Part IV

Gaps in the International Institutional Framework

Towards a Better Financial Architecture

Stephany Griffith-Jones[1]

I Introduction

The deep integration of developing countries into the global economy has many advantages and positive effects. In particular, capital flows to developing countries have clear and important benefits. The benefits are especially clear for foreign direct investment, which is not only more stable but also brings technological know-how and access to markets. Other external flows also have important positive microeconomic effects, such as lowering the cost of capital for creditworthy firms. At a macroeconomic level, foreign capital flows can complement domestic savings, leading to higher investment and growth; this latter positive macroeconomic effect is very valuable for low-savings economies, but may be less clear for high-savings economies like those of East Asia.

However, large surges of short-term and potentially reversible capital flows to developing countries can also have very negative effects. Firstly, these surges pose complex policy dilemmas for macroeconomic management, as they can initially push key macroeconomic variables, such as exchange rates and prices of assets like property and shares, away from what could be considered their long-term equilibrium. Secondly, and more important, these flows pose the risk of very sharp reversals. These reversals – particularly if they lead to currency and financial crises – can result in very serious losses of output, investment and employment, as well as dramatic increases in poverty. This has been dramatically illustrated by the impact of the current crisis in Asia, which has spread to many other countries, including most recently Brazil.

Asian-style currency crises – and their extremely high development costs – raise a very serious concern about the net development benefits for developing countries of large flows of potentially reversible short-term international capital. While the high costs of reversals of those flows are evident, the benefits are less clear. This is in sharp contrast with foreign direct investment (FDI) and trade flows, where the very large developmen-

[1] This paper draws partly on joint work with José Antonio Ocampo, to which Jacques Cailloux contributed. I thank officials in the UK and US Treasury, Bank of England and Federal Reserve Board, as well as colleagues in private institutions for valuable insights. The responsibility is, as always, my own.

From: The Management of Global financial Markets, FONDAD, April 2000, www.fondad.org

tal benefits clearly outweigh the costs. As a result, volatile short-term capital flows emerge as a potential Achilles' heel for the globalised economy and for the market economy in developing countries. If the international community and national authorities do not learn to manage these flows better, there is a serious risk that such volatile flows could undermine the tremendous benefits that globalisation and free markets can otherwise bring.

The current functioning of the international financial system is clearly unsatisfactory, particularly because it leads to recurrent financial crisis, with very high development costs especially implying increases in poverty for developing countries. It thus risks undermining the development achievements of the otherwise broadly successful market reforms.

As a result of the Asian crisis – which spread to other emerging markets – a broad consensus has emerged on the need and the urgency for reforming the international financial system. Though quite important progress has been made, there is however lack of agreement and precision in proposals on the exact nature of the changes required. This paper aims to contribute to the discussion, by making more precise and comprehensive proposals, both for crisis prevention and for better crisis management.

Section II looks at improved transparency and information on developing countries, as one way to deal with currency crises; however, the limits of this approach are also analysed, as well as the need for improved transparency on international financial markets. Section III deals with better regulation. It examines the need to fill global regulatory gaps, as well as discussing the recently created Forum for Financial Stability. Section IV deals with the appropriate scale, timeliness, modalities and conditionality in the provision of official liquidity in times of crisis, including a discussion of the recently created Contingency Credit Line. Section V deals with involving the private sector, both in crisis prevention – for example via private contingency credit – as well as in crisis management, for example via amendment of bond clauses or via standstill arrangements. Section VI concludes.

II Improved Transparency and Information

Actions Taken

One of the areas defined initially by the G-7 countries and the IMF as central for future crisis avoidance was enhancing transparency and disclosure of timely and reliable information, basically on developing countries, so as to make it available to market actors. The assumption was that insufficient

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

information had contributed significantly to the Asian crisis (for a critique of this assumption see below).

A flurry of activity in improving information followed, as reflected in the fact that the first of the three working groups of the G-22 (which included G-7 countries and a range of emerging economies) was devoted to Enhancing Transparency and Disclosure of Information. Amongst some of the key significant data gaps and deficiencies identified were: (i) information on foreign exchange reserves, including undisclosed forward positions, and any other claims against them; (ii) maturity and currency exposures of the public and private sectors; and (iii) the health of the financial system, including information on non-performing loans.

A number of steps have already been taken, of which the main ones are Public Information Notices (PINs) by countries and strengthening by the IMF of the Special Data Dissemination Standard (SDSS).[2] The PINs are prepared yearly by all countries after their Article IV consultation with the IMF, and countries are encouraged to release them speedily. The IMF has also started a pilot programme for voluntary release of Article IV staff reports. Of particular importance has been the strengthening, in the areas of international reserves and external debt, of the SDSS, the information standard that the IMF had already established in 1996, after the Mexican peso crisis. Particularly significant is that these will incorporate full details on reserves, and any claims against them (for all countries), from April 1999.

Besides information standards, a number of other standards are being defined (by the IMF and the BIS, in collaboration with institutions like the World Bank and the OECD) which are meant to provide codes of good practice for economic, financial and business activities. The IMF will help in the dissemination of these standards and the monitoring of their implementation, by different measures including having them as conditions for IMF lending. These standards will include creating Codes of Good Practices on Fiscal Transparency, and in monetary and financial policies, improving the quality of banking supervision, as well as developing standards relevant for the functioning of financial systems, including on accounting and auditing, bankruptcy, corporate governance, insurance regulations, payment and settlement systems, and securities market regulations.

Though many of these standards and their implementation may have very positive effects – e.g. on strengthening financial systems – three rather serious concerns need to be raised and addressed. Firstly, is the definition

---

2 For details of these and some of the other main measures of progress on transparency and standards, see IMF website: http://dsbb.imf.org/

of "desirable standards" sufficiently participatory, that is, do developing countries which will be asked to implement these standards in their own economies have enough participation in the definition of these standards? Should developing countries just be encouraged to adopt these standards, rather than them being part of IMF conditionality? These concerns could be summarised in the phrase "No standardisation without participation".[3] Secondly, will implementing these standards be really effective in significantly improving the resilience of developing countries for avoiding crises, and making them less acute if they do happen? Thirdly, will implementing these standards not impose excessive administrative and other burdens on developing country governments, especially the poorer ones, which have more limited resources and expertise? To help deal with the third problem, appropriate technical assistance – particularly for the poorer countries – is essential.

Limits of this Approach, Due to Inherent Problems of Asymmetries of Information

Clearly, improved information, along the lines of the changes described above, will be welcome and useful, contributing to a better market performance. However, improved information on developing countries will not by itself avert crises. First, information available to financial markets will never be perfect and information asymmetries will always exist. Second, it is not clear that better information will be sufficient for financial markets to function well, as the key issue is how information is processed and acted upon. Phenomena such as euphoria and herding imply that "bad news" is ignored in periods of "boom" and magnified in periods of "bust", with the reverse being true for "good news". Third, better information on developing countries has to be complemented by equally important improved information on international financial markets.

As regards the first point, there is both clear theoretical analysis and practical experience which shows that information will always be imperfect, and that this may cause or contribute to financial crises. A clear forerunner of much of the imperfect information literature was Keynes, who in Chapter 12 of the General Theory stressed "the extreme precariousness of the basis of knowledge on which our estimates of prospective yields have to be made". The seminal contributions in modern analysis of asymmetries of information and their particular significance for financial markets, have come from Stiglitz.[4] Most recently, Eichengreen (1999) has rather strongly

---

[3] I thank Gerry Helleiner for this point.
[4] See, for instance, the classic paper by Stiglitz and Weitz (1981).

summarised the limits of improved information for crises prevention: relying excessively on improved transparency "underestimates the extent to which information asymmetries are intrinsic to financial markets It is unavoidable that borrowers should know more than lenders about how they plan to use borrowed funds. This reality is a key reason why banks exist in market economies Bank fragility is inevitable. The advocates of information-related initiatives mislead when they assume the problem away".

Indeed, sophisticated and increasingly informed financial markets have continued to be extremely (and even increasingly) volatile. This has occurred also in some of the most developed economies in the world, where serious problems and crises have occurred in their banking systems, even though they had the highest ratings on transparency, as illustrated by the banking crises in Scandinavian countries (Bhattacharya and Miller, 1999; Stiglitz and Bhattacharya, 1999).

One very important reason for imperfect information is the fact that much of the relevant information to which the market reacts comes only with a lag, and depends on macroeconomic conditions not entirely known in advance (even though the changes in macroeconomic conditions may be partly or largely determined by the aggregate effects of the behaviour of financial agents). For example, some of the lending or investment decisions made in East Asia before the 1997 crisis may have been unsound, but the magnitude of the losses associated to them were even more determined by the major macroeconomic shocks that these regions experienced, whose large magnitude was probably unpredictable and indeed these shocks were largely unpredicted. Increasing information that may thus be relevant to improve microeconomic market efficiency may do little to reduce macroeconomic volatility (Ocampo, 1999). Particularly as regards macroeconomic information, markets are necessarily imperfect when time is involved, as the information necessary to correct such "market imperfections" will never be fully available.

Secondly, there are problems as regards the processing of information. As pointed out above, the key issue is that increasingly investors (and lenders) are concerned, not with what an investment is really worth to a person who buys it for keeps, but with what the market will value it at in a few hours or days. The concept behind this was perhaps best captured by Keynes' "beauty contest", in which each actor tries to interpret what the average opinion in the market is. To the extent that this is true, available information on developing countries will be less important than how the average of the market is likely to perceive it. The interrelation of the "information" that financial actors manage at any particular time – or rather, of the opinions and expectations that are formed from such information – is central to the rich contemporary literature on self-fulfilling booms and busts.

Microeconomic factors, on how financial firms and banks operate, reinforce such problems. This may be related both to costs and to firm organisation. A board of a financial institution deciding to invest or lend to a particular country may not be able (or willing) to take account of the rich information available in the research departments of that institution.[5] Smaller banks, with small research departments, tend to rely even less on their internal expertise, and follow even more decisions of other banks. As a result, changes in the opinions of those investors that are considered to be "informed" may lead to overreactions by non-informed ones, who rely on the formers' lead to make their decisions (Calvo, 1998).

A key problem is that changes in opinion can occur without any significant change of underlying fundamentals; this occurs because basically the same information about a country may be interpreted totally differently at different times, due to factors such as the "mood of the markets", events in other economies, etc. Also, "small news" that does not alter fundamentals, may affect market perceptions dramatically in a world of instant communications and 24-hour trading.

Some concern has even been expressed that, in some cases, information disclosure could lead to more, and not less, variability in the price of an asset (Stiglitz and Bhattacharya, 1999). Lack of information may serve to "average" good and bad news; as a consequence, it could even be the case that improved capabilities of processing and transmitting certain information could increase volatility. However, empirical evidence on this is inconclusive, and further research is required.

Overall, we can conclude that, though on the whole very helpful and important, improved information on developing countries will clearly not be sufficient to prevent future crises, and that far stronger actions are required. This is increasingly – though slowly – being recognised by the international community. A third problem is that, as pointed out above, better information on developing countries has to be complemented by better information on international financial markets available to policymakers.

Providing Additional Information on Markets to Developing Countries

Indeed, particularly during the crisis that started in Asia, emerging country policymakers (and specifically emerging country central banks) have found

[5] A recent survey of banks by the Bank for International Settlements showed that most of them took decisions without taking much notice of information available in research and other departments even within their own bank.

important limitations in the essential information available on the functioning of international capital and banking markets.[6] The type of information required is both on more long-term structural changes in these markets, but particularly on almost day to day changes in the functioning of markets – and their key actors – globally and regionally.

In the same way that the IMF has led the way in improving information – and its dissemination – on emerging market economies, particularly useful to markets, a parallel symmetric effort needs to be done to gather and provide timely information on market evolution to emerging market policymakers. This task should perhaps be led by the BIS, and coordinated by the newly created Forum for Financial Stability, though inputs from other institutions, e.g. the IMF, the private sector (e.g. Institute of International Finance), would be very valuable. Though possibly not giving it sufficient emphasis, suggestions in the October 1998 G-22 Report of the Working Group on Transparency and Accountability did provide important elements for this task. These suggestions relate not just to better statistics on international banks' exposures, but also on "compiling data on international exposures of investment banks, hedge funds and other institutional investors"; the latter would include presumably pension funds and mutual funds. Furthermore, the growth of financial innovations, such as over-the-counter derivatives, while designed to facilitate the transfer of market risk and therefore enhance financial stability, have also made financial markets more complex and opaque. This has created difficulties in monitoring patterns of activity in these markets and the distribution of risks in the global financial system for regulators, central banks, market participants and other authorities, including particularly in developing countries.

In response to this situation, the Euro-currency Standing Committee at the BIS has drawn up a framework for the regular collection of statistics on over-the-counter derivatives markets on the basis of reporting by leading market participants. Such efforts to improve transparency, particularly in relation to derivatives, and on highly leveraged institutions (such as hedge funds), are widely welcomed. However, this sector is constantly evolving and there is a concern that regulatory reporting will never be able to keep pace with this complex and dynamic markets. Difficulties are made greater by the fact that there are already many gaps in reporting derivatives and activities of institutions like hedge funds; it would seem appropriate for major central banks and the BIS to attempt to improve registration of derivatives and institutions like hedge funds, by making it obligatory.[7] It

6 Interview material; own experience.
7 Interview material.

seems essential that developing countries – including representatives from the poorer countries – should participate in the relevant Working Groups where information needs are discussed and decided, so that their information needs on markets are also fully considered.

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

To summarise, crucial information on capital and banking markets available to policymakers, especially in LDCs is clearly insufficient, especially just before and during currency crises.

The BIS (and the Forum for Financial Stability) seem well placed to build on the useful information they already provide, and their network of links with central banks, securities' regulators and markets by expanding it in two directions: (i) broadening coverage, for example to include more information on institutional investors and in rapidly growing instruments, such as derivatives; and (ii) increasing significantly frequency of information, to provide timely inputs to policymakers on rapid changes in banking and financial markets' trends.

This exercise would be in some ways symmetrical to the efforts being led by the IMF to improve information available on developing countries, mainly of use to markets; the proposed activity would improve information on markets, mainly for the use of country and international policymakers.

If approved, a meeting or a set of meetings, including representatives from LDCs, working with BIS staff or the relevant BIS Committees, seems appropriate for effective implementation. Representatives of LDCs' central banks could for example present initial ideas on desirable additional information, especially from a developing country perspective, that the BIS (or

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

more broadly the Forum for Financial Stability) could provide, its frequency, etc. The feasibility and value of such additional information could then be explored.

III Better Regulations, Nationally and Internationally

National Regulations[8]

The experience of developing countries at different levels of development indicate that the management of capital account volatility requires: (a) consistent and flexible macroeconomic management; (b) strong prudential regulation and supervision of domestic financial systems; and (c) equally strong "liability policies", aimed at inducing good debt profiles, public and private, domestic and external. Moreover, despite the traditional emphasis on crisis management, the focus of authorities should rather be the management of booms, since it is in the periods of euphoria from capital inflows and trade expansion and terms of trade improvement that crises are incubated. Crisis prevention is thus, essentially, an issue of adequate management of boom periods.

Regulation of capital inflows may also be essential to avoid unsustainable exchange rate appreciation during booms, particularly in the face of improved terms of trade in commodity-exporting countries. Some appreciation may be inevitable and even an efficient way to absorb the increased supply of foreign exchange, but an excessive revaluation may also generate irreversible "Dutch disease" effects. Regulations of capital inflows thus play an essential role in open developing economies as a mechanism to allow monetary and domestic credit restraint, as well as to avoid unsustainable exchange rate appreciation during booms. The macroeconomic role of regulation of inflows has, unfortunately, received much less attention in discussions than the issue of regulation on outflows during crises; they are, however, more important, as they are associated to the essential issue of crisis prevention.

