debt restructuring. In the aftermath of crisis it felt increasingly the urgent need for a new international financial architecture that can promote greater stability in both the international and domestic financial systems. In April 1999, the Ministry of Finance and Economy published a document (MOFE, 1999) that illuminates Korea's perspective on the new international financial architecture.

With regard to PSI in resolving the Korean crisis, the Korean government expressed its opinion that there was great room for improvement in debt restructuring process, although it has extended maturity of short-term debt with the participation of private creditors. The document states that "the time and money spent in overcoming the crisis could have been reduced, along with the social costs involved if negotiations on maturity extensions had taken place in conjunction with the provision of assistance by international financial institutions."

[2] Report from G-7 Finance Ministers to the Heads of State and Government in Fukuoka meeting contains the operational guidelines for PSI as well as outlines for the international financial architecture.

As reviewed in the Introduction, major creditor banks agreed semi-coercively to maintain credit lines for three months, one and a half months after Korea applied for the IMF loans. After this agreement, the Korean government spent more than two months contacting each individual creditor institution.

In order to deliberate and reach collective decisions on existing private debt, the Korean government proposed an ad hoc representative committee, comprised of representatives from the debtor and creditor governments, central banks from most of the G-7 countries, the IMF and other relevant international organizations. Proposed in addition was a sub-committee of creditor banks in which decisions could be made either on a majority basis or by a consensus of two-third of the members. Non-participants in the sub-committee could be penalized to the extent that the international community would allow, so as to promote participation of creditor banks in the sub-committee and their acceptance of the sub-committee's decision.

The reasons for establishing both the ad hoc committee of representatives from governments, central banks and international financial institutions and the sub-committee of creditor banks can be found in the nature of the crisis. Once a crisis erupts, there ensue debates on whether the crisis was caused by weak market fundamentals or financial panic and whether the debtor is insolvent or illiquid. In the case of financial panic and illiquidity, the ad hoc committee could arrange official loans to stabilize the financial markets. In the case of weak market fundamentals and insolvency, the sub-committee of creditor banks should decide on either debt restructuring or debt reduction. In fact, economic distress contains elements of both weak market fundamentals and self-reinforcing financial panic. Therefore, the ad hoc committee must endeavor to facilitate the sub-committee of creditors.

The Korean government also proposed temporary standstills or an automatic rollover of debt during the first three months of IMF assistance in order to provide the time needed for debt restructuring negotiations.

The above suggestions for the ad hoc committee and temporary standstills are based upon the Korean experience. Although Korea has overcome its financial panic, processes of both the bail-out and bail-in are so ad hoc as to have worsened the crisis soon after the provision of the IMF loans. The IMF did not seem to take PSI into consideration when it provided $10 billion in accordance with the standby agreement with Korea on December 4, 1997. The creditor banks continued to withdraw from Korean financial institutions, necessitating the bail-in mechanism for private investors. PSI had not started until Korea was embroiled in effective standstills on short-term debts. Upon the moral suasion of G-7 central banks and governments, the major creditors agreed to tentatively rollover their exposure for three months until the final contracts are signed.

During the negotiations for debt restructuring, the G-7 governments and central banks as well as the IMF played the central roles in reaching the final contracts. They established effective standstills by persuading major creditors to maintain credit lines through March 1998. In addition, they pledged a second line of defense on top of the official financing, although it was not disbursed.

Other suggestions were presented by the Korean government. In consideration of the insufficiency of the IMF program financing to stabilize its financial markets, the Korean government proposed that the emergency funding from international financial institutions should be linked to a private sector debt workout program as arranged by an ad hoc committee. It further proposed that the conditionalities should be imposed on the country through the cooperation of the IMF, the World Bank and other regional development banks. The negotiations on the conditionality should proceed simultaneously with the negotiations of the ad hoc committee.

Korea supported the inclusion of the collective action clauses in sovereign and quasi-sovereign bonds with the initiative of the G-7 countries. It asked contingency financial agreements with international banks to secure more liquidity in crisis. It also supported lending into arrears, temporary stays on creditor's litigation for non-sovereign debt, and sanction on a temporary halt of debt repayments to strengthen the IMF's role in helping crisis-hit countries.

I will discuss Korea's suggestions for PSI by topic and specific measures as follows. Since there have already been heated debates on PSI in the aftermath of the Asian crisis, I take stock and establish my position.

1. Moral Hazard

Moral hazard of the creditors constitutes the argument for PSI because the practice of bailing out the private investors through the official financing creates a moral hazard problem on the part of the private investors, since they will knowingly be rescued from the crisis. The distortions created by the creditors' moral hazard should be removed by involving the private sector in crisis prevention and resolution. This moral hazard rationale for PSI could be mitigated by the moral hazard of debtors. If the financial crisis was caused by the debtor's moral hazard, e. g., the government guarantees of bank loans, such distortions will remain even after bailing in the private sector. Thus we should pay close attention to the practical as well as theoretical significance of moral hazard distortions in crisis prevention and resolution.

