A financial crisis is a learning experience. Traditionally, each new episode has revealed new sources of vulnerability particularly in the sphere of domestic policies. In more recent years cracks have also appeared in both domestic financial architecture and international financial markets, extending the debate on international financial architecture (IFA) in the process. Our role is to attempt to extract lessons from such crises in order to put the necessary safeguards and systems into place. However, such measures cannot act as a guarantee that a new crisis will not manifest itself in some new form. As my previous speaker pointed out, although we now know that macro-stability is not enough, there was a time when this was widely believed to be a panacea to a crisis. Subsequent crises have revealed the problems of contagion and herding and now also micro-factors such as the health of the balance sheets of the domestic financial system.

Today, I am going to argue that although our understanding is limited to working out ex ante the new sources of crisis, we have not dealt adequately with the issues in international financial architecture emerging out of the previous crises. The proposals on which some progress has been made following the East Asian crisis have tended to focus more on making it possible for the market to reward good behaviour and penalise bad. The post-crisis emphasis has been on strengthening players: stronger risk management, more prudential standards and improved transparency (on the part of the borrowing countries). Although the issues related to lender of last resort, transparency on part of international banks and hedge funds, volatility and sharp reversals of capital flows gained attention prior to East Asian recovery, the quick recovery has considerably weakened political support for the debate. The spring meeting of G-24 ministers also stressed the lack of participation by developing countries in the new architecture. The UN Financing for Development consultation process provides an opportunity to seek consensus on policies dealing with the revealed weaknesses in previous crises. Another forum where these discussions could be taken further is at the G-20 meet in autumn this year. Below I will detail some of the areas where consensus is lacking or where weaknesses have emerged. Progress has been made on information and working towards healthy balance sheets in the financial system by creation of the Financial Stability Forum.

Increasing liquidity as a response to the crisis

The idea of lender of the last resort arose soon after the crisis and has yet to gain political support. Suggestions have been made to overcome the resource constraint at the IMF for crisis management by Michael Camdessus. Others, such as the US Council of Foreign Affairs, have suggested that resources for crisis management could be funded by temporary and self-liquidating issues of SDRs. However, there has been no progress on this.

IMF’s Contingency Credit Line was created almost a year ago for crisis prevention, management and prevention of crisis spillovers. It has recently been modified to allow greater automacity as a lending facility for both crisis prevention and management but has not been utilised due to its pricing and the burden of pre-qualification. There is also the perception that it may send signals to the market about a country’s creditworthiness.

At the national level, the level of reserves has risen in many countries. A new perception is that a country should maintain reserves beyond three months of imports with new criteria such as the ratio of short-term debt to reserves as well as portfolio flows to reserves. Thus capital inflows have a cost because reserves are investment in bonds, which yield a lower return than at which they are
borrowed.

Other measures are private sector involvement, debt standstills and debt restructuring. Progress has been rather limited because the measures taken are clearly inadequate in light of the revealed problems.

These are issues related to dealing with the few middle-income countries in receipt of private capital flows. For poorer developing countries the issues are ones connected with the availability of official finance and the need to take the debate beyond HIPC. This will be addressed towards the end of my talk.

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Codes and Standards

In the discussion I will focus on the arguments that provide answers to some of the following questions:

**Why do we need codes and standards?** The scale of the East Asian crisis is believed to be a result of weaknesses of the financial sector. Consequently, much effort has gone into defining prudential regulation, corporate governance and bankruptcy insolvency procedures. 12 of the codes that have been defined have been designated as fundamental to the soundness of financial systems. The full FSF compendium includes an additional 52.

One of the measures taken in this area was the introduction in 1966 of the IMF’s Statistical Data Dissemination Standard (SDDS), which seeks commitment from developing countries on timely reporting of critical economic and financial data. The emphasis is on timely information regarding short-term debt and other liabilities, improved data on international reserves, which show reserve related liabilities such as forward transactions, and also potential drains on reserves. The General Data Dissemination System is for countries that cannot meet the strict criteria of the former.

Concerns exist in relation to the question of whether codes and standards are enough to prevent a crisis, whether they are appropriate and whether it is necessary to implement standards uniformly across the developing world?

