EMEPG Seoul Report

REBUILDING THE INTERNATIONAL FINANCIAL ARCHITECTURE

October 2001

Contents

FOREWORD

Waves of financial crises in emerging markets during recent years have given rise to widespread calls for a new 'international financial architecture' that would allow global capital markets to function properly and ensure global financial stability.

A number of distinguished expert groups have recently addressed these issues and have put forward valuable proposals for reforming the international financial architecture (IFA). However, these reports primarily reflect the views of G7 industrialised countries without reflecting the views of emerging markets, although emerging markets are most vulnerable to international financial instability and are most directly affected by the proposed institutional and regulatory arrangements.

With the support of the Ford Foundation, a group of experts from emerging markets has been established to gather consensus views among themselves regarding major issues for reforming the IFA. The Group first met in Seoul, Korea on 9-10 November, 2000, where critical issue areas were identified and discussed among EMEPG members together with leading experts as resource persons. The second meeting was held in Santiago, Chile on 7-8 March, 2001, where a preliminary report was prepared based on discussions among EMEPG members. The final meeting took place in New York, USA on 3-4 May, 2001, where the preliminary report prepared in Santiago was closely reviewed. The views of the EMEPG members who could not attend these meetings were incorporated in the draft through communication.

The Emerging Markets Eminent Persons Group (EMEPG) is made up of the following independent senior personalities:

Il SaKong (chair)	Korea
Edmar Bacha	Brazil
Kwesi Botchwey	Ghana
Solita Collas-Monsod	Philippines
Ruth de Krivoy	Venezuela
Mar'ie Muhammad	Indonesia
Jaime Serra-Puche	Mexico
Manmohan Singh	India
Noordin Sopiee	Malaysia
Chalongphob Sussangkarn	Thailand
Roberto Zahler	Chile

The Group invited world-renowned experts regarding these issues to join the Advisory Board for the project, which was composed of:

C. Fred Bergsten	USA
Rolf Lüders	Chile
Ronald I. McKinnon	USA
Ernest Stern	USA
Joseph Stiglitz	USA
Paul Volcker	USA

The advisory board members were invited to attend the EMEPG's New York meeting, where they provided their comments and participated in the discussions.

Professor Valpy FitzGerald of the University of Oxford, who participated in the project as a rapporteur and resource person, drafted the report. Dr. Manuel F. Montes participated in all meetings both as a Ford Foundation representative and a resource person. The secretariat was provided by the Korea Institute for International Economic Policy (KIEP) and led by Dr. Yunjong Wang.

The EMEPG is naturally concerned with the role of emerging market economies in establishing new international financial architecture. In particular, despite the fact that most of the officially proposed changes to the existing system mainly affect emerging markets, the governments of these countries have not formed part of the bodies that have been mainly responsible for formulating these international norms. The Group is also concerned that stances taken by the G7 countries on their domestic financial, monetary or fiscal policies may have major externalities which destabilise emerging markets despite their best efforts to maintain sound economic policies. The orderly functioning of the global capital and currency market as a whole is central to both the short-term stability and sustainable growth of emerging markets.

The main aim of the Group has been to address the international financial architecture. In consequence, our Report focuses on international financial issues rather than domestic policy reform. Where we do discuss national policies, it is mainly in the context of the international norms or actions that constrain government actions. This focus in no way implies that emerging market governments have no responsibility for instability: in many cases there is still much to be achieved before sound fiscal, monetary and regulatory positions are reached. However, there is clearly an incomplete international agenda to which this Group attempts to contribute.

In the light of these considerations, the Report makes a total of thirty-three recommendations for the consideration of the international policy-making community, which relate to the eight topics that constitute its separate chapters.

The views contained herein represent those of the EMEPG in general. Although not all members are in full agreement with all details of the report, they support the general thrust of the report and the logic of the recommendations. It also has to be mentioned that although the Advisory Board members were asked to review the report and share their valuable opinions, the views contained herein are solely of the EMEPG and do not necessarily reflect the views of the Advisory Board or any of its members.

October 2001
Il SaKong
Chairman, EMEPG

Executive Summary

A central characteristic of the world in the twenty-first century is the increasingly free movement of goods and services across national boundaries. It is now generally agreed that the integration of middle-income developing countries (the ‘emerging market countries’) to global capital and currency markets can lead to increased access to a larger savings pool, the transfer of modern technologies and the opportunity to diversify risk. This integration thus forms part of the economic strategy of almost all countries, although the potential gains must be set against the risk of exogenous shocks transmitted from international markets that can destabilise emerging markets, with profound economic and social consequences.

The first half of the 1990s saw a massive expansion of private financial flows from developed to developing countries, which was widely welcomed as a positive contribution to development. However, the second half of the 1990s revealed that these private flows could be easily reversible, as a succession of financial crises in emerging markets seriously set back important progress in economic growth and poverty reduction. The opening months of the twenty-first century have seen remarkable recuperation of production levels in some emerging markets but continued financial vulnerability in others, while contagion still appears to affect international investors and global capital markets are conditioned by uncertainty as to G3 growth prospects.

Financial fragility in many emerging market economies has been exacerbated in the past by poor corporate governance in (domestic) financial institutions and corporations (both state-owned and private), inadequate financial regulation and supervision, weak institutions and insolvent fiscal systems. Much progress has been made - often under adverse circumstances - to correct these deficiencies by almost all emerging market governments in recent years. However, stronger prudential standards, sound macroeconomic fundamentals, enhanced risk management and improved transparency, although necessary, are not sufficient to provide an assurance of market stability. International action on a coordinated basis is clearly also required.

A number of distinguished expert groups have recently addressed these issues and have put forward valuable proposals. However, these reports primarily reflect the views of G7 industrialised countries, despite the fact that emerging markets are the most vulnerable to international financial instability. With the support of the Ford Foundation, a group of independent and authoritative persons from emerging markets has thus been established to gather consensus views among themselves regarding major issues for reforming the 'international financial architecture' (IFA). The Emerging Markets Eminent Persons Group on International Financial Architecture is thus composed of eleven senior private figures from emerging market countries. The Group also invited six leading international experts regarding these issues to join the Advisory Board for the project.

The Group is naturally concerned with the role of the emerging market economies in establishing new international financial architecture. In particular, despite the fact that most of the officially proposed changes to the existing system mainly affect emerging markets, the governments of these countries have not formed part of the bodies that have been mainly responsible for formulating these international norms. The Group is also concerned that stances taken by the G7 countries on their domestic financial, monetary or fiscal policies may have major externalities which destabilise emerging markets despite their best efforts to maintain sound economic policies. The orderly functioning of the global capital and currency market as a whole is central to both the short-term stability and sustainable growth of emerging markets.

The main aim of the Group has been to address the international financial architecture. In consequence, our Report focuses on international financial issues rather than domestic policy reform. Where we do discuss national policies, it is mainly in the context of the international norms or actions that constrain government actions. This focus in no way implies that emerging market governments have no responsibility for instability: in many cases there is still much to be achieved before sound fiscal, monetary and regulatory positions are reached. However, there is clearly an incomplete international agenda to which this Group attempts to contribute.

In our Report, we discuss eight key topics grouped in three issue areas. First, how emerging market countries should best manage their integration into global financial markets so as to ensure stability and growth; and how best this integration might be supported by the international institutions and the policies of G7 countries themselves. This area includes the speed and sequencing of ***capital account liberalisation*** and the choice of appropriate ***exchange rate regime.*** Second, how the inter-governmental regulatory regimes affecting international banks, bond and equity funds and other financial intermediaries can support emerging markets, and by extension global financial stability. This area includes the ***regulation of highly leveraged institutions,*** the setting of ***international financial codes and standards,*** and ***private participation*** in crisis prevention and resolution. Third, how institutions at the international, regional and country level can best be adapted in order to reduce social cost of financial instability and develop a system of global monetary and financial governance appropriate for the changed global financial market. This area includes ***social protection mechanisms*** for financial stability, the ***reform of international financial institutions*** (IFIs), and ***regional monetary and financial co-operation.***

In the light of these considerations, the Group has made a total of thirty-three recommendations for the consideration of the international policy-making community, which relate to these eight topics.

THE SPEED AND SEQUENCING OF CAPITAL ACCOUNT LIBERALISATION

We urge emerging market governments to adopt appropriate sequencing, pace and scope of capital account liberalisation. After all, capital account liberalisation is not an end in itself, but a means to sustained higher growth.

Prior actions that should be undertaken before liberalizing the capital account include not only fiscal and monetary discipline and trade liberalisation but also measures to attain a private sector savings-investment balance and prudential regulation of bank and non-bank financial intermediaries.

Governments should not be prevented from using market-based instruments (such as transaction taxes or reserve requirements) on short-term capital flows in order to prevent disruptive capital inflows that threaten effective domestic monetary policy and raise the probability of sudden reversals of capital flows. However, such instruments should be used as a temporary safeguards.