There have been contrasting views on the importance of moral hazard. Calomiris (1998), Meltzer (1998), and Dooley (2000) stress the moral hazard aspect of crisis prevention and resolution, while Fischer (1999) and IIF (1999) underrate the importance of moral hazard. When we discuss the importance of moral hazard, we must make distinction among various aspects of moral hazard. First, one must distinguish between the moral hazard of the debtors and the moral hazard of creditors. Second, one must distinguish between the moral hazard before the crisis and the moral hazard after the crisis. Third, one must distinguish the static aspect of moral hazard from the inter-temporal aspect.

For instance, the practice of bailing out the private sector may create or not clear away moral hazard of both the creditors and debtors, both before and after the crisis, and both in the static and inter-temporal sense. However, if the IMF conditionality imposed after the crisis succeeds in removing the debtors' moral hazard which was prevalent before the crisis, and if the sanctions from the international community are enough to prevent the strategic defaults of the debtors, we can concentrate on PSI to remove the creditors' moral hazard.[3] Thus the real issues in the moral hazard lie in whether the conditionalities on the debtor country are so appropriate as to inhibit the debtors from suffering moral hazard and whether the private sector is involved in crisis prevention and resolution.[4]

As far as the moral hazard issue is concerned, the case of Korea poses a question on the effectiveness of the IMF program and the debt restructuring. The government fully guaranteed deposits at all financial institutions and bailed out some non-bank financial institutions and corporations during the financial restructuring process. It replaced the short-term inter-bank loans with the government-guaranteed bonds to extend maturities in the debt restructuring. In a situation of financial panic, the government may guarantee deposits at the financial institutions and bail out some, not all, financial institutions and corporations. Nonetheless, the extension of government guarantees to short-term inter-bank loans cannot be justified since it creates the moral hazard problem not only of the creditors but also of the

[3] Lane and Phillips (2000) test whether the IMF programs are a source of moral hazard and find no evidence.

[4] IIF (1999) argues that private investors share the burden with the losses in the stock and bond markets. But the losses incurred by the crisis might be attributable to the creditors' moral hazard before the crisis so that the creditors should share enough burden to bail in the private sector.

domestic financial institutions.

PSI entails enhancement of debts through partial or full guarantees. However, such guarantees are provided in general by official creditors including international financial institutions on new debt instead of existing debt (IMF, 1999a). The Brady Plan can be cited as a case of enhancement of existing debt, but in this case the official sectors provided collateral to facilitate the reduction of existing debt.

The provision of government guarantees on maturity extension as found in Korea's debt restructuring would not be listed in the appropriate framework of PSI. The Korean government should not have replaced short-term inter-bank debt with government-guaranteed bonds, because the maturity extension is distinguished from the new debt. If the Korean government has to provide guarantees, it should preferably guarantee new debt rather than old debt. If it has to guarantee existing debt, guarantee would be associated with the debt reduction as in the Brady Plan.

2. Creditors' Committees or Collective Action Clauses

The Asian crisis countries are all in the same situation in that a non-sovereign debtor has a number of private creditors. They all seek to establish collective negotiations through the creditors' committee and achieve voluntary standstills before the final contract for debt restructuring. However, they learned that establishing collective negotiations was unquestionably difficult due to the diversity of creditors and the complexity of financial instruments.

Korea's suggestion for the ad hoc representative committee is based on the London Approach that was developed by the Bank of England in the early 1990s to establish debt workout program in the private sector. The London Approach is the framework of collective negotiations in which creditor banks adhere to the non-binding principles for collective action with the sufficient information needed to make decisions and reach a voluntary standstill often in conjunction with new financing for non-sovereign debtors. Even the negotiations within the creditors' committee would not be easy. The diversity of creditors and the complexity of financial instruments impede negotiations, as seen in the recent cases of Pakistan, Ukraine and Russia. While those cases are complicated by bonded debt, the Asian cases involve short-term inter-bank claims. The formation of creditor's committee would help facilitate collective negotiations when the bond instruments and credit derivatives are not used widely.

The suggestion of the ad hoc committee instead of the standing committee intends to emphasize the special character and role of the ad hoc committee compared to the standing committee. Examining the formation of a permanent creditors' body that can represent creditors, the IMF (1999c) finds difficulty in establishing it on an ex ante basis due again to the growing diversity of creditors and the complexity of financial instruments. The standing committee that existed relied on experts rather than creditor representatives to conduct negotiations or on both. It was not engaged in the sovereign debt restructuring, but worked to establish ad hoc committees conducting the negotiations, if necessary.

As far as the bonded debt is concerned, Korea as much supports the inclusion of collective action clauses as it suggests the ad hoc representative committee. There have been many arguments for and against collective action clauses. Eichengreen and Ruhl (2000) criticize the ad hoc approach to PSI and argue that introducing collective action clauses into loan agreements to bail in the private sector is the time-consistent and forward-looking solution to the moral hazard problem. The Cologne Summit followed by the Fukuoka Summit also endorsed the collective action clauses to strengthen the principles and tools of the case-by-case approach.