The experience of many countries indicates that strong domestic prudential regulation and supervision are essential to avoid costly financial crises. The experience of both developing and industrialised countries indicates that financial crises are very costly, both fiscally and in terms of

[8] The literature on national regulations is extensive. See in particular, among recent contributions, World Bank (1998a), ch. 3, ECLAC (1998a and 1998b), Ffrench-Davis (1999), Helleiner (1997a) and Ocampo (1999).

economic activity, particularly if they are mixed with currency crises (the so-called "twin" crises).[9] Given the role of the domestic financial system in the intermediation of external lending, prudential regulation and supervision also play an essential role in managing the risks associated to capital account booms.

The essential role of domestic financial regulation and supervision is to guarantee the solvency of domestic financial intermediaries, by guaranteeing capital requirements adequate to the risks that financial intermediaries face, avoiding excessive risk taking, including an excessive concentration of risks, and requiring that loan losses are adequately accounted for. However, it has become increasingly clear that in the face of financial volatility, domestic financial regulation and supervision should also guarantee an adequate liquidity of financial intermediaries, as the link between liquidity and solvency problems are stronger than traditionally perceived. Thus, avoiding significant mismatches between the term structure of assets and liabilities, and establishing higher reserve or liquidity requirements for the short-term liabilities of the domestic financial system also play an essential role in domestic financial management.

Prudential regulation and supervision must take into account not only the micro but also the macroeconomic risks typical of developing countries. In particular, due account should be taken of the links between domestic financial risk and changes in key macroeconomic policy instruments, notably exchange and interest rates. The risks associated to the rapid growth of domestic credit, to currency mismatches between assets and liabilities, to the accumulation of short-term liabilities in foreign currencies by financial intermediaries and to the valuation of fixed assets used as collateral during episodes of asset inflation must be adequately taken into account. Moreover, given these macroeconomic links, prudential regulations should be stricter in developing countries, and should be strengthened during years of financial euphoria or terms of trade improvements to take into account the increasing risks in which financial intermediaries are incurring. These links also imply that contractionary monetary or credit policies during booms, particularly higher reserve or liquidity requirements and ceilings on the growth of domestic credit, may be strongly complementary to stricter prudential regulation and supervision; indeed, this would imply that counter-cyclical elements in both monetary and regulatory policies are desirable for small economies, subject to large trade or capital account shocks.

In the case of the public sector, direct controls by the Ministry of Finance are the adequate instrument of a liability policy. More indirect

9 See, in particular, IMF (1998), ch. IV.

tools are necessary to induce a better private debt profile. Again, direct exchange controls may be the appropriate instrument. An interesting alternative are reserve requirements on capital inflows, such as those used by Chile and Colombia in the early 1990s; indeed, as in both countries reserve requirements can be substituted for a payment to central banks of the opportunity cost of the said requirement, they are in effect a tax on inflows. A flat tax has a positive effect on the debt profile, as it induces longer-term borrowing, for which the tax can be spread over a longer time frame. This has been generally recognised in recent controversies. The effects of this system on the magnitude of flows have been subject to a more heated controversy. In any case, to the extent that elusion is costly and that short and long-term borrowing are not perfect substitutes, the magnitude of flows is also affected.[10] If this is the case, the system operates both as a "liability" and a macroeconomic policy tool. A basic advantage of this instrument is also that it is targeted at capital inflows, and it is thus a preventive policy tool.

Simple rules such as the Chilean-Colombian system can also play a very positive role. Any such system must also meet an additional requirement: it must have the adequate institutional backing. A permanent dynamic system, which is strengthened or loosened throughout the business cycles is preferable to the alternation of free capital movements during booms and quantitative controls (e.g. prohibitions on outflows) during crises. Indeed, the latter system may be totally ineffective if improvised during a crisis, simply because the administrative machinery to make it effective is not operative and thus leads to massive evasion or elusion of controls. Such a system is also procyclical and leaves aside the most important lesson learnt on crisis prevention: avoid overborrowing during booms and thus target primarily capital inflows rather than outflows.

International Measures

Clearly an important part of the responsibility with discouraging excessive reversible inflows – as well as managing them – lies with the recipient countries. However, the large scale of international funds – compared to the small size of developing country markets – leads us to question whether measures to discourage excessive short-term capital inflows by recipient countries are enough to deal with capital surges and the risk of their reversal. Three strong reasons make complementary action by source countries and internationally necessary. Firstly, not all major recipient countries will be willing to discourage short-term capital inflows, and some may even

[10] Agosin (1998), Agosin and Ffrench-Davis (1999) and Ocampo and Tovar (1998).

encourage them. Thus the tax and regulatory measures taken, for example, to encourage the Bangkok International Banking Facility, encouraged short-term borrowing. Secondly, even those recipient countries which have deployed a battery of measures to discourage short-term capital inflows have on occasions found these measures insufficient to stem very massive inflows. Thirdly, if major emerging countries experience attacks on their currencies, which also result in difficulties to service their debt, they will be forced to seek large official funding. As a consequence, there is a clear need for international and/or source country regulation that will discourage excessive reversible capital inflows. If this is not developed, international private investors and creditors might continue to assume excessive risks, in the knowledge that they will be bailed out if the situation becomes critical. This is the classical moral hazard problem.

The Asian crisis – and its repercussions worldwide – clearly demonstrated that it is necessary to strengthen source country regulations, coordinate them globally and fill important regulatory gaps.

The crisis also provoked a serious debate on how supervision and regulation of the international financial system could be strengthened in order to help prevent economic crises of this sort happening again in the future. The debate has partly focused on whether existing arrangements should be extended and improved, or whether there is now a need for new institutions to cope with the increasingly globalised financial system, so as to achieve better the necessary improvement of international financial regulation and supervision.

At the more institutionally radical end of the scale, there have been proposals for the creation of a new international body such as a World Financial Authority (Eatwell and Taylor, 1998) or a Board of Overseers of Major International Institutions and Markets (Kaufmann, 1992). Such a body would have wide-ranging powers for the oversight of regulation and supervision globally.

The other approach has been to develop and build on existing institutional arrangements. The virtue of this approach was the greater ease, both technically and especially politically, to move forward on this. Indeed, the Forum for Financial Stability, which is described below, has been created and has started to operate, with impressive speed; this seems one of the most positive steps towards a new international financial architecture.

Both the Canadian and the British government put forward proposals based on this approach in 1998. In the autumn of 1998, Chancellor Gordon Brown and Secretary of State Clare Short proposed a standing committee for global financial regulation to coordinate the multilateral surveillance of national financial systems, international capital flows and global systemic risk. It was proposed that the committee would bring

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

together the World Bank, the IMF, the Basle Committee of the BIS and other regulatory bodies on a monthly basis to develop and implement ways to ensure that international standards for financial regulation and supervision were put in place and properly coordinated.

The Financial Stability Forum

In October 1998, the G-7 finance ministers and central bank governors approved this idea in principle and asked Hans Tietmeyer, then president of the Bundesbank, to develop the UK proposal and more generally consider the cooperation and coordination between the various international regulatory and supervisory bodies and to make recommendations for any new arrangements. Tietmeyer's report, released in February 1999, outlined areas where improvements to current arrangements were necessary, but stated that "sweeping institutional changes are not needed to realise these improvements" (Tietmeyer, 1999). Instead it was proposed that a Financial Stability Forum, which would meet regularly to discuss issues affecting the global financial system and to identify actions needed to enhance stability, be convened. The Forum was formally endorsed by finance ministers and central bank governors from the G-7 at their February meeting in Bonn, and met for the first time in the spring of 1999.

The Tietmeyer report had correctly outlined three main areas for improvement to current arrangements which have been highlighted by recent events in international financial markets: (a) identify vulnerabilities in national and international financial systems and sources of systemic risk and identify effective policies to mitigate them; (b) ensure that international rules and standards of best practice are developed and implemented, and that gaps in standards are identified and filled; and (c) ensure consistent international rules and arrangements across all types of financial institutions.

The Financial Stability Forum will be limited in size to 35 members, in order to allow for an effective exchange of views and decisionmaking. Each G-7 country will have three representatives on the Forum, from the finance ministry, central bank and supervisory authority. The G-7 stated that while the Forum will initially be limited to G-7 countries, it is envisaged that other national authorities, including from emerging market countries, will join the process at some stage. The IMF and the World Bank will have two representatives each, as will the Basle Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The BIS, the OECD, and the two BIS Committees will all have one representative on the Forum.

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

The Forum will be chaired by Andrew Crockett, general manager of the BIS, for the first three years and it will have a very small secretariat in Basle. One of the key aims of the Forum will be to better coordinate the responsibilities of the main national and international authorities and supervisory bodies, and to pool the information held by these various bodies, in order to improve the functioning of markets and reduce systemic risk. The Forum has defined three ad hoc working groups, to tackle recommendations on three subjects defined as key:

(a) to recommend actions to reduce the destabilising potential of institutions employing a high degree of leverage (HLIs) in the financial markets of developed and developing economies; this group is chaired by Howard Davies, Chairman of the UK Financial Services.

(b) to evaluate measures in borrower and creditor countries that could reduce the volatility of capital flows and the risks to financial systems of excessive short-term external indebtedness; this group is chaired by Mario Draghi. Reportedly, amongst developing countries, Chile and Malaysia will participate.

(c) to evaluate the impact on global financial stability of the uses made by market participants of financial offshore centres, and the progress made by such centres in enforcing international prudential standards and in complying with cross-border information exchange agreements. As regards offshore centres, reportedly an assessment will be made of the additional efforts required to avoid under-regulation or inappropriate disclosure in offshore centres contributing to global financial instability. This group is chaired by John Palmer, Superintendent of Financial Institutions.

It is important to stress that the working groups comprise officials of developed and developing market economies, international financial institutions and supervisory groupings, and will draw on work completed or under way in various public and private sector forums. It is interesting that senior officials from developing countries have been included, where their expertise is seen as particularly relevant. For example, the group that will study measures to study volatility of capital flows includes senior representatives from Chile and Malaysia, two countries that have implemented measures to curb inflows and outflows (Malaysia for both, and Chile for inflows).

The setting up of the Financial Stability Forum is clearly a very necessary, and valuable first step towards improving the coordination and cooperation of the various bodies which work towards improving the way markets work in order to improve global stability. The question lies, however, in whether the Forum, as it has been proposed, will be a representative enough and strong enough body to address all these complex issues.

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

First, the omission of any developing country authorities in the initial years of the Forum itself appears to be an important error. It has been increasingly accepted, especially since the Mexican peso crisis and the current international financial crisis, that international finance is more and more globalised, that developing countries are important actors in this globalised financial system, and that currency crises in LDCs pose both systemic threats to the international financial system and threats to their development prospects. The experiences of developing countries, will not be directly represented at the Forum itself. Representation of developing countries on the Forum would be desirable for both legitimacy reasons, and because it would provide the body with a wider range of expertise and perspectives. However, the representation of developing countries in the ad hoc Working Groups is clearly a positive development.

Ways could easily be found to include developing countries in the Forum without making it too large. If three developing countries representatives were included, the membership of the Forum would rise from 35 to 38, that is by less than 10%. Developing country representatives, from countries with large levels of private capital inflows or who have major financial centres could for example be chosen on a regional basis; there could be one Asian, one Latin American and one African. This would ensure also that the interests of poorer countries would also be represented. These representatives could be appointed for a fairly short period (e.g. 2 years) and then rotated. This type of representation by developing countries has been working rather well in other contexts, for example in the Boards of the Bretton Woods institutions. It has also been suggested that not all G-7 countries would need to be included if it was felt that size needed limiting. For example, all G-7 countries, which have large financial centres, could be included as permanent members; other G-7 countries could be rotated.

The Forum for Financial Stability is a very important initiative, that hopefully will reduce vulnerabilities in the international financial system, by promoting coordination and cooperation among G-7 regulators, central bankers and international financial institutions. Adding a small representation from developing countries to the Forum would increase those countries' commitment to its aims, as well as add valuable insights to its decisionmaking process. It would seem to be beneficial to all involved.

Second, doubts have been voiced over the institutional strength of the new Financial Stability Forum. With a very small secretariat in Basle (currently it has only three staff members), meeting only twice yearly, and no power of enforcement, will the Forum have the sufficient institutional muscle to deal with the tasks that have been identified? Can its response be speedy and agile enough to a rapidly changing international private system? The setting up of the Forum represents a significant enhancement of the system of global regulation by agreement and peer pressure that has been shown to work reasonably well in the context of the Basle Committees of the BIS (Griffith-Jones, 1999). International cooperation at the BIS has always been based on home country control, where sovereignty remains at the level of the nation-state, and agreements are reached through negotiation and then implemented, where necessary, through national legislation or regulation. Countries which are not represented at the Basle Committee have also adopted some of their directives (most notably, the capital adequacy standards). However, in the medium term, in a world of open financial markets, an international body whose Board meets regularly and has the power to make and enforce policy may well be needed (Eatwell, 1999). This would point towards a body more akin to some kind of World Financial Authority, which would be endowed with executive powers along the lines of a WTO for finance.

In the meantime, however, the Financial Stability Forum is a very important step in the right direction. Time will tell whether this body is sufficient to promote international financial stability, and to fill the important gaps in financial regulation which undermine such stability.

Filling Regulatory Gaps

There are three categories of flows and institutions to emerging markets where additional international and/or source country regulation and supervision may be particularly necessary, as these flows seem insufficiently regulated and their surges, as well as outflows, have played a particularly prominent role in sparking off recent currency crisis; the latter would seem to occur particularly because they are reversible. One of these are short-term bank loans (particularly important in the Asian crisis); the second are easily reversible portfolio flows, made by institutional investors, such as mutual funds (especially important in the Mexican peso crisis but also important in East Asia); the third are activities by hedge funds and more generally highly leveraged institutions, relating in particular to different types of derivatives.

As discussed above, the Forum for Financial Stability (FSF) will examine in its Working Groups issues relating to short-term bank loans and to highly leveraged institutions. However, it would also be desirable for the FSF to examine issues relating to easily reversible portfolio flows made by institutional investors such as hedge funds.

Bank Loans. International bank loans (including short-term ones) are already regulated by industrial countries' central banks; these national regulations are coordinated by the Basle Committee. However, existing regulations were not enough to discourage excessive short-term bank lending to several of the East Asian countries, whose reversal played a major role in triggering of crises in those countries. A key reason for such high short-term bank lending to East Asia was that till just before the crisis most of these East Asian countries (and particularly countries like South Korea) were seen by everybody including regulators as creditworthy. Another, important reason has been current regulatory practice, which has a bias in favour of short-term lending. For example, for non-OECD countries, loans of residual maturity of up to one year have a weighting of only 20 percent for capital adequacy purposes, whilst loans over one year have a weighting of 100 percent for capital adequacy purposes. This was done to reflect the fact that is easier for individual banks to pull out from renewing short-term loans. However, as a result of this rule, short-term lending is significantly more profitable for international banks. Therefore, to banks' economic preference for lending short term, especially in situations of perceived increased risk, is added a perverse regulatory bias that also encourages short-term lending. The initial intention was to protect banks, and their liquidity, by encouraging more short-term lending. An overall increase in short-term loans, however, makes countries more vulnerable to currency crises and therefore, paradoxically, banks more vulnerable as well, to risk of non-payment of short-term loans.

