GLOBAL FINANCE AND THE ROLE OF INTERNATIONAL STANDARDS FOR FINANCIAL STABILITY

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Fears of emerging market contagion from Argentina's financial problems could provide the first real test of much heralded efforts to make global markets less vulnerable to crises like those in Asia in 1997-98.

Fears that capitalism had run amok and globalisation would lead to poverty for most of the world galvanised Western leaders into promising swift reforms of the so-called "international financial architecture."

The phrase "reform of the international financial architecture" has been bandied about for years now, topping the agendas of international summits and countless meetings by institutions and policy-making bodies. The following is an overview of the reform, the issues, the architects and the new catchphrases

The phrase "international financial architecture" encompasses the institutions, markets, rules and practices used by governments, businesses and individuals to carry out economic and financial activities.

REFORM OF INTERNATIONAL FINANCIAL ARCHITECTURE

The Asian crises led to the first global debate about the market-led international financial system in which governments are at the mercy of huge flows of private capital that spill across borders, playing havoc with currencies.

The debate triggered by the Asian crises -- which engulfed Thailand, Indonesia and Korea and then spilled over into Russia, New York financial markets and Brazil -- initially centered on who was to blame and what went wrong. Fingers were pointed at unscrupulous speculators, irresponsible bankers and cronyism.

But a plethora of proposals to scrap the existing framework and replace it with a "new" international financial architecture was sidelined by promises of "reform" of the international financial architecture.

The idea was to strengthen rather than tear down and rebuild the skeleton holding together the international financial system, which has no true global authority to enforce rules on sovereign governments.

Work on reforming the global financial system did not originate with the 1997-98 crises, but had been under way since 1994 as part of the 50th anniversary of the Bretton Woods conference, which created the International Monetary Fund and the World Bank, the guardians of the current structure.

Events in Mexico in late 1994 -- described as "the first crises of the next century" -- exposed deep cracks in the international community's response to crises, a lack of funds to resolve them and an inability to spot and prevent such situations.

While the IMF's war chest to combat crises was topped up, it was apparent that globalisation was not a one-way street to greater wealth for everyone and events in emerging markets had the potential to disrupt global financial markets.

ISSUES AT STAKE

Reform efforts have crystallised into seven areas with the aim of making the international financial system less prone to crises and better equipped to manage a crises when it hits.

1) THE IMF

The IMF has been reformed and is now aimed at crises prevention. Country surveillance has become sharper, lending is aimed at being more effective, loan conditions are fewer and less intrusive, its work is less secretive, interest rates aim to encourage repayment, new loan facilities have been created.

2) Increased transparency.

The lack of timely and accurate data on countries' debt and currency exposure was diagnosed as contributing to the severity of crises. International reporting standards now cover a wide range of macroeconomic data and policies.

3) International Standards and Codes

There are now more than 60 international standards and codes of good practice aimed at helping countries improve their economies and thus the international system. These cover a wide range of financial activities, including data dissemination, banking, securities and insurance supervision, fiscal policy, payments and settlements, accounting, auditing and insolvency.

4) Strengthening financial systems

The main emphasis is on strengthening financial systems in emerging markets, but banking supervisors also continue to upgrade standards for the increasingly large global banks in developed countries to keep abreast with innovations.

5) Involving the private sector

Private money dominates the flow of international capital with sudden reversals often triggering crises. With limited official funds, policy makers want to engage the private sector in crisis prevention and management.

6) Exchange rates

The Asian crises illustrated the vulnerability of rigid exchange rates and debate continues over the appropriate regime -- fixed, floating, managed, hard or soft peg. Proposals for global currency zones continue to be aired. The IMF has concluded no single regime is right for every country, but whatever regime is chosen it must be backed up by credible government policy.

7) Social policies

Debt relief under the highly indebted poor country (HIPC) initiative is at the core of international efforts to ensure that all nations benefit from globalisation. The work of multilateral development banks is being targeted at combating poverty and a fund to tackle diseases has been launched.

