Reflections on the Asian Crisis: Causes, Culprits, and Consequences

Jack Boorman

"Let us live in as small a circle as we will, we are either debtors or creditors before we have had time to look round".
Goethe

"An ounce of prevention is worth a pound of cure"
Benjamin Franklin, Franklin's Gazette, 1734

In recent weeks, many individuals and groups have started reflecting on the Asian crisis and the lessons that could be drawn from it in order to strengthen the international monetary system. The Fund has taken an active part in these discussions. This conference provides a perfect opportunity to pursue this work. This paper first considers recent developments in emerging capital markets. In light of these, it then attempts to review what went wrong in Asia. It concludes with reflections on what to do primarily to help prevent another crisis but also to improve the management of the next one – which will eventually come.

I Recent Developments in Emerging Capital Markets

Introduction

During the 1990s emerging markets' access to international capital markets improved dramatically. As demonstrated by Chart 1, private capital inflows to these countries quadrupled from around \$50 billion in 1990 to almost \$200 billion in 1996 before declining somewhat last year to around \$150 billion. The Mexican crisis of 1994-95 had only a temporary and limited effect on the scale and geographic distribution of capital flows and the cost of external borrowing.

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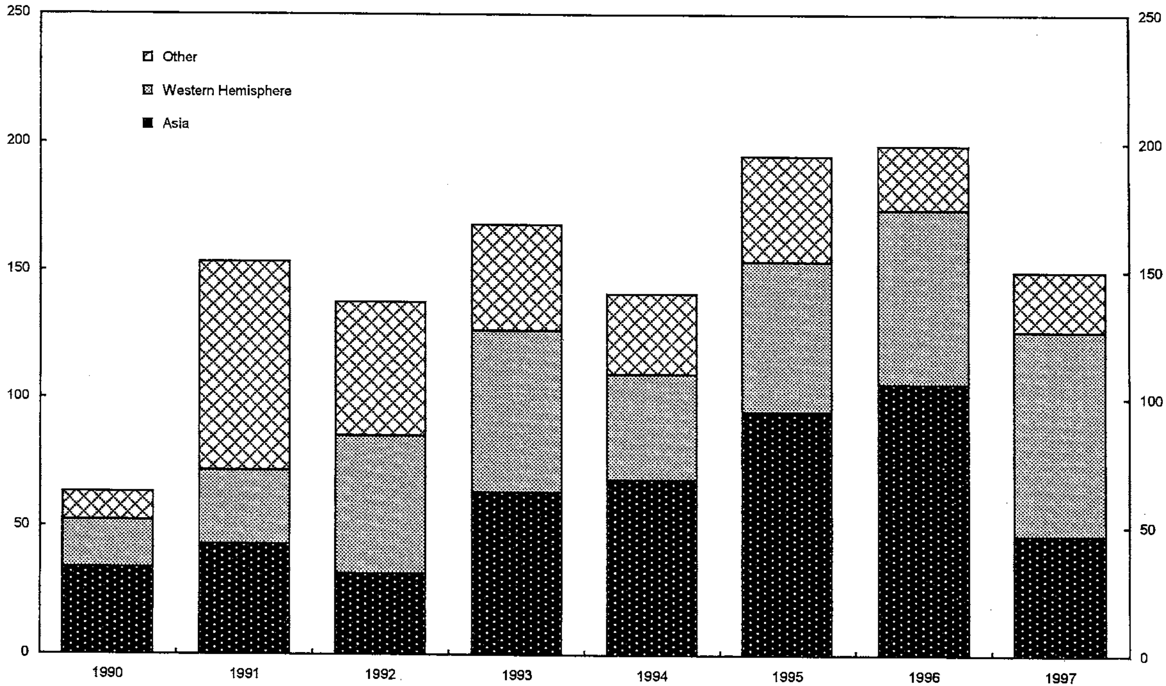
Chart 1 Net Private Capital Flows to Emerging Markets



Source:
World Economic Outlook Database.

Regional Composition

A larger number of countries have been able to attract these private capital flows. As an indication, the number of countries rated by international credit-rating agencies, often viewed as a prerequisite for the issuance of Eurobonds, has risen from 11 in 1989 to 49 in 1996. The regional composition of these flows continued to favour Asia and Latin America through most of this decade. Asia's share of these flows rose steadily until 1996 reaching around one half (about $100 billion). Last year this share fell to one third (just under $50 billion).

The regional distribution of private capital flows has been closely linked to the macroeconomic performance of countries in the various areas, reflecting an improved ability of investors to discriminate among countries according to the quality of policy and economic performance. Three factors were behind the general improvement in access to international markets: (i) search for higher yields by investors in mature markets caused them to move down the credit spectrum and increased demand for high-yield sovereign and corporate bonds issued by emerging market countries; (ii) institutional investors' seeking to diversify their portfolios took a sanguine view of the economic fundamentals in most emerging markets which had improved through macroeconomic stabilisation; and (iii) extensive structural reforms including the opening up of international trade and capital flows.

Type of Instruments

The composition of external financing by emerging markets in the 1990s was characterised by the increased reliance on bond issuance as opposed to bank loans although these remained important. However, there were some differences between Asia and Latin America. While in Latin America bonds have been the dominant instrument, in Asia bank loans continued to be the main source with a marked increase in the share of short-term loans. Inflows into equity have been relatively small with the larger share going to Asia (Chart 2).

The rise in borrowing by emerging markets reflected a general improvement in the terms and conditions under which borrowers in emerging markets could access global markets. As Chart 3 shows, yield spreads on sovereign bonds declined sharply on Latin American and European sovereign bonds from peaks reached during the Mexican crisis but rose sharply in recent months following the Asian crisis. Spreads on Asian sovereign bonds rose sharply in recent months but were hardly affected by the Mexican crisis. Moreover, the average maturity for sovereign bonds, which