It is interesting that soon after the Asian crisis (around April 1998), clear proposals emerged (Greenspan, 1998, see also Griffith-Jones with Kimmis, 1998) to increase the capital charge through the assignment of a higher risk weight to short-term interbank credits than the 20 percent assigned under the Basle Capital Accord, so as to reduce the excessive incentive towards such short-term loans. However, even though this change seemed to have very broad support, progress was not made for a year on it as a stand-alone proposal (IMF, 1999; interview material). Instead, a review on this issue was placed within the context of a comprehensive reassessment of Basle treatment of credit risk, for which a special task force was created. Unfortunately, a totally separate issue (linked to the capital adequacy required for mortgages lent by German banks) delayed overall agreement for at least a year, on revision of capital adequacy rules (Financial Times, May 14, 1999). Questions need to be raised, therefore, not just on appropriate technical measures to build a new international financial architecture, but on mechanisms for speeding up the process through which decisions – especially those on which there is agreement – can be quickly taken. This should be particularly so for the case where clear institutional mechanisms already are in place (in this case the Basle Committee of Bank Supervisors) that should allow rapid decisionmaking to take place.

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

The East Asian crisis confirms what was particularly clearly visible in the Mexican peso crisis (Borio, 1998; Griffith-Jones, 1998). Institutional investors, like mutual funds, given the very liquid nature of their investments can play an important role in contributing to developing country currency crises. It seems important, therefore, to introduce some regulation to discourage excessive surges of portfolio flows. This could perhaps best be achieved by a variable risk-weighted cash requirement for institutional investors, such as mutual funds. These cash requirements would be placed as interest-bearing deposits in commercial banks. Introducing a dynamic risk-weighted cash requirement for mutual funds (and perhaps other institutional investors) is in the mainstream of current regulatory thinking and would require that standards be provided by relevant regulatory authorities or agreed internationally. The guidelines for macroeconomic risk, which would determine the cash requirement, would take into account such vulnerability variables as the ratio of a country's current account deficit (or surplus) to GDP, the level of its short-term external liabilities to foreign exchange reserves, the fragility of the banking system, as well as other relevant country risk factors. It is important that quite sophisticated analysis is used, to avoid simplistic criteria stigmatising countries unnecessarily. The views of the national Central Bank and the Treasury in the source countries and of the IMF and the BIS should be helpful in this respect. The securities regulators in source countries would be the most appropriate institutions to implement such regulations, which could be coordinated internationally by IOSCO, probably best in the context of the Forum for Financial Stability.

The fact that the level of required cash reserves would vary with the level of countries' perceived "macroeconomic risk" would make it relatively more profitable to invest more in countries with good fundamentals and relatively less profitable to invest in countries with more problematic macro or financial sector fundamentals. If these fundamentals in a country would deteriorate, investment would decline gradually, which hopefully would force an *early correction* of policy, and, a resumption of flows. Though the requirement for cash reserves on mutual funds' assets invested in emerging markets could increase somewhat the cost of raising foreign capital for them, this would be compensated by the benefit of a more stable supply of funds, at a more stable cost. Furthermore, this smoothing of flows would hopefully discourage the massive and sudden reversal of flows that sparked off both the Mexican and the Asian crises, making such developmentally costly crises less likely.

Given the dominant role and rapid growth of institutional investors in countries such as the US, the UK and France, this proposal – for a risk-weighted cash requirement on mutual funds – could possibly be adopted first in those countries, without creating significant competitive disadvantages soon after international harmonisation would have to be introduced. However, an alternative route would be for such measures to be studied and implemented internationally being discussed initially within IOSCO, and/or in the broader context of the Forum for Financial Stability. International coordination of such a measure would prevent investments by mutual funds being channelled through different countries, and especially offshore centres, that did not impose these cash requirements (the latter point draws on communication with the Federal Reserve Board).

Such IOSCO international guidelines would be formulated through international consultations similar to those employed by the Basle Committee in developing the "Core Principles for Effective Banking Supervision". The guidelines could be developed by a working group consisting of representatives of the national securities' regulatory authorities in source countries together with some representation from developing countries, in the context of IOSCO. Due account should be taken of relevant existing regulations, such as the European Commission's Capital Adequacy Directive.

Finally, it is important to stress that additional regulation of mutual funds should be consistent with regulation of other institutions (e.g. banks) and other potentially volatile flows.

Highly Leveraged Institutions. Further urgent study is required to detect and cover any other existing monitoring and/or regulatory gaps, e.g. as relates to instruments such as derivatives and institutions such as hedge funds. Careful analysis – both technical and institutional – is required on how hedge funds and other highly leveraged institutions can best be regulated to reduce their impact on magnifying volatility of capital flows, exchange rates and stock markets in developing countries, and the negative effect that this volatility has on development and on poverty. It is encouraging that there is a growing consensus, as reflected for example in the January 1999 Report by the Basle Committee on "Banking Supervision, on Banks' Interactions with highly leveraged institutions (HLIs)", that HLIs can pose important risks both to direct creditors and, under certain market conditions, to the financial system as a whole.

An additional crucial concern – of the impact of HLIs on magnifying volatility in developing countries – has not yet been sufficiently studied and accepted, nor have measures designed to deal specifically with this issue been proposed internationally. However, policy responses to address risks posed by HLIs to creditors and the financial system as a whole will also help reduce negative impact on developing countries.

It is firstly important to stress that the problem does not just relate to hedge funds, but to other highly leveraged activities or institutions, such as proprietary desks of investment banks. HLIs can be defined as having three characteristics: (a) they are subject to little or no regulatory oversight, as a significant proportion operate through offshore centres; (b) they are subject to limited disclosure requirements, and often their operations are very opaque; (c) they take on significant leverage.

There are three sets of responses that can be used to address risks posed by the HLIs. Often, they are presented as alternatives. However, it would seem better to consider them as complementary.

The first response is indirect, through the major counterparties of HLIs (mainly banks and securities houses). This can be done by promoting sounder practices in the way banks and securities houses assess risks when they deal with hedge funds and other HLIs. However, further actions by supervisory authorities also seem desirable. In particular it seems desirable for supervisors to impose higher capital requirements on lending or other exposures of banks to HLIs, to reflect the higher risks involved in such exposures, due to HLIs opaqueness, high leverage and the fact they are not regulated. It may also be desirable for supervisors to, either formally or informally, prohibit banks from lending to a particular class of risky counterparty. Such measures may not only protect banks, but could also possibly stimulate HLIs to manage risks in a more responsible way.

A second avenue, which is clearly complementary with the first, is to increase transparency on total exposures to HLIs by all financial institutions. One possibility would be an extension of the concept of a credit register for bank loans (along the model of the French "central des risques", which provides banks access to the aggregate amount of bank lending to each company). Such a register would collect, in a centralised place total exposures (both on and off balance-sheet positions) of different financial intermediaries to single counterparties, such as major hedge funds. Counterparties, supervisors and central banks (both of developed and developing countries) could then get information about total indebtedness of such institutions, which would help them assess risks involved far more precisely. For this purpose, the information would have to be both timely

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

and meaningful (especially to take account of rapid shifts in HLIs positions). It would seem best if such a register would be based at the BIS itself or at the Basle Committee on the Global Financial System (formerly the Euro-currency Standing Committee) which already has experience in similar information gathering.

A third avenue is to directly regulate hedge funds and other highly leveraged institutions. Such direct regulation could take a number of forms, including licensing requirements, minimum capital standards and minimum standards for risk management and control. In its recent report, the Basle Committee on Banking Regulation has argued that such a regulatory regime should focus on the potential to generate systemic risk by HLI activities due to their excessive size and risk-taking, which could endanger financial stability. However, if as seems probable, HLIs also have additional negative effects on increasing volatility of exchange rates in developing countries, this concern should also be addressed in attempts at their regulation.

There is at present more support for the first two forms of dealing with HLIs and relatively less support for their direct regulation, even though the latter would deal with the problem in a more direct and straightforward manner.

The opposition to such direct regulation is presented as based on practical grounds. For example, it is argued that HLIs could restructure themselves so they escape any regulatory definition that may exist. However, this problem can be overcome by an appropriate system of monitoring and policing; its costs would surely outweigh the benefits of alleviating large potential systemic risks, as well as risks of currency instability in developing countries! The most frequent argument against direct regulation of hedge funds is that they would be able to circumvent such regulations, because these institutions either are or could move easily offshore.

This problem can either be tackled by accepting the absurd existing *status quo* (and incurring continued high costs of risk of major instability) or raising the issue of extending that and other regulation to offshore centres. Indeed, if global supervision and regulation is genuinely accepted as essential in today's world of globalised financial markets, there can be no justification for "no-go" areas, where such regulations could be evaded or undermined. Both as regards provision of information, and as regards global regulation of institutions such as hedge funds, it is essential that offshore centres comply with international standards. If the G-7 countries in particular backed this clearly, and if developing countries supported it, a political initiative in this respect should be both effective and useful.

More generally, further work is required to gain a better understanding of recent changes in global credit and capital markets, and – more specifi-

From: The Management of Global financial Markets, FONDAD, April 2000, www.fondad.org

cally – of the criteria used by different categories of market actors – including banks, mutual funds, hedge funds and others – to go in and out of countries as well as the incentives that encourage particular patterns of market actors' behaviour that contribute to speculative pressures on individual countries and to contagion to other countries. A better understanding of behavioural patterns and of trends in outflows could help design measures – to be taken by individual firms, by parts of the financial industry via self-regulation, by regulators and/or by governments (e.g. via tax measures) – to discourage market imperfections, like disaster myopia and herding, that contribute to currency crises.

It can be concluded that a package of measures need to be taken to make currency crises in emerging markets far less likely, and therefore ensure the efficient operation of the market economy in emerging markets, which should be a basis for sustained development. The objective of crises avoidance seems to require some discouragement and/or regulation of excessive and potentially unsustainable short-term inflows. Such measures would be most effective if they are applied both by source and recipient countries (though the main responsibility lies with recipient countries), if these measures avoid discouraging more long-term flows – which on the contrary need to be encouraged – if the rules designed are simple and clearly targeted at unsustainable flows and, particularly, if they are complemented by good policies in the emerging economies.

IV Provision of Official Liquidity in Times of Crisis

The Role of IMF and Other Institutions in Official Liquidity Provision

The need for liquidity provision in times of crisis is a well-accepted principle. It may be called the principle of the "emergency financier", to differentiate it from the role that a central bank plays at the national level as a "lender of last resort", which is not exactly matched by the IMF. Particularly, the Fund provides exceptional lending but certainly not liquidity,[11] a fact which is reflected in the lack of automaticity in the availability of financing during crises. Such emergency financing role has led, as we saw in Section II, to the provision of anti-cyclical lending by the IMF, matched in some major "rescue packages" by bilateral financing from major countries, in addition to their contribution to IMF's agreements to borrow. Some major advances during the recent international financial crises were the significant increase in IMF resources through: (a) a new quota increase and the New Arrangements to Borrow,

[11] This important distinction is made by Helleiner (1999).

finally effective in 1998; (b) the launching of the new window in December 1997, to finance exceptional borrowing requirements during crises; and (c) the creation of the Contingency Credit Line (CCL) in April 1999 to provide financing to countries facing contagion.

Timing of Provision of Official Liquidity, the New Contingency Credit Lines

The CCL has responded to the strong demand for the IMF to leave aside the principles of "fundamental disequilibrium" of the balance of payments, on which it was built, to finance countries in difficulties before and not after international reserves are depleted. This is an essential requirement in the era of rapid capital outflows that can destabilise economies in a matter of days, a lesson that the international community learnt during the Mexican, Asian and post-Asian shocks. It is also, above all, a response to the request for new credit lines to finance countries facing contagion. Although this problem is certainly not new, it has reached unprecedented levels in the current decade, which led finally to a strong request for support to countries facing contagion.

The CCL has been widely perceived as a significant move from the IMF in the area of crisis prevention for countries victim of contagion. The facility was implemented by the IMF in April 1999 as part of its ongoing work on strengthening the architecture of the international financial system and as a response to the increased need for liquidity provision for crisis prevention. The facility is a "precautionary line of defense readily available against future balance of payments problems that might arise from international financial contagion" (IMF, 1999). To qualify, the increased pressure on the recipient country's capital account and international reserves must thus result from a sudden loss of confidence amongst investors triggered by external factors.

Early provision of liquidity should help reducing external constraints on domestic monetary policy, increasing the level of reserves available for currency defense and relaxing the constraints on interest rates. It is thus a very important and positive step further as it should, in principle, reduce the chances of entering into a crisis.

The CCL differs from the Supplementary Reserve Facility (SRF) mainly because of the timing of disbursement.[12] Indeed, the SRF is designed for

[12] The SRF was implemented at the end of 1997 as a response to the Asian financial crisis. It provides financial assistance for exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence. Up to now, SRF loans have been made to Korea, $2.8 bn, Russia, $0.9 bn and Brazil. The lending terms for the SRF are similar to those for the contingency facility.

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

countries already facing a financial crisis whereas the CCL is triggered early on, in a precautionary manner, for countries not facing a crisis at the time of commitment but rather fearing to be affected by contagion. The cost of the credit line, 300 basis points above the rate of charge on regular IMF drawings with a penalty of 50 basis points every six months, has been set up to reduce moral hazard on the debtor side and is the same as for the SRF. It should prevent countries from drawing on the line in "good" times.

The CCL's crucial aim is thus to reduce the chances of countries to be caught by contagion. Its way of functioning, to give leverage of conditionality to the IMF early on, is such that, ideally, countries should not suffer from contagion and thus need not draw on the line. Put differently, the CCL provides a strong incentive for countries to make sound policy choices that provide a stable economic and financial environment. The facility works as a two stage process, very much like an option that is bought in "normal times". Its cost is the country's compliance with four sets of criteria:

Adoption of Strong Policies. Member countries should have implemented a combination of policies that provide a stable economic environment such that in the absence of contagion, no IMF financing should be required. Economic stability together with financial sustainability should be evident. Special attention is paid to an economic and financial programme to be implemented within the period of examination.

Macroeconomic Performance. The article IV consultation is used as a benchmark for economic performance. An ongoing assessment of the country is also carried out once the consultation is over. This monitoring is used to assess the countries' willingness to – and effectiveness in – adopting policy suggestions.

Advances in Adhering to Internationally Accepted Standards. This is an area which is still evolving as some standards have not been finalised yet (notably the codes of transparency in monetary and financial policy). Other standards include the subscription to SDDS, the Basle Core Principles for bank supervision, the code of transparency of fiscal policy (see above). Countries need not necessarily meet all the standards but should prove some progress in adhering to them.

Relation with the Private Sector. The IMF stresses the importance of "constructive" relations with private creditors. These relations encompass management of external debt (limiting external vulnerability) and a number of arrangements with private creditors. Examples of arrangements given by the Fund include private sector CCL, call options in debt instruments (allowing debtors to extend maturities), a modification of bond covenants (see section on involving the private sector below), and domestic bankruptcy laws.

The monitoring of external vulnerability through indicators of sustainability such as the level of international reserves, the ratio of short-term external debt in relation to reserves, and the exchange rate regime also are conditions. These conditions should help prevent Asian style crises in the future and therefore are very positive.

Once the above criteria are met and the CCL agreed, the country can exercise the option at any time but with one further restriction. An "expeditious" consultation is carried out by the Board to verify if the country is still eligible, before funds are disbursed.

However, the new credit line raises a number of issues, at least in five areas:

First, the question of the scale of liquidity provision. Formally, the size of the CCL is unlimited. This is imperative as very large amounts of liquidity might be required in times of major loss of confidence. The rationale of this argument is based on Bagehot's rules, namely that, to perform well in a crisis, a Lender of Last Resort should lend quickly, freely and readily. However, in practice because of financial constraints, the Fund has disclosed a range of disbursement from 300 to 500% of member nation's IMF quota.[13] This limitation is problematic, as in a crisis it is the unlimited nature of contingency financing which is crucial. A limited facility could, in certain circumstances, accelerate outflows, as creditors "rush for the door" for fear it may close, if revenues run out.