THE ARCHITECTS AND THEIR TOOLS

In response to criticism over how the international community handled the Asian crises, two new groups were founded: the Group of 20 and the Financial Stability Forum.

- GROUP OF 20: Created in 1999 to promote dialogue between the Group of Seven leading industrial nations with 12 emerging and growing nations, such as Argentina, Brazil, South Korea and Australia. G20 has no permanent secretariat and seeks to form a consensus on international issues. Viewed as a potential successor to the G7, which has been criticised for lacking the legitimacy to act as a forum for global decision making.

- FINANCIAL STABILITY FORUM: Created in 1999 to enhance cooperation among financial supervisors and international financial institutions, such as the IMF, OECD, World Bank and Bank for International Settlements. The aim is to include developing nations. Its objective is to spot vulnerabilities that could threaten the international financial system and ensure action is taken. FSF was a response to calls for a global financial regulator.

Tools used in the new international financial architecture include the following:

- OCS: Reports on the Observance of Standards and Codes. IMF and World Bank's assessment of how well countries live up to a string of international standards and benchmarks.

- FSAP: Financial Sector Assesment Programme. Part of the IMF and World Bank's surveillance programme, which analyses a country's financial system to spot vulnerabilities.

- SDDS: Special Data Dissimination Standard, the IMF's guide to what data countries, seeking to tap international markets, should publish.

I. THE IMF

If there is unanimous agreement on the need to improve its "preventive" role, there are major divergences on the future role of the Fund. Many analysts have argued that some of the recent financial crisis -especially the 1997 South-East Asian crisis- could have been prevented -or at least mitigated- if the proper warning signals had been provided early enough by the IMF and by those who are in charge of assessing the economic performance of emerging countries. In particular, it can be observed that not enough attention had been focused at the time on the indebtedness of the private sector, on its maturity and currency structure.

But for such early warning indications to be provided in time, there is a need in the emerging countries for reliable, timely and transparent data. Hence the efforts by the IFIs to provide assistance to countries on data collection and reporting. Hence the encouragement provided by the IMF to member countries to publish article IV reports on their economies. Hence the incentives provided to emerging countries to adhere to the Fund's program of "special data dissemination standards" that is intended to provide the market timely and homogeneous economic and financial data. Hence the regular quarterly publication by the IMF of the "Financial Stability report". Hence the encouragement to emerging markets to engage in regular meetings and "road shows" with private investors. Hence the collaboration between the IMF and the World Bank to strengthen banking systems, risk management and surveillance functions in LDC's.

A. <u>But disagreements persist on the future role of the IMF :</u>

Here we need to recall the essence of the Meltzer Report.

1. <u>The Meltzer Report :</u>

Basically, the Report recommends :

a) eliminating IMF lending to countries affected by long term problems. The IMF should not be involved in long-term development assistance (as in Africa) nor in structural transformation (as in the post-communist transition economies). Therefore the enhanced structural adjustment facility and the poverty reduction and growth facility should be eliminated ;

b) limiting IMF's lending operations to the provision of short term liquidity to solvent member governments when financial markets close. The IMF would therefore play a role of "quasi-lender of last resort" for solvent emerging economies in crisis situations. Liquidity provided by the IMF would be short term, carry a penalty rate (i.e. above the borrowers recent market rate) and be secured by a clear priority claim on the borrower's assets. There would be no need for detailed conditionality since countries eligible to the short term lending would have to be "financially sound".

2. <u>Reactions to the Meltzer Report and recommendations for the future:</u>

I think one should distinguish two types of situations : helping countries on the road to balance of payments viability and handling financial crisis.

a) <u>The Fund should continue to provide assistance to countries as long as they demonstrate that they are committed to adjustment :</u>

There is obviously here a major weakness in the Meltzer Report. It is not because a country is facing structural problems (development wise or transition wise) that it should not be eligible to IMF balance of payment support.