The objections were raised in three directions. First, collective action clauses reduce the bargaining power of bondholders and increase the debtors' moral hazard. Dooley (2000) argues that the market failure on account of the coordination problem among bondholders is justified by moral hazard and possible strategic defaults of the debtor side. His argument is related to the discussions on the above moral hazard. Again, if the IMF and other agents cannot prevent the debtor from falling into moral hazard and strategic defaults, Dooley's point makes sense. If the debtor defaulted because she is insolvent and not because she suffers from the moral hazard problem, collective action problems of creditors become the stumbling block to crisis resolution.

Second, some argue that collective action clauses deepen a crisis as investors withdraw funds for fear of burden-sharing when uncertainty closes in. This forward-looking behavior of the investors should not be blamed to have aggravated the financial market because the investor behavior accords with the markets that are exempt from the collective action problem. On the contrary, such forward-looking behavior facilitates and advances PSI instead of magnifying the crisis. Eichengreen and Mody (2000) find that collective action clauses reduce the cost of borrowing for more credit-worthy issuers because of the advantages of orderly restructuring. It is interesting to note that, in their study, collective action clauses increase the spreads of less credit-worthy issuers. This is interpreted as that the benefits of orderly restructuring are offset by moral hazard and default risk accompanying easy restructuring. Thus their findings could support concerns raised by Dooley (2000) for debtors of bad ratings. In this case the IMF or other influential official sectors should be alert to the debtors' moral hazard. Their surveillance role should not be overlooked in the debt restructuring under the collective action clauses.

Third, it is argued that the benefits of collective action clauses are marginal so that their importance is exaggerated. Looking at the recent cases of bond restructuring in Pakistan, Ukraine, Russia, and Ecuador, Roubini (2000) argues that debt restructurings have occurred through debt exchange in the cases of Pakistan and Ukraine where the bonds included collective action clauses. Such clauses were marginally useful, as the possible threat of their use may have induced some creditors to accept the debt exchange offer. The debtor and debt agents such as trustees are concerned that the formal negotiations in the bondholder meetings may take two long. However, Eichengreen and Ruhl (2000) are very negative about the debt exchange offer in Ukraine by writing that "(b)ut this conversion is likely to be more difficult than the 1998-1999 restructuring of domestic treasury bonds, because holdings are more widely dispersed and there exist cross-default clauses. Because the most widely held bond is subject to New York law, there is the danger of bondholder lawsuits, which will hold hostage the entire restructuring process." The recent cases of bond restructuring in Pakistan and Ukraine do not prove that the current practice of debt exchange is an efficient alternative to the formal negotiations under the collective action clauses.

3. Standstills or Automatic Rollover

The temporary standstills that Korea proposed in early 1999 are now more widely discussed as a way of PSI. More recently, it has been suggested that the country could resort to the debt standstills through a combination of the suspension of debt payments and the comprehensive but temporary exchange and capital controls. The capital controls, standstills and lending into arrears were recommended as policy tools at the Cologne Summit. If a financial panic creates a liquidity crisis, the standstills would inhibit the creditor-grab race and contribute to restoring the investor confidence. Eichengreen (2000) proposes payments standstills sanctioned by the IMF in the event of liquidity crisis.

While the liquidity crisis can justify the standstills, the country would also be willing to impose standstills in the opposite case of the fundamental solvency problem. If the country is insolvent, the rollovers and new loans by the creditors are involuntary in nature. It will be quite difficult to reach agreements of involuntary lending if there are no institutional mechanisms like the creditors' committee and collective action clauses. Even if they exist, collective negotiation takes a long time. The standstills in this extreme situation may provide breathing space for successful debt restructuring and protect the country from unnecessary disruptions. The temporary suspension of debt payments needs to be distinguished from outright sovereign defaults since the standstills will be lifted immediately after the conclusion of negotiations.

Note that the standstills bring costs as well as benefits so it is not obvious that they would have worked. The credible threat or actual imposition of a standstill could catalyze a voluntary and market-based agreement, but it could trigger the rush to the exits in the form of large capital outflows and the contagion. Concerns about the turbulence created by the standstills deter the actual imposition, although the benefits might offset the costs of financial turbulence due to the standstills. The IMF study (2000) on the effects of the standstills finds that the effects vary according to the factors such as the composition of external liabilities, the systemic importance, and the general state of capital markets of the country.[5] Thus the implementation of the standstills should not be automatic but dependent upon various factors.

The alternative of the automatic rollover is similar to the call options to inter-bank credit lines as a means of providing a contractual basis for extension of maturities under specified conditions. The country can avoid the debt suspension by exercising the rollover option whose price has been paid in advance. The concern here is whether to charge a penalty rate when the borrower extends the maturity for a specified period, as in the universal debt rollover option with penalty (UDROP). The penalty can be justified by the moral hazard of the borrowers who tend to exercise the rollover option under orderly market conditions. However, if the borrower exercises the option when she became insolvent under disorderly market conditions, she might not have paid the penalty. Thus it is not easy to charge the penalty when the option of debt rollover is exercised. The option price may include the penalty that will ensure the rollover at a rate higher than the normal rate, but lower than the market rate prevailing when the market turned disorderly. Even the call options to inter-bank credit lines may hardly be traded in the market, since the modalities of such an instrument are problematic. IMF (1999a) correctly points out that "the design of a satisfactory trigger appears elusive, which does not augur well for the pricing of the instrument."[6]

IV. Assessment of the Private Sector Involvement in Korea

1. A Brief

When the usable foreign reserves rapidly depleted below the $10 billion line in November 1999 with capital outflows and intervention in the foreign exchange market, Korea had no other option than to request the IMF assistance. Table 1 shows the trends in balance of payments and foreign reserves during August 1997-July 1998. In November 1997, the capital account showed net outflows of $4.5 billion, but the usable foreign exchanges excluding the deposits at offshore subsidiaries of financial institutions decreased by $15 billion.