Estimates from April 1999, based on the upper ceiling of 500% of quota, evaluate the CCL to be of an order of $20 bn for Brazil, $11 bn for Korea and $7.4 bn for Thailand. Non-affected countries like Argentina would receive up to $14bn, Chile $5.8bn, Mexico $17bn, Hungary $7bn and South Africa $12bn (Davitte, 1999 and Chote, 1999). These amounts appear quite low and could turn out to be insufficient to fully absorb external shocks. For example, Brazil which accessed a financial package in some ways similar to the CCL but before its formal implementation, received more than twice the amount it is eligible for at present.

At the time of writing, no country had officially declared applying to the scheme although some policymakers had expressed their opinions on it. Mexican officials, for example, fear not to be eligible due to their current involvement with the IMF through a stand-by loan facility. Others have

[13] In April 1999, the Fund had $76 bn in uncommitted resources plus $46 bn available under pre-arranged credit lines.

underlined the paradoxical situation of "good" countries not willing to be labeled with the CCL while countries in potential difficulty finding it very hard to comply with too stringent conditions.

Second, the special "activation" review by IMF Board – as the CCL is today structured – does not look necessary. Indeed, the eligibility conditions have been designed so that the CCL is drawn as rarely as possible. As a matter of fact, the implementation of strong macro policies and the adherence to international standards together with the building up of sound relationships with private creditors should, by themselves, protect countries from financial crisis triggered by the deterioration of domestic factors. If a given country complies with these criteria, then, the only possible reason why it could face a financial crisis is because of contagion.

Furthermore, the automatic triggering is critical to the good functioning of the CCL as it would give instantaneous access to new liquidity. Indeed, as seen recently in several cases, a loss of confidence can have major impacts in a very short period of time. A few hours or days might then have a determinant impact on the outcome of the crisis. The approval required by the Board, even if it were expeditious, would still not be fast enough and could allow large outflows of funds.

The automatic disbursement, if implemented, could be associated with a shorter repayment period, possibly six months. Countries that experienced liquidity crisis in the past usually required fairly large amounts of liquidity, extremely rapidly but for a brief period.

Third, it is still not very clear what will be the potential signaling effect on private investors of countries applying for the CCL but failing to meet the criteria or of countries loosing their access to it. A certain degree of confidentiality could possibly dampen this effect. For example, information could only be disclosed on countries that have been accepted but not on those applying for it.

Fourth, as already mentioned, the facility is not open to countries with current or expected regular IMF financing. It could thus eliminate access to this type of financing to countries which are in a strong process of recovery from a past crisis but still have pending IMF credits.

So, despite significant advance, in practice the approved credit lines will continue to lack the full stabilising effects that are expected from IMF interventions during crisis, as the negotiation process will continue to be cumbersome and funds may not be available to all countries that require them at the appropriate time and in adequate quantities. Equally important, funds available to the IMF for exceptional financing will continue to be short of the amounts required, as the experience of the 1990s indicates. This is obviously a crucial issue, as stabilising effects will continue to be absent to the extent that the market judges that the intervening authorities are unable or unwilling to supply funds in the quantities required to stabilise speculative pressures. Moreover, under these conditions, national authorities may be forced to overreact, adopting a pro-cyclical stance, in an effort to generate confidence in private markets. For the world economy as a whole, this would be reflected in enhanced deflationary biases.

Well-funded IMF contingency financing is obviously the *sine qua non* of any reform effort. As bilateral financing and contributions to the IMF will continue to be scarce, the best solution could possibly be to allow additional issues of SDRs under critical financial conditions, to create the additional liquidity required (United Nations Task Force, 1999a). These funds could be destroyed once financial conditions normalise. This procedure would also create an anti-cyclical element in world liquidity management and would give SDRs an increasing role in world finance, a principle that developing countries advocated in the past and should continue to do so. Though technically very attractive, this proposal may face significant opposition, particularly as several of the major countries have been opposed to any issues of SDRs at all, which has implied that no issues have taken place for a very long time. A second best alternative would be to allow the IMF to raise in the market the resources needed to adequately fund contingency financing or to rely on central bank swap arrangements, arranged either by the IMF or the BIS.

V The Role of Private Sector Involvement in Preventing and Resolving Crises

A number of proposals have been put forward for *ex ante* measures directly involving the private sector, to be designed and put in place before crises occur (for a very useful recent overview of such measures, see IMF, 1999), these would not only help diminish severity of crises should they occur, but also (for example by improving the pricing of risk) diminish the likelihood of crises occurring.

Measures involving the private sector can (a) help limit moral hazard, that arises when lenders and investors are repeatedly bailed out, (b) imply fairer burden-sharing between the official and private sector, should crises occur and (c) most importantly, contribute to fairer burden-sharing between capital-recipient countries and their creditors and investors. Indeed, the standard crisis response in situations like East Asia – where creditors and investors suffer only fairly limited losses and the people of the capital-recipient countries see their country's growth undermined and suffer large increases in unemployment and poverty – clearly needs modifying.

However, measures to involve the private sector (particularly in burden-

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

sharing) need to be carefully designed, so as to avoid excessively discouraging desirable private flows to emerging markets, or too sharp increases in their cost. The views of developing countries therefore need to be carefully considered.

In what follows we will review some of the main measures under discussion, briefly evaluating their costs and benefits.

Contingent Financing Arrangements From Commercial Banks

At the heart of currency and financial crises is the issue of provision of sufficient liquidity in times of distress, particularly for countries that are potentially creditworthy in the long term. Indeed, if sufficient liquidity is not provided in a timely fashion, there is a risk that liquidity crises can be turned into solvency problems, which increases the costs to all involved, and particularly to debtor countries.

An important reason for contingent financing arrangements is the existence of multiple equilibria (Stiglitz and Bhattacharya, 1999). Individual lenders and investors, who believe that others are going to withdraw their money, do so for that reason. The provision of temporary funds can limit a liquidity crisis, and stop it becoming a solvency crisis. Even better, the belief that there are funds available eliminates the incentive to pull out; as a result, the liquidity crisis can be avoided.

We have discussed above contingent finance provided by the IMF and other official bodies, and in particular, the recently created CCL. It seems important that such official facilities are complemented by private contingent credit lines. Indeed, one of the possible pre-conditions for an IMF CCL is for the country to have "in place, or be putting in place, contingent private credit lines or similar arrangements" (IMF Summing Up by Chairman of Executive Board Meeting 99/48, available on IMF website).

An important operational issue is how private-IMF credit levels would be coordinated if a CCL is approved. One possibility would be for the IMF to approve a CCL in broad terms, for private financing then to be sought, and for levels of contingent IMF credit to be finalised afterwards. Though this could reduce the scale of IMF lending, and improve burden sharing, between the official and private sector, it could have the problem of indeterminacy. Therefore, it may be easier for countries to arrange, for example, a full CCL first (including the actual levels of contingency lending) and then approach the private sector for complementary contingency lending.

It is interesting that Argentina, Indonesia and Mexico have already arranged such lines of credit with private banks, to be drawn upon in the event of difficulties. These arrangements – though having different modalities – all include a regular commitment fee. Mexico's creditor banks initially argued against the drawing, even though as IMF (1999) rightly argues, Mexico had adhered strictly to the arrangement. However, the loan was disbursed when Mexico requested it. Mexico's Finance Minister Gurria[14] argued, the creditor banks resented disbursing loans at the low spreads that had been pre-committed, at a time when spreads for Mexico and other emerging market countries were much higher. A possible way to overcome such problems could be to for example link the loan spread, when arranging the loan, to bond market yields prevailing at the time (Gray, 1999). This could encourage creditors, but could – in times of crisis – increase the cost of such borrowing. The Argentina line has not been drawn, but its existence may have helped forestall market pressures.

This seems clearly an appealing mechanism. However, several questions remain. Firstly, would banks be willing to provide this kind of finance to a broad range of countries, including for example poorer ones. Secondly, do these facilities really provide additional financing in times of crisis, or do they partly crowd out other lending? Even more seriously, could banks involved in extending credit lines adopt dynamic hedging strategies to offset their exposure, and as a consequence leaving their overall exposure to the country the same? This would clearly neutralise the positive impact of such an arrangement.

Restricting Put Options in Debt Contracts

To reduce risk of loans, creditors like to introduce put options, which give them the option (but not the obligation) of shortening the contractual maturity of loans of bonds. For example, a five year loan – statistically recorded as such – can have a one year put, which allows the creditor the option of asking for repayment in a year, increasing his/her flexibility. Debtors accept such put options because it allows for somewhat lower spreads; however, in doing so, they often under-estimate the risk that conditions may deteriorate significantly – as a result they may lose market access – and the put may be exercised.

Put options have become an important additional source of vulnerability for developing countries, – including some low-income ones – as these countries have increasingly accepted puts in the last years, as derivatives became more widespread and as the risk of crises increased (for example in Brazil, the share of "putable" bonds increased significantly as the crisis approached). According to the IMF (1999), a minimum estimate of $20

[14] Presentation in May 1999 at HSBC, London.

billion in loans and bonds is “putable” in 1999 alone, which is a very high figure.

It is therefore very important for countries to be far more careful than in the past about accepting or using derivatives, such as put options, as well as other such investments when these increase countries’ vulnerability to crises. It is also important to improve transparency and understanding of such modalitites and issues, as the operations of financial intermediaries are often both complex and opaque. This may be particularly urgent for low-income countries, where there may – as yet – be less familiarity with such instruments. Technical assistance (from the IMF, World Bank, BIS or others) could thus be very valuable, and particularly so for poorer countries.

Amending Sovereign Bond Clauses

There is an urgent need to have flexibility in debt contracts for the case of unpredictable shocks arising. In a national context, this can be achieved by bankruptcy proceedings. Whilst this option is not yet available internationally (even though there have been several interesting proposals to establish one), a good “second best” is to have internationally state contingent contracts, that is to have flexibility for changing contracts if unforeseen circumstances arise.

After the Mexican peso crisis, the discussion of such changes has been particularly applied to international bonds, possibly because emerging bond finance has rapidly grown, with gross flows of bond placements increasing from $6 billion in 1992 to over $40 billion in 1997 and 1998. This is particularly true for Latin America. Indeed, it is unclear to what extent changes in the bonds contracts would have had a significant impact on the East Asian crisis, where the greatest part of the problem related to short-term bank lending and not to bonds.

Specifically, Eichengreen and Portes (1995) proposed changing the contractual provisions governing sovereign debt to allow for: (a) collective representation of bondholders in the event of a crisis; (b) qualified majority voting on changing the terms and conditions of the debt contract; and (c) sharing of proceeds received from the debtor among creditors. These clauses would facilitate a more orderly resolution of crises, for example by preventing a minority of dissident investors from holding up settlement. More broadly, it would help overcome problems associated with lack of creditor coordination, particularly the creditor “grab-race”, whereby actions taken by individual creditors in pursuit of their self-interest can disrupt orderly debt workouts, and thus reduce the potential resources available to all creditors and help create a situation of panic.

The ideas for modifying bond contracts were supported by the 1996

G-10 Deputies report (after the Mexican crisis), by the G-22 Working Group on International Financial Crisis (after the East Asian crisis) and has been both supported and developed further in the 1999 IMF document on Involving the *Private Sector*, quoted above. However, little concrete progress has been made to date.

This lack of progress has two main reasons. On the one hand, most creditors are reluctant (see, for example, IIF, 1999), though some creditors especially in Europe, see possible advantages in modifying bond clauses (for an interesting discussion, see Gray, 1999). On the other hand, debtors are concerned that such clauses could restrict future access, in terms of volume, or at least in terms of cost. This concern needs to be evaluated seriously, as long-term bonds are an important mechanism for funding development. However, the view can also be taken that, once the market has accepted these changes, the clearer "rules of game" would actually improve market access.

In any case, it does not seem appropriate for international institutions like the IMF to impose, as part of conditionality, modifications to bond contracts on developing countries, as it has been recently suggested. A very positive way forward would be for G-10 sovereigns to include in their new bond issues the new contractual terms discussed above. This would have two positive effects: the G-10 would lead by example and they would help define a new market standard. If the completely creditworthy G-10 countries would modify their new bond contracts (which would be extremely unlikely to increase their spreads), this would imply that it would become far more acceptable for developing countries to do so, and that negative effects on availability and costs of new bonds for them would deteriorate far less than if they did it on their own. However, there seems to be some resistance amongst G-10 governments for them to undertake such changes. The reasons given are purely technical, the problems raised seem relatively small, so they could be easily overcome if political will was there. One problem is that not all G-10 countries are currently active in international markets; this could be overcome either by modifying bond clauses only for those G-10 countries currently issuing bonds or by G-10 countries issuing bonds beyond their normal funding programme. Another, highly technical objection, is that modifying bond clause covenants, for those G-10 countries where secondary markets are very liquid and where parts of the bonds are "stripped", could lead initially to some fragmentation of that strips market.

It is important to point out that the problems for restructuring bonds do not apply to all types of bonds. Indeed, British-style bonds contain a number of important characteristics that facilitate an orderly restructuring. This is because they include provisions for the debtor, bondholders or the trustee (if there is one, see analysis below) to call bondholders meetings,

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

and for a qualified majority of bondholders represented to agree to changing the terms of the bonds for all holders. Furthermore, under one of two categories of British-style bonds (called Trustee Deeds) individual bondholders are generally prohibited from accelerating the bonds and initiating litigation. As IMF (1999) points out with British-style bonds it may be fairly easy to achieve high participation rates, as creditors that are reluctant to participate in changing conditions will know that they face the alternative of a modification of terms that can be imposed by a majority of bondholders. In the case of Trustee Deed bonds, the limits on individual creditors to initiate litigation provides further incentive to participate in an orderly restructuring.

However, there are difficulties in achieving an orderly bond restructuring after market access has been lost for countries with debt structured in the form of American-style international bonds – the most prevalent bonds issued by developing countries – or by German-style bonds. Those instruments do not include provisions for majorities to modify terms of bonds, and impose those changes on minority holders. Furthermore, in case of a default, the bonds have few limits on individual bondholders to start – and benefit from – litigation.

It is interesting that up to now there is no premium in favour of US-style bonds, that is investors have not discriminated in favour of those more "protected" instruments, possibly because they have not noticed the difference. This is rather encouraging, as it would imply that drawing on the precedent of UK-style bond clauses and generalising them would not increase the cost of borrowing for developing countries. However, reportedly, some of the major rating agencies have started to examine the terms of specific sovereign debt obligations, with distinctions being placed on technical nuances of different debt issues, which could possibly lead to differential pricing. Perhaps a problem has been the excessive publicity given to the possibility of amending conditions on developing country bonds (without actually doing it), which has focused too much attention on this issue. A more effective way could have been to modify the terms of new bonds – to make them similar to UK-style ones – without so much public discussion of the matter.

There is a second, more technical difficulty, for rescheduling bonds. Currently, these bear the modality of bearer bonds, which makes it far harder to get bondholders together, so they can agree restructuring or other changes. This problem can, however, be remedied for new issues by the appointment by the issuer of a single trustee, who is empowered to act for bondholders. Such trustees can: (a) prevent bondholders taking unilateral action, and (b) provide a useful channel for communication and possible negotiation between bondholders and the debtor.[15]

The modification of bond terms has attracted a lot of debate and attention, and could have important positive effects in that in the medium term it could contribute very significantly to orderly debt-workouts, and to a more level playing field amongst different categories of instruments. The initial impact on modifying debt servicing would be restricted by the fact that these changes would apply to new bonds only, and would not provide flexibility in the event of payments difficulties for the large existing stock of bonds. Furthermore, as discussed above, particularly if these changes were introduced only by developing countries, they could – especially initially – limit access and increase cost for them to this important source of funding.