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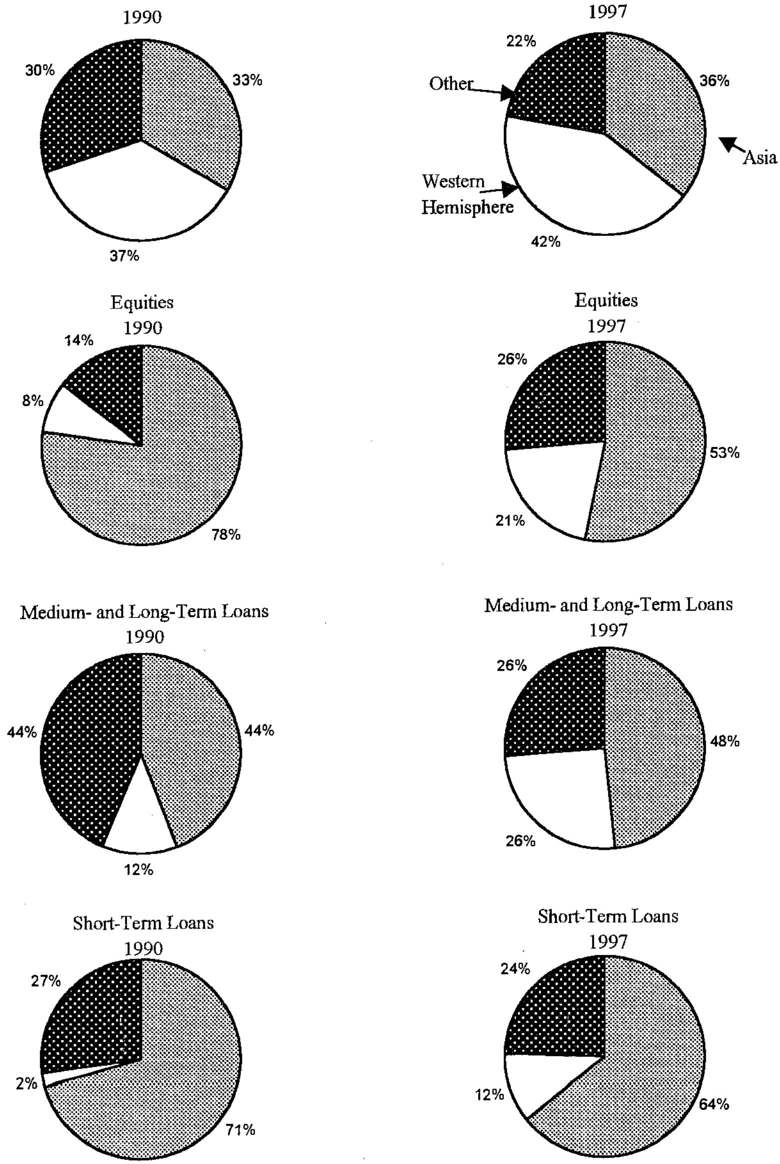
Chart 2 Private Capital Flows to Emerging Markets: Regional Shares by Type of Flows[1] (in percentages)



Source:
DCBEL Database.

1 Gross primary market financing

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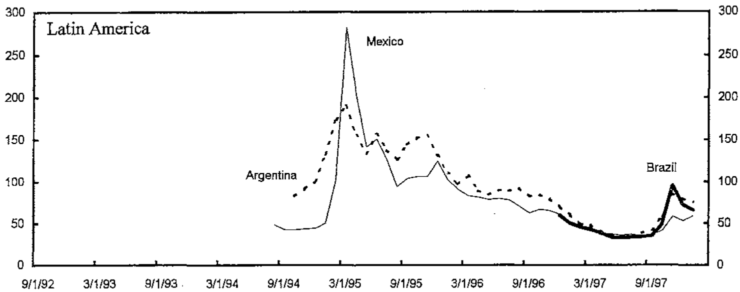
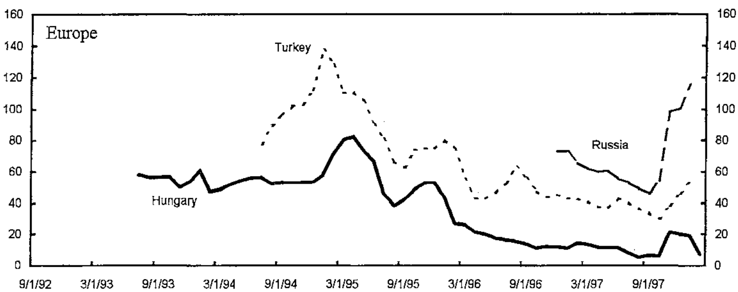
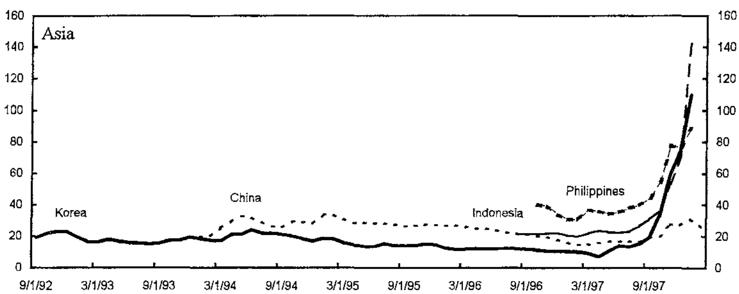
Chart 3 Secondary Market Yield Spreads on US Dollar-Denominated Eurobonds by Selected Emerging Markets[1] (in basis points)