**Transparency.** While international organisations are increasingly arguing that more transparency is a panacea to crisis, some in the private sector are arguing that too much transparency is not necessarily a good thing. Avinash Persaud (2000) makes a convincing case for not making information available on reserves etc. on a daily basis. He bases his arguments on the following:

- In the short run, there is compelling evidence to indicate that the markets cannot distinguish between the good and the sustainable.
- In a herding environment, tighter market-sensitive risk management systems and more data transparency actually makes markets more prone to a crisis.
- The growing fashion in risk-management is to move away from discretionary judgements about risk to more quantitative and market sensitive approaches. Analysis is based on daily earnings at risk. Rise in market volatility hits the DEAR limits of some banks causing a hit in the DEAR limits of some more banks. Several banks sell the same asset at the same time leading to an increase in market volatility and higher correlations.
- Banks or investors like to buy what others are buying and sell what others are selling. Their performance is rated relative to each other. Employees are more likely to be sacked for being wrong and alone than being wrong and in company.

Therefore, although transparency is necessary, there is a question mark over how transparent
developing countries should become. Similar points were made at an ODI conference in June last year. The case for transparency rests on the fact that information and transparency are central to successful policy in developing countries. Precise, regular information is essential to attracting investors to countries. For instance, a case can be made that the marginal product of information in Africa is still very high given the poor record of disclosure there and investor ignorance of the region. Many have also argued that the vulnerability of developing countries to self-fulfilling crises emerges because their lack of transparency leads to herd-like behaviour in the financial markets. However, the private sector also acknowledges that the provision of information could backfire since it could highlight faults that are shared by many countries but publicised by only a few.

Transparency alone cannot avert a crisis or contagion. Moreover, in a contagion situation there is a distinction between fully informed traders who follow fundamentals and less informed "noise traders". In the Keynesian "beauty contest" world, informed traders anticipate irrational trading by noise traders since it is not a question of what one's own beliefs or knowledge regarding fundamentals but rather that of the common perception. Information may help ameliorate this situation but it is unlikely to eliminate it entirely.

Transparency for hedge funds and banks is being increasingly relegated to the background. The burden of providing information is asymmetric. Thus, it is the developing world that follows transparency rules. Information on the share of a portfolio allocated to a particular country and the time horizon in which this share would be reached would enable developing countries to plan for their resource gaps in a more effective manner and finance development from alternative sources.

Why the emphasis on codes and standards?

1. In a paper presented at a Conference on Global Financial Architecture, Shankar Acharya (2000) points out that the emphasis on codes and standards exists because many analysts and policy-makers, particularly in the G-7 countries, believe that uniformly implemented standards provide the panacea for prevention of financial crisis. It is also likely that codes and standards are the lowest common denominator of agreement among key players regarding restructuring after the East Asian crisis. Their implementation requires very little fresh effort by the G-7 or OECD economies. Therefore, the burden of fresh effort rests with the developing world.

2. Implementation of codes and standards is not a low cost proposition for the developing countries - it is a long and arduous process. A case exists for cost-benefit analysis and prioritisation but, to my knowledge, this cost has never been estimated. Dani Rodrick draws parallels from other areas to argue that legal harmonisation can be very costly. A case is the WTO codes. He cites Mike Finger (1999) who reasons that it costs a typical developing country $150 million to implement only three of the WTO agreements (those on custom valuations, sanitary and phystosanortroy measures (SPS), and intellectual property rights (TRIPS). One does not know who accurate this number is but it emphasis a point that implementation needs research. While, undoubtedly, codes and standards can play a useful role in strengthening domestic financial systems, there is a need for prioritisation and identification of core standards. Should a developing country divert resources for implementation of these from other more pressing development objectives? Clearly there is a case for sequencing and resource management.

3. In discussing the appropriateness of the selected standards, Dani Rodrick (September 2000) points out that many rich countries have prospered following different paths in corporate governance (where insiders and stakeholders have played a much more significant role) and in finance (where close links between the governments have often been the rule rather than the exception). Similar points have been made by the Reserve Bank of India, perhaps the only country that evaluates the appropriateness of sequencing issues. The reports of the various committees are available on the RBI web site.

4. Can imported legal standards be effective? Katharina Pistor (2000) argues that historical evidence supports the proposition that imported legal systems have in most cases not produced very efficient outcomes. The content of the rules is not as important as the existence of constituencies that demand these rules and the compatibility of the imported norms with pre-existing legal norms as well pre-existing economic and political conditions.
Voluntary compliance is important.

Pace, pattern and intensity should be left to the individual country and country ownership - it should not become a part of conditionality. Market incentives should play a key role. The information on compliance and IMF IV Consultations should not be placed in the public domain without the consent of individual country governments.