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[5] The standstills raise the legal issues related to the litigation to seize the assets of the debtor. The stays of litigation should be discussed in association with the standstills.

[6] Eichengreen and Ruhl (2000) also comment on the UDROP that it remains in the realm of the theory without any practical experience yet.

<Table 1> Balance of Payments and Foreign Reserves in Korea

(100 million, U.S. dollars)

	Current Account	Capital Account			Usable Foreign Reserves
		Total	Direct Investment	Portfolio Investment	
1997					
Aug.	-5.0	-15.6	-2.7	8.0	231.3
Sep.	-5.1	4.5	-1.4	19.5	224.2
Oct.	-4.9	9.2	-1.0	4.1	223.0
Nov.	8.6	-44.6	0.5	-8.2	72.6
Dec.	35.9	-63.7	-1.6	8.3	88.7
1998					
Jan.	29.6	-11.6	0.8	3.7	123.6
Feb.	41.8	-1.3	-0.4	21.7	185.4
Mar.	35.8	-1.2	-0.7	12.7	241.5
Apr.	36.2	29.1	-0.0	36.7	307.6
May	40.7	0.9	3.8	-12.0	343.5
June	33.2	-4.3	1.8	-19.0	370.4
July	37.7	-5.6	9.3	-6.7	392.6

Source: Bank of Korea, database.

In November 1997, the foreign exchange holdings decreased by $6 billion, a little larger than net capital outflow of $4.5 billion. The drastic decline in the usable foreign reserves by $15 billion is attributable to the channeling of the reserves to banks' offshore subsidiaries that could not already roll over their short-term inter-bank loans.[7]

<Table 2> shows the external liabilities in Korea. At the end of September 1997, the short-term liabilities accounted for more than half of the total liabilities. The three fourths of the short-term liabilities were owed by the financial sector. In particular, the short-term liabilities of the offshore subsidiaries of financial institutions amounted to one fourth of the total short-term liabilities. Most liabilities are attained by the borrowings, as the bond financing comprises one fourth of the total liabilities. This feature in external debt distinguishes Korea from other Asian crisis countries and transitional socialist countries.

On December 3, 1997, the IMF approved a three-year stand-by arrangement with Korea that amounted to $21 billion ($13.5 of supplemental reserve facility and $7.5 billion of standby loans). The World Bank and the ADB promised to provide $10 billion and $4 billion, respectively. In addition, 13 countries pledged $23 billion as a second line of defense. The total package amounted to $58.4 billion.

[7] The foreign currency financing of the commercial banks for their offshore subsidiaries through the facility provided by the Bank of Korea was problematic even after the IMF standby agreement on December 3, 1998. According to the IMF program, the spread applied to this facility widened to 400 basis points over LIBOR. However, as the market spread rose much higher, the banks made extensive use of this facility. The spread was adjusted to 1,000 basis points in tune with the market rates.

<Table 2> External Liabilities in Korea

(billion, U.S. dollar)

	Total	Long-term	Short-term				
			Total	Financial Sector	(Offshore Subsidiaries)	Private Sector
1997 3/4	180.5	82.3	98.2	75.4	(27.3)	22.7
4/4	159.2	95.7	63.6	42.4	(9.4)	21.2
1998 1/4	154.4	100.9	53.5	38.8	(9.8)	14.7
2/4	155.2	121.3	33.8	21.2	(2.8)	12.6
3/4	151.9	121.2	30.7	18.4	(2.7)	12.2
4/4	148.7	118.0	30.7	18.9	(3.0)	11.8
1999 4/4	137.1	97.8	39.2	22.5	(3.4)	16.7

Source: Bank of Korea, database.

The large financing package was accompanied by the program of structural reform and macroeconomic adjustment. The structural reforms were comprehensive, but it concentrated on the financial and corporate sectors. The macroeconomic adjustment aimed to stabilize exchange rate and contain inflation through the tight monetary and fiscal policy.

Despite the assistance from the IMF, the rollover of short-term debt went down sharply and the capital outflows accelerated to exhaust foreign reserves to $4 billion and push up the won/dollar exchange rate. This led to the quasi-voluntary PSI with suasion from the G-7 authorities on December 24, 1997 that entails the agreement to rollover their exposure. The rollover rate of the short-term debt increased from 26.3% in December 1997 to 81.9% in January 1998. Therefore the quasi-voluntary or semi-coercive agreements on December 24, 1997 are considered to be equivalent to the effective standstills.