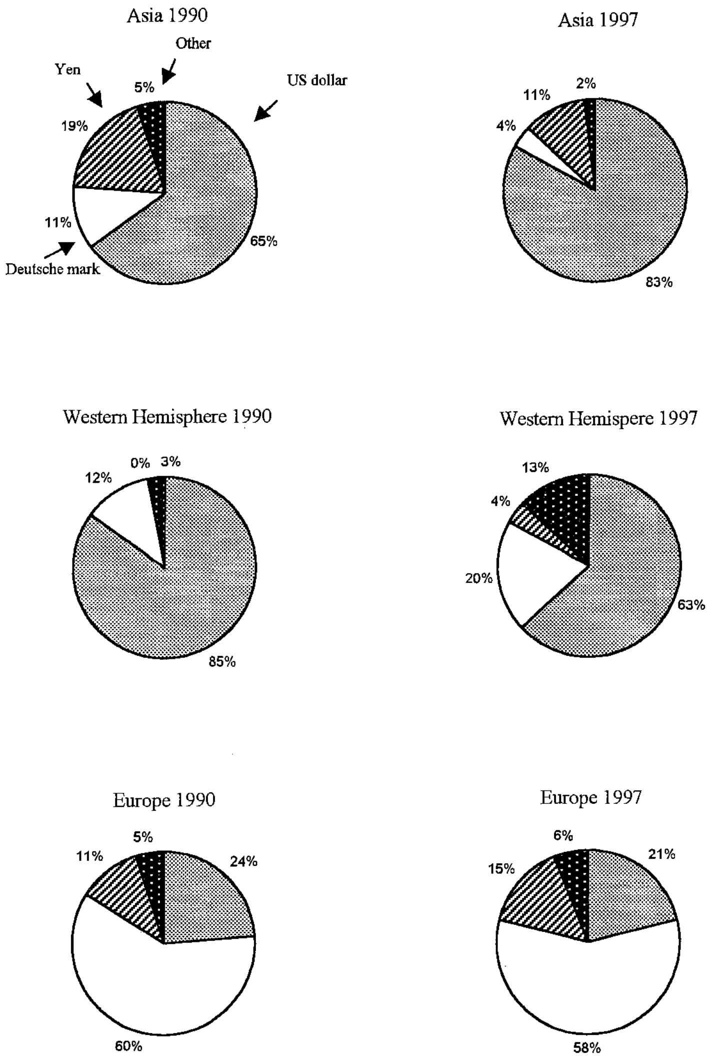




1 Latin America: Republic of Argentina bond due 12/03, United Mexican States bond due 9/02, and Republic of Brazil bond due 11/01.
Europe: National Bank of Hungary bond due 6/98, Republic of Turkey bond due 6/99, and Ministry of Finance Russia bond due 11/01/
Asia: People's Republic of China bond due 11/03, Republic of Indonesia bond due 5/96, Republic of Philippines bond due 10/16, and Korea Development Bank bond due 2/02.

Sources:
Bloomberg; and Reuters.

Chart 4 Emerging Market International Bond Issues by Currency of Denomination: Selected Regions[1]



Note:
[1] 1997 figures are based on data for the first quarter

Sources:
Capital Data Bondware; and IMF estimates.

had fallen sharply in the wake of the Mexican crisis to 3.9 years, rose dramatically in 1996 to 9.8 years. At the same time, the currency composition of bond issues has changed in Asia and Latin America between 1990 and 1997 (Chart 4). In Asia the share of US dollar-denominated bond issues rose from 65% in 1990 to over 80% in 1997 at the expense of smaller shares for yen and Deutsche mark denominated issues. This probably reflected the stability of the pegs of most Asian currencies to the US dollar. The opposite was true in Latin America where the share of US dollar-denominated bond issues fell from 85% in 1990 to just over 60% in 1997 while the shares of issues denominated in yen, the Deutsche mark and other European currencies rose. In the case of European emerging market bond issues, the currency composition barely changed with about 60% being in Deutsche marks.

Derivatives

The rise in international investors' exposure to emerging markets was accompanied by the development of offshore derivative products. Derivatives enhance the ability of investors to manage the risks associated with their emerging market investments and foster arbitrage between different instruments. A noteworthy feature of these products is that they allow investors to circumvent official controls on financial transactions. One example is the over-the-counter (OTC) non-deliverable forward (NDF) foreign exchange contract, which allows investors to hedge foreign exchange risks on financial instruments of emerging market countries that have underdeveloped local forward and futures markets or rely on capital controls. The price of these contracts is linked to movements in a particular emerging market currency, but settlement is made in US dollars. The Asian segment of this market has been particularly active. Other derivative instruments include exchange-traded emerging market debt derivatives, such as futures and options on Brady bonds, emerging market index funds, OTC swaps and options on stocks, and equity derivatives.

Hedge Funds

The recent financial market turmoil in Asia drew attention to the role of institutional investors, particularly of hedge funds. Some have suggested that hedge funds precipitated the sharp movements in assets prices in Asian markets, either through the sheer volume of their own transactions or through the tendency of other market participants to follow their lead. However, little concrete information is available about the extent of hedge funds' activities. As a result, there is no consensus on the implications of

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these activities for financial stability, much less on whether and how to adapt the regulatory framework in response. Hedge funds are eclectic investment pools that are not subject to the usual disclosure and prudential requirements that apply to, say, mutual funds, even though they engage in the same type of transactions as other institutional investors. A recent Fund study on the role of hedge funds has concluded that, despite their ability to leverage their capital, hedge funds are much smaller than other institutional investors (e.g. pension funds, mutual funds and banks) and that observers are sceptical that they precipitated the financial crisis in Asia or even played a major role in it. Indeed, the broadening of international investment vehicles, of which hedge funds are but one example, has had a positive effect on global financial markets.

II What Went Wrong in Asia?

A striking feature of the Asian crisis is that the weaknesses in affected Asian economies did not arise from the classic macroeconomic problems – excess demand, trade fueled by loose fiscal and monetary policies, resulting in high inflation and large current account deficits – which characterised the debt crisis of the 1980s. Indeed, most of the countries hit by the crisis pursued relatively sound macroeconomic policies for many years. Their fiscal positions were in surplus, inflation performance was good, and, in most cases, current account positions seemed manageable. The primary sources of difficulties instead lay in the financial and corporate sectors and the way in which capital movements were regulated.

Background

By way of background, a short sketch of the situation of each country leading up to its request to the Fund for assistance is useful.

Thailand

The macroeconomic situation in Thailand was deteriorating prior to the crisis. By 1996, the failure to dampen overheating pressures had become increasingly evident and the current account deficit reached 8% of GDP – a warning signal by any standard. The financing of an external current account deficit of this magnitude was facilitated by the opening of an important channel for short-term capital movements through the establishment of the Bangkok International Banking Facility (BIBF) in 1993. The express aim of the BIBF was to enhance the capability of Thai finan-

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cial institutions in international lending and other international banking business, thereby reducing the cost of foreign borrowing for Thai entrepreneurs. Foreign banks were afforded two incentives for participation in the BIBF which tilted the playing field toward shorter-term financing, and away from long-term capital. First, the BIBF enjoyed various tax privileges; and second, indications that the future granting of licenses to establish banks in Thailand would be determined, inter alia, by the scale of foreign banks' participation in the BIBF. The three years following the establishment of the BIBF saw a burgeoning of the current account deficit (by some 3% of GDP), financed by short-term capital inflows. The facility allowed weak domestic financial institutions to intermediate short-term capital inflows. These institutions lacked the ability to assess and manage risks of intermediating such capital. Moreover, Thailand maintained a fixed exchange rate, and responded to overheating by tightening monetary policy, thereby putting upward pressure on domestic interest rates. This both encouraged residents to borrow in "cheap" dollars, and foreign investors to take long baht positions – the so-called carry trade.