Emerging markets should encourage longer maturities on private capital inflows, and discourage short-term borrowing by domestic firms. Banks should be regulated to avoid unmatched and unhedged currency exposure in their balance sheets. Foreign direct investment should be encouraged as it combines long maturity with other benefits such as risk sharing and technology transfer.

Emerging economies should be cautious in internationalising their currencies as offshore markets can be used for speculative activities that can destabilise vulnerable financial systems. Countries should apply an integrated set of rules and regulations to prevent an overly active offshore market for domestic currencies, with the support of international authorities where appropriate.

THE CHOICE OF APPROPRIATE EXCHANGE RATE REGIMES

The international financial community should acknowledge the systemic problems faced by countries whose financial markets are still at an intermediate stage of development and not sufficiently integrated to global markets to rely on permanent access to private financing. The choice of exchange rate regime in order to avoid misalignment should be left to the government. This choice should not be constrained by international financial institutions to the ‘corner’ options of a permanently fixed parity or a free float.

An ‘intermediate’ exchange rate regime may well be preferable in practice for countries trading worldwide and subject to external financial shocks. This intermediate exchange rate regime may need to be supported by market-based intervention instruments or other appropriate regulations in order to contain speculative attacks.

The wide swings of dollar/yen/euro exchange rates are one of important sources of external shocks to emerging market economies, undermining their efforts to maintain sound financial policies and macroeconomic balances. We strongly urge the G3 countries to develop a system by which stable exchange rates among major currencies be maintained.

The Regulation of Highly Leveraged Institutions

Although the use of modern financial instruments such as derivatives can help develop emerging markets, they can also be a destabilising factor in times of economic stress. It is thus urgent that the G7 governments adopt the proposals of the Financial Stability Forum for indirect regulatory measures to be applied to Highly Leveraged Institutions.

In particular, it is important for G7 supervisors to regulate bank lending to HLIs in order to reduce their ability to mount speculative attacks on emerging markets. The timely disclosure of the uncovered positions of large hedge funds and the proprietary trading desks of global banks would also assist in this aim.

G7 governments should encourage their financial supervisors to share appropriate information regarding financial intermediaries under their supervision with emerging markets’ regulatory authorities. By creating mechanisms for effective information sharing, G7 supervisors could effectively monitor the overall size of creditors’ exposure to HLIs.

Setting International Financial Codes and Standards

There is an evident need for emerging market authorities to apply sound regulatory standards, both to ensure the integrity of their own financial markets and to gain sustained access to international capital markets. However, these codes and standards must be flexible in terms of both their timing and their scope. Prior implementation of a single set of 'core' codes and standards should thus not be made a condition for support from the international financial community - such as pre-qualification for contingent credit lines.

This flexibility is required in order to permit adaptation to the specific characteristics of emerging market economies. It is necessary to focus on those aspects of the Financial Stability Forum proposals (such as transparency and timely reporting) needed to ensure access to private capital markets.

The international bodies concerned with global financial standards (the Financial Stability Forum in particular) must adequately represent emerging market authorities because it is these economies where the proposed codes and standards will have most impact.

The G7 governments and the international financial institutions themselves should provide resources and technical assistance to support emerging market governments without sufficient domestic implementation capacity.

The revision of the Basle Capital Accord on bank supervision needs a particular attention paid not to shorten the maturity of private bank lending to emerging markets.

The G7 should take steps towards ensuring stricter supervision of financial transactions in offshore financial centres, and support the US initiative to increase the risk weighting on lending to such centres not meeting international supervision standards.

PRIVATE PARTICIATION IN CRISIS PREVENTION AND RESOLUTION

Over borrowing by emerging market governments, banks and firms is logically matched by voluntary overlending by private investors in advanced economies. There is thus a need for more equitable burden sharing when initial expectations are not supported by subsequent events. Increased private burden sharing would also help to reduce moral hazard on the part of lenders.

For that purpose, the international financial community should explore measures to facilitate greater private sector involvement on fair burden sharing principles. Such measures should be used for a quick and orderly execution of debt relief and restructuring, without undermining the debt contracts, which would restrain market access. Protection of debtors and creditors should be carried out on equitable grounds.

In the long-term, the establishment of an international legal mechanism for restructuring sovereign debt contracts similar to the Chapter XI proceedings under the US bankruptcy law may be desirable. Emerging market economies should first strengthen their domestic bankruptcy laws. They should then explore the possibility of establishing mutual recognition agreements with the leading financial centers.

Ex ante measures for debt restructuring will enhance the degree of predictability when a need to restructure international sovereign bonds arises. Sovereign debtors, both G-7 and emerging market countries alike, should encourage the use of 'collective action clauses' in debt contracts. Conditions such as put-options and cross default clauses that can precipitate default during payment difficulties should be cautiously utilized.

When a debtor country has entered 'bona fide' negotiations with a majority of its private creditors, and is following the terms of an agreement with the IMF, the International Monetary Fund should sanction, and the G7 governments support, a temporary suspension of payments if needed in order to allow negotiations to be successfully concluded.

Social Protection Mechanisms for Financial Stability

The international community should recognise that sound social protection systems should be in place in order to both protect vulnerable groups in emerging market countries and maintain political consensus on sound economic policy.

Greater use of fiscal resources by emerging market governments for public provision of social protection should be encouraged by creditors, so long as it is consistent with fiscal prudence.

The international financial institutions should provide more long-term social funding for emerging market countries when the need arises. Provisions should be made for more rapid and less conditional disbursement of funds as safety nets in crises.

The Reform of International Financial Institutions

Reformed International Financial Institutions (IFIs) form an essential part of the new International Financial Architecture: their constitutional structures, developmental mandates and operating principles require revision in the light of the realities of global capital markets in the 21st century.

In view of the extremely pro-cyclical nature of private capital flows, there is an urgent need for the International Monetary Fund to stand ready to provide the required liquidity on a timely basis, for which purpose greater resources will be needed.

The policy conditions included in loan agreements with the Fund should be tailored to specific economic conditions of the recipient country in question. The imposition of a single model of monetary stabilisation and structural adjustment should be avoided, particularly in the midst of financial crises. The Fund should strengthen and broaden its understanding of the characteristics of emerging market economies by drawing on expertise from these countries.

The pre-qualification conditions for Contingent Credit Lines should be made more realistic so that they help rather than hinder crisis prevention and resolution. This would increase the likelihood that such facilities would be taken up by emerging market governments.

The ‘division of labour’ between the Bretton Woods institutions should be clarified. The IMF should focus on short-run stabilisation policy advice and the provision of liquidity; and should avoid pressures to extend its mission to wider matters of institutional change and development strategy.

The World Bank should focus on longer-term development support, particularly the funding of social and economic infrastructure where private capital is not available on reasonable terms. The ability of the World Bank and other multilateral development banks to support long-term private lending should be augmented by a modification of the gearing ratios in their guarantee schemes. The Bank and the Fund must also coordinate more effectively in crisis situations.

Emerging market countries’ representation in the share capital and executive boards of the International Financial Institutions (IFIs) should reflect more accurately their respective importance in the world economy. Meanwhile, the IFIs themselves should apply internationally accepted principles of institutional transparency and accountability in order to protect the interests of emerging market countries as ‘minority shareholders’.

Regioanl Monetary Arrangements and Financial Co-operation

Regional economic and financial cooperation arrangements should be strengthened in order to promote regional stability, and contribute to crisis prevention and resolution. This in turn should contribute to the stability of the global economy. Regional arrangements for monetary and financial cooperation should be encouraged and supported by the G7 as complementary to the multilateral IFIs.

A future direction for the coordinated use of reserves by central banks in order to prevent speculative attacks has been illustrated in the currency swap arrangements under the initiative of ASEAN+3 countries. Such arrangements may not be as effective for regions where the level of reserves is limited, but the scope for collective action by monetary authorities in support of regional financial stability is worth further exploration.

RECOMMENDATIONS

THE CONTEXT: GLOBAL FINANCE AND EMERGING MARKETS

1. A central characteristic of the world in the twenty-first century is the increasingly free movement of goods and services across national boundaries. It is now generally agreed that the integration of middle-income developing countries (the 'emerging market countries') to global capital and currency markets can lead to increased access to a larger savings pool, the transfer of modern technologies and the opportunity to diversify risk. This integration thus forms part of the economic strategy of almost all countries. However, the potential gains must be set against the cost of exogenous shocks transmitted from international markets that can destabilise emerging markets, with profound economic and social consequences.

2. The factors that make for sustainable economic growth are those that promote private investment, and thus reduce the risk to foreign investors. These factors are a robust, transparent and predictable regulatory system, skilled and disciplined human capital and modern economic and social infrastructure, and above all the rule of law. In terms of economic policy, a low level of debt and debt service, a budget deficit consistent with long-term solvency, low inflation and a competitive real exchange rate are all widely agreed to be policy parameters.