While the 12 codes will undoubtedly lead to better balance sheet management, the question is whether vulnerability, fragility, liquidity are just a matter of sound balance sheet management. Financial crises have many causes and the danger is that too much emphasis on standards can detract attention from other policy measures such as poverty removal. It is also useful to look at the degree of openness and not apply a one size fits all model. Greater involvement of the private sector in individual countries and public policy makers is needed.

The link between the degree of capital account liberalisation and codes and standards. In closed economic systems, although financial systems suffer from weaknesses they have not been an important cause of financial crisis. In the East Asian crisis, bad balance sheet management was a visible contributory factor. India and China escaped the East Asia contagion because they were less open. In India, prudential regulations prevent the banks from putting their balance sheets at risk unlike their East Asian neighbours. A limit to assets in real estate, currencies and stocks. There is no evidence to support the view that a fully convertible capital account is a necessary pre-requisite for sustainable economic development.

Michael Mussa, Economic Counsellor and Director of the IMF Research Department, admits that there is no available evidence for putting in place liberal policies towards capital flows, particularly for portfolio flows rather than FDI flows. He accepts that it may not be wise for all countries in all circumstances to liberalise the capital account. Pursuit of openness in countries with weak and inconsistent macro policies and inadequately capitalised and regulated markets. For such countries the big challenge for public policy is to prepare these economies for capital market integration.

In a recent paper I have argued that, if one accepts the view that globalisation has come to stay, one cannot disagree with Michael Mussa assertion that the challenge is to prepare developing countries for a highly integrated world.

Some of the main conclusions of my research for capital account liberalisation are:

- The forces leading to globalisation and moves towards greater liberalisation of capital account transactions are irreversible. Capital account liberalisation is not a choice. It is part of prudent policy to work out an orderly opening of the capital account instead of reforming under duress once a crisis has hit the economy. Many capital control regimes in developing countries also failed to prevent balance of payments crises from developing and inhibited access to international financing and diversification.
- While liberalisation is generally beneficial, it also greatly heightens a country's vulnerability to reversals in capital flows that can precipitate severe currency and balance of payments crises.
- The risks inherent in capital account convertibility thus justify a gradual approach to liberalisation. Gradualism also allows time for the inevitable learning curve in developing countries. It is important that countries focus on the pre-conditions for liberalisation. Especially prominent among these are fiscal balance, the right mix of instruments to manage capital flows, exchange rate policy and financial sector reform and bank supervision. It is also necessary to integrate different segments of the financial market in developing countries.
- Liberalisation of the controls on the current account combined with a relatively closed capital account leads to the loss of capital through leads and lags in the current account. Some restrictions on the current account are needed in the transition phase to give the country time to reform without dealing with the problem of capital flight through this channel. The decision to open up the capital account because of pressures introduced by the opening of the current account is a poor policy decision. It must be mentioned that the volume of capital
lost through leads and lags is likely to be smaller than that lost through an open capital account under unsuitable conditions.

- Capital account liberalisation requires that central banks have effective regulatory, supervisory, enforcement and informational structures in place. Liberalisation must not be seen to require authorities to retreat from these essential functions.
- The need to regulate short-term flows arises from the inability of financial systems in developing countries to intermediate capital from the short-end to the long end and cannot therefore bear the risk of financial intermediation. The management and monitoring of short-term inflows must be a central concern.
- Authorities must be concerned not only with the foreign exchange exposure of the financial system but also that of the non-bank private sector. Experience has shown that these “hidden” exposures can be a prime source of national exposure to currency depreciations.
- The composition of capital flows must also be closely monitored. FDI flows are in general more costly but are also more stable and beneficial to development. At the other end of the spectrum, short-term borrowing is highly volatile and more likely to underwrite consumption rather than productive investment.
- Capital controls must be viewed pragmatically. A distinction must be made between capital control and prudence. Many controls are inefficient and ineffective. However, a distinction must be drawn between these controls and controls that serve a prudential function. In particular, authorities wishing to limit exposure to sudden capital reversals must consider some quantitative restrictions and controls on short-term flows such as those in Chile. Price controls on short-term flows are only effective in the short-run in altering maturity transformation and providing monetary autonomy, they cannot be used to insulate monetary and exchange rate policy. Controls must be carefully targeted to where they are most effective and must make distinctions between various classes of agent (resident, non-resident, and bank, corporate, individual). In the transition phase, restrictions on certain class of institutions, such as banks, pension funds and authorised dealers are generally effective. During this time, depending upon conditions, both price controls and prudential limits can be used. Efficient administrative machinery is needed for their effectiveness. Controls must not, however, be used to put off essential reforms directed at structural imbalances and the financial sector.
- The composition of capital flows has implications for conduct of exchange rate policy. A stable exchange rate attracts bond flows, while equity investors prefer floating exchange rates, which stimulates competitiveness of enterprises in the host countries. Moreover, bonds are usually denominated in domestic currency, while equities of successful exporting business are hard currency and more protected. The implication is the avoidance of a fixed or pegged exchange rate with large bond markets.
- The IMF makes a case for corner solutions with respect to exchange rate policy. Calvo and Reinhart (2000) analyse the reasons why a fully floating exchange rate is problematic in developing countries because of their structural difference from advanced countries.