As markets began to perceive the unsustainability of the current account deficit in the context of slowing exports and concerns about competitiveness, the exchange rate came under attack. Following speculative pressures on the baht, the authorities introduced measures restricting domestic financial institutions from undertaking certain types of transactions with foreign financial institutions, which were designed to limit speculators' ability to take short positions, as well as limiting the ability of speculators to unwind existing short positions.[1] Notwithstanding these measures, capital outflows continued. The authorities defended the exchange rate through ultimately unsustainable intervention in the forward market. (By mid-July the forward/swap obligations amounted to about $28 billion compared to spot reserves of $31 billion.) In the face of persistent outflows, on July 2, 1997, Thailand abandoned its exchange rate peg and allowed the baht to float. Later in July, the Thai authorities asked the Fund for help – but only when their net foreign exchange reserves were nearly depleted as a result of attempts to defend the exchange rate.

1 These included: a temporary limit on baht lending to nonresidents through foreign exchange swap and other transactions in order to prevent the build-up of baht positions on the offshore market; limit on outright forward transactions with and selling baht against foreign currencies to nonresidents; and, daily reporting requirements on foreign exchange transactions with nonresidents.

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Indonesia

The turmoil in Thailand soon spilled over to Indonesia and the rupiah fell sharply on July 27. While the macroeconomic imbalances in Indonesia were not as pronounced as in Thailand, the economy suffered from deep rooted structural problems. Trade restrictions, import monopolies, and regulations impeded economic efficiency and competitiveness, and also reduced the quality and productivity of investment. Indonesia's regulations regarding capital account transactions were quite liberal. The system permitted a broad range of money market and credit transactions between residents and nonresidents. In particular, it allowed resident entities, especially nonbank private sector companies, unrestricted offshore borrowing from nonresidents. In contrast to Korea and Thailand, Indonesia's external debt difficulties are concentrated in the corporate sector, rather than the banking sector. Indonesian corporations became overexposed, particularly at the shorter maturities. These difficulties did not stem from the structure of exchange controls. Rather, it reflected an inability – or unwillingness – of the domestic banking system to exert discipline over corporations' financial structure, and a willingness of the foreign creditors to extend short-term credits, notwithstanding the structure of corporations' liabilities. As a result the corporate sector in Indonesia accumulated sizable external liabilities denominated in foreign exchange.

As in Thailand, the banking system was weak. Nonperforming loans accounted for almost 14% of total loans at state-owned banks at end-June 1997, and a number of insolvent institutions continued to exist with central bank subsidies.

Following the fall of the rupiah at the end of July, measures to tighten liquidity conditions failed to stem the growing exchange market pressures, and the authorities allowed the rupiah to float on August 14. In late September, after a period of relative stability, the rupiah depreciated sharply, triggered by Indonesian banks buying foreign exchange to cover their imprudent exposure to exchange rate risk in the form of options. This led Indonesia to ask the Fund for help in early October 1997.

Korea

A cyclical slowdown in economic growth in Korea and emergence of financial difficulties in key corporate conglomerates *(chaebols)*, which reflected overinvestment in projects that were not able to earn adequate rates of return, created pressures in the financial sector in 1997. Non-performing loans grew rapidly and banks' spontaneous access to international capital markets shrank, and came to an abrupt halt in November. The difficulties

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in the financial sector reflected a combination of factors. Exchange controls limited the ability of corporations to access foreign savings directly. Instead, the controls forced corporations to access international capital markets through capital intermediation by banks. As a result, the *chaebols* became heavily dependent on debt intermediated by Korean financial institutions. Corporate entities, many of which were pursuing unwise expansion strategies in the context of weak corporate governance, fell into difficulties and were kept afloat by further extension of credits. The management and supervisory and regulatory authorities paid little attention to the analysis and containment of risks.

Against this background, the downward pressures on the Korean currency intensified in the last week of October, and equity prices fell sharply, reflecting diminished confidence about prospects for an orderly workout of corporate debt problems and the growing difficulties encountered by the financial sector in rolling over external loans. After intervening heavily to defend the currency, the authorities allowed the currency to float in late November and asked for Fund help – again, only after they had virtually exhausted their reserves.

Financial Sector Flaws

In all three countries, weaknesses in the financial sector lay at the heart of the crisis. In particular, these weaknesses included: limited capacity of financial institutions to assess and manage risks and inadequate prudential supervision in the context of Thailand and Korea of regulations encouraging intermediation of short-term capital inflows by weak financial institutions. These deficiencies were a recipe for disaster reminiscent of the Mexican crisis of only a few years earlier.

Weak Risk Management

The limited capacity of financial institutions to assess and manage risks engendered imprudent and improper decisionmaking. Borrowing was used to finance unsound investments and projects, many of which were unable to earn a satisfactory rate of return. As a result, the quality of bank assets deteriorated sharply, ultimately leading to the loss of market confidence that helped spark the crisis. Poor risk management led to mis-matches of maturities and exchange rate risk, causing a fundamentally unstable financial structure, with unhedged positions and a concentration of liabilities at the short end of the maturity spectrum.

Foreign players in these markets also failed to anticipate the problems. Many of them were operating in Asia on the basis of little information, wishing not to miss out on the boom but without appreciating the risks. When the problems in Thailand became evident, they began asking tough questions about the vulnerability of other economies in the region. This is part of what has been referred to as "contagion".

Some institutions were simply unwilling or unable to assess the risks they were taking. The case of Korea provides a glaring example, where a number of off-shore institutions (guaranteed by domestic Korean banks) took highly leveraged bets on exchange rate movements in ASEAN currencies. When these deals went bad due to the fall in exchange rates, such investors seemed genuinely surprised at the magnitudes of the losses they incurred.

Inadequate Prudential Supervision

Regulators did not require financial institutions to analyse the risks of on- and off-balance sheet items and paid little attentions to lending and trading strategies, and liquidity management. Indeed misguided regulation – notably in Korea – forced transactions off-shore and off-balance sheet, where enormous risks could escape from the limited capabilities of the supervisors – almost to the point where the attitude of investors seemed to be: "If we can't have our casino close to home, we'll play elsewhere." At the same time, corruption and conflict of interest pervaded the regulatory systems in all three countries. Cozy relations between companies, banks, and supervisors encouraged a rolling-over of debts long after the bank should have foreclosed. And these problems were obviously exacerbated where loans were extended to companies owned by well connected individuals. Finally, poor regulatory standards meant that some banks – notably in Thailand – could show loans on their books as performing, when this was untrue by any reasonable measure.