After a series of extensive negotiations, the Korean government and 13 representatives of foreign commercial banks agreed on the principles of maturity extension on January 28, 1998, which necessitated the conversion of short-term claims worth $24 billion on the Korean banks into government-backed bonds, due to mature within one to three years at spreads of 225-275 basis points. The final contracts were signed on March 31, 1998. On April 8, 1998, the Korean government issued global bonds (Foreign Exchange Stabilization Bonds) of $4 billion with maturities of five and ten years. The spreads were 345 to 355 basis points over the TB rates, lower than that of 400 basis points for a Eurobond launched by the Korea Development Bank in February 1998.

The conclusion of the negotiations on maturity extension did not immediately contribute to stabilizing the financial markets. Since the maturity extension was anticipated in late December 1997, its positive effects seem to have appeared in advance. Both the interest rate and the exchange rate have shown a stabilizing trend since the early 1998. However, the stock price continued to nosedive after a recovery in January 1998. The stagnant stock market could be explained by the substantial contraction of output associated with the IMF program of tight monetary policy and structural adjustment. The repression of real activity can help stabilize the interest and exchange rates at least in the short term, as the curtailed domestic demand reduces the demand for funds in the financial markets and the demand for foreign exchange needed for imports in the exchange market. Indeed, the magnitudes of the negative growth and the consequent slackening in the demand for funds and surplus in the current account exceeded the forecasts of most institutions including the IMF. It is interesting to see in <Table 1> that the portfolio investment showed net inflows during February-April 1998 while the stock price was plummeting.[8]

The brief overview above raises a couple of issues related to PSI for Korea. First, the IMF did not envisage PSI when it announced the rescue package on December 3, 1997. Having seen the continued decline in the rollover of the short-tem debt, it began to hurry to exert pressure on the creditor banks through the moral suasion from the G-7 governments and central banks in late December 1997. Second, Korea's PSI was as much ad hoc as in other cases of debt restructuring. A consensus on the maturity extension principles was reached through very informal negotiations between the Korean government and 13 representatives of foreign commercial banks. Third, the burden-sharing between the debtors and creditors was so ambiguous that one can ask whether the bail-in of private sector was actually the shift of the burden from the official sector into the debtor. We discuss each issue in the following.

2. Delayed PSI

As described earlier, the process of bailing in the private sector did not start until the depletion of foreign reserves drove Korea at the brink of a moratorium or standstills in late December of 1997. In a self-assessment of the IMF-supported program in Asia, Lane et al. (1999) admit that the programs in Korea and Indonesia were formulated without any advance agreement to restructure debt, while the authorities received assurances and indications regarding maintenance of credit lines of foreign banks resident in Thailand. Then they expressed the opinion that, if the creditor banks were pressed to restructure debt beforehand, "this would likely have lengthened and complicated program negotiations by turning them into (at least) a three-way process, and (particularly in Korea) there was not much time before a moratorium and/or exchange controls would have had to be activated."

This opinion is not highly convincing. If the programs in Korea and Indonesia were faced with unfavorable market reactions compared to the program in Thailand, it might stem from the absence of steps to restructure debt. The economic situations in Korea and Indonesia were not worse than in Thailand at the outset of the crisis. The pre-crisis macroeconomic figures of Korea looked far better than those of Thailand. By some measures in the early warning system (Goldstein, Kaminsky, and Reinhart, 2000), the chances for crisis turned out relatively scarce in Indonesia.

The reasons for delayed PSI are in order. First, the relative ease with which the debt is restructured would likely have shortened and simplified program negotiations and there was much time before a moratorium would have had to set in. In Thailand, assurances of the rollover were facilitated by the fact that the bulk of short-term debt involved Japanese banks on the creditor and debtor side. In contrast, most of the private debt was owed by domestic financial institutions in Korea and by private corporations in Indonesia.

Second, the IMF might be persuaded by Korea's relatively sound market fundamentals that the large official financing with the appropriate adjustment program would be sufficient to alleviate the liquidity problem and draw a positive response from creditors. A pure liquidity crisis validates a full bail-out or full bail-in, so says the so-called Krugman hypothesis, since a partial bail-out or a partial bail-in would not remove the instability in the multiple equilibria and bring about the rush to the exits in order not to be bailed in. Then the IMF opted for the full bail-out rather than the full bail-in because the former can be implemented quickly.

This is a question about market fundamentals versus self-fulfilling expectations or insolvency versus illiquidity. Those who emphasize the self-fulfilling nature of crisis assert

[8] IIF (1999) describes that "Although experience varies, in the case of Mexico and South Korea portfolio equity proved to be "patient money" during crisis and played an active role in new investment inflows in the post-crisis recovery." Are portfolio investors really patient?

that crisis occurs due to speculation even in the absence of structural problems. However, they miss the important point that the self-fulfilling model envisions the triggering mechanism in the presence of structural weaknesses. It does not show that crisis occurs irrespective of market fundamentals, but that the self-fulfilling crisis occurs when the economy enters a crisis zone due to structural weaknesses. The difference is the timing. While the market fundamentals model admits the immediate crisis when the economy enters a crisis zone, the self-fulfilling expectations model points out the possibility of crisis at any point of time within the crisis zone. In this context, Krugman (1996) downplayed the self-fulfilling nature of crisis.