3. Financial fragility in many emerging market economies has been exacerbated by poor corporate governance in financial institutions and corporations (both state-owned and private), inadequate financial regulation and supervision, weak institutions and insolvent fiscal systems. Much progress has been made - often under adverse circumstances - to correct these deficiencies by almost all emerging market governments in recent years. However, stronger prudential standards, sound macroeconomic fundamentals, enhanced risk management and improved transparency do not by themselves provide an assurance of market stability.

4. Countries with these 'sound fundamentals' have also suffered financial collapse, often because of the unsustainable financial behaviour of the private sector. It is also difficult for many reforming governments to overcome the inherited constraints of debt overhang, external shocks and limited administrative capacity. The degree of financial development of the host country is also crucial. The depth and breadth of the

domestic securities market determines the positive effect of capital inflows and outflows on asset prices and the supply of credit. Similarly, the strength of the banking systems (in terms of both capital adequacy and management skills) determines the ability to use borrowed funds properly.

5. The first half of the 1990s saw a massive expansion of private financial flows from developed to developing countries, which was widely welcomed as a positive contribution to development. However, the second half of the 1990s revealed that these private flows could be easily reversible, as a succession of financial crises in emerging markets seriously set back important progress in economic growth and poverty reduction. Increasing concern was expressed in both developing countries and international fora, leading to discussions on a new international financial architecture. The major challenge for this architecture is the facilitation of the access of emerging market countries to sufficient stable long-term capital flows on reasonable terms to support sustainable growth and poverty reduction.

6. Capital markets do not function well on their own, which is why a high degree of prudential regulation of their own national capital markets needs to be maintained by developed and developing countries alike. Markets in many assets may not exist at all. For instance, a market does not exist for longer-term securities in domestic currency issued by many countries, or even for medium-term bank loans for such countries in G3 currencies. There are also significant systemic sources of market inefficiency: asymmetric information leads to lenders knowing less about the value of an asset than borrowers, so lending is sub-optimal; agency problems mean that investors cannot ensure that their contracts are honoured, leading to strong liquidity preference; and economic externalities arise where profit-maximising decisions impose costs on other agents as in the case of 'herding' by fund managers. Finally, financial markets require that risk be effectively priced in order to set it against expected returns. In many emerging markets uncertainty about future circumstances is such that risk cannot be priced and thus investors resort to quantitative limits on their exposure to particular markets or classes of borrower, leading to volatile responses to 'news'.

7. The response to this challenge has taken two directions. On the one hand, there are initiatives to improve the management of capital inflows by emerging market

countries; on the other hand, attempts to reduce global financial instability itself. Efforts to improve capital flow management in host countries include the adoption of sound ‘fundamentals’ through IMF conditionality, World Bank led financial reform programmes, and the introduction of new codes and standards under the aegis of the Financial Stability Forum. Considerable progress has been made and will continue to be made in this direction. In order to mitigate the negative aspects of disruptive capital flows, a number of specific regulatory instruments regimes have also been utilised. However, it needs to be emphasised that as the effectiveness of such interventions tends to decline with time as means of evasion emerge, they should be considered to be utilised as crisis safeguard measures.

8. In contrast, international measures or measures in G7 countries to help stabilise international financial markets have been relatively limited in scope and depth. As regards regulation of banks, little has yet been done to reduce the regulatory bias in favour of short-term loans and proposed changes may make lending even more pro-cyclical than at present. Private international investors seem unwilling to share the burden of crisis prevention, and there are few legal constraints or financial incentives to cause them to become involved.

9. Above all, the continued volatility of the key G3 currencies themselves, while tolerable for these three large economies, causes serious instability in emerging markets that engage in trade and financial relationships with all three currency areas.

10. In sum, there is clearly an incomplete agenda regarding the international financial architecture to which this Group attempts to contribute. In the rest of this Report, we discuss three issue areas:

First, how emerging market countries should best manage their integration into global financial markets so as to ensure stability and growth; and how best this integration might be supported by the international institutions and the policies of G7 countries themselves. This area includes ***the speed and sequencing of capital account liberalisation*** and the ***choice of appropriate exchange rate regimes.***

Second, how the inter-governmental regulatory regimes affecting international banks, bond and equity funds and other financial intermediaries can support emerging markets, and by extension global financial stability. This area includes ***the regulation of highly leveraged institutions,*** the ***setting of international financial codes and standards,*** and ***private participation in crisis prevention and resolution.***

Third, how institutions at the international, regional and country level can best be adapted in order to reduce social cost of financial instability and develop a system of global monetary/financial governance appropriate for the changed global financial market. This area includes ***social protection mechanisms for financial stability,*** the ***reform of international financial institutions,*** and ***regional monetary and financial co-operation.***

THE SPEED AND SEQUENCING OF CAPITAL ACCOUNT LIBERALISATION

11. Free capital movements can facilitate a more efficient allocation of savings, channelling resources to countries where they can be used most productively, and thereby increasing growth and welfare. Access to foreign capital markets may enable investors to achieve a higher degree of portfolio diversification, allowing them to obtain higher risk-adjusted returns. However, the repeated emerging market crises of the 1990s have been closely related to premature and sudden capital account liberalisation.

12. Full convertibility for capital account transactions may complement the multilateral trading system, broadening the channels through which emerging market countries can obtain trade and investment finance. Finally, by subjecting governments to greater market discipline and penalising unsound monetary and fiscal policies, liberalisation may improve macroeconomic performance. These arguments essentially relate to allocational efficiency and macroeconomic policy discipline; but in emerging markets considerations of individual freedom with regard to asset disposition may need to be set against the public good of financial stability.

13. However, both theory and experience indicate the desirability of scheduling capital account liberalisation after appropriate domestic financial liberalisation. Significant foreign investment in domestic financial markets and foreign borrowing by domestic

banks and corporations call for minimum levels of both market efficiency and institutional and regulatory capacity to safeguard stability. The liquidity and volume effects of large foreign capital inflows on the domestic equity, bond and foreign exchange markets, can be highly destabilising.

14. The conventional wisdom holds that properly sequenced and orderly external liberalisation should proceed from the current account to the capital account and capital account liberalisation should be in the order of long-term to short-term. Major industrial countries and OECD members adopted this gradual and sequenced approach toward capital account liberalisation in the 1960s and early 1970s. Nonetheless, in recent decades, some emerging market economies adopted wrongly sequenced liberalization programmes and undertook 'big bang' approaches-often under pressure from G7 governments.

15. Foreign direct investment (FDI) flows are generally stable and difficult to reverse, because they reflect intra-firm transactions involving the acquisition of fixed assets as part of a corporate internationalisation strategy. Although FDI is the largest component of private capital flows to emerging economies, market access for FDI remains constrained for particular sectors or regions. One consequence has been an undesirable reliance on foreign capital inflows of shorter maturities and greater liquidity in many emerging markets.

16. A shift in external market sentiment can cause a sudden (possibly excessive) reversal in the availability of external finance, destabilising the economy. Experience indicates that before liberalising capital account fiscal and monetary balance and discipline, measures to attain a private sector savings-investment balance, and prudential regulation of bank and non-bank financial intermediaries should all be in place. However, these prior actions and measures have not proved sufficient to prevent the overheating of domestic financial markets consequent upon capital inflows, followed by their subsequent reversal and market collapse.

17. Until recently, international financial institutions were pressing for the immediate liberalisation of the capital account. But recent experience suggests that premature opening without macroeconomic pre-conditions and capital market depth and efficient

and sound financial regulation and supervision may actually be destabilising. This problem arises not only from distortions or imbalances in the host economy, but also from the lack of breadth and depth in emerging capital markets.

18. Unrestricted capital inflows have costs in terms of excessive appreciation of the domestic currency, current account deterioration and increased instability of the economy more generally. Active intervention in money markets in order to sterilise capital inflows can be a policy response. However, large-scale sterilization policies could lead to higher domestic short-term interest rates, which would in turn further stimulate short-term capital inflows.

19. An alternative policy option to maintain free capital mobility is a free-floated exchange rate system. However, large exchange rate fluctuations in emerging economies may have significant economic impacts. Consequently, if emerging market economies decide to stay with flexible exchange rate regimes, they might consider establishing mechanisms of managing short-term capital movements. The IMF itself, while advocating the overall liberalization of capital account transactions, recognises the necessity of implementing measures to influence the volume and composition of capital flows. In this regard, market-based instruments, such as taxes on short-term foreign borrowing, can be utilised to lengthen the maturity structure of external liabilities.

20. The role of offshore currency markets in fuelling speculation have recently become cause for concern, leading to a questioning of the extent to which emerging market economies should encourage the internationalisation of their currencies or deregulate non-resident domestic currency accounts without underlying transactions. There is clearly a strong 'sequencing' case for carefully monitoring and restricting the size of offshore currency markets in relation to the depth of the onshore market.

21. In sum, there are thus strong arguments for caution and a need for international support to those emerging market governments that adopt appropriate sequencing, pace, and scope of capital account liberalisation. To prevent continued massive capital inflows that threaten effective domestic monetary policy and raise the probability of sudden reversal of capital flows, the emerging market governments should be ready to

utilise market-based intervention instruments on short-term capital flows. However, these instruments of crisis prevention and resolution should not become a substitute for sound regulatory and financial policies.