In the case of Korea, the regulatory framework provided incentives for short-term flows through the banking system, further increasing the vulnerability of the system. Exchange controls limited the ability of nonresidents to purchase equities and bonds issued by Korean corporations, and residents' ability to borrow directly from international markets. As a result, the *chaebols* became heavily dependent on debt intermediated by Korean financial institutions. In addition, lack of competition from well managed international financial institutions perpetuated the weaknesses in the financial system. As noted earlier, Thailand tilted the playing field toward short-term flows channelled through the BIBF.

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Additional Factors

Beyond the financial sector, but related to it, additional factors were at play.

Public Sector Support to the Corporate Sector

In a number of instances, public sector support to ailing corporations or implicit guarantees of support in case of need compounded difficulties. In some cases, corporate entities, which were pursuing unwise expansion strategies in a climate of weak corporate governance, were kept afloat by further extensions of credit at the behest of the government. This allowed them to further deteriorate their balance sheet and that of the lending financial institutions. In others, as Paul Krugman recently argued, financial institutions in the region were able to operate with an implicit guarantee.[2] Banks could raise capital at home and abroad. These liabilities then financed highly speculative investments with a payoff expectation of: "Heads I win, tails somebody else loses." This behaviour fueled a speculative boom, making the financial situation that much more precarious.

Exchange Rate Policy

An important factor in the overall picture was historically fixed exchange rates which engendered expectations of continued exchange rate stability and lulled investors into complacency. To some extent, the complacency seemed warranted, given the strong macroeconomic performance that underpinned those expectations.

Investors' Behaviour

On the part of investors, the search for higher yields led to excessive risk-taking. This behaviour may have been more pronounced in Japan where a sluggish economy and unresolved problems in the financial sector may have encouraged imprudence in the search for investment opportunities. In the case of Korea, for example, the search for higher yields by domestic investors led to behaviour tantamount to gambling: unhedged borrowing in yen to lend in rupiah, with an expectation of capitalising on the higher yields in rupiah.

2 See *What happened to Asia?* on P. Krugman's website.

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III What Needs to Be Done?

Prevention is better than cure. This principle has been a driving force behind both the reflections on reform of the international monetary system in the wake of the Asian crisis and the work of the Fund, which has always put surveillance at the core of its activities. Accordingly, most of this section of the paper is devoted to crisis prevention. A variety of issues will be considered. On each of these topics, both reforms that could be undertaken by many different actors and avenues for strengthening Fund surveillance are addressed. No system of crisis prevention will ever be foolproof of course. This section therefore also considers improved mechanisms of crisis management.

CRISIS PREVENTION

Part I of this paper described how capital flows have evolved during the past decade, not only in volume but also in composition and how capital markets have gained in sophistication, including through widespread use of derivative products. Part II analysed causes of the Asian crisis, including the surge in capital inflows to many Asian countries in the 1990s and their recent abrupt drying-up, the central role of banking systems in intermediating these flows, weaknesses in regulatory and supervisory frameworks, and macroeconomic policy inadequacies. Combining these elements, improving the functioning of the international monetary system, and the Fund's surveillance over it, could centre on five elements: improving information provision to market participants, increasing the transparency of economic policies, facilitating the dissemination of Fund's views of members' policies, strengthening financial systems, and promoting orderly capital account liberalisation.

Data Provision

Comprehensive, accurate and up-to-date data are essential ingredients of sound decisionmaking by both private market participants and public entities. With hindsight, the Asian crisis revealed that the data known to market participants – and sometimes to the Fund – regarding foreign exchange reserves and short-term indebtedness, as well as comprehensive information on the health of the financial system of certain countries, suffered from severe deficiencies. When the facts finally came to light (as they always do): market reactions were severe, and they endured when skepticism about official statistical information contributed to difficulties

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in re-establishing market confidence. Improving data provision to the public therefore is crucial. In some instances, this requires significant modifications to statistical systems, and in others improved dissemination of existing data.

Improving Statistical Systems

With the furious pace of innovations in international financial relations, statisticians face a formidable task when attempting to develop comprehensive, timely and accurate statistics for countries' international investment positions. A number of sources, including the BIS, the OECD, the World Bank, and private companies, report data on external indebtedness. Many countries compile data on debt liabilities through a domestic or external liability registration or surveying process. Monetary survey data and commercial banks' financial statements can also provide data on foreign liabilities of the banking sector. However, all these sources suffer from weaknesses, due to limitations in coverage or lack of completeness stemming from the absence of a comprehensive reporting requirement. Even the use of all these sources together may fail to give a complete picture of a country or a sector's external liabilities. This is particularly true for short-term liabilities.

Statistical improvements are thus needed. It must be recognised that this is bound to be a complex and lengthy task. The existence of complex relations between on-shore and off-shore institutions (e.g. foreign subsidiaries of domestic firms), the development of off-balance sheet transactions such as swaps, forward contracts, and options, and difficulties in the classification of certain instruments in domestic or foreign debt, all present very real obstacles to deriving a true picture of a country's international investment position. Nevertheless, efforts must be made to overcome this obstacle. In the first instance we should focus on short-term debt given its volatility and its role in the Asian crisis, and the IMF has started a process aimed – in the first instance – at identifying gaps in the coverage of available data and at offering recommendations for better reconciliation of existing data sources and improved data compilation.

Enhancing Data Dissemination

Regular and timely data dissemination of a wide array of economic statistics is not only beneficial to market participants but also in the best interests of national authorities. Indeed, rapid publication of accurate data in both good and bad times is for governments one of the best protections against the false hope that current difficulties will miraculously vanish and that corrective measures can be safely postponed.

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This lesson, which emerged from the analysis of the Mexican crisis, led the IMF to launch in 1996 the Special Data Dissemination Standard (SDDS) and to establish and maintain an associated Dissemination Standard Bulletin Board (DSBB) on the IMF's website (www.imf.org). The SDDS specifies coverage, periodicity and timeliness for 17 data categories of macroeconomic statistics, along with advance release calendars and other aspects of data access, integrity and quality. The DSBB was conceived as the location to identify members subscribing to the SDDS and as a convenient source for access to countries' information about their statistical practices (metadata). In addition, the DSBB eventually became a location for access to some subscribers' national data. At present, 43 Fund members subscribe to the SDDS, 37 of them have their metadata posted on the DSBB, and 12 of these have hyperlinks from the DSBB to national internet data sites. The SDDS is in a transitional period until the end of 1998, by which time subscribers should be in full compliance with the standard.