Right after the inception of the Asian financial crisis, there appeared different views of weak market fundamentals and self-fulfilling expectations on the causes of the Korean crisis. Many identified the structural problems of the crisis countries and went further to define the Asian economic system as the crony capitalism. In the case of Korea, many argued that Korea suffered from the crisis due to lax financial supervision and regulations of financial institutions and the significant mismatch in the sources and uses of funds, despite the fact that it maintained sound macro-fundamentals compared to other Asian neighbors (Krugman, 1998; Corsetti, Pesenti and Roubini, 1999, Park and Choi, 1998). The dissenting views that investors' panic triggered a sudden reversal of capital inflows are also popular (Radelet and Sachs, 1998; Lee and Lee, 1998; Krugman, 1999).

With the occurrence of the financial crisis, the market fundamentals view seemed to have gained popularity, but the swift recovery of the Asian economies after the drastic output decline strengthened the financial panic view that stresses the role of self-fulfilling expectations. For example, Krugman (1999) switched to the latter view from his early position, which held to structural factors such as moral hazard, when he saw the sharp contraction and massive unemployment in the crisis-hit region. Different views on the causes of the crisis lead to different approaches to debt restructuring. The lesser success of the IMF program financing may stem from the mistaken view that the IMF holds for the Korean economy and debt solvency.

If the Korean crisis was driven by weak fundamentals, a full bail-out to rule out the multiple equilibria may not be needed. A partial bail-out cum a partial bail-in or full bail-in is the better alternative, taking into account the creditors' moral hazard.

Third, the IMF might be ambitious over its program of structural and macroeconomic adjustments. While Lane et al. (1999) argue that the creditors did not respond positively to the rescue package because of hesitant program implementation, Sachs (1998) asserts that the IMF's crude program inappropriate to the liquidity crisis aggravated the economic conditions and subsequently delayed PSI.

3. Ad Hoc Approach

The PSI approach in Korea is characterized by the semi-voluntary maturity extension with the moral suasion of G-7 authorities. This is another example of the case-by-case approach with principles and tools in which the 'constructive ambiguity' applies. However, Korea proposed a more rule-based approach that was discussed in the previous section. Korea suggested that the negotiations on the conditionalities for the debtor country should proceed simultaneously with the negotiations of the ad hoc committee in session. It supported the collective action clauses and the temporary standstills as a means of coping with the coordination problem among creditors.

Recently the international financial institutions are making efforts to mitigate the moral hazard created by their rescue package by involving the private sector in crisis prevention and resolution. However, their practical approaches to PSI taken in Pakistan, Ecuador, Romania, and Ukraine are questioned on their appropriateness. The same question can be raised for the case of the Asian crisis. PSIs in Korea, Indonesia and Thailand look dissimilar to one another, but there is no convincing explanation for their difference. The collective negotiations were carried out, but they were very informal and not transparent. For instance, the rollover agreements in Thailand seemed less formal than the ones in Korea and Indonesia. (Could it be because the Japanese banks are involved in Thailand?) The spreads on the rollover of the Thai debt are not known in public, while those of the Korean and Indonesian debts are known openly.

4. Burden Sharing between the Debtors and the Creditors

The burden sharing between the debtors and the creditors is very important for the success of PSI since the inappropriate burden sharing will bring about another chain of negotiations. Korea signed on the contracts by which $22 billion of inter-bank claims were converted into bonds with maturities of one to three years and spreads of 225 to 275 basis points. It can be judged that the creditor bore the burden to a larger degree since the spread applied to the debt restructuring was lower than the market spread at that time and spread on the global bonds issued by the Korean government in the following month. The Korean government regained access to the international market after signing the final contract for maturity extension, by issuing global bonds with maturities of five and ten years at spreads of 345 to 355 basis points.

This kind of judgment on burden-sharing has limitations. First, we must discern the old money and new money. The negotiations were carried out on the old money- inter-bank credits that were already made-which has difficulty in paying. The spread applied to the existing debt would be lower than the spread on the new bond issues, since the new money has option value due to uncertainties regarding capabilities of debt repayments (Krugman, 1988). Second, we must take into account that the government provided guarantees to the commercial bank debts. The government-guaranteed bonds should be distinguished from the KDB bonds, KEPCO bonds and other bonds of private companies without any government guarantee. Third, the lower-than-market spread could not be a burden to the creditor if the debtor is insolvent, not illiquid. The spread cannot be high because the debtor cannot pay. We discussed previously whether the Korean crisis was driven by market fundamentals or self-fulfilling expectations. Since the economic vulnerabilities in Korea reflected weaknesses in the market fundamentals and stemmed from the fundementals insolvency, the creditors should bear the larger burden.

V. Concluding Remarks

This paper reviewed the PSI process in Korea and discussed its suggestions for PSI. Since the paper was written from a Korean perspective, it may be biased toward the debtor side. But a few people would agree that the IMF-supported program was successful in Korea in terms of the private sector involvement. PSI was much delayed and ad hoc. The burden should be shared for the sake of fairness.