Helping a developing -or emerging- country to reach balance of payments viability over the medium term is, on the contrary, one of the most important functions of the Bretton Woods institutions. There are, in the history of the IMF, a host of examples that show how the Fund can be effective in it's role of providing policy advice and helping the adjustment. Let's mention, in this respect, the remarkable achievements in terms of fiscal discipline and monetary stability that have been obtained in Latin American, North African or Eastern European countries over the last two or three decades or so.

In cases of financial crisis, the IMF should enhance its catalytic role vis a vis the private sector :

Making the Fund the "quasi lender of last resort" seems to me a solution fraught with danger. The "moral hazard" objection should be taken seriously all the more so because it is often difficult to distinguish a liquidity crisis from a solvency one. Besides, the Fund has only limited resources and, by contrast to a "normal" lender of last resort (i.e. a Central Bank), has no ability to issue money.

And if one assumes that a solvent country loses market access (the only case where the Meltzer Report envisages a lending role by the IMF), one fails to understand how a "penalty" rate applied by the Fund so as to make its assistance more expensive than the most recent market rate obtained by the country in question (by definition, already significantly dissuasive since it would be a "pre-seizure" rate) could help the interested debtor when one thinks of the potential magnitude of present spreads in crises situations. The fact of the matter is that, in a crisis situation, regaining market access requires the combination of several "reassurance factors" :

a program negotiated by the Fund with the debtor country (macroeconomic discipline is always at the heart of the process allowing a country to regain market access). Here, the Fund has a unique role to play, one that no other institution can taker over ;

some financing provided by the IMF, but not necessarily in very large amounts (much depends on the balance of payments requirements, on market sentiment, and on the degree of involvement of the private sector in the problem).

Indeed it seems logical that the IMF should devote more attention and efforts to the private sector involvement (PSI) in debt crises management. In a world where most of the debt is incurred by and owed to the private sector, it is normal and healthy that private creditors be called upon at an early stage to discuss debt reschedulings, standstills…. Today, the problem is more complex than it was in the 80's (when banks were the main actors) but it remains that private creditors (be they banks or bondholders) can and should be involved in orderly solutions whenever that appears possible.Hopefully there are signs that suggest that the new IMF management is moving in that direction. The revival of the debate by Anne Krueger, Deputy Managing Director of the IMF on a bankruptcy procedure, and the new position of the US Treasury for encouraging collective action clauses means that the PSI debate is coming to a new level.

3 <u>The functioning of the international monetary system</u>

Aside form multilateral surveillance -which has its limits- and barring any revival of the SDR (international liquidity creation in cases of global need) -which I presently see as very remote-, the Fund could play a major role in the functioning of the exchange rate system <u>if</u> the main players (G 3) decided to coordinate their policies in a way conducive to more stability. But that is another story

After reviewing the IMF and the World Bank activities, we draw here a scenario for the involvement of the private sector in playing a role in shaping the new international financial architecture through the monitoring of countries compliance with international financial standards.

THE WAY FORWARD : The Private Sector and Standard Formulation and Enforcement

The formulation of internationally acceptable standards represents a significant (if not the only) element of efforts to reform global financial architecture. Following the financial crisis of 1997/98, the international community reached a consensus that elaboration of best practice standards in key policy areas and the creation of public and private incentives to achieve compliance were desirable. To their credit, international institutions and other standard-setting bodies, encouraged by the G-7, have in fact succeeded in articulating these standards .

The on-going standard-setting process, however, has suffered from important weaknesses. In the first place, non-G7 countries have had little effective participation in the standard-setting process. If non-G7 countries are excluded from that process and therefore do not have the incentives to embrace and implement international financial standards, the process may come to little consequence. Broadening the number of countries actively involved in identifying and developing financial standards (and other norms that have bearings on financial system stability) in the institutional form of the G20, which includes G7 countries and many non-G7 emerging market economies, has been an important step in the right direction.