The IMF is presently considering ways in which the SDDS could be strengthened. In particular, the sequence of events leading to the Thai and Korean crises suggests extending the SDDS to cover foreign exchange reserve liabilities (including off-balance-sheet transactions such as forward contracts and other financial derivatives), private external debt, and indicators of financial sector soundness (so-called macro-prudential indicators). Of these three elements, inclusion of foreign exchange reserve liabilities in the standard is perhaps the one presenting the least technical difficulties. As discussed above, coverage of private external debt, including short-term debt, may require significant new data compilation efforts. Definition and inclusion of some macro-prudential indicators, such as data on sectoral concentration of lending and the maturity structure of assets and liabilities, may possibly be derived from existing analytical accounts of the banking sector and other bank supervisory data. However, derivation of other key prudential ratios would appear to depend critically on national rules for asset classification, valuation, and provisioning. Their eventual inclusion in the SDDS might thus be dependent upon a prior major international effort to establish commonly accepted bank accounting standards, including rules for loan classification and provisioning.

Policy Transparency

Beyond good data, sound judgment on investment and other economic decisions require a clear understanding of the design and conduct of national economic policies. Policy transparency can help avoid shocks provoked by abrupt changes in private agents' behaviour caused by unantici-

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pated policy changes. It can also increase policy credibility, with for instance positive consequences on the climate for long-term productive investment.

In the past decade, numerous initiatives have been implemented in different countries to improve policy transparency. Some of these initiatives concerned monetary policy: a number of industrial countries clarified the central objective of their central bank (maintenance of price stability or achievement of a public inflation target), while providing it with a framework conducive to fulfilment of its objective – e.g. by granting the central bank operational independence. Others pertained to fiscal policy, such as New Zealand's adoption of the pioneering Fiscal Responsibility Act of 1994. The outcome of these initiatives suggests that transparency in fiscal and monetary operations – defined as public openness in government institutions, fiscal and monetary policy intentions, public sector accounts, indicators and forecasts – can indeed contribute to macroeconomic stability, allocative efficiency, and fairness, increase confidence in a government's economic policies, and thus limit the risk of financial market shocks.

In the fiscal sphere, a recent review points to the importance of a number of sound practices, which might be considered possible elements of an eventual code of fiscal conduct.[3] Examples of such practices are: a clear demarcation between the public and private sectors, publication and quantification of the extent of government intervention in areas such as support to banks and enterprises, information on the costs of any quasi-fiscal activities of state-owned financial institutions and non-financial enterprises, public disclosure of budget documents, open procurement and hiring practices, audits of budget operations subject to public scrutiny, no recourse to discretionary tax concessions or negotiated tax liabilities, and fiscal accounts covering the entire general government.

Dissemination of Fund Views

The Fund may also be in a position to improve information about members' policies by making known its views on them – and, perhaps, in so doing creating increased incentives for appropriate changes, when necessary. When approaching this issue, the Fund has been mindful of two widely shared considerations: first, increasing the transparency of IMF policy assessments may be a powerful means to strengthen the effectiveness of surveillance; second, dissemination of information must not come at the

3 See G. Kopits and J. Graig (1998), *Transparency in Government Operations*, Occasional Paper No. 158, IMF, Washington D.C., January.

detriment of the quality of the policy dialogue between the Fund and its members, including the candid exchanges that take place in the context of the IMF's main vehicle for bilateral surveillance known as the Article IV consultation process.[4]

Balancing these two factors, the Fund had traditionally made public the results of its multilateral surveillance exercises, the bi-annual *World Economic Outlook* and *International Capital Markets* reports, and disseminated a vast amount of applied research. In April 1997, considering the general trend toward increased openness in a number of member countries – including through the release of concluding statements and joint press conferences following Article IV consultations – the Fund's Executive Board decided to go a step further. It agreed to the issuance of Press Information Notices (PINs) on a voluntary basis, following the conclusion of Article IV consultations, for member countries seeking to make known the views of the IMF to the public. PINs are typically 4 to 5 pages long: they contain a background section with factual information and the Fund's assessment of the member country's economic prospects and policies, as reflected in the IMF Executive Board's discussion of the Article IV consultation. Since the inception of this policy, Article IV consultations have been concluded with roughly 110 member countries. Approximately half of them have elected to have the Fund issue a PIN.

Is it desirable to go still further? The general issue of transparency of Fund advice clearly remains alive, especially in the wake of the Thai experience where repeated confidential warnings of impending serious difficulties went unheeded. It has been pointed out that the Fund's Articles of Agreement contains a provision stipulating that, by a qualified majority of votes in the Executive Board, the Fund may "decide to publish a report made to a member regarding its monetary or economic conditions and developments which directly tend to produce a serious disequilibrium in

4. Article IV refers to Article IV in the Fund's Article of Agreements. This article is the one that enshrines the Fund's surveillance responsibilities. Specifically, it states in part that "each member shall: (i) endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances; (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does note tend to produce erratic disruptions; (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and (iv) follow exchange policies compatible with [these] undertakings" and that "the Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with [these] obligations".

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the international balance of payments of members.[5] It should be noted that this provision has never been used, perhaps because the Fund has been concerned that involuntary dissemination of views based on confidential information provided by a member would have serious long-term consequences on the quality of the dialogue with its members.

Overall, while it is difficult to predict the evolution of the balance of arguments between the benefits of transparency and those of confidentiality, one would expect that more and more countries would on their own come to value the benefits of regularly providing to market participants the Fund's assessment of their policies.

Financial Systems

In a large number of countries, long-simmering financial system weaknesses have at one time or another severely affected macroeconomic developments. The Asian crisis is, in this respect, only the latest manifestation of an often repeated pattern. This consideration has led numerous international bodies to consider how financial systems could be strengthened. In April 1997, the G-10 published a report on financial stability in emerging market economies. In September of the same year, the Basle Committee on Banking Supervision issued its Core Principles for Effective Banking Supervision. In January 1998, the IMF produced a document entitled Toward a Framework for Financial Stability. Other institutions, including the World Bank, have also been active in this area.[6] All these efforts of course built upon the extensive work done by the BIS for a number of years, which resulted for instance in the 1988 Basle Capital Adequacy Accord and the subsequent Market Risk Amendment.