Some of the difficulties this gives rise to are:

- Bandwagon effects are ever more likely to operate in emerging markets, which renders a market driven exchange rate volatile. Imperfect credibility of monetary authorities can result in self-fulfilling depreciations. Alternatively, long periods of capital inflows can result in sustained appreciations. This has implications not only for short-term instability, but also medium term misalignments. There is evidence that exchange rate instability is more damaging for trade and investment in developing countries and the pass through from exchange rates to prices is problematic in countries with a history of inflation. Those developing countries that do adopt floating exchange rates operate them like intermediate regimes.
- The option of a fixed exchange rate, besides the point raised above regarding the composition of capital flows, results in developing countries losing an important policy tool that has served them well in the past. Appropriate use of exchange rate flexibility is a valuable option. Dani Rodrick (2000) points out that adjustments in real exchange rate are needed for economic stability, which are more costly to bring about in terms of wages and prices, especially in economies with low inflation environments. In the long run, a sizeable and persistent depreciation can be an important contributor to growth spurts across wide
range of countries, which have been brought about by significant nominal depreciations. Some examples of this are Chile (mid 1980s), Turkey (early 1980s), India (early 1980 and since 1994), Uganda (since 1986) and Mauritius (mid-1980s). Flexibility remains important whether countries opt for a managed floating exchange rate regime or an exchange rate band.

In view of the preconditions, it is imperative that developing countries adopt a gradualist approach to capital account liberalisation. Capital account convertibility can be part of the overall reform agenda and contribute to the fulfilment of the pre-conditions. As the majority of developing countries lack the preconditions to capital account liberalisation and therefore will need to adopt a gradualist approach, it maybe some years before they reach the degree of openness which Mexico or East Asian economies had reached. Therefore, in terms of sequencing and prioritisation, each country needs to make its own decisions as to where they want to be on the spectrum of currency convertibility and make decisions on the allocation of resources for implementing the various codes and standards. Moreover, one size cannot fit all.

There is clearly a case for a priori setting of which codes are necessary for the relatively closed economies, issues of sequencing, the resources needed for implementation, and a case that one does not need uniform standards to avoid a crisis.

Regional Initiative

Regional lender of last resort. Japan proposed the idea of an Asian Monetary Fund after the outbreak of the crisis. The idea still faces strong opposition from the United States and European countries as well as the IMF. The Korea Institute of Economic Policy has come out with a blueprint for regional arrangements to borrow that needs to be further debated. One needs to look at how regional surveillance and regional arrangements to borrow can assist the IMF in its role in the global economy.

The Chang Mai Initiative. As a move towards regional self-help, an initiative emerged named after the Asian Development Bank Annual Meeting in Chiang Mai, Thailand, in May 2000. ASEAN countries plus China, Japan and South Korea jointly recognised the need to establish a regional financing arrangement to supplement the existing international facilities. As a start they agreed to strengthen the existing co-operative frameworks among monetary authorities in East Asia. The Initiative involves an expanded ASEAN swap arrangement that would include all ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among ASEAN + 3. The details are being worked out to strengthen regional financial co-operation and stability. The previous ASEAN SWAP facility was not utilised during the East Asian crisis and therefore there was the need to overhaul the existing framework. Under the previous arrangement the maximum outstanding by each participant was $40 Million. This amount was too small and therefore new arrangements are being worked out.