Since Korea's suggestions on the framework of PSI are based upon its own opinion on the focal points from the perspective of developing countries, I draw the following implications from Korea's approach to PSI.

First, the PSI approach should have respect for the rule to make PSI transparent and consistent, although the complexity and novelty of each case of crisis attest the value of constructive ambiguity. The current case-by-case approach stresses the principles and tools to prevent it from being ad hoc. However, the PSI framework prepared in the Cologne and Fukuoka summit has not yet been implemented comprehensively in the recent cases of debt restructuring.

Second, the debtor's moral hazard should not be overemphasized, in particular after the crisis when the international financial institutions would not allow it. The distortions are created by the moral hazard of both the debtors and creditors, but the sanctions from the creditors can prevent the debtors from indulging in strategic defaults or the pre-crisis moral hazard that caused the crisis. The recurrent crises in many developing countries could represent the poor PSI and too much bail-out. They should not be totally attributed to the moral hazard on the part of debtors.

Third, the tool of collective action clauses for bonded debt endorsed in the Cologne and Fukuoka summit should be pursued by the U.S. Albeit some caveats, the incorporation of the collective action clauses is the time-consistent and forward-looking solution to the moral hazard problem.

Finally, the tool of standstills and lending into arrears should also be implemented into the debt restructuring. Soon after the crisis, the crisis-hit countries enter the effective standstills, as seen in Korea, although it did not formalize the debt standstills. What distinguishes the actual standstills from the effective standstills is the balance of negotiation power between the creditors and debtors. The actual imposition of a standstill could bring costs such as the rush to the exits, but the costs would not be significant when the country entered or is entering the stage of the effective standstills.

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Comments and Discussion

Khee-Giap Tan: I have few questions to ask him about the problem of debt in Korea. Is it more of solvency or is it more of liquidity? If it is a solvency problem where you want to get the private sector involvement, you will have different kind of angle as compared to liquidity. In liquidity, it is easier to have private sector involvement but in solvency, it is much more massive and messier as well. You also said that most of the debt in Korea, unlike other countries, the creditors were Japanese banks. I want to know if most of the creditors are foreign banks and if this is the case, what kind of problem do you have? If it is an interbank creditor, then it will have big number, so do you have problem in Korea of pervasive creditor coordination problem? Also I would like to know that how this private sector involvement (PSI) can come in to solve the debt problem without creating further complication where bankers don' t have core competence.

You also mentioned that PSI only comes in after the standstill of few months. Obviously, what is the major reason for getting the PSI not as early as expected? In terms of PSI, are there other sources of PSI where we can tab? I am referring to the case how Singapore banks were involved in PSI in Thailand where ADB came in as a guarantor for the bond issues by the corporations. I think one of the constructive way when access liquidity cannot find avenue and where you have a debtor who needs restructuring, is that the regional agency plays a role as a facilitator. That comes to the next point I am talking about, in terms of the debt restructure problem that we now see in Thailand, Malaysia, and Indonesia, how to get PSI here. I think we need professional bankers act like an auctioneer who can repackage the debt and also package in such a way to put aside the conflict of interest which is the reason for making those debt restructuring not taking place as fast as we would like to in Thailand, Malaysia, and Indonesia. So when you have professional middlemen to repackage these debts, I think we would be in an easier position to move on to these restructuring process. If the restructuring is not making fast enough progress, all the recovery we are seeing now could be artificial and I think this is one of the time bomb that is really making us worried about ASEAN. This restructuring process is just dragging on under the false hope that recovery is almost there. But I think that we may be misleading ourselves.

So the process of waiting for someone who is not involved in the whole process, someone outside to come in where they can bypass all the interests is, I think, holding down many of restructuring process

Jang Yung Lee: Let me make few comments on some issues raised such as the assessment of PSI in Korea, and on how to cope with collective action problems.

The negotiation period from Dec. 24, 1997 to March 31, 1998 for Korea was relatively short and really amazing compared to other cases. For example, the Mexico in 1982 took more than 2 years of intensive negotiation. So we must ask what contributed to such a successful restructuring experiment in Korea. Obviously, one of the factor is the pressure on the creditors through moral suasion from G-7. But also, the fact that there were only handful of creditor banks and virtually one debtor, which is Korean government has facilitated orderly restructuring in such a short period of time.

This case of Korea cannot be easily replicated in other countries. So, we need to institutionalize some formal process by which creditor banks can communicate among themselves or the debtor would agree on more mutually acceptable terms. In this sense, Korean proposal of ad hoc committee, or sub committee on creditor bank is a very good idea.

Second issue I would like to talk a little bit about is the IMF lending policy so called lending into arrears. Until 1980s, the IMF lending policy was to lend to countries in balance of payment difficulties only after they reach agreement with their creditors. But since 1989, they changed this policy to start providing emergency financing before agreement with debtors had been reached. The main reason was the recognition that the old approach was not so successful in encouraging the burden sharing by the creditor banks because it gave the banks in Paris Club or London Club the de facto veto power to refuse the settlement with the debtor country on favorable term. The debtor country could not obtain any new IMF money unless it accepts creditor' s terms and conditions in the negotiation. But on the other hand, the new approach provided working capital for the crisis-stricken economy and thereby it helped. However, in the case of Korea and Indonesia, the new IMF policy fell short of full crisis resolution and finalization of Korea' s IMF package has failed to convince private lenders of the creditworthiness of the Korean economy. In the past the commitment of the IMF resources in support of specific country signaled the confidence of that country' s economy but in the case of Korea such signal was very weak and resumption of private capital was not materialized as expected. In other words, so called the catalytic function of the IMF money did not work at all.