Secondly, the burden of designing institutional reforms and developing international financial standards has so far fallen primarily on international financial institutions, the IMF in particular, and national governments. At the heart of the reforms are *national* policy changes: better data yielding greater informational transparency, better IMF monitoring, more clarity in terms of insolvency and supervisory procedures. National policy changes and institutional reforms promoted by the Bretton Woods institutions have not always been responsive to the needs of the private sector in many emerging and developing economies, and it follows that the inputs from private market actors have not been fully incorporated into the process of standard formulation.

This leads to the third and most critical point. Private-sector involvement in the process of standard formulation and implementation has been insufficient and is particularly weak in the context of emerging market economies. As mentioned in the previous sections, one major lesson derived from recent financial crises suggests that institutional reforms needed to minimise the incidence of such crises should extend beyond macro-economic management policies. Without greater efforts to integrate the information and norms developed through these standards into the investment and risk management decisions of private firms, the process remains incomplete. The private sector as such constitutes the "front line" in terms of risk management and financial supervision in the global financial order. Market oriented and prudent private sector behaviour is central to the containment of systemic risk.[1] Trends in Basle Committee banking supervisory standards recognise this important element of private sector responsibility.[2] In this sense the next stage of the standard-building process in emerging market economies is to better integrate the information provided by the new official standards into the decision-making processes of private firms, and to encourage better standards of corporate governance and behaviour in the financial sector. This can be viewed from two angles: providing information for companies seeking to measure the investment climate in a particular country; and to ensure that the risk management, corporate governance and investment behaviour of the financial institutions of a

[1] See Group of Thirty, Report on Systemic Risk

particular country (and therefore its financial sector) are sound.

The position of the private sector relative to the standard-setting process is nonetheless problematical in emerging market countries. “Given their recent origin, most market participants are not very familiar with either the 12 standards recognised by the FSF as key to sound financial systems or the [International Monetary] Fund-[World] Bank *Reports on Observance of Standards and Codes* (ROSCs)”, observed a report published in connection with the September 1999 meeting of the Forum. “Few market participants to-date explicitly take account of an economy’s observance of standards in their lending and investment decisions or use ROSCs directly for risk-assessments leading to pricing and allocation decisions”.[3]

The report also notes that market incentives are more likely to be effective if market participants use information on the economy’s observance of standards in their risk assessments and reflect this in pricing or allocation of credit or investment to that economy or institutions in that economy. Furthermore, pre-conditions for market incentives to work are also needed. As suggested in the report, for market incentives to work, market participants need to: (1) be familiar with international standards; (2) judge them to be of relevance to their risk assessments; (3) have access to credible and timely information on the observance of standards.

Currently, however, there is no source of credible, timely information available to the private sector (from either public or private sectors) which profiles the country observance of standards. The ROSC process, which has just been initiated, is not comprehensive or updated to stay current. The information generated from the reports on the observance of standards and codes is not organised and presented in a form that is usable by market participants. Concerning the role that the private sector should play in generating information on the observance of standards,

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[2] Basle Committee on Banking Supervision, New Capital Adequacy Accord.

these reports have noted that views are "mixed."

The balance of this section focuses on the desirability of private activity in generating usable information on standard compliance and on the importance of such information for risk management functions in private institutions, including rating agencies.

At present, country risk assessment in the private sector, including rating agencies, concentrates on macro-economic analysis and forecasting. Recently efforts have been made to improve the efficiency of macro-models, particularly by complementing them with scenario analysis and "stress testing conventions",[4] and to improve both predictive capabilities and crisis preparedness. The rating agencies seem to be better acquainted with and pay more attention to observance of standards. They claim that their direct access to national authorities (and sometimes confidential data) provide them with a more in-depth understanding of the quality of supervision and regulation, policy and data transparency and market infrastructure.[5] Very little specific information about standards