Debt Standstills and Orderly Debt Workout Procedures

There has also been growing international consensus on the need to create internationally sanctioned standstill provisions, though these proposals have been less well worked out by institutions like the IMF, especially on the legal aspects. However, it is important that the G-22 report had examined alternative ways of achieving standstill-type arrangements, including ways in which the international community might be able to signal its approval for standstills in exceptional cases. Though countries should make every effort to meet the conditions of all debt countries in full and on time, in certain cases – the G-22 report accepted – a temporary suspension of payments could be a necessary part of the crisis resolution process. The preventive suspension of debt service and agreed rescheduling would help to solve the coordination problem, typical when creditors panic and rush for the door, and thus to help avoid some of the worse effects of such outflows. As a result, in a context of potential multiple equilibria, such a practice could lead to an equilibrium with higher output, less bankruptcies and – probably – less long-term disruptions to capital flows.

The G-22 report went further in recognising that there may be extreme cases when an orderly and cooperative restructuring process would be aided by "an enhanced framework for future crisis management", that would allow the international community to signal its approval of a temporary payments suspension by providing financial support for the crisis country. The G-22 supported the IMF decision to extend its policy of lending to countries in arrears on payments to private creditors. According to the G-22, this signal (and the explicit support which the IMF would give thus to the standstill) would only be provided where the international community believed the government's decision to suspend debt payments was

[15] I thank Robert Gray for this point.

the only reasonable course open to it, that it was implementing a strong programme of policy reform, and that it was making every effort to reach agreement with creditors. The IMF would be signaling confidence in the debtor's policies and long-term prospects, and indicating to creditors facing temporary standstills that their interests would best be served by reaching quick agreement with the debtors. A standstill imposed as part of such a cooperative and non-confrontational process would hopefully be less penalised by creditors.

UNCTAD (1998), which has provided a forceful and detailed defense of the standstill mechanism, has suggested a possible second alternative procedure to implement standstills. This would allow countries to unilaterally call the standstill, but then to submit it for approval to an independent international panel within a specified period, whose sanction would then give it legitimacy. Such a procedure would be similar to WTO safeguard provisions allowing countries to take emergency actions. A third complementary possibility (Ocampo, 1999) would be to draft *ex ante* rules under which debt service would be automatically suspended or reduced if certain macroeconomic shocks are experienced; such rules have sometimes been incorporated into debt renegotiation agreements (e.g. Mexican Brady bonds). A problem may be that crises have both common – but also different – features, which may make it more difficult *ex ante* to define the macroeconomic shocks.

As regards any of these three alternatives, it can be argued that they would increase perceived country risk, and therefore could increase cost and limit access to international capital flows for developing countries. On the contrary, it may be argued that such a mechanism would only legally recognise default risks that already exist, and that it could actually reduce the default risk for individual operations. Alternatively, it could be argued that if initially there was some increase in interest rates – especially by short-term foreign lenders – this could be good as it would make those lenders focus more clearly on the risks involved in such lending; these risks extend beyond the parties to the transaction, to innocent bystanders – workers and small businesses – repeatedly hurt under existing financial arrangements (Stiglitz and Bhattacharya, 1999).

In some ways an even more radical proposal for a standstill has been made by Buiter and Sibert (1999); this suggest a universal debt roll-over option with a penalty (UDROP); *all* foreign currency lending – private or sovereign, long or short, marketable or not – would have to have such a roll-over option for a specified period (e.g. three or six months) at a penalty rate. The penalty rate would be high to discourage debtors using this option. In this proposal, the roll-over mechanism would be automatic, and activated only at the discretion of the borrower. As such it would be speedy. This proposal has the important attraction of simplicity, speed and universality (both for all debtors and all instruments). However, it has two problems. Firstly, it does not elaborate the legal and other mechanisms necessary to enforce it. Secondly, it seem somewhat unlikely that creditor countries' governments would accept such a mechanism, as it could be unattractive to creditors.

To some extent of course some kind of concerted standstill for one key category of debt – short term, cross-border interbank credit lines – have been fairly successfully implemented in the recent crises in South Korea and Brazil, even though the delays in arranging them led to fairly significant haemorrhaging of outflows before it was arranged. However, in South Korea, the concerted roll-over of short-term bank lines was helpful in stabilising a critical situation and also facilitated a restructuring of interbank claims into sovereign guaranteed bonds. Also Brazil was able to secure agreement of international banks to maintain their exposure to Brazilian financial institutions. However, there is a widespread view that, particularly South Korea's success, reflected especially favourable circumstances – such as the problem being limited to short-term debt, with the rest of the capital account fairly closed – which would be difficult to replicate in other countries.

Furthermore, the fear has been expressed (IMF, 1999) that concerted operations in one case could lead creditors to withdraw credit lines in advance of a crisis elsewhere for fear of a concerted roll-over.

A broader standstill mechanism – than just concerted roll-overs of short-term debt – seems very important to establish. However, the relative success of existing roll-overs or partial standstills, provides a valuable precedent for a more structured standstill mechanism.

VI Summary and Conclusions

It seems important to attempt to evaluate progress so far, as regards the reform of the international financial architecture. A positive feature is that a fairly important proportion of the proposals on the table by spring 1998 (for a review and analysis then, see for example, Griffith-Jones, 1998) have either been seriously studied or actually began to be implemented. This is particularly true for those proposals that do not require significant institutional innovation.

Amongst the most positive steps are the creation of the Forum for Financial Stability (FSF), the creation of new facilities of the IMF (including most recently and significantly the CCL), as well as improvements in information, particularly on developing countries. However, the way in which each of these have been implemented have serious limitations. Furthermore, in the areas of amending bond clauses and internationally sanctioned standstill arrangements, little actual action has taken place, though the discussion has become increasingly more specific and certain consensus seems to be broadly emerging.

As regards progress in global regulation of private flows, the rapid creation and beginning in the operation of the FSF is an important step forward. However, the current lack of participation of developing countries in the decisionmaking Forum is a serious limitation, even though these countries do participate in the Working Groups, where important work is beginning. Participation of developing countries – including low-income ones – in this Forum is urgent, as they are the main victims of the volatility that this Forum is attempting to stem. Secondly, the Forum may need to be strengthened in its decisionmaking power, as its purely coordinating and consensus-seeking role may not be sufficiently strong in the future.

Thirdly, it is unfortunate that certain regulatory changes – on which very broad consensus has been reached – such as modifying capital adequacy rules to reduce regulatory incentives for short-term bank lending to developing countries, have taken so long to be made. Fourthly, the initial priority areas of work (highly leveraged institutions, offshore centres and curbing volatility of short-term flows) are extremely important; however, other areas – such as evaluating prudential regulation of other institutional investors, such as mutual funds, could be usefully added.

As regards the creation of the CCL, this is also potentially an important step forward to limit contagion, by encouraging countries to adopt policies that will discourage crises happening and by signaling to the markets that this facility is available. Both may help avoid crises happening. However, there are several concerns about the way the CCL is being structured. Firstly, would the scale be sufficient to stem a crisis? Secondly, why is disbursement – in the stage of crisis threat – not automatic, for countries that have pre-qualified? Thirdly, why is the CCL not open to countries with current or expected regular IMF financing? Fourthly, will conditions be too restrictive, and thus make countries unwilling to negotiate CCL? Careful monitoring of evolution of the CCL and its use is required, as well as continuous analysis on the complex issue of how best official liquidity can be used in emergency financing.

Much useful progress has also been made on improving information on developing countries, which hopefully will help markets and policymakers take better decisions. However, the possibilities and benefits of improved information have very important limits, both due to asymmetries of information and because of the significance of how information is processed. Furthermore, more limited progress has till now been made on the equally important issue of improving information on international financial markets. Much emphasis has also been placed on the development of numerous standards, and their implementation by developing countries. A source of concern is that developing countries – especially low-income ones – do not on the whole participate much in the definition of those standards, though they are being asked to implement them. Both meeting standards and enhancing information puts an important burden on developing countries, especially low-income ones. As a consequence, technical assistance in this field, especially to the poorer countries, is a priority.

As regards the issue of emergency measures involving the private sector during crises, some limited progress has been made, especially as regards broadening the power of IMF lending into arrears and the arrangement of concerted roll-over of credit for Brazil and Korea. However, the larger issues have not yet been tackled, both because of their complexity and because of different interests and perspectives involved. It is important that concrete progress be made on orderly debt work-outs, including particularly changes in bond covenants; interestingly UK-issued bonds already have more flexible clauses, and these do not as yet carry higher spreads; this provides a very important precedent for modifying clauses in US and German bonds. It is, however, important that changes in these clauses are introduced both by developed and developing country borrowers, to avoid stigmatising and marginalising developing country borrowers. In particular, modifying bond contracts should not be imposed by IMF conditionality on developing country debtors, as has been suggested. Whilst bond covenants are not modified for all countries – including developed ones – developing countries need to have the freedom to decide whether they want to modify them, assessing carefully costs and benefits of such a measure; the costs include possible reduction in access to bond markets and possible increases in spreads, whereas the benefits include greater flexibility and better burden-sharing in times of crises. As regards internationally sanctioned standstills, even less progress has been made, though a number of interesting proposal have emerged on mechanisms, modalities and institutional arrangements.

There is still much to do on financial architecture. This is particularly so because recent crises have had an unacceptably high cost in terms of interrupting and – sometimes – reversing growth and development, increasing poverty, and discouraging future private investment, both by national and foreign investors. These currency crises also distract the international official community from the crucial task of increasing and improving official flows to low-income countries, which need to play a continued role in helping their growth and in supporting poverty alleviation in them.

Though this paper has focused more on issues of international measures

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

to prevent and better manage crises, clearly these need to be complemented by national measures, both in the prudential and capital account regulatory area and in macroeconomic policy. Prudence in the liberalisation of certain categories of capital flows (the more volatile ones) is also an important area.

More generally, at a national level, the traditional emphasis on crisis management needs to be changed to the management of booms, since it is in the periods of euphoria from capital inflows and terms of trade improvement that crises are incubated. This implies introducing stronger counter-cyclical elements in: (a) macroeconomic policy; (b) strengthening as well as increasing counter-cyclical elements of financial regulation and supervision, to prevent excessive risk taking. Indeed, prudential regulation must take into account not only the micro but also the macroeconomic risks typical for developing countries in an increasingly globalised and volatile world. Firm, as well as total, debt exposures need to be carefully monitored, as well as their profiles, to prevent vulnerability to crises. And (c) if excessive short-term, potentially reversible, capital flows enter the economy, measures – such as Chilean style or Colombian style reserve requirements – clearly need to be taken.

References

Agosin, M. (1998), "Capital Inflows and Investment Performance: Chile in the 1990s", In: R. Ffrench-Davis and H. Reisen (eds.), *Capital Flows and Investment Performance: Lessons from Latin America*, OECD Development Centre/ECLAC, Paris.

Agosin, M. and R. Ffrench-Davis (1999), "Managing Capital Inflows in Chile", In: S. Griffith-Jones, M.F. Montes and A. Nasution (eds.), *Short-Term Capital Flows and Economic Crises*, Oxford University Press and UNU/WIDER, forthcoming.

Bhattacharya, A. and M. Miller (1999), "Coping with Crises: Is There a Silver Bullet?, In: Agenor, R., M. Miller, D. Vines and A. Weber (eds.) (1999), *The Asian Financial Crisis: Causes, Contagion and Consequences*, OUP (forthcoming).

Buiter, W.H. and A.C. Siebert (1998), "UDROP: A Small Contribution to the New International Financial Architecture", Paper presented at a Seminar at De Nederlandsche Bank, Amsterdam, 5 March.

Calvo, G. (1998), "Capital Flows and Capital Market Crises: the Simple Economics of Sudden Stops", In: *Journal of Applied Economics*, Vol. 1, November, pp. 35-54.

Chote, R. (1999), "IMF Anti-Contagion Credit Plan Agreed", In: *Financial*

Times, Saturday April 24.
Davitte J. (1999), "Contingent Credit Lines", In: IDEAglobal.com, http://www.ideaglobal.com/research5.html
Eatwell, J. and L. Taylor (1998), "Global Finance at Risk: The Case for International Regulation", New School for Social Research, Cambridge University, mimeo, April.
ECLAC (1998a), *América Latina y el Caribe: Políticas para Mejorar la Inserción en la Economía Mundial*, Second Edition, Fondo de Cultura Económica/CEPAL, Santiago, Chile. An earlier English language version appeared in 1995, *Latin America and the Caribbean: Policies to Improve Linkages with the Global Economy*, CEPAL (LC/G.1800/Rev.1-P), Santiago, Chile.
——— (1998b), *The International Financial Crisis: An ECLAC Perspective*, CEPAL (LC/G.2040), Santiago, Chile, October.
——— (1998c), *Preliminary Overview of the Economies of Latin America and the Caribbean*, Santiago, Chile.
Eichengreen, B. (1999), *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*, Institute for International Economics, Washington D.C.
——— and R. Portes (1995), *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, CEPR, London.
Feldstein, M. (1998), "Refocusing the IMF", In: *Foreign Affairs*, Vol. 77, Nº 2, March/April.
Ffrench-Davis, R. (1999), *Reforming the Reforms in Latin America: Macroeconomics, Trade, Finance*, Macmillan, London, forthcoming.
Fischer, S. (1998), "Reforming World Finance: Lessons From A Crisis", In: *IMF Survey*, Special Supplement, 19 October.
Gray, R. (1999), "Insights from the Asian Financial Crisis for Sovereign Debt Management", Speech delivered at the Governments Borrowers' Forum, IBRD, Shanghai, China, May.
Greenspan, A. (1998), *Financial Times*, 28 February.
Griffith-Jones, S. and J. Kimmis. (1998), "Capital Flows: How to Curb Their Volatility", In: *1999 Human Development Report*, Background Paper.
——— (1998), *Global Capital Flows*, Macmillan, London.
——— and J. Kimmis (1999), "The BIS and its Role in International Finance Governance", Paper commissioned by the G-24.
Helleiner, G. (1999), "Financial Markets, Crises and Contagion: Issues for Smaller Countries in the FTAA and Post-Lomé IV Negotiations", Paper prepared for the Caribbean Regional Negotiating Machinery, Kingston, Jamaica, January.
——— (1997a), "Capital Account Regimes and the Developing Countries", In: *International Monetary and Financial Issues for the 1990s*,

Vol. 8, UNCTAD, New York.
——— (1997b), "External Conditionality, Local Ownership and Development", In: J. Freedman (ed.), *Transforming Development*, University of Toronto Press, forthcoming.
IMF (1999), "IMF Tightens Defenses Against Financial Contagion", IMF Press Release No 99/14, April 25th.
——— (1998), *World Economic Outlook*, IMF, Washington, D.C., May.
Kaufmann, H. (1992), "Challenges for Global Regulation", paper presented to 1992 IOSCO Conference, mimeo, Montreal.
Ocampo, J.A. (1999), *"Reforming the International Financial Architecture: Consensus and Divergence"*, Serie Temas de Coyuntura No. 1, ECLAC, Santiago, April.
——— and C. Tovar (1998), "Capital Flows, Savings and Investment in Colombia, 1960-96", In: R. Ffrench-Davis and H. Reisen (eds.), *Capital Flows and Investment Performance: Lessons from Latin America*, ECLAC/OECD Development Centre, Santiago and Paris.
Stiglitz, J. and A. Bhattacharya (1999), "Underpinnings for a Stable and Equitable Global Financial System", Paper prepared for the 11th Annual Bank Conference on Development Economics, April 28-30.
Stiglitz, J. and A. Weitz (1981), "Credit Rationing in Markets with Perfect Information", In: *American Economic Review*, Vol. 72, pp. 393-410.
Tietmeyer, H. (1999), "Report by the President of the Deutsche Bundesbank", Report presented at the G-7 Meeting in Bonn, February.
UNCTAD (1998), *Trade and Development Report, 1998*, United Nations, New York/Geneva.
United Nations Task Force (1999a), *Towards a New International Financial Architecture. Report of the Task Force of the Executive Committee on Economic and Social Affairs*, ECLAC (LC/G.2054), Santiago, Chile, March.
——— (1999b), *Finding Solutions to the Debt Problems of Developing Countries. Report of the Task Force of the Executive Committee on Economic and Social Affairs*, May.
World Bank (1999), *Global Development Finance 1999*, Washington, D.C., March.
——— (1998a), *Global Economic Prospects and the Developing Countries, 1998-99*, Washington, D.C., December.
——— (1998b), *Assessing Aid*, World Bank Policy Research Report, Oxford University Press, New York, November.
Wolfensohn, J.D. (1998), "The Other Crisis", Address to the Board of Governors, Washington, D.C., October 6th.