22. We therefore conclude that:

Emerging market governments should adopt appropriate sequencing, pace and scope of capital account liberalisation. After all, capital account liberalisation is not an end in itself, but a means to sustained higher growth.

Prior actions that should be undertaken before liberalizing the capital account include not only fiscal and monetary discipline and trade liberalisation but also measures to attain a private sector savings-investment balance and prudential regulation of bank and non-bank financial intermediaries.

Governments may utilise market-based instruments (such as transaction taxes or reserve requirements) on short-term capital flows in order to prevent disruptive capital inflows that threaten effective domestic monetary policy and raise the probability of sudden reversal of capital flows. However, such instruments should be used as a temporary safeguards.

Emerging markets should encourage longer maturities on private capital inflows, and discourage short-term borrowing by domestic firms. Banks should be regulated to avoid unmatched and unhedged currency exposure in their balance sheets. Foreign direct investment should be encouraged as it combines long maturity with other benefits such as risk sharing and technology transfer.

Emerging economies should be cautious in internationalising their currencies as offshore markets can be used for speculative activities that can destabilise vulnerable financial systems. Countries should apply an integrated set of rules and regulations to prevent an overly active offshore market for domestic currencies, with the support of international authorities where appropriate.

The Choice of Approriate Exchange Rate Regimes

23. The Mexican and East Asian crises and their sequels in Russia, Brazil and Turkey on the one hand, and recent experiments in parity fixing (ranging from the EMU through currency boards in Argentina to full dollarisation in Ecuador) on the other, have given rise to an intense debate on appropriate exchange rate regimes for emerging market economies.

24. One widely held view of international financial institutions and many economists is that adjustable (or crawling) pegs and currency bands are not viable in a world of free and volatile capital movements. The pressure from massive capital flow reversals (particularly of bank lending) on fragile domestic financial systems has been too strong, even for countries with sound macroeconomic fundamentals and low debt.

25. The difficulty of the policy choice derives from the fact that devaluations are much more contractionary in emerging markets than in industrial countries, particularly in the short run after a severe currency crisis. When banks and firms face balance sheet effects due to their inadequate risk management on their assets and liabilities, drastic exchange rate depreciation increases the debt burden on banks and firms and thus raises the likelihood of a financial crisis. If financial sector's vulnerability deepens due to sharp exchange rate depreciation, the sovereign credit rating of the emerging economies would deteriorate, limiting their access to the international financial market.

26. The instability of emerging market exchange rates is exacerbated by the lack of any common reference point to which the parity can be expected to return after the crisis, which can contain investor expectations. Historically such a reference point was provided by the gold standard, to which countries were expected to return after crises. Since the demise of the Bretton Woods System there has been no such frame of reference for exchange rates.

27. Currency boards or even dollarisation may have some applicability in some cases such as small economies near large currency areas with close trade links (the traditional 'optimal currency area' criterion) or where domestic currency has lost all confidence. There exist, however, serious implementation problems in the choice of a fixed peg,

which must be backed by constitutional legislation or international treaty to be credible.

28. The choice of an appropriate currency to which to peg (especially where trade is diversified between the three main currency blocs as it is in most emerging market economies) is difficult. The stability of the domestic financial system in the absence of a lender of last resort is also doubtful. In practice public agencies other than the central bank can perform this role in the absence of a central bank (e.g. external treasury borrowing in Argentina or open market operations with public pension funds in the case of Hong Kong); but this is clearly a practice with potentially high costs if it is not successful.

29. At first sight (particularly that of the international financial institutions) floating appears to be more widely applicable, particularly since it is easier to move nominal than real exchange rates (and by extension, real rather than nominal wage rates) in response to a shock. In the case of many emerging market economies these shocks will be exogenous in the form of commodity prices or global interest rates and sudden shifts in capital inflows or outflows, responding to improved or deteriorated confidence respectively, rather than domestic factors. It is widely believed that for flexible exchange rates to be stabilising they must be implemented by an independent central bank with a credible commitment to low inflation.

30. However, the authorities still have to intervene to counter external shocks and these will have real effects; so some management is inevitable. In particular, inflation targets in most open economies are difficult to attain if the exchange rate fluctuates widely due to the influence on domestic prices. So some degree of management (the so-called 'dirty float') is inevitable even if limited to an active reserves policy, and even more so if interest rates are actively managed. Indeed, it could be argued that truly freely floating rates do not exist beyond the G3, because all central banks have implicit target zones even if they do not make these public in order to avoid speculation.

31. Recent empirical studies suggest that exchange rates in emerging markets that do not have formal pegs have limited flexibility in practice because the central bank does not allow the exchange rate to float due to its own domestic inflation target and the

constant speculative tendency towards overshooting. The monetary authorities appear in practice to tolerate a high volatility of reserves and interest rates in order to reduce the volatility of their exchange rates. Large economies where external trade represents a relatively low proportion of activity, and where the domestic financial markets are sufficiently deep, can tolerate a floating exchange rate; most emerging markets - highly exposed to foreign trade with shallow capital markets - cannot do so.

32. Many emerging markets still practice real exchange rate targeting, although with severe difficulty due to the importance of capital movements - which tend to be pro-cyclical, causing the nominal exchange rate to fluctuate widely. In addition, there is evidence that real exchange rates tend to revert to their long-term trend after a few years. Moreover, the sensitivity of domestic to international interest rates appears to be as high under floating exchange rate regimes as under fixed ones, despite the theoretical belief to the contrary. In consequence, the supposed benefits of monetary policy autonomy under a floating regime are often smaller than is usually supposed.

33. The essential case for managing emerging market exchange rates is that free-floating strategies have high costs including excessive domestic price volatility and business uncertainty in the trading sector. De facto dollar peg strategies have proved incapable of accommodating diversified trade patterns, greater capital mobility and independent monetary policies in practice. In crisis situations, currency boards suffer many of the defects of pegged regimes and have in fact required last resort lending (and borrowing) by domestic authorities in order to sustain domestic liquidity.

34. In sum, the argument that only the ‘corner solutions’ of a credibly fixed peg or a completely free float are feasible today is not valid for emerging markets. This is because emerging markets have financial sectors that are not fully developed, and are only partially integrated into global capital markets. Their fragile structures of banking and corporate finance cannot withstand a free float, while a fixed parity would prevent the active monetary policy required to sustain their financial development. In this intermediate stage, therefore, a ‘second best’ solution may in fact be desirable.

35. Above all, emerging market authorities should be allowed to choose the exchange rate regime that they judge best for their circumstances, and international support should

not be made conditional on the adoption of a particular regime - unless of course it imposes significant external diseconomies on other countries. Further, for any exchange rate regime to be sustainable for an emerging market economy with diversified trading and investment patterns, it is essential that G3 exchange rates (i.e. between the dollar, euro and yen) should not be too unstable. The G3 currency volatility experienced over the past decade has imposed significant exogenous shocks on emerging markets.

36. We therefore conclude that:

The international financial community should acknowledge the systemic problems faced by countries whose financial markets are still at an intermediate stage of development and not sufficiently integrated to global markets to rely on permanent access to private financing. The choice of exchange rate regime in order to avoid misalignment should be left to the government. This choice should not be constrained by international financial institutions to the 'corner' options of a permanently fixed parity or a free float.

An 'intermediate' exchange rate regime may well be preferable in practice for countries trading worldwide and subject to external financial shocks. This intermediate exchange rate regime may need to be supported by market-based intervention instruments or other appropriate regulations in order to contain speculative attacks.

The wide swings of dollar/yen/euro exchange rates are one of important sources of external shocks to emerging market economies, undermining their efforts to maintain sound financial policies and macroeconomic balances. We strongly urge the G3 countries to develop a system by which stable exchange rates among major currencies be maintained.

The Regulation of Highly Leveraged Institutions

37. In the wake of the financial crises of the late 1990s, the international community has come to the view that greater prudential regulation is required of 'highly leveraged institutions' (HLIs) - particularly hedge funds and the proprietary trading desks of investment banks and securities companies. The Financial Stability Forum has recently made proposals for better disclosure of and transparency of cross-border financial flows, including the activities of HLIs, in order to protect the integrity and stability of global financial centres.

38. HLIs enhance their ability to take large long or short positions by making substantial use of debt financing. The funds also increase their leverage through activities in the futures and options markets. As a result, their position taking can far exceed its capital base. The size of the positions taken by some HLIs, and their aggressive trading strategies, has given them the capacity to move some emerging markets. It is also difficult for other market participants to judge the extent of HLI activity in a particular market, and mere rumours of hedge fund activity can be sufficient to cause market volatility.

39. HLIs run large long or short positions in securities and in derivative instruments for speculative purposes. The funds are usually registered as partnerships in an offshore financial centre; their ability to run large speculative positions makes hedge funds an attractive investment vehicle for high net worth individuals, as they offer better investment returns (and higher risks) than conventional mutual funds. Although it is difficult for banks to judge the extent to which the fund is leveraged, this rarely seems to have been an obstacle to the provision of credit.