We all agree that some mechanisms are needed to effectively pre-commit private sector participants to maintain or provide additional net exposure in times of crisis. However, the mechanisms are also needed to limit the moral hazard on the part of debtors, and distortion to the market in normal times. Introducing new contractual provision can make easier for debtor countries to get out of the difficulties but we must question whether such provision in fact raise the borrowing cost. This is an empirical question that needs to be confirmed or reputed on the basis of the actual evidence. So far, there is no convincing evidence found to support the argument that collective action clauses will raise the cost of borrowing. As pointed out in the paper, Eichengreen and Mody' s finding could be used to support the argument only partially that such clause will raise the spread of less creditworthy issuers only. So there is no reason why investors should shun the bonds with such features.

Having said this, I must point out the fact that, though there are many proposals made, and endless discussions followed, there have not been any concrete progress made so far. Professor Park mentioned that G-7 summit has endorsed collective action clauses repeatedly but I think they need to elaborate further. All these G-10, G-20 report have reluctantly acknowledged the need for such clauses but, again, they failed to commit specific actions. So one way of pushing it ahead would be to have the IMF to urge its members to add collective action clause to all international bonds as a condition for being admitted to the domestic market.

Final remark on this call option. I think the short term interbank loan was at the heart of Korean liquidity problem. This interbank loans are more difficult case than the bonded debt. And interbank loans are not governed by formal contract and therefore the re-negotiation cannot be made easy by altering contractual provisions. So the call option could be one of the ideal measure for involving private sector lenders in times of crisis because it helps to extend maturity of interbank credit lines. However, in extreme situation, the exercise of such options could lead to lots maturing short term credit line in advance of call. Therefore, when interbank credit line is major source of country' s short-term liquidity as was in Korea, the triggering of the call options could actually aggravate or precipitate the situation.

General Discussion: Griffith-Jones mentioned that collective action clauses are already in the CCL which of course has not been used. She said she is not sure if they specify collective action clauses but the IMF do say something about link between debtors and

The recent Asian financial crisis which first began in 1997 has raised a critical question on the adequacy of the existing international financial architecture and provided an impetus for discussion on how it can be modified or redesigned. The basic institutional framework of the current international financial architecture was laid more than 50 years ago when the Bretton Woods system was established. Obviously, today's international financial environment is so much different that it poses new challenges to the global financial system. In fact, the speed and breadth of contagion of the Asian financial crisis seems to reflect the change.

There have already been many reports and policy recommendations put forward regarding this issue. They include the G-7 Finance Ministers' Report, the Meltzer Commission Report, Task Force Report sponsored by the Council on Foreign Relations, and the Financial Stability Forum's recommendations. However, these reports and policy recommendations are frequently criticized because emerging market views are not fully recognized and their concerns are not fully reflected, although emerging markets are most vulnerable to the systemic risks of the global financial system. Certainly, the global community should make every effort to consolidate emerging market views in establishing a viable new international financial architecture.

An Eminent Persons Group, consisting of experts mostly from emerging markets, was formed with the sponsorship of the Ford Foundation to gather its consensus views regarding critical issues of international financial architecture. For this purpose, an international conference was organized by the Institute for Global Economics and the Korea Institute for International Economic Policy to concentrate on discussing these critical issues among Group members and international experts. This volume is the proceedings of the conference.

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creditors. Lee responded, the UK law permits this kind of bond clauses but the bond issued under the jurisdiction of New York law does not have this kind. And, the IMF has similar facility but that is official contingent credit line, but this we are talking about private contingent credit line like call option on interbank loans.

Wang commented that Korean case is very unique so its successful case can not be adopted to other country's case. He continued, we should be very careful to apply Korean case to other crisis countries because first, the Korean case confirmed the case of implicit guarantee, second, Korea's private debts were turned into the public debt so the issue was very delicate. He also added that PSI mostly involved the sovereign debt, but in the case of Korea, private debt turned into the public debt and then the government intervened and the negotiation started. So the situation was complicated and different from the general case of PSI.

Wang clarified his view that now he prefers the case-by-case approach rather than the rule-based approach. As the former was argued by the U.S. and the latter was proposed by Canada and other European countries, he said he thinks the case-by-case approach developed with some principles and now that has operational guidelines. That is certainly a progress. The problem is that we don't have any specific conclusion so far about the collective action clauses. So many emerging countries, particularly borrowing countries are still very reluctant to go to the London bond market having collective action clauses, even though Eichengreen and Mody strongly advertised it. Finally, he mentioned that the IMF involvement is very crucial. The IMF should develop analytical capacity to distinguish between liquidity and insolvency crisis. Based on that assessment, different types of prescription for PSI could be applied.