Comment on "Towards a Better Financial Architecture," by Stephany Griffith-Jones

Jack Boorman

Having wrestled with all too many papers in the various areas that Stephany has touched upon, she is to be complemented for producing a reader-friendly compending of all these various issues. Let me try to give a flavour of what is going on in this area, at least as far as the Fund is concerned. I would like to thank Stephany in particular for giving us a sense that it hasn't been all talk and all words, that there really is quite a lot that has been done in this area. Needless to say progress has been made above all in the areas where agreement was easier – there still is a lot left to do. But things are changing and they have been changing fairly rapidly.

Transparency and Standards

Let me talk first about the two issues of transparency and standards, which in my view are key elements of the "institutional substructure" of the capitalist market economy or what some refer to as "the plumbing". It seems to me there is a very important change taking place in the view of the international community about what is needed to successfully run a market economy. You can't forget the plumbing, you can't forget the institutions, you need standards, you need transparency, you need discipline, you need supervision, you need regulation and you need the agencies to be able to manage all of those things. That is critical.

Stephany makes a number of points about the processing of information. She makes a distinction between micro data and macro problems and questions whether more information on the micro efficiency side will help to limit crises on the macro level. Though I agree with Stephany that improvements in this area by themselves are certainly not going to prevent future crises, I am a bit more optimistic than she is. If you look back to the Asian crisis and at the experience of both Korea and Thailand – and Martin Mayer made reference to this in his paper – you can make a reasonably good case that if the market had known in time the quality and the way in which both the Thais and the Koreans were using their reserves, the market probably would have reacted quicker, perhaps more gradually

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

and perhaps more orderly, and the whole history of this episode might have been different.

But there is progress in this area. Along with the committees in the BIS and the G-10, we have constructed a template for the provision of information on international reserves. It is now part of the special data dissemination standard, the SDDS. It is very detailed: it is not just gross reserves, it is not just net reserves, it is a very detailed listing of the reserve accounts of a central bank or reserve holding authority. This holds the prospect to make the kind of difference that we are talking about. I would have been happier if the industrial countries would have been a little bit more ambitious on this, as ambitious as some of the developing countries are and some of the emerging market countries, like Mexico for example who now is a model of presentation on reserve data. However, the industrial countries refuse to put out more than monthly data and that is disappointing. They should have been leading on this and they didn't.

We have also made progress by establishing an inter-agency task force asking the following question: if you gather all of the external debt statistics of a country together, how do they fit? Are they consistent with each other, where are the gaps, where are the holes, what else needs to be done? One result of this task force is a presentation on the websites of the BIS, the World Bank, the OECD and the Fund, showing the external debt position of developing countries – emerging market countries – in a detail that was either not available at all or not easily available. I agree with Bill White that while much of these data were available, they were not available in a terribly user-friendly way. We really do need systems where market analysts and everybody else can easily get a picture and a portrayal of a country's data situation. That is partly what these presentational devices are trying to get to.

Also in the area of standards there is major work underway. We have in the Fund put forward standards on fiscal policy. There is also a standard just about to be completed on monetary and financial policy, and there is the SDDS of course, which was created right after the Mexican crisis. We are now also taking to the full membership of the Fund the Basle Core Principles on banking supervision and doing assessments of the extent to which member countries adhere to those standards. The Fund has been asked by the G-22 to do transparency reports on each member country as well and we are experimenting with that. The big question, however, is on what aspects these transparency reports need to focus; that question was not given much thought in the G-22. With all this attention on standards, it is useful to have an agency report on countries' adherence to transparency standards and the Fund, because of its surveillance mandate, has been given that responsibility.

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

Reporting on transparency, however, is not an easy job. Early on, when I was working on the policy side of transparency standards, I said that the Fund should not get involved in simply checking off the extent to which a country is transparent; that can be highly misleading. We have to go behind transparency itself to see what exactly is being reported and what the quality is of what is being reported. It will do neither us nor anybody else any good to say that a country's corporations are putting out semi-annual balance sheets, if these balance sheets are inaccurate. Somebody has to make decisions about the quality of the auditing systems and so forth, to assess whether the information that is made transparent is in fact quality information that can be relied upon.

I'm not sure that I agree with Gerry Helleiner or Stephany's quotation of Helleiner on taxation without representation. I think there is participation or representation to a reasonable degree in the Fund as well as in the other organisations. The standards that we have created are endorsed and discussed by the 182 member countries in the Board of the Fund. IASC, the International Accounting Standards Committee, for example has about a 100 countries in its body. The IAIS, the International Association of Insurance Supervisors, has 80 member countries. So these are broadly representative organisations that are setting the standards.

As I said, we are experimenting with these transparency reports. My colleague Roger Nord, who is the Fund's regional representative in Central Europe, is in fact deeply engrossed in doing these reports with the Czech Republic authorities. I don't know what such reports will look like in the end. I'm beginning to think that the only way these reports are going to be able to be done, partly because of the complexity of doing them in each of these different standard areas – accounting fiscal code, monetary code, SDDS, corporate governance, bankruptcy and so forth – is to conceive something like a loose-leaf folder. Then basically as you do an assessment in each one of these areas of the extent to which a country adheres to the standards, you fill up the loose-leaf folder. We in the Fund can do it on the standards in which we have responsibility in four core areas; the World Bank will do it perhaps with the OECD on corporate governance. I don't know exactly how this will emerge in the end, but the idea that you can run across an entire set of standards for a given country in a three-week mission, strikes me as impossible. I think we are going to have to find a way to build it up over time and that is why I say that we are experimenting with it right now.

I won't say anything about capital controls, since Stephany was kind about the remarks I made earlier. On the Financial Stability Forum, I agree. It is a good initiative. It has already been expanded the way Stephany was calling for in her draft paper. The G-7, at its summit, agreed

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

to bring in Singapore, Hong Kong, Australia and the Netherlands on the grounds that those four countries have major financial centres and therefore should be part of the Forum. That is to the good. Where I probably disagree a bit with Stephany is the thrust of her remarks which go to making the Forum an institution. I think the Forum as a concept is the right concept: a forum for countries with major financial markets, for the standard-setting bodies and others, to come together, share information, make sure that gaps in the system are seen and are taken care of. The work can be done as a collaborative forum; I'm not sure it needs to be an institution.

On this issue of regulatory gaps I share Stephany's concern about the potential bias in the inter-bank market on short-term flows and I was surprised that Bill McDonaugh's report was not more concrete in addressing this issue. I understand it is based on a paper that was done by the New York Fed, which I have not yet read but seems to come to the conclusion that the bias some of us see in this market is likely not there. I think that we need to go back and revisit that issue.

Private Creditors

Let me take up two other issues quickly. One is the private sector and its involvement in not just crisis cases, but also in what can be done in terms of countries' management of the claims on the country by private creditors in a preventive fashion, so as to avoid crises. This is probably the most important area that is now under discussion. It holds the potential to change financial markets in a way that none of us see right now. I don't think it is going to be done by dictum, because many of the ideas that have been put on the table do not yet receive sufficient support for them to be moved into actual policy. But as we work through some of the cases that we are dealing with, precedents are going to be set which the markets are going to take very seriously. I will talk a little bit about that.

There is a consensus of views, in principle, about what needs to be done. The most important part of that consensus is that the official community has come to the conclusion that it simply will not tolerate official money being put into countries if it is at risk of leaving the country, so as to permit the exit of private creditors. That's a fairly hard conclusion, supported to different degrees by the official community.

Most progress to date has been made on preventive measures. How can you build an external debt profile of a country in a way that limits its vulnerability? Many ideas have already been mentioned, such as limiting puts, limiting short-term exposure, possibly removing bias in inter-bank transactions which some of us think stem from the specific capital adequacy requirements. All this is in a sense on the negative side, what you shouldn't

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

do. On the positive side there is more encouragement to foreign direct investment, perhaps calls in short-term debt, use of structured notes, use of private contingent credit lines à la Mexico and so forth.

And here, just to go to a point that Martin Mayer has made, my understanding of the Argentinean and Mexican contingent credit lines in fact is that they do not have "material change in circumstances" clauses; that is one of their novel features. The banks may well have been unhappy when the Mexicans decided to draw, because they thought that the spread which had been written into the negotiated agreement was not appropriate to the then prevailing circumstances. However, Mexico had every legal right to draw and in the end did draw. One result of this, however, is that the contingency mechanism went back to the drawing board to devise different ways of pricing these mechanisms.

Another aspect of this debate Stephany has touched upon is bond contracts. I'm not sure where this is going to go. The G-10 deputy group is actively examining this issue. The signals coming out of that group are a bit negative on whether or not the G-10 is willing to lead by example. I would be surprised, actually, if they concluded that they will. There is the concern on the part of the emerging market countries themselves about the costs and spreads. I don't know what the bottom line of that argument is. One can make what to me sounds like a perfectly credible analytical argument, that introduction of these clauses will increase costs and spreads for borrowing countries and one can make just as good and convincing an argument on exactly the other side of the issue. It is an empirical question and people looking back at the data have not been able to find a difference in spreads between bonds that do and bonds that do not include such clauses. But it is interesting, when you talk to players in the market, that most of them are unaware of the legal differences between American-style bonds and British-style bonds. The people we have talked to said it was never part of their consideration when deciding whether to go to London or New York as the venue of issue. But as Stephany says, maybe now that the issue has been raised, they will take it into consideration. We will see whether the future empirical results are different from those in the past.

On the other issues there has been some progress. If the official community is going to say: we will not put money into a country if it is at risk of leaving the country simply so that private creditors can exit, then we are going to be faced with the situation where, if the country doesn't pay its private creditors and goes into arrears, the Fund's support is put into question. The Board of the Fund has already taken the decision, establishing the criteria, that it indeed will support member countries in arrears to private creditors under certain circumstances. That is another decision made, which may be tested very quickly as I'll come to in a second.

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

The more radical proposal to have the IMF in a legal position to be able to endorse a stay on payments of a country by modifying Article VIII 2b of the Fund's articles of agreement, is much more contentious. There are a number of countries in our Board who are in favour of doing this. There may even be a slight majority by voting power. However, the United States, among others, is quite opposed to it, on the grounds that it is not needed. We, the staff, are accused of overstating the risk of litigation from private creditors when a country defaults. It is argued that you don't need it because the private creditors won't litigate, they will cooperate. There are other reasons as well, such as the sovereignity issue that was already mentioned. The idea of going to the US Congress with this proposal and expecting them to smile and agree is beyond my comprehension. So, I don't think it is going to happen in the near future.

The problem is, though, that we are now working with Ecuador, Pakistan, Romania and Ukraine on exactly these issues, and that the community does not yet have the tools. We don't have the tools in the Fund necessary to do the job in a way where we can be confident about the results. For example, when a country defaults on its obligations, the question is whether the creditors will sue. We don't know the answer. And if they do sue, what will their options be in terms of claiming assets of that country? We don't know the answer to that question either.

We have several situations. The Paris Club has demanded comparability of treatment from the bondholders in Pakistan. We don't know how that is going to work out. We don't know whether the Pakistani authorities will be sued by the bondholders, when finally they begin to confront them on this issue. The timeframe on that is a little bit longer. Ecuador is going to be a tremendously interesting case, because it is so complicated. It has inter-bank lines, it has trade-lines, it has Brady bonds, it has Euro bonds, it has foreign currency denominated domestic debt, it has everything! And when that comes onto the table, it is going to raise enormously complicated issues about how to proceed. Korea, on the other hand, was easy, because the only thing that was involved basically was inter-bank lines, and you could get those banks together around the table and you could get the central banks to exert a little moral suasion on them to roll over and then to restructure. And it worked.

Contingency Financing

Let me take just a couple of minutes on the CCL, the Contingency Credit Line. You know the Fund has always had the capacity to help countries before a crisis. Countries had only to come and ask for a programme. In fact we had precautionary arrangements: a country could come and ask for

From: The Management of Global financial Markets, FONDAD, April 2000, www.fondad.org

a precautionary arrangement. When president Clinton made his proposal for this kind of facility last September, I noted that I thought the Fund already had the capacity to do this. But notwithstanding my reservations, the US went ahead and pushed for it anyway. Then, as I thought about it, I came a little bit more to their view partly for its virtue in emphasising the need for a more activist policy in this area.

I came to the view, because we had had a discussion on something called the short-term financing facility in 1994. It did not go anywhere, a hard proposal was never made. It was more a think-piece that the staff did and that was discussed by the Board. It got side-tracked by a couple of things, one of which was an inability to make a proposal on a conditionality for the facility that the Board was comfortable with. One of the ideas proposed then was to endorse a country's policies under Article IV consultation and, on the basis of that endorsement, the country would have access to a line of credit, let's say for six months or a year. The Board was not comfortable with endorsement and then automatic access to resources. The other thing that blew it away was the Mexican crisis. That crisis more or less ended the series of discussions that had been held. But as I thought through the CCL and how we were going to construct this, I came to the conclusion that the world has changed enough that this was more feasible now than it was before, partly because of this work that I started with, standards and transparency.

I think we have a better grip now on some of the things that one would want to judge to decide whether or not the infrastructure of a country's policies is reasonably robust. That was something which was not on the table at all in the previous discussions in 1994. The other is the involvement of the private sector, and this goes a little bit to Stephany's questions about access. Two points on that. One is, there is a specification in the decision on the CCL which says that access normally will be in the range of three hundred to five hundred percent of quota, but it is not a hard access limit. In the case of a country whose situation warrants something more than that, something more could be proposed. But even more important than that are the qualifying criteria. A country has to show that it has a robust external debt situation, that it has made efforts to try to put in place some of these private contingent credit lines, that it has avoided undue use of puts in its medium and long-term credits, and so forth. That will make the situation inherently more stable. It is the combination of that more stable external situation vis-à-vis private creditors plus a commitment of some resources from the Fund that makes the CCL potentially useful.

But the Board still was not ready to give a free line of credit on the basis of some kind of endorsement. They have insisted that when a country asks for help, the Board will have to review the country's situation. The decision on the CCL however, stresses that such consideration will be "expeditious" and "fast" and "quick" and so forth – that was the compromise that was struck. What we intend to do is to monitor a country as closely as possible and certainly get involved very quickly if the situation begins to threaten. I'm not sure that I would agree with Stephany that it is a matter of hours and not days. It seems to me when you look at the way the pressure has developed on Thailand and Korea, it was in fact a matter of weeks and months that you could see it coming. I am confident that there is a chance during that period to do the kind of assessment that would need to be done.