Principles for Sound Banking and Financial Systems

These various endeavours have helped identify key elements of sound banking and financial systems. These elements include: a legal environment conducive to the full enforcement of contracts, including effective bankruptcy procedures; internationally accepted accounting principles; robust payment and settlement arrangements; demanding standards for

5 Article XII, Section 8, of the Articles of Agreement of the International Monetary Fund.

6 See Group of Ten (1997), *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems*, BIS, April (available on the BIS website); Basle Committee on Banking Supervision (1997), *Core Principles for Effective Banking Supervision*, BIS, September; IMF (1998), *Toward a Framework for Financial Stability*, International Monetary Fund, Washington, D.C., January.

disclosure of key financial information; effective systems of risk control; adequate capital requirements; a structure of ownership of financial institutions conducive to strict stakeholder oversight; openness in banking and financial markets, within essential prudential safeguards; competent management; deposit insurance arrangements, lender-of-last-resort facilities, and exit policies conducive to the preservation of stakeholders' incentives to exercise oversight and act prudently; independent but accountable supervisory and regulatory authorities; sufficient supervisory powers, including powers to issue and withdraw licenses, request and verify relevant data, conduct on-site inspection, restrain unsound practices, and force the exit of financial institutions; and international cooperation and coordination of national supervisory authorities.

In addition, these efforts highlighted that development of a set of sound principles and practices in a variety of domains could significantly contribute to the strengthening of financial systems. This set prominently encompasses international, high-quality accounting and financial reporting standards, which would ensure that information contained in financial statements of both non-financial enterprises and financial institutions is accurate, timely, comprehensive, and comparable across countries.

Financial Sector Surveillance

The Fund's role in financial sector issues stems from its responsibilities in promoting sound macroeconomic policies and the potential impact of banking crises on the macroeconomic environment. It stems also from the near-universal membership of the IMF, which makes it very well placed to disseminate standards and best practices for use in the financial sector, such as the Core Principles for Effective Banking Supervision recently developed by the Basle Committee on Banking Supervision. These considerations had led the Interim Committee of the Board of Governors of the Fund to call for greater attention to financial sector and capital account developments in the aftermath of the Mexican crisis.[7] Recent events in Asia confirm the merits of that call.

With limited resources, the Fund's attention to financial sector issues will have to be selective and its focus put on the identification of problems that have a potentially significant macroeconomic impact. A full assessment of the health of individual financial institutions or the certification of

7 See "IMF Updates Surveillance over Members Economic Policies," In: *IMF Survey*, April 21, 1997; and *Communiqué of the Interim Committee of the Board of Governors of the IMF*, April 28, 1997 (both documents available on the IMF website).

the overall soundness of financial systems go beyond the scope of Fund surveillance. Rather, Fund surveillance should aim at probing vulnerabilities in financial systems and at increasing the awareness of their potential consequences. Such an assessment could be facilitated by the examination or development of bank soundness indicators in key areas, such as foreign-exchange exposure of financial institutions, sectoral credit concentration, exposure to large holdings of securities, and the share of resources obtained from the central bank. It could also encompass examination of aspects of the institutional, legislative, supervisory and prudential regulation frameworks that could entail risks for the soundness of the financial system. In cases of widespread problems in the financial system necessitating major restructuring, Fund involvement would likely be addressed in the context of a programme supported by the use of Fund resources, in close collaboration with the World Bank – which would be expected to have primary responsibility over banking system restructuring – and possibly other multilateral institutions.

Even with this limited agenda, adequate conduct of financial sector surveillance will require devotion by the Fund of a substantial amount of staff resources. It will also require upgrading the skills of Fund staff in financial sector issues.

Capital Account Liberalisation

Capital account liberalisation can be greatly beneficial to countries that undertake it and, overall, to the international economy. It can broaden the means to finance trade and investment in recipient countries and thus boost investment and growth. It can provide investors with increased opportunities for portfolio diversification and achievement of higher risk-adjusted rates of returns. It can provide access to sophisticated technology in financial intermediation and make domestic financial systems more efficient. At the same time, it carries well-known risks if, for instance, macroeconomic conditions are not adequate or liberalisation is not appropriately coupled with a strengthening of the domestic financial system. A proper objective is thus the promotion of orderly capital account liberalisation.[8]

Recent events in Asia reinforce these conclusions, as they provide examples of difficulties created by both disorderly capital account liberalisation

8 For detailed discussions of these issues and of the future role of the Fund, see *The Role of the IMF: Past, Present, and Future*, Remarks by Michel Camdessus at the Annual Meeting of the Bretton Woods Committee, Washington, D.C., February 13, 1998; and *Capital Account Liberalisation and the Role of the IMF*, Remarks by Stanley Fischer at the seminar on Asia and the IMF, Hong Kong, September 19, 1997 (both available on the IMF website).

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and insufficient capital account liberalisation. As discussed in Section II, in Thailand, free capital flows coupled with weak financial institutions and ineffectual banking supervision can be seen to have led to excessive short term borrowing from abroad and easy financing of risky long-term projects and speculative activities – in the context of rapidly rising domestic asset prices. In Korea, exchange controls forced corporations to access international capital markets through banks. As a result, large corporate conglomerates became heavily dependent on debt intermediated or guaranteed by Korean financial institutions. In addition, these institutions' short term debt rapidly grew, as a substantial share of their resources came from borrowing from international banks and as this type of interbank financing is usually provided at short maturities. Thus, the financial structure of both non-financial and financial corporations came to suffer from severe weaknesses.

Given its mandate and its nearly-universal membership, the Fund is uniquely placed to play a central role in efforts to promote orderly capital account liberalisation. As a matter of fact, it is already actively supporting members' efforts toward liberalisation. The Interim Committee of the Board of Governors of the IMF considered that an amendment to the Fund's Articles of Agreement would provide the Fund with the most effective means to fulfill this role.[9] Such an amendment would make the promotion of capital account operation a specific purpose of the IMF and extend, as needed, the Fund's jurisdiction through the establishment of carefully defined and consistently applied obligations regarding the liberalisation of such movements. With the use of safeguards and transitional arrangements, it would allow the IMF to encourage the liberalisation of capital flows while paying due regard to the varying circumstances of member countries.

At a recent IMF-sponsored seminar in Washington, there was a wide consensus on the benefits of capital account liberalisation. At the same, many participants cautioned that the pace and sequencing of liberalisation had to be carefully adapted to the specific circumstances of each country, including their macroeconomic situation and financial system structure.