40. Systemic problems occur when securities market intermediaries are highly leveraged. If the market experiences a sudden fall in securities prices, these intermediaries will be forced to liquidate their holdings, prompting further price falls. This may in turn result in highly leveraged market participants defaulting on their bank loans. If these loans are sufficiently numerous, or are concentrated in just a few banks, the resulting losses may be sufficient to impair the capital base of the banking system. In extreme cases, it may even lead to the failure of key banks in the

payments system due to the rapid deleveraging of positions.

41. Distress selling by a hedge fund, combined with the large positions it runs, might be sufficient to depress securities markets. Given the already fragile state of investor confidence, further significant market falls caused by distress selling might have been sufficient to trigger a market cascade effect, with falling prices resulting in further selling. In these circumstances, other leveraged intermediaries and investors in the securities markets would have suffered losses and might have been forced to default on their bank loans.

42. The systemic problems created by hedge funds and other highly leveraged financial institutions are rooted in their lack of transparency. Where other market participants are not in a position to judge the size of the positions that a fund could unload onto the market, they may be inclined to liquidate their positions ahead of any possible distress selling. The prospect of distress selling can thus be self-fulfilling. There have been numerous attempts to encourage greater transparency in offshore centres but, as long as these jurisdictions gain an advantage from the secrecy they offer, these initiatives are unlikely to make significant headway. In this regard, greater emphasis should be put on the point that partial disclosure and limited transparency may be counterproductive, since it may divert transactions to the less regulated and less transparent venues.

43. A different approach would involve limiting hedge funds' access to bank credit. This might take the form of increasing the capital requirements applied to bank lending to hedge funds. The Basle Committee on Banking Supervision established a working group to review banks' relations with HLIs, which reported in 1999 and was unusually blunt in criticising the lax credit appraisal processes that many banks have applied in their dealings with these institutions. In its proposals for future regulatory action, the Basle Committee supports a further strengthening of supervision, and leaves open the possibility of higher capital requirements on lending to HLIs. However, the direct regulation of the funds themselves is considered impractical. Moreover, the main criteria adopted are the maintenance of the integrity of international capital markets; not the stability of emerging markets themselves.

44. Emerging market bank regulators should take a more intensive interest in the way in which banks monitor and control their exposure to hedge funds as part of the ongoing supervisory process, but in doing so will need support from G7 regulators in the form of both information exchange and technical assistance. The requirement for assessing and measuring unsecured exposure under collateralised derivatives transactions and adequate stress testing of counterparty credit risk under a variety of scenarios implies that adequate information must be received and due diligence performed.

45. HLIs should still be encouraged to invest in emerging markets, in order to spread risk on high yield assets for institutional investors and thus deepen markets. However, because HLIs can cause major difficulties for emerging market securities regulators, greater co-ordination between regulators internationally is clearly required, particularly the timely disclosure of investor positions. The sharing of information between G7 and emerging market regulators is clearly essential for this purpose, which in turn requires close working relationships and the building of trust between supervisors.

46. We therefore conclude that:

Although the use of modern financial instruments such as derivatives can help develop emerging markets, they can also be a destabilising factor in times of economic stress. It is thus urgent that the G7 governments adopt the proposals of the Financial Stability Forum for indirect regulatory measures to be applied to Highly Leveraged Institutions. In particular, it is important for G7 supervisors to regulate bank lending to HLIs in order to reduce their ability to mount speculative attacks on emerging markets. The timely disclosure of the uncovered positions of large hedge funds and the proprietary trading desks of global banks would also assist in this aim.

G7 governments should encourage their financial supervisors to share appropriate information regarding financial intermediaries under their supervision with emerging markets' regulatory authorities. By creating mechanisms for effective information sharing, G7 supervisors could effectively monitor the overall size of creditors' exposure to HLIs.

SETTING INTERNATIONAL CODES AND STANDARDS

47. Technical changes in financial transactions and the progressive liberalisation of national financial systems both led to the explosive growth of international capital markets in the 1990s. Private sector behaviour - and thus its regulation - has become the key to stability of financial flows, together with governments' fiscal and monetary stances. Appropriate supervision of domestic financial markets and institutions has always been seen as essential in order to prevent market failure that is endemic to finance. However, the existing global financial system has to be improved to properly deal with the new challenges posed by the changed international financial environment.

48. There already exist a large number of standards and codes to be observed on the part of emerging economies. The Financial Stability Forum (FSF) has now highlighted 12 key codes and standards that are crucial, and identified additional 64 standards relevant for sound financial systems. The FSF Compendium of Standards contains the work of six separate bodies: the Basle Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS), the International Association of Insurance Supervisors (IAIS), the International Monetary Fund (IMF), the International Organisation of Securities Commissions (IOSCO) and the Organisation for Economic Co-operation and Development (OECD). The standards for the strengthening and extension of existing systems of global banking supervision are defined along clear (albeit contested) lines with defined objectives, monitoring and implementation.

49. Other standards are concerned with increasing the availability and timeliness of information (mainly of official statistics) to the markets. The issues in debate are the difficulties (and costs) of implementing these codes and standards all at once, and whether they will really affect market behaviour in the right direction. The positive effects of improved bank supervision are widely agreed. However, despite improvements in the technical aspects of risk modelling and the provision of increasingly timely and accurate information, markets still tend to react collectively to 'news' which do not necessarily reflect the underlying fundamentals of emerging markets rather than investing in serious research.

50. In most of the forums or agencies drawing up codes and standards, emerging market economies are not included or, at best, are underrepresented. If the G7 countries wish to introduce a set of common international standards, it is necessary to ensure that those countries most affected by these standards - that is, the emerging markets - are closely involved in both the design and the implementation stages. This is necessary for two reasons: first, in order to establish the legitimacy and thus ‘ownership’ of the new standards; and second, so as to draw upon knowledge and experience of very diverse financial structures.

51. Not all countries can be expected to meet the same standards because they are not at the same stage of financial development. All emerging market economies cannot be expected to comply with standards that nations with advanced financial sectors have only reached after many decades of experience. Moreover, standards should not be biased towards a particular model of any one industrialised country. In sum, a ‘one size fits all’ approach should be avoided in designing and implementing global codes and standards.

52. For the poorest developing countries, technical and financial assistance will be necessary in implementing global codes and standards. Otherwise, these countries would end up straining their ordinary program of development and poverty reduction.

53. Furthermore, it is not always clear what the incentives (and penalties) for adherence to the codes and standards are to be. In the case of banking regulations, the inclusion of Basle standards in the rules applied by national regulators may help, but they imply a very high cost in terms of specialised staff and reserve capital; while the supervision and control of international transactions as such is left open.

54. The implication is that those emerging markets that adhere to the key standards proposed by the FSF will enjoy enhanced market access, but this is only a potential benefit. The specific penalties for non-compliance are clearer, and are of two types. First, financial regulators in OECD countries could apply penalties or constraints (such as capital requirements) on their investors acquiring assets in non-compliant countries. Second, official lenders (particularly the IMF) could refuse to support non-compliant countries. In practice, however, this may affect emerging markets in a

differential and inequitable manner as larger countries (whose instability has systemic consequences for global financial markets) tend to be treated more leniently.

55. The new supervisory standards are primarily aimed at encouraging better management of emerging markets' financial systems. Although to some extent these are addressed to all countries, the burden of measures clearly falls on those furthest from OECD norms. In effect, these are codes for an improved international financial architecture that put the responsibility for change upon emerging markets. Although these improved standards are generally beneficial for emerging markets and should encourage more sustainable lending, they do not directly address the problem of encouraging more lending at longer maturities by the private sector.

56. The standards are ultimately underpinned by a desire to protect the integrity of the global financial system, rather than to ensure sustainable access by emerging economies to international capital markets. In particular, if the recommendations for the new Basle Accord on bank supervision are implemented then the maturity of loans on inter-bank markets would be shortened even further than at present, which would not be helpful for emerging market stability.

57. The role of offshore financial centres in the global market poses particular problems for emerging markets because much of the short-term speculative capital flows that destablise emerging markets originate from these centres. Funds - including those arising from money laundering and tax evasion - are attracted to these offshore centres by the lack of close banking or securities supervision and regulatory standards below the international norm. Better supervision in these centres, closer coordination between their supervisors and counterparts in emerging markets, and disincentives to banks to lend to these centres (such as the recent US initiative to increase their risk weighting) would all contribute to international financial stability.

58. We therefore conclude that:

There is an evident need for emerging market authorities to apply sound regulatory standards, both to ensure the integrity of their own financial markets and to gain sustained access to international capital markets. However, these codes and standards *must be flexible in terms of both their timing and their scope. Prior implementation of a single set of 'core' codes and standards should thus not be made a condition for support from the international financial community - such as pre-qualification for contingent credit lines.*

This flexibility is required in order to permit adaptation to the specific characteristics of emerging market economies. It is necessary to focus on those aspects of the Financial Stability Forum proposals (such as transparency and timely reporting) needed to ensure access to private capital markets. The revision of the Basle Capital Accord on bank supervision, which is focused on the reduction of international financial fragility, should not result in provisions that have the effect of shortening the maturity of private bank lending to emerging markets.