Last week the finance ministers of these governments put the finishing touches to these arrangements and agreed to link the currency swap in ASEAN + 3 to IMF conditions. The original agreement allowed only 10 percent of the total bilateral swap to be disbursed without linking to the IMF to ease short-term liquidity, but then tied the rest to reforms supervised by the IMF. The main idea behind this is to borrow quickly from international reserves to avert a crisis. The agreement will be signed in the next annual meeting of the ADB.

There is the issue of ownership here. Since the facility is designed voluntarily out of countries own reserves, IMF conditions should not operate when temporary loss of liquidity is being covered with this facility. The danger is that IMF involvement may take away the automaticity and speed of the facility.

The Manila Framework. The Manila framework has no formal status. Members of the Asian Pacific Economic Co-operation (APEC) created the Manila framework to develop a concerted approach to restore financial stability in the region. This has been achieved through such initiatives as regional surveillance, economic and technical co-operation to strengthen domestic financial systems and
regulatory capacities, and co-operative financing arrangements that supplement those provided by international financial institutions.

**Regional solutions: Latin America.** In a recent study carried out for DFID by Stephany Griffith Jones, Brigitte Granville and Dr. Ricardo Goshalk, Dr. Goshalk reports that Latin American governments are showing interest in two initiatives. The first relates to regional financing corporation, which could take the form of a regional fund financed by countries own reserves as a first line of defence against capital flow reversals. The second idea is greater macroeconomic co-operation.

ECLAC proposes a regional fund, which aims at providing financial assistance as a complementary institutional mechanism to assist countries in times of financial crisis and also balance of payments problems arising from external shocks, such as a sudden deterioration in terms of trade. The main source of funds for this would come from reserves through a quota system. As a complementary measure, the Fund would also have access to emergency credit lines provided by the Central Banks of member countries. The existing fabric of Fondo Latinamericano de Reservas (FLAR), which is a Latin American fund of reserves, and the Convenio de Pagos y Creditos Reciprocos is providing reciprocal credit lines. Expansion on these lines would serve the regional effort for financial stability. The Fund could act as an intermediary between the IMF and the region as well as provide a forum for exchange rate stability with Mercousor already taking steps towards macroeconomic co-ordination. Exchange of information is also considered crucial to the regional initiative.

The idea of creating a regional fund out of reserves has some merit. Presently many developing countries are keeping reserves in excess of the traditional measures of reserve requirement. The adequacy of reserves is measured against the ratio of short-term debt to reserves as also a margin for other volatile flows. The level of reserves has implications for exchange rate and macro policy. A second problem is that reserves are invested at lower rates than that at which the funds are made available to the country. The scheme needs to be though over. It gives emerging markets space for independent monetary policy and the re-allocation of liquidity for temporary losses of liquidity.

There is also a need for solutions for smaller economies with least developed financial sectors and enterprises. For countries with thin and undeveloped financial markets, it will take years to get systems to a level that attracts sufficient and stable private capital. The role of official borrowing must be stressed. Enhanced HIPC is not enough and a re-thinking of issues with respect to governance and official flows is essential. Diwan (20001) advises that a complete write off of debt would be advisable. Further, the present HIPC initiative suffers from flaws; an understanding I gained from a recent workshop at CWS on country experiences and from which I have benefited greatly. The IMF’s new concessional lending facility - the Poverty Reduction and Growth Facility - is ad hoc and lacks the depth to make significant systematic inputs. Additional resources are needed; otherwise the danger is that it will put back whatever has been achieved thus far. The current facilities under HIPC initiative suffer from the some of the following defects.

- It does not take into account terms of trade shocks. The programme needs to be worked out taking in a range in which prices can move affecting the benefits from debt relief.
- A Compensatory Financing Facility to deal with terms of trade shocks. This facility should be automatic and developing countries should not have to return to the negotiating table. It should be widened to deal with exogenous shocks.
- The funds available are not enough to deal with the resource gap. Further, not only is there a resource gap but there is also considerable uncertainty in financing this gap.
- Harmonisation of official flows with donor flows needs to be re-considered as whilst donors wait for IMF decisions, the country is starved of funds and this further undermines the process of growth and poverty reduction.

I have argued that the sequencing and pace for implementing codes and standards needs to be worked out differently for poorer countries. The degree to which these countries can open up their capital account is limited and it will take some years to make the progress on the necessary pre-conditions. It is important to finance the transition period with official borrowing. Therefore, whilst sequencing of capital account liberalisation will have to include Codes and Standards, these cannot
take precedence over the priority of the removal of poverty.

References


Appendix One

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*Source:* FSF