Crisis Management

While stringent efforts should be made to reduce the likelihood of crises, it

9 See *Communiqué of the Interim Committee of the Board of Governors of the IMF*, April 29, 1997; *Communiqué of the Interim Committee of the Board of Governors of the IMF*, September 21, 1997; and *The Interim Committee Statement on The Liberalization of Capital Movements Under an Amendment of the IMFs Articles*, September 21, 1997 (all documents available on the IMF website).

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is certain that no system can guarantee that future crises will not happen. Thus, we need to extend our reflection to how financial crises should be managed. This section considers first the role of the Fund and of other official creditors during crises. It then turns to the involvement of the private sector in the resolution of crises.

Role of the IMF and of Other Official Creditors

Since the Bretton Woods conference, the general rationale for IMF financial support to members is enshrined in Article I(v) of the Articles of Agreement, which reads: "[The purposes of the Fund are:] To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." This rationale remains as valid today as it was more than fifty years ago.[10]

Put differently, the provision of financial resources by the IMF conditional on the implementation of a strong programme of economic policies remains an essential part of crisis management: prompt implementation of corrective policy measures by the affected member(s) is a key to mitigating the impact of a crisis and limiting contagion effects; and supply of adequate financial resources is essential to ensure balance of payment financing while corrective measures take effect and private sector confidence is being re-established. Thus, the IMF retains a central role in crisis management. To fulfill this role, it is clearly essential that the IMF dispose of sufficient financial resources.

Other international financial institutions and bilateral official creditors are also likely to play important roles in financial crisis management. The size and volatility of private international capital flows increase the probability that, in the event of a crisis, financing needs may be substantial. Therefore, as seen recently, provision of sufficient financial resources may require contributions from a number of official multilateral and bilateral sources. In addition, with high probability, a crisis will reflect structural weaknesses as well, requiring not only adjustment to macroeconomic policies but also structural reforms. International financial institutions with expertise in the relevant structural issues would thus be expected to be

10 For a detailed discussion of the rationale for IMF financial support, see P. Masson and M. Mussa (1995), *The Role of the IMF: Financing and Its Interaction with Adjustment and Surveillance*, IMF Pamphlet Series No. 50, IMF, Washington, D.C.

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closely associated with the design of the programme of remedial policies.

Beside support from a strong reform programme, success of financial rescue packages depends to a crucial extent on their ability to restore private sector confidence. This cannot be obtained when doubts exist about policy direction and rumours abound. Thus, perhaps more than at any times, policy decisions have to be fully transparent in times of crises. Publication of letters of intent, describing the authorities' policy commitments vis-à-vis the Fund and the international community, is one way to achieve this goal. Immediate improvements in the quality, comprehensiveness or timeliness of economic data provision is another.

Involvement of the Private Sector

Provision of official financial assistance in a crisis must not lead market participants to downplay the risk of investing in one country or another: private sector borrowers must face appropriate incentives, which entail that they should appropriately share the profits and losses resulting from their decisions. Limiting moral hazard stemming from official intervention in financial crises requires that the private sector be involved in the resolution of crises.

The globalisation of international financial markets, the switch away from syndicated bank lending toward sovereign bond issues, and the lack of modern experience with participation of bondholders in the management of sovereign liquidity crises have raised concerns that crisis management procedures developed in the 1980s may no longer be fully adequate. In particular, there is a risk of a disorderly sovereign bond default stemming from aggressive creditor litigation, if a sovereign were to face severe liquidity difficulties. Such a disorderly default would make resolution of the crisis, including adoption of a strong adjustment programme and provision of new financing, that much more difficult.

This prospect, which has been given serious consideration by both the G-10 and the IMF, has led to reflections along three lines: introduction of new legal provisions in sovereign bond contracts, establishment of an international bankruptcy court, and allowance of IMF-sanctioned temporary debt standstills.[11] All three types of proposal have appeals and drawbacks. Introduction of clauses in bond contracts on sharing, qualified majority voting, and bondholder representation could facilitate orderly

11 For the G-10 analysis of this issue, done in the aftermath of the Mexican crisis, see Group of Ten (1996), *The Resolution of Sovereign Liquidity Crises*, May (available on the BIS website).

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renegotiation in case of necessity. However, it would only apply to new bonds and not to the large existing stock of bonds. The appeal of an international bankruptcy court is in the parallel with national bankruptcy procedures: such a court might be able to prevent a race to seize assets while a country is given breathing space to "restructure". However, this analogy is not perfect: sovereigns cannot be sanctioned as corporate management can be for past inappropriate policies; thus, moral hazard on the debtors' part could be high. In addition, variations in national bankruptcy procedures might make it very difficult to agree on a single international code. Finally, IMF-sanctioned debt standstills could contribute to crisis resolution: it might facilitate provision of conditional financing from the Fund and catalyse resources from other sources. However, care should be taken that the possible imposition of standstills does not affect the efficiency of capital markets and create incentives for excessive borrowing on the debtors' side.

After initial consideration, establishment of an international bankruptcy mechanism has received little support. Conversely, while substantial questions remain to be worked out, further work on the other two proposals – new legal clauses in bond contracts, and IMF-sanctioned temporary debt standstills – would appear worthwhile.

Two Final Thoughts

In conclusion, let me return with two thoughts on crisis prevention and, specifically, on Fund surveillance.

The earlier discussion of crisis prevention highlighted the benefits that could be gained from dissemination of various standards and codes, such as the Basle Core Principles for Effective Banking Supervision, international accounting and disclosure standards, and an international fiscal code of conduct. As outlined above, much work remains to be done in these areas, and achieving international agreement may be far way off in some cases. However, looking ahead, one might expect the Fund to play an increasingly important role in encouraging members to adopt internationally-agreed standards and, in its areas of expertise, monitor compliance with those standards.

Events in some Asian countries have reminded us that for surveillance be effective governments must be willing to pay due attention to its warnings and recommendations. To strengthen the effectiveness of surveillance, cooperation between regional fora and the Fund might be enhanced. While the Fund has unique responsibilities in surveillance, regional fora have an inherent interest in effective surveillance over economic policies in their region, given the risks of contagion, and a unique perspective stemming from in-depth knowledge of local conditions. There would thus

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appear to be natural opportunities for cooperation between the Fund and regional fora. In particular, regional fora may be in a position to apply appropriate peer pressure to help implement recommended policy changes.

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