The international bodies concerned with global financial standards (the Financial Stability Forum in particular) must adequately represent emerging market authorities because it is these economies where the proposed codes and standards will have most impact.

The G7 governments and the international financial institutions themselves should provide resources and technical assistance to support emerging market governments without sufficient domestic implementation capacity.

The G7 should take steps towards ensuring stricter supervision of financial transactions in offshore financial centres, and support the US initiative to increase the risk weighting on lending to such centres not meeting international supervision standards.

PRIVATE SECTOR INVOLVEMENT in CRISIS PREVENTION AND RESOLUTION

59. It is widely agreed that the private sector should be more closely involved in the prevention and resolution of financial crises in emerging markets. However, discussions on involving the private sector have proved complex and difficult and there is no consensus on specific measures. G7 finance ministers and central bank governors have also failed to make progress in this area, reflecting the problem of

designing suitable mechanisms and instruments.

60. Attempts to enhance the involvement of bondholders and bank creditors in the orderly resolution of debt problems are driven by the perception that the international assistance to crisis countries becomes a source of moral hazard on the part of private creditors. If private sector creditors are bailed out through official assistance without bearing any cost of crisis, their poor lending habits and reckless investment decisions will not be rectified. It is not realistic to abandon international public participation in emergency financing operations because of the large externalities involved. However, because the international financial institutions always ensure repayment of their own support loans, in effect it is the taxpayers in the crisis countries who end up bearing the cost of bailouts. In consequence, there are good efficiency and equity grounds for including private sector 'baling in' as a core element in the international financial architecture.

61. Policy makers have begun to search for mechanisms to give private lenders an incentive not to withdraw their funding from a troubled emerging market at the first sign of financing difficulties. By discouraging capital flight, policy makers are also trying to avoid the self-fulfilling 'rush for the exits' that has removed credit from several already-distressed economies at precisely the time when IFIs have come under pressure to supply more resources.

62. The increased size, sophistication and heterogeneity of recent capital flows has reduced the relevance of procedures used in the past to ensure an appropriate private sector role in resolving debt crises. The procedures, which eventually worked in the early 1980s in the Latin American debt crisis, are no longer effective. The Latin American crisis involved only a relatively small group of large international banks, which were the main providers of capital. The small number of institutions involved and their close community of interest made it possible to negotiate a settlement of the debt problem.

63. The recent emerging market crises have involved a larger number of lenders, and the creditor group has been more diverse, including portfolio investors as well as commercial banks. This makes a negotiated settlement more difficult to achieve, given

the diversity of interests involved. It is also necessary to handle sovereign and private debt separately as their underlying contractual natures are quite different.

64. By involving the private sector in crisis prevention and resolution, it should be possible to harness some of the same capacity for financial innovation that helped to create markets for a range of new emerging market debt instruments. Such innovations may include new ways to securitise and trade the assets derived from the liabilities of indebted nations. However, international lenders have shown a marked reluctance to be bailed in to crisis resolution packages. Lenders have a clear incentive to avoid bearing part of the costs of resolution.

65. One proposed solution to the problems of crisis resolution would be to institute an international equivalent to the US commercial practice of Chapter XI bankruptcy proceedings. This facilitates an orderly workout of corporate debt crises by mandating creditor co-ordination and a payments standstill when an enterprise has difficulty in servicing its contractual payments. However, a consensus within the international community on the creation of an agreed and binding insolvency framework for sovereign debtors is not expected in the foreseeable future - not least because of the pressure from lenders.

66. However, for private debtors emerging market bankruptcy procedures under local commercial law could be used much more than at present. This would of course require that this law be suitably reformed to bring it up to international standards. It should then be possible to establish mutual recognition agreements with the leading financial centres (particularly New York and London) to make these proceedings binding on lenders as well as borrowers.

67. Nonetheless, some elements such as an institutional framework for a mandatory payments standstill (and thus on court claims, put options and cross-conditionality) could be useful for minimising the risk of disruptive litigation, while not reducing the present value of debt service obligations. IMF leadership in major debt workouts would probably be essential for these changes to be effective.

68. When a debtor country has entered ‘bona fide’ negotiations with a majority of its

private creditors, and is following the terms of an agreement with the IMF, the International Monetary Fund should sanction, and the G7 governments support, a temporary suspension of payments if needed in order to allow negotiations to be successfully concluded. IMF-sanctioned standstills, although used temporarily, might increase the cost of and reduce the flow of capital, leading to market shrinkage and limit higher risk borrowers' capital market access. However, temporary standstill arrangements should be differentiated from outright sovereign defaults. Moreover, the IMF should not act as an arbiter determining the terms of subsequent debt restructuring - that must be left to voluntary negotiations.

69. As an ex ante measure for debt restructuring, the inclusion of collective action clauses (CACs) is favourably considered in the international financial community. Some developed countries (such as the UK) now issue bonds in this way. These clauses would provide for creditors to be collectively represented; for majority voting to alter the payments terms of the contract; and for payment sharing among bondholders. It should also be recognised that the application of put options in bond contracts effectively transforms long-term to short-term maturities in a time of crisis, to the advantage of the lender.

70. While these clauses could provide a framework for restructuring bond payments in an orderly manner, they do not guarantee that a sovereign issuer and the required majority of bondholders would be able to agree on a restructuring package sufficiently rapidly to avert a crisis. However, these 'London contracts' (which contain CACs) would provide a better mechanism than the 'New York contract' (which does not) for negotiating co-operative solutions to payments problems that stem from sovereign bond issues. Borrowing under London contracts does not appear to be more expensive under New York contracts (i.e. the yields are similar) but there is some evidence that higher risk borrowers can gain market access more easily under the latter than the former.

71. A new channel of communication between the official community (especially the IMF) and private creditors has been proposed in order to provide market participants with the information needed to assess risks more effectively and thereby price them more accurately. However, this would inevitably create a tension between the desire to stabilise markets and the need to maintain the confidentiality that international

financial institutions owe to all their member countries. The lack of trust that might arise under these circumstances would make effective crisis response more difficult.

72. Private lenders from advanced countries will remain reluctant to offer new funding on a voluntary basis to emerging markets experiencing payments difficulties, as they have no incentives to share the cost of sovereign bailouts or to exchange short-term financial claims for longer-term, less liquid obligations. Any new arrangements must therefore be supported by specific incentives - ranging from regulatory legislation to tax incentives - from G7 governments to be effective in lengthening the maturity of emerging market liabilities.

73. We therefore conclude that:

Over borrowing by emerging market governments, banks and firms is logically matched by voluntary over lending by private investors in advanced economies. There is thus a need for more equitable burden sharing when initial expectations are not supported by subsequent events. Increased private burden sharing would also help to reduce moral hazard on the part of lenders.

For that purpose, the international financial community should explore measures to facilitate greater private sector involvement on fair burden sharing principles. Such measures should be used for a quick and orderly execution of debt relief and restructuring, without undermining the debt contracts, which would restrain market access. Protection of debtors and creditors should be carried out on equitable grounds.

In the long-term, the establishment of an international legal mechanism for restructuring sovereign debt contracts similar to the Chapter XI proceedings under the US bankruptcy law may be desirable. Emerging market economies should first strengthen their domestic bankruptcy laws. They should then explore the possibility of establishing mutual recognition agreements with the leading financial centers.

Ex ante measures for debt restructuring will enhance the degree of predictability when a need to restructure international sovereign bonds arises. Sovereign debtors, both G7 and emerging market countries alike, should encourage the use of 'collective action *clauses' in debt contracts. Conditions such as put-options and cross default clauses that can precipitate default during payment difficulties should be cautiously utilised.*

When a debtor country has entered 'bona fide' negotiations with a majority of its private creditors, and is following the terms of an agreement with the IMF, the International Monetary Fund should sanction, and the G7 governments support, a temporary suspension of payments if needed in order to allow negotiations to be successfully concluded.

SOCIAL PROTECTION MECHANISMS FOR FINANCIAL STABILITY

74. Economic instability in general and financial crises in particular can place an excessive burden on poor and vulnerable members of society in emerging market economies. The poor are not in general the main beneficiaries of an asset price boom, while the subsequent downturn involves a sharp fall in aggregate output and severe fiscal retrenchment and vulnerable groups are thus likely to experience serious income decline. Moreover, sustained poverty reduction requires long-term growth and substantial public investment in social infrastructure, both of which are negatively affected by financial crises.