Will it work? I don't know. It is under discussion by a number of countries. We consider it extremely important that we get countries in which really have first-class policies, so that this facility takes on a very special character. What will be important is that it happens and that it really does invite a positive reaction from the private market in terms of spreads. The countries need to see a reward and if they do see a reward it seems to me that the CCL does have the capacity to catch on. How many countries will we have under this facility six months from now? I don't know.

From: The Management of Global financial Markets, FONDAD, April 2000, www.fondad.org

Comment on "Towards a Better Financial Architecture," by Stephany Griffith-Jones

John Williamson[1]

As she has done so often, Stephany Griffith-Jones provides us in this paper with a well-informed review of recent thinking on how to deal with financial problems (in this case, financial crises), interjecting her own judicious judgments on the way forward, viewed from the standpoint of developing countries. I am in broad sympathy with her diagnosis and her objectives, and also with many of her proposals, but I will focus my discussion on my two major disagreements with her approach.

In the first place, I fear that the paper minimises what I see as an inherent conflict between the provision of additional liquidity intended to head off crises by bolstering confidence and the resolution of crises by the ability to order a standstill.[2] If we create an orderly mechanism for decreeing standstills, then we have to anticipate that the private sector will attempt to predict when it is likely to be invoked, and will endeavour to get out before it is invoked. This implies that the cost of an orderly mechanism for resolving crises will be that crises happen earlier and more often than would otherwise have been the case. If we also have a Contingency Credit Line (CCL), or even if we respond to a crisis by lending under the old-fashioned IMF stand-by facilities, this will enable some of the creditors to get out before the standstill is ordered. Indeed, the mere call on IMF resources is likely to alert foreign creditors, and domestic holders of mobile capital, that there is a risk of a standstill being invoked, and is therefore likely to encourage the very withdrawal of capital that will require a standstill. Hence IMF lending before a standstill will simply enable some of the creditors to get out whole rather than take a haircut, and is quite unlikely to avoid the need for a standstill. As someone who has been sceptical of the currently popular claim that capital mobility has eliminated the possibility of interior solutions to the choice of exchange rate regime, I think we have here a genuine case where we are going to have to choose between the two extreme solutions.

1 On leave at the World Bank at the time of the conference.
2 This dilemma was emphasised by Martin Wolf at a recent conference held by the IMF.

From: The Management of Global financial Markets, FONDAD, April 2000, www.fondad.org

One choice is to be prepared to put unlimited sums of money behind any country whose policies win the approval of the international community. This does not imply wasting taxpayer money: on the contrary, US taxpayers could undoubtedly have enjoyed the same windfall profits from Korea's misfortunes in December 1997 that they did from Mexico's catastrophe in January 1995, had the US Treasury weighed in as it did with Mexico. There are of course big, if familiar, problems in designing the conditionality that would justify providing the liquidity that would be needed, but I doubt if those are the principal obstacle to this solution. This is, shall we say, the improbability of the US Congress voting the $100 billion plus increase in the US quota in the Fund that would be needed to make such an approach credible.

The other approach is to abandon IMF lending except in the context of supporting a standstill. I suspect that this is where we will drift over time, which implies that the CCL will prove a temporary aberration rather than the wave of the future. This is a world in which crises will be better handled but, *ceteris paribus*, more frequent. That in turn suggests that the emphasis ought to shift toward preventing ceteris being paribus, i.e. toward crisis avoidance.

I agree with Stephany in thinking that the primary emphasis in terms of crisis avoidance needs to be placed on the source countries rather than the host countries. And I agree with many of the proposals that she advances toward that end. I agree that there is a case for considering some modest variation in capital adequacy requirements driven by anti-cyclical considerations. I certainly agree that short-term bank loans should carry at least as great a risk weight as long-term loans. I strongly agree that there should be a heavy risk weighting applied to loans made to "highly leveraged institutions" (i.e. hedge funds), as well as disclosure requirements and perhaps other regulations on those institutions themselves. I agree that it is high time that we brought the offshore centres within the regulatory net, and that this would be perfectly feasible. When loans contain put options, it seems clear that their maturity should be counted up to the next put, not until their nominal maturity.

My other major disagreement with her is that I am not convinced by her proposal that mutual funds should be required to hold a risk-weighted cash requirement, which seems to me of more relevance to reducing the risks faced by the investors than to easing the instability facing the borrowers. I would instead seek to encourage a move back to closed-end funds.

Would those proposals suffice to address what I perceive to be perhaps the main problem of the capital markets, which is that in good times they are prone to direct excessive funds toward countries with good fundamentals, thereby destroying those good fundamentals? I doubt it. This is a subject that is going to need more thought.

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

Floor Discussion of "Gaps in the International Institutional Framework"

Counter-Cyclical Regulatory Policies

Bill White started the discussion by pointing to the need for a better connection between regulatory and macro issues. He suggested to examine the possibility of counter-cyclical regulatory policies with respect to both domestic booms or bubbles and inflows of foreign capital. "One of the things we learned from the Mexican crisis is that financial stability and macro stability are two sides of the same coin. Yet, the monetary policy is done in one place and the regulatory stuff is increasingly done some place else. I am sure there are all sorts of reasons for separate supervisory authorities, but it seems a bit odd since all the recent crises have shown how interrelated these two things are and how financial instability leads to macro instability and vice versa.

One could think of counter-cyclical capital ratios. These are not easy to determine with internationally active banks whose cycles they would be responding to. But there are examples, such as Hong Kong and Singapore, where, as prices on commercial property increase, the proportion that you can actually use as collateral against loans decreases. This recognises the fact that what goes up might also go back down again.

Closely related to this is provisioning. At the moment, there are too many banks which wait until things have gone bad and then say, 'Oh my God, we'd better provision against that loan'. But this is the most inopportune moment to try to do this because the economy has already turned down, the loans are going bad, and provisioning means that you lower your capital, so you have to restrict your lending even more. There should be far more attention to ongoing provisioning, so that whenever your loans go up, you automatically provision a certain part of it because you know that an expected loss is associated with it. This would have an actively counter-cyclical element because you would be provisioning to the loss when the economy was still expanding and you were making the loans.

At the very least, we should try to make sure that the regulatory framework that we have in place is not pro-cyclical. Consider the nature of the Basle Capital Accord and what it allowed the Japanese to do as a result of a difficult set of international negotiations. It allowed them to take 45 percent of the unrealised gains and factor it back into their capital. This meant that the more prices went up, the more capital the banks had, the more loans they made, and the more prices went up. Here is an example where

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

the macro people, had they been around the table, might have had something to say about the design. So there should be better ways through which the regulatory people, who tend to look at individual institutions, can interact with the macroeconomic people, who look at the larger picture.

And if this is true in terms of design, it is also true in terms of the application of the regulatory apparatus. For example, in Japan and Korea, regulators were saying almost in a mindless way, 'You are starting to violate the 8 percent capital restriction and therefore we ask you to cut your loans so that you can meet the capital ratios'. But the macroeconomists responded, 'Wait a second, you are using the capital regulations to force banks to behave in a way that capital is designed to avoid, it is a fallacy of composition'. Regulators tend to have a bottom-up approach, they have a very micro view. There must be better interaction with the macro people who say, 'But if everybody does this, we have a problem'."

Stephany Griffith-Jones agreed with Bill White. "This idea that you should provision more in boom times is a good way forward in terms of the idea of counter-cyclical regulatory policies."

Jack Boorman suggested that one easy way to improve the connection between regulators and macroeconomists in the source countries would be to improve the accessibility of Fund reports to regulators. "I did a bit of exploration and found out that there are virtually no supervisory authorities in the world who receive Fund country reports. Why don't the Japanese supervisory authorities have access to Fund reports on Thailand and Malaysia? This is bizarre to me. In the US it varies. The Federal Reserve certainly has them, while their availability in the FDIC is random at best. And other countries don't circulate them widely. This is a simple step that could be taken in the source countries so that supervisors and regulators become more conversant with what the Fund sees as some of the threats."

Standards

Stephany Griffith-Jones reacted to Jack Boorman's comment on standards. "Jack wants to improve the plumbing, and I think that is fine, but we don't all have to have the same house. Countries fear that they will be forced into having uniform economies with Anglo-Saxon style banking because it is presumed to be superior. So I would say 'yes' to standards, but 'no' to total homogeneity.

Zdeněk Drábek agreed with Griffith-Jones' emphasis on the adoption of standards, but wondered what the character of these standards should be. "What kind of status would you envision for these standards? Is there an obligation on the part of countries, just like WTO member countries have to notify the WTO of their commitments, or would the standards be voluntary?"

Griffith-Jones responded that she would prefer them to be voluntary. "If they are good for the country, then they will follow them voluntarily because they will feel benefited by them. I don't think they should become a part of conditionality."

Boorman confirmed that most of the standards would be voluntary with the exception of the somewhat mandatory SDDS. He also said that the market needs to reward countries that adhere to the standards. "The adoption of the SDDS, the special data dissemination standard, in the IMF has been made one of the qualifying criteria for access to the CCL, the Contingency Credit Line. So there is a somewhat mandatory nature in that if you want the CCL, you have to adhere to the SDDS. But, the other standards are voluntary.

My own view is that if this initiative is going to work, countries will have to see that they begin to get rewarded for adhering to good standards. It needs to show up in spreads. If the markets don't reward countries for doing these things, then we'll continue to have episodes like we had in Indonesia where nobody – and I insist nobody – knew what the exposure of the Indonesian corporate sector was, let alone what the nature of that exposure was. This type of episode will continue to occur unless countries like Indonesia can see that it is in its financial interest to be more transparent and to accept these various standards."

Drábek drew a parallel with the WTO and wondered whether the standards could be applied with differential treatment for emerging economies. "I can imagine that there would be some arrangement for developing countries and emerging economies similar to what the WTO knows as special and differential treatment for emerging economies.

Griffith-Jones agreed that further parallels with the WTO should be investigated. "It is interesting to think about parallels with the WTO because regulations in trade seem to work better, on the whole, than regulation in finance, which is a bit behind. Zdeněk's ideas on special and differential treatment for emerging economies is something we could look at, and we can learn more from other WTO rules as well."

The Contingency Credit Line

Stephany Griffith-Jones was not impressed by the observation that John Williamson made in his comment about the inherent conflict between the CCL and the standstill. "That conflict is, of course, also a problem under the current and previous arrangements because of this contradiction that

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

people tend to rush-out of the lender of last resort facility if they think there will be some kind of standstill. On the other hand, choosing one or the other on its own is also problematic. A standstill by itself may be too radical and may risk not being used when the crunch times come. And simply providing additional liquidity presents the problem that the liquidity you need is so much that central banks get worried."

György Szapáry had some questions about the rationale for the CCL. "If I understand it correctly, the CCL was established as a precautionary line of defense against financial contagion. For that to be useful, you need to foresee a crisis somewhere, and we haven't been very good at that in the past. And even assuming that we can foresee a crisis, then the best thing to do is to go quickly to that country and do something in order to avoid the crisis. I don't know how the CCL is supposed to work then.

My second point about the CCL is that there is a moral hazard issue. If countries know that there is a line of defense which is providing their bailout, then they may not follow the policies that are required to arm themselves against contagion. I am thinking, for instance, about the countries that have a lot of capital inflow. If these countries are aware that this is fickle capital, then the best line of defense is to accumulate reserves and to use those reserves when faced with the threat of a crisis. But the existence of the CCL may preclude them from doing that.

Third, Jack mentioned that with the CCL, there would be some benefit and therefore the spreads would narrow. But I am afraid that our announcement that we are going to a CCL would actually *widen* our spreads. Because even though we are doing well, if we think that there might be a crisis in the Ukraine or Brazil or somewhere else and we go to the CCL, investors will say, 'What is happening to this country, and why is it going to this facility?'.

Fourth, on this idea of penalty interest, let's assume that I go to the CCL and that it does not increase the spread. In the case of contagion, however, I have to go to the CCL with a penalty interest. Then I am better off accumulating reserves or maybe even borrowing before I get there. So, who would ultimately use the CCL? Maybe those who will use it are not the ones that you thought should use it, the ones that it was originally designed for. Maybe I do not correctly understand what the CCL is; perhaps it is not intended for the good countries that are exposed to contagion, but for countries that might actually be the source of the crisis and that is a different issue."

Griffith-Jones dwelled on Szapáry's point that the CCL could encourage moral hazard because countries could say, 'I have the CCL, so I don't need to accumulate reserves'. "My question is: why should countries allow major inflows if all the money, or most of it, will go into reserves? That is

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

very expensive, you have to sterilise it and so on at costs. The advantage of something like the CCL is that you could use more of the money for some growth – obviously not too much because if it is too much, we are talking about a boom."

Martin Mayer pointed to another problem of the CCL. "The announcement-effect associated with these credit lines is enormous. Just as banks are very hesitant to borrow at the discount window because it reveals that they are in trouble, countries would be concerned that they would be rejected by going to the CCL.

Another point is on the terms of the Argentinean credit facility, as outlined in a recent speech at the World Bank. There is an annual commitment fee of 25 basis points and US Treasury paper is being used as collateral on the loan of something like seven billions of dollars. It is remarkable that people should pay 25 basis points on a few billions dollar loan, and pay that out every year to have the right to buy money on those terms."

Jack Boorman defended the CCL. "It is a concept that should answer the kinds of questions raised by John Williamson. There is a set of decisions, there are qualifying criteria and there are access guidelines. The kind of country that ought to be able to qualify for a CCL should be far from a situation where we would have to impose a stay on its own payments to creditors – because of the structure of its external debt, its policies, its adherence to standards and all the features that are qualifying criteria. It should not be in the same camp – unless the world really deteriorated in a much more dramatic way than occurred with the Asian or the Russian crisis. We have countries in two different camps.

On György's question of penalty interest rates and Martin Mayer's point about the Argentine credit line, paying a charge of a quarter percentage point is a lot cheaper in most cases than holding reserves. Paying a quarter of a percent to have reserves online is not really a bad deal. The only cheaper way to provide reserves would be for us to allocate SDRs, but as you all know, we can't get them to the right countries. Basically you have to allocate SDRs according to quota, so we can't provide liquidity to the countries that need liquidity.

On the moral hazard side and the surcharge. I don't know what Hungary's spread is now, but I suspect that it is more than the surcharge on the CCL. What is the bottom line on this? The bottom line is in terms of the countries in the two camps. If this concept is turning into reality, we are going to have countries with first-class policies coming in. And we are going to have to establish the rules of this facility and create an environment in which the markets will make the kind of judgements about it that we want. We have been harmed to a certain extent by initial reactions to the CCL and maybe this was our fault because of how it was put out.

David Folkerts-Landau was saying, 'Why would a country expose its weaknesses by going to the Fund?' That is exactly the reverse of the rationale for the facility. The rationale for the facility is for a country to expose its strengths by getting the endorsement under the very difficult eligibility and qualifying criteria that are established with the CCL. But that notion has not been circulated partly because of these types of remarks and the reception it was given in the market. So, it is a concept, and I cannot predict where this is going to be six months from now."

Alternative Ways to Solve Liquidity Problems

Warren Mosler suggested that an emerging economy could solve its debt-servicing problems in a completely different way: through a debt for labour swap. "Consider the problem of servicing the external debt, for instance of the Ukraine. Short-term dollar debt is rolling over and part of the problem that the markets have with all of these papers is uncertainty. One day everybody is going to be bailed out and the spreads come in, and the next day you might lose everything and the spreads go out. There is no certainty. All you have is a promise by a government to pay. There is no bankruptcy procedure and there are no rules for what the final outcome will be.

The entire package of emerging market debt has almost become the same thing. As a market participant, I hear that that is what people are doing and that is why people who are in are prepared to get out. I am suggesting that there may be an anchor at the end. Some anchors have already been tried. To some extent, the proceeds from privatisations are an example because it gives people some sense that there is an exit strategy for the country involved. Another example is something that Martin Mayer mentioned, which is the idea that the world is going to securitisations, which is somewhat similar: put some collateral behind it.