75. The consequence of currency collapse for levels of output, and thus employment, can be dramatic. Real wages also fall sharply. The main transmission mechanism for the impact of financial instability on the poor is thus through labour markets - particularly for unskilled labour. In the short term this impact takes the form of employment loss and real wages decline as firms reduce output and thus labour demand. In the longer run the loss of business confidence due to financial instability leads to lower private investment rates and thus reduced employment opportunities.

76. Short-term capital inflows, and the resultant macroeconomic instability, have a number of important consequences for domestic industry. What is particularly significant here is the asymmetric impact of increased levels of macroeconomic uncertainty on firms. In financial crises banks tend to restrict credit to all but preferential borrowers (e.g. those with better collateral, usually large firms). Since

smaller firms tend to be more labour-intensive, their employment contribution is relatively greater and thus their credit starvation in financial crises can have serious social consequences. The protection of the SME sector in financial crises is thus crucial to prevent these turning into social (and thus political) crises.

77. The longer economic and social consequences of financial crisis may also be considerable. This is due to the large and sudden redistribution of assets and liabilities between domestic and foreign agents and between the public and private sectors. This redistribution clearly depends on the form that the rescue package takes; but in most cases this has involved the assumption of large new liabilities by the public sector in the form of new external borrowing and the taking over of bad loan books of domestic banks. This in turn implies future fiscal retrenchment with inevitable social consequences.

78. It is generally agreed that emergency actions clearly need to be underpinned by strong social policies: providing safety nets without excessive fiscal strain and actions to make sure that the needs of the poor are given proper consideration. Increased social and economic stability will not only help households cope with shocks but also help build the political consensus in support of government policy that prevents social conflict from worsening, and thus help restore private sector confidence more quickly.

79. However, not all emerging markets experiencing crises have had adequate social protection mechanisms in place, or the existing mechanisms based on family networks or voluntary organisations have been unable to bear the strain of widespread unemployment and income decline. At best governments can 'ring fence' the share of social sectors in the budget, but when real public expenditure falls and the number of claimants rises in a crisis, then expenditure per head will inevitably fall and social tension rise. The need for adequate and timely international support for targeted fiscal expenditure is thus particularly acute during such crises, in addition to support for financial stabilisation itself.

80. The lack of social protection means that the economic restructuring needed to support the initial monetary and fiscal response to external financial shocks has become politically difficult in may cases. The restructuring of inefficient corporations

(whether private or state owned) often generates widespread opposition if labour cannot be quickly absorbed in other growth sectors and there is no effective social support system available for the unemployed. Similarly, public expenditure reductions can threaten social cohesion if large numbers of poor families feel that they risk being excluded from access to basic health and educational services.

81. We therefore conclude that:

The international community should recognise that sound social protection systems should be in place in order to both protect vulnerable groups in emerging market countries and maintain political consensus on sound economic policy.

Greater use of fiscal resources by emerging market governments for public provision of social protection should be encouraged by creditors, so long as it is consistent with fiscal prudence.

International financial institutions should provide more long-term social funding for emerging market countries when the need arises. Provisions should be made for more rapid and less conditional disbursement of funds for safety nets in crises.

THE REFORM OF INTERNATIONAL FINANCIAL INSTITUTIONS

82. The International Financial Institutions have a key role to play in the world economy, due to the need for collective action in order to overcome the problems derived from inefficient or missing markets. Global capital markets are characterised by three types of systemic failure: asymmetric information between borrowers and lenders; economic externalities such as investor herding; and contract enforcement problems.

83. These problems lead to instability and exclusion in all financial markets, but legal and regulatory systems exist to overcome them at the domestic level. No such systems yet exist at the international level. Some private agents have emerged to address these market inefficiencies - such as ratings agencies to deal with information asymmetry and insurance providers to deal with contract risk.

84. Nonetheless, from the perspective of the emerging market economies the role of the international financial institutions is still essential in order to maintain their access to capital markets on reasonable terms at all times. Middle-income emerging market countries are not in so much need as low-income countries of concessional assistance, or of expert policy advice. However, some low-income emerging market countries still need official development assistance for physical infrastructure and social sector development.

85. Thus there is still a strong need for international support to emerging market countries during adjustment to external shocks, as private capital flows (other than intra-firm foreign direct investment) are clearly pro-cyclical. The experience of crises in the 1990s also demonstrates the need for the appropriate mechanisms to deal with crises when they do occur. The IFIs themselves should continue to play this role.

86. The G7 governments - as 'majority shareholders' in the international financial institutions - have considered a wide range of proposals as to their reform. A consensus appears to be emerging that concessional lending should be more sharply focused on poverty reduction, while the private sector should be encouraged to increase its role - particularly in the provision of long-term finance to emerging markets. It is also proposed to refocus the International Monetary Fund and the World Bank on their original core functions.

87. The 'division of labour' between the Bretton Woods institutions should be clarified. The IMF should focus on short-run stabilisation policy advice and the provision of liquidity; and should avoid pressures to extend its mission to wider matters of institutional change and development strategy.

88. The World Bank should focus on longer-term development support, particularly the funding of social and economic infrastructure where private capital is not available on reasonable terms. The Bank and the Fund must also coordinate more effectively in crisis situations.

89. Global financial activity has grown faster than real output, and the sheer magnitude of global capital flows is now a significant constraint on the official sector's ability to

supply liquidity in an emergency. Notwithstanding the IMF's recent quota increase and the implementation of new lines of credit with member countries under the New Arrangements to Borrow, the scale of international private capital flows far exceeds the resources that can be reasonably provided by the official community.

90. There is evidently an urgent need for more counter-cyclical lending by IFIs: support should be rapidly available in sufficient quantity to halt speculation, albeit at above-market interest ('penalty') rates to avoid moral hazard and ensure rapid repayment. This implies that present conditionality rules - which provide funds at below market rates but not speedily - may require considerable changes. Further, conditionality should only refer to measures required to ensure crisis resolution and resumption of payments.

91. The recently instituted Contingent Credit Lines (CCL) appear to be unattractive both to borrowers, as it sends a negative signal to markets in normal times, and to lenders as it reduces creditor flexibility in uncertain conditions. Moreover, in practice pre-qualification is very difficult to implement because before an external shock a country's policies may be sound, but what is in question during a crisis is the nature of the policy response under new and unforeseen circumstances. In addition, the fact that CCLs have senior status means that other lending may be crowded out.

92. In principle, the role of the IMF should be to act as a lender of last resort in situations where the borrower is fundamentally solvent but there is a liquidity shortage due to market expectations that become self-fulfilling where the maturities of borrowers' assets and liabilities are mismatched. This is particularly important in cases of international contagion in order to counteract negative externalities. The Fund could also assist emerging markets restructure and refinance their outstanding liabilities where longer-term solvency obtains, and to allocate the costs of writing off debt when the borrower is insolvent.

93. Although the World Bank probably should concentrate its scarce resources on the poorer countries without access to international capital markets, middle-income countries still need support for social infrastructure finance - possibly by underwriting long-term bond issues. It should also be borne in mind that the middle-income

countries are already net debt repayers to the Bank and Fund. If the World Bank were to abruptly stop lending to emerging market countries, this would cause an unmanageable amortisation problem.

94. The maturities of private bank finance to emerging markets are still very short, so that intermediation by multilateral development banks, which can raise funds at minimal spreads on global capital markets due to the guarantees offered by their shareholding governments, can still play an important role. The ability of the World Bank and other multilateral development banks to support long-term private lending should be augmented by a modification of the gearing ratios in their guarantee schemes. This would be particularly effective for infrastructure projects and post-crisis re-entry of established emerging market borrowers to global capital markets.

95. Last, but far from least, country and regional representation in the IFIs should be updated in order to reflect the importance of emerging markets in the global economy and their crucial role in global capital markets. This is not a simple matter of 'fairness' but rather one of enhancing the effectiveness by building confidence among borrowers as well as lenders. In particular, the role of minority shareholders in electing the leadership could be strengthened; the share capital allocation needs revision; and the 'constituencies' for board membership should be rationalised.

96. In consequence we conclude that:

Reformed International Financial Institutions (IFIs) form an essential part of the new International Financial Architecture: their constitutional structures, developmental mandates and operating principles require revision in the light of the realities of global capital markets in the 21st century.

In view of the extremely pro-cyclical nature of private capital flows, there is an urgent need for the International Monetary Fund to stand ready to provide the required liquidity on a timely basis, for which purpose greater resources will be needed.

The policy conditions included in loan agreements with the Fund should be tailored to specific economic conditions of the recipient country in question. The imposition of a *single model of monetary stabilisation and structural adjustment should be avoided, particularly in the midst of financial crises. The Fund should strengthen and broaden its understanding of the characteristics of emerging market economies by drawing on expertise from these countries.*

The pre-qualification conditions for Contingent Credit Lines should be made more realistic so that they help rather than hinder crisis prevention and resolution. This would increase the likelihood that such facilities would be taken up by emerging market governments.

The 'division of labour' between the Bretton Woods institutions should be clarified. The IMF should focus on short-run stabilisation policy advice and the provision of liquidity; and should avoid pressures to extend its mission to wider matters of institutional change and development strategy.