A country's ability to service its debt is based on its net exports. That is where the revenues are supposed to come from to service the debt. But what is export revenue? Apart from privatisations, net export revenue output is always the labour content of the product. And with marginal cost pricing nowadays, you can be sure that all net exports are pretty much the labour content of value added through local labour of the product. Given that, in the case of the Ukraine, for example, with a 160 million dollar problem, you might say, 'Why don't we convert this into a labour commitment because that is all it is anyway?'. Maybe instead of 160 million dollars you owe 80 million hours of labour and the creditor takes 80 million hours of labour. What you can do with it is sell it to Coca-Cola or Budweiser, who I'm sure has a bottling plant over there. The local government then reimburses them and meets their payroll in local currency.

This would probably be traded at some discount and it would then become a local currency commitment which does a couple of things. It certainly does not increase unemployment. In fact, quite the opposite, it probably encourages more local employment. It encourages foreign direct investment because now along with it, you can have these vouchers so that the labourers are paid for. And it provides the basis of analysis for the debt burden. An analyst can say, the most a country can provide is 5 or 6 percent which is translated into so many labour hours. That way we can look at the debt burden in a fresh way and it provides a final anchor which will stabilise the value of the outstanding debt."

Ariel Buira saw the access to a collective pool of reserves as a solution to liquidity problems. "When we have the issues of volatility and changing expectations that can lead to problems with liquidity, the first question is: why didn't you accumulate reserves? Well, of course you did accumulate reserves. At some point last year developing and emerging economy countries were holding 1.2 or 1.3 trillion dollars in reserves, which cost them an enormous amount in terms of the interest rate differentials and so forth. This is a form of self-insurance and it seems a very primitive sort of approach to risk that everyone applies. Why do you have to have self-insurance? Why don't you have collective group-insurance? In fact, why doesn't the IMF or the BIS or somebody else provide these reserves? Why don't we just pay a commitment fee and have access to some pool of reserves in order to have some kind of group-insurance?

Another case is the type of contingency credit line Argentina and Mexico have with private banks. The problem with this is not the costs which were mentioned earlier, it is additionality. Investors want to have a specific amount of exposure to Mexico, and once they have committed this amount to the Mexican government, they won't lend anymore to Mexican companies. The overall exposure is whatever they decided it is going to be. So this doesn't really add to the availability of resources to the country and it doesn't really solve the problem.

Why don't we have some kind of group-insurance or why doesn't the Fund or the BIS just do it? We can do this by either pulling reserves or through quotas and have a commitment fee. And we can guarantee such a facility by pledging export revenues in the future."

Back to the CCL

Jack Boorman reacted to Ariel Buira by saying that the CCL is exactly what Buira just described, collective insurance. "The CCL is an insurance fund. I agree with your comments on the private contingent credit lines. It would be nice to think about this as co-insurance from the official sector and the private sector. But resorting to guarantees by pledging export revenues doesn't really change anything. Because in order to generate the revenue from future export receipts, you'd still have to have an adjustment programme to generate those exports. So you are back to where we are."

György Szapáry observed that, because of the conditionality attached to the CCL, the resources would not be as quickly available as a country's reserves. He added that the reason why emerging countries cannot use large parts of their capital inflow is that growth cannot be based on capital that might leave the country again after a short period. "The CCL can, in fact, be a substitute for reserves. There must be a certain amount of reserves to insure confidence. It would be nice to say to investors, 'We have very low reserves compared to our other liabilities, which we believe are short-term liabilities, but don't worry about it, we have a CCL'. However, we will have to convince them that they are just as quickly available as our reserves would be. But this is difficult because conditionality is attached to it. If one could display it as part of reserves, it might help.

Stephany asked, 'Why accumulate reserves? Why don't you use them for growth?' The answer is that it is the nature of emerging markets that this money is here for a short term. I cannot confidently base growth on it and commit it to use until I am convinced that it is going to remain here for a while – and after a while, it will. But until you convince the markets that the money will not go out if something happens elsewhere in the world, it cannot be used for growth."

Griffith-Jones agreed with Szapáry that there shouldn't be additional conditionality attached to the CCL. "If we base it on Ariel Buira's idea that it should be insurance, then there should not be additional conditionality. If you have fire insurance and your house burns down, then you just get the money. If the CCL is for cases where no mistakes have been made in the countries and an external shock – which in this case is a contagion shock – occurs, it would be illogical to have additional conditionality. Similarly, the initial Compensatory Financing Facility with commodity prices had zero conditionality. The argument was that it was not the country's fault, for instance in the case of Chile, that the price of copper had fallen. If we're talking about pure contagion, then there should be no additional conditionality.

I agree also with György that you can't use the reserves because the money is so easily reversible. But then why does a country accept the money if it can't really use it? What is the point of borrowing short-term if one is unable to use it? Why incur these differential costs of holding the reserves, vis-à-vis for example sterilising them which has a fiscal cost?"

Ariel Buira dwelled on the conditionality of the CCL funds and pursued the analogy with a fire insurance. “In my scheme of things, the insurance would be unconditional of course. Access would be automatic. There could be conditionality in the sense of saying, ‘O.K., you get fire insurance provided your house is made of certain materials, or you follow certain policies and you have certain fire security measures’. If you comply with the standards of the fire department, you get the insurance. But the insurance is automatic. Once you have complied, the access is assured. You pay the fee and if you need it, you can draw. But this is not what we have yet, and thus you cannot count it in reserves. If it were automatic, you could.

Once some years ago in the Bank of Mexico, we counted reserves as what we had in actual reserves as well as the lines of credit that we had open which were fully assured. This could include a swap with so and so, or whatever we wanted to include as long as we felt confident that we could draw on it, if necessary. In the Bank’s annual reports, we included reserves and what we called the secondary lines of credit which were available on a call-in basis.”

Boorman thought Buira’s insurance analogy was a good one and said that was where the CCL headed. “The way Ariel put it is right. That is what is going on under the CCL. You have to comply with the standards in order to qualify for it. But, even with fire insurance, the insurance company checks to make sure you didn’t start the fire. And that is what this is all about. It has to be contagion, it has to be from the outside and the activation review is basically for the Board to check that the country didn’t start the fire.”

The Role of Information

Rohinton Medhora added that apart from financial issues, there are ‘real’ issues that need to be looked at in order to avoid crises and elaborated the example of information. “The issues raised in Stephany’s paper are necessary but not sufficient conditions for crisis avoidance. The East Asian crises, for example, were a consequence of several events of which the financial one was only one. There was also a real side, be it over-investment, over-capacity, wrong product lines or whatever. Generally, there is a real issue of who collects the information, what kind of information is collected, who processes it, and who synthesises it. This is not a question of gathering a few financial data and publicising them, although that is an important component. The problem is that a lot of the so-called information that is out there is really opinion. So we need to sort out some of these questions of who collects information and why, and what sort of process spin is put on it.”

Griffith-Jones agreed that it may be necessary to include some real variables in the analysis, but she saw some limitations to that. "It would make it more complex, and could the BIS or the IMF look at indicators of overcapacity? Could anybody do it? But it is an interesting question because most of the indicators are in the financial macro sphere and to the extent that there are some real economy elements in overcapacity, this may be interesting – even though it will also increases the amount of information."

Roger Nord elaborated the issue of symmetry in information and argued for increasing information. "Let me first say that I subscribe to much of what Stephany Griffith-Jones said. One point in Stephany's paper, which is her argument for more symmetry, can be usefully divided into two questions. One is whether asymmetry, or the absence of symmetry, is harmful. Some central banks argued that it was harmful for them to disclose information if the private sector, the so-called speculators, were not obliged to disclose information as well. I disagree with this view. Transparency benefits markets, and if you believe that markets function better with information, then releasing the information ought to benefit central banks as well. A good example is Argentina which believes that total transparency on its reserves and the daily publication of reserves is beneficial for running the currency board, regardless of whether they receive information on speculators.

That is one way of looking at symmetry. The other way of looking at it is to ask if more information on private sector positions is useful, regardless of whether you start in asymmetry or not? I think the answer is yes. One shouldn't forget however that private sector positions also have a counterpart. In many cases of recent crises, the counterpart was an official position. With regard to certain engagements by the Thai central bank in the forward markets, you could ask for disclosure by whatever counterparties they had, but you could also simply ask for the central bank to be more transparent. As concerns counterparties in the private sector, there is a lot of work to be done. Some countries have gone into this in a major way. The IMF has worked fairly closely with a number of countries, both those in crisis such as Korea and those that are not under our surveillance mantle, to try to improve the amount of information that is available on what private sector positions are. That kind of information is useful and you often need to set up information systems to create that information. I think that is good, and it will make markets function better."

Jan Kregel argued that more information would not have prevented the crises. "The emphasis that has been placed on increasing information to increase market efficiency is a bit of a red herring, and it is distracting us from the basic problems. Who needs the increased information and what should they have done with it, had they had it? From reading the BIS reports from 1996 on, it is quite easy to know that there were difficulties in

Southeast Asia. Also, the IMF had been recommending to the Thai government at least a year before the crisis, that they do something about the exchange rate. Furthermore, I was part of an UNCTAD mission in 1996 to Southeast Asia. We visited a number of countries and indicated that, from our point of view, there were serious difficulties about to arise and that they should do something to deter them very rapidly. So clearly, the BIS, the IMF, UNCTAD – and I presume the World Bank – had sufficient information to assess that there were difficulties.

Still, this argument persists and the example of the trades in the forward market of the Thai central bank is often given. Anybody who knows anything about the Thai forward market, or the non-deliverable forward market, knows that it is an extremely small market with one predominant dealer, which is J.P. Morgan. On May 11th and 12th, the Thai central bank put something between 15 and 20 billion dollars worth of forward contracts through this extremely thin market: this could not have been unnoticed. It is impossible that people did not know. If the BIS, the IMF, UNCTAD or anyone else wanted to know the Thai central bank's real position on reserves, they could have telephoned J.P. Morgan or anybody else who operated in that market. They could also have sent people around to the local bar to listen to what the traders said after business that day. So, this information was widely available. The question is whether things would have turned out any differently, and I would say no. The problem was not that we didn't know what the Thai position was in terms of non-deliverable forwards, the problem was that nobody managed to convince the Thais that they had difficulties a year before the crisis occurred, and that they should do something about them. I would suggest that the market information we are recommending to make the market function more efficiently would have done absolutely nothing to prevent the crises. I am not against increasing information, but in terms of crisis avoidance, the great importance we place on information is not going to produce much of improvement in the way the system currently operates."

Griffith-Jones agreed that the unavailability of information is not the real problem. "I also have an anecdote about information. I wanted to know Mexico's level of reserves for a paper I wrote for CEPAL. Exceptionally, Ariel Buira was not very helpful because he said that it was confidential. So I phoned up some of my friends in London, and then spent less than an hour doing some calculations. Everybody in London knew what the level of reserves was. In spite of that, I think it is useful to improve information, but one should just not expect too much from it because the people who are trading or trying to make profits, don't look at the information very much. I will give you another anecdote. When I wrote a country report for a bank where I worked, the manager phoned me

From: The Management of Global financial Markets,
FONDAD, April 2000, www.fondad.org

up saying that he didn't like the report. I asked him if something was wrong with it, and he said, 'No, it is perfectly fine technically, but I don't like the conclusion'. The problem was that my conclusion differed from the one he had in mind. I understand from a BIS survey that this is actually quite common. The decisions that banks make in lending are often made without properly reading the reports of their own research departments or they are made against the advice of their own research departments. Therefore one shouldn't place too much trust in improved information."

Jack Boorman objected to Jan Kregel's and Stephany Griffith-Jones' comments by calling for a better system where information is transparent and accessible to everyone. "I am not as sanguine as Jan or perhaps even Stephany about this issue of data. You should not have to spend an hour on the telephone calling contacts in financial centres in order to find out a country's level of reserves. That is not how financial markets should work. Nor should you have to send your research assistant to the bars in New York to find out information about a country's reserves. Similarly, I think that you could go to all the bars in New York, and all of the bankers in New York could be in those bars, and you will still be unable to accumulate Long-Term Capital Management's exposure to the banking system. You shouldn't waste your time gathering data from secret sources, but you should be able to call up those data, particularly with today's technology, and do analysis and stress-testing and risk-analysis. It should be facile. I think it is just wrong to say, *ex post:* You could have read this particular journal and over the weeks you could have accumulated the Mexican auctions of *Tesobonos.* Yes, you could have, but that doesn't help run an international financial system in a fair, clear and transparent manner. I think there is a lot to be said for getting systems in place and making sure that everybody has access to this kind of information."

Jan Kregel responded that he wasn't against more information, but that it would not have avoided the crises. "Jack, I'm not arguing that more information is bad, I'm saying that having that information available would not have changed what happened. On May 11th, if the Bangkok Post had published that the Thai central bank had just committed, I can't remember the exact figure but let's say15 billion dollars worth in forwards, would this have changed anything?"

Boorman said that with the right information, the market would have reacted differently and policies would have been modified earlier and in a more orderly way. "The Thai authorities were willing to totally utilise their reserves down to a net level of virtually zero through the forward market. I don't know what the counterfactual is, but I don't think the market would have permitted them to do that if it had known. The Thai report on their own situation says that there were two officials in Thailand who knew what was being done in the forward market. I don't know of anyone in Washington who knew what was going on there.

Similarly, I don't think the Koreans would have been able to basically work their reserves down to 7 billion dollars from what was supposedly 50 billion dollars before they decided to call the IMF. The market would have reacted in a different way, and it would have pressured the authorities in both these cases to modify policy earlier and in a more orderly fashion, rather than to be faced with a situation where their hands were totally tied behind their backs because they had no money left at the moment that information was released. It is both the reaction of people in the market to the smooth unfolding of the situation along with the pressure on the authorities to react differently than they did."

Kregel insisted that the information on Thailand was available before the crisis. "J.P. Morgan knew and the Fund was already recommending to the Thais that they should have done something. As I understand it, in July of 1996, a year before, there was already a formal Fund letter to the Thais recommending that they either do something in order to reduce their foreign exposure or change the exchange rate. What more information did you need and would more information have changed your position?"

Boorman then said that the IMF was unable to convince the Thai authorities to act. "We couldn't convince the Thai authorities because there was political commitment to the pegged exchange rate. They were willing to go to the wall, with a hope and a prayer, that if they continued to use reserves, something would happen to turn it around. But there was an alternative to the crisis and that was more pressure from the markets on the Thais in a more orderly fashion, which I think would have emerged if the markets were aware of what was happening to the reserve situation through a steady release of information. And this is where we differ. You are presuming that the markets knew. I'm pretty confident that the markets in general simply did not know what was happening either to the Thai reserve situation or to the Korean reserve situation. It was not common knowledge by any means."

Martin Mayer turned the discussion on information to Griffith-Jones' idea of a credit register for bank loans. "I want to stand up and cheer about this notion of a credit register for bank loans in Stephany's paper. There are all sorts of things where information helps. The more information that is out there, the greater the possibility that some small boy will see that the emperor is not wearing any cloths and make a fuss about it. It is quite clear that if people, including bankers, had been paying attention, they would not have done some of the dumb things they did. The information doesn't have to be published, it simply has to be available within the market. You have to see how much weight is on the shelf to know how much trouble you are going to be in if the shelf suddenly breaks and falls on you. And you can never get this in the secretive world of banking and derivative traders unless you have to register somewhere. I would not worry about driving business offshore with that because these markets care desperately about a legal order, and the legal order is in the control of the government."