The World Bank should focus on longer-term development support, particularly the funding of social and economic infrastructure where private capital is not available on reasonable terms. The Bank and the Fund must also coordinate more effectively in crisis situations.

The ability of the World Bank and other multilateral development banks to support long-term private lending should be augmented by a modification of the gearing ratios in their guarantee schemes.

Emerging market countries' representation in the share capital and executive boards of the International Financial Institutions (IFIs) reflect more accurately their respective importance in the world economy. Meanwhile, the IFIs themselves should apply internationally accepted principles of institutional transparency and accountability in order to protect the interests of emerging market countries as 'minority shareholders'.

Regional Monetary Arrangements and Financial Cooperation

97. The vulnerability of the individual emerging market economies to speculative currency attack and contagion despite sound macroeconomic fundamentals derives from the small size of their reserves and the lack of depth of domestic capital markets in relation to the magnitude of international capital flows. Problems of timeliness, scale and conditionality of multilateral currency support operations in the latter half of the 1990s have given rise to considerable concern. In consequence, the potential role of regional monetary arrangements in support of multilateral and national initiatives merits further consideration.

98. In the case of East Asian emerging economies and Japan, the recent Asian financial crisis provided a strong impetus for them to reform and strengthen their domestic financial systems. At the same time, there is a strong feeling that a regional financial cooperation needs to be strengthened to prevent and help resolve financial crises in the future. A particular problem is the very high and costly levels of foreign exchange reserves accumulated by East Asian countries as a means of warding off future speculative attacks. The currency swap arrangements under the so-called ‘Chiang Mai Initiative’ are designed to release these resources for more productive uses and are the first instance of the institutionalisation of economic cooperation among ASEAN+3 countries.

99. Emerging market authorities in Latin America have been considering two contrasting potential regional monetary arrangements. On the one hand, two countries (Ecuador and El Salvador) have joined a third (Panama) in adopting the US dollar as the national currency, although without any monetary co-ordination with the US Treasury or the Federal Reserve. A number of others are believed to be considerig similar unilateral steps, albeit with the tacit acquiescence of Washington. Dollarisation is not appropriate for all Latin American economies, particularly those with substantial extra-regional trade, as it reduces the domestic capacity to adsorb external shocks.

100. However, a ‘hard peg’ is particularly attractive to those countries suffering from hyperinflation and a lack of confidence in the domestic monetary authorities. In any case, more extensive dollarisation - whether de jure or de facto (due to private sector

asset portfolio shifts) - would require US involvement in liquidity provision. On the other hand, the eventual increasing integration of Mercosur members - and thus their exposure to mutual macroeconomic shocks - has led to discussions of the need for greater monetary co-ordination and possibly even a common currency or at least the use of a common reference basket and co-ordinated interest rate policies.

101. For the emerging markets of Europe, the establishment of EMU and the prospect of future membership of the EU have implied a linking of currency parities to the Euro. During the current decade this will probably involve the management of parities within narrowing bands along the lines of the former European Monetary System (EMS). This in turn will require closer monetary co-operation between their central banks and the European Central Bank (ECB) in coming years. The indirect role of the Euro in Africa (through the CFA) may also develop further. The eventual UK membership of the EMU will consolidate the role of the Euro as an international reserve currency, and thus the ability of the ECB to play a full part in international activities designed to preserve market integrity and prevent speculative instability.

102. Effective regional bodies would form a valuable complement to multilateral arrangements for a number of reasons. First, the monetary objectives of member countries are more likely to coincide in a regional than in a global arrangement, particularly since there is an increasing degree of trade integration on a regional basis. A financial crisis in one country can force a sharp reduction in domestic demand, which then reduces imports from (and thus exports by) neighbouring countries as in the case of East Asia and more recently in Mercosur. Regional action can be effective in providing liquidity, sustaining trade links and reassuring investors under these circumstances. This cooperation could also lead to more effective emerging market representation in international forums.

103. Second, emerging markets are particularly vulnerable to contagion during financial crises as the collapse of securities prices and exchange rates in one country rapidly spreads to neighbours with otherwise sound fundamentals and even towards other regions. International markets simply assume - in the absence of reliable information - that because one country is in trouble then the risk is greater in its neighbours. This can then generate self-fulfilling currency crises as investors withdraw, exacerbated by

‘herd’ behaviour as investors move together and ratings agencies downgrade whole asset classes. Improved information on the true prospects of individual emerging markets should help reduce this contagion, and regional efforts to improve monitoring and reporting could be valuable in this context. Above all, the knowledge that regional liquidity provisions are in place should reassure investors.

104. Monitoring and surveillance are the bedrock on which coherent policy formulation under the regional financial arrangements rests. A joint effort of monitoring and surveillance would provide prompt and relevant information for assessing the situation of countries in trouble and potential contagious effects of a crisis to neighbouring countries. Furthermore, a joint exercise based on region-wide early warning indicators would facilitate closer examination of financial vulnerabilities in the region. In addition, the regional monitoring and surveillance process would contribute towards effective implementation of globally accepted accounting and auditing standards, strong disclosure requirements, credible ratings and appropriate corporate governance.

105. Regional arrangements for monetary and financial co-ordination to support sound parities should thus be encouraged and supported by the G7. Strict rules, full disclosure, joint monitoring and short-term support at penal rates could prevent ‘moral hazard’ problems from arising from national monetary authorities conducting unsound policies in the expectation of support on lax terms. This would give more confidence to international investors when such systems come under strain in future currency crises; particularly if the IMF were to provide ‘second line of defence’.

106. We thus conclude that:

Regional economic and financial cooperation arrangements should be strengthened in order to promote regional stability, and contribute to crisis prevention and resolution. This in turn should contribute to the stability of the global economy. Regional arrangements for monetary and financial cooperation should be encouraged and supported by the G7 as complementary to the multilateral IFIs.

A future direction for the coordinated use of reserves by central banks in order to *prevent speculative attacks has been illustrated in the currency swap arrangements under the initiative of ASEAN+3 countries. Such arrangements may not be as effective for regions where the level of reserves is limited, but the scope for collective action by monetary authorities in support of regional financial stability is worth further exploration.*

Appendix

Membership of the Eminent Persons Group

Membership of the Advisory Board

Membership of the Eminent Persons Group

Name	Country	Previous Office	Present Position
Il SaKong (chairman)	Korea	Minister of Finance, Korea (1987-88), Chief Economic Advisor to the president (1983-87)	Chairman and CEO, Institute for Global Economics, Korea
Edmar Bacha	Brazil	President, National Development Bank, Brazil (1993-95)	Senior Adviser, Banco BBA-Creditstalten, Brazil
Kwesi Botchwey	Ghana	Minister of Finance, Ghana (1982-85)	Adjunct Lecturer in Public Policy, Harvard University, USA
Solita Collas-Monsod	Philippines	Socio-Economic Planning Secretary, Philippines	Professor of Economics, Philippines University, Philippines
Ruth de Krivoy	Venezuela	President, Central Bank of Venezuela (1992-94)	President, Sintesis Financiera C.A., Venezuela
Mar'ie Muhammad	Indonesia	Minister of Finance, Indonesia (1993-98)	Chairman, Oversight Committee for Bank Restructuring Agency, Indonesia; Chair, Indonesian Society for Transparency
Jaime Serra-Puche	Mexico	Minister of Trade, Mexico (1988-93) Minister of Finance, Mexico (1994)	Senior Partner, Serra Associates International, Mexico
Manmohan Singh	India	Minister of Finance Secretary, India (1991-96)	Leader of the Opposition, Rajya Sabha(Council of States), India
Noordin Sopiee	Malaysia	Member, Executive Committee of National Economic Action Council, (1997-present)	Chairman and CEO, Institute of Strategic and International Studies, Malaysia
Chalongphob Sussangkarn	Thailand	Economist, The World Bank, USA (1979-85)	President, Thailand Development Research Institute, Thailand
Roberto Zahler	Chile	President, Central Bank, Chile (1991-96)	President, Zahler & Co., Chile

Membership of the Advisory Board

NameName	Country	Previous Office	Present Post
C. Fred Bergsten	USA	Assistant Treasury Secretary for International Affairs, USA (1977-81)	Director, Institute for International Economics, USA
Rolf Lüders	Chile	Secretary of Economy and Finance, Chile (1982-83)	Professor of Economics, Pontifical Catholic University, Chile
Ronald I. McKinnon	USA	Professor of Economics, Stanford University, USA	William D. Eberle Professor of International Economics, Stanford University, USA
Ernest Stern	USA	Managing Director, World Bank, USA (1991-95)	Managing Director, J.P. Morgan, USA
Joseph Stiglitz	USA	Chairman, Council of Economic Advisers, USA (1993-97)	Professor of Economics, Columbia University, USA
Paul Volcker	USA	Chairman of the Board of Governors, Federal Reserve, USA (1979-87)	Professor of International Economic Policy, Emeritus Woodrow Wilson School, Princeton University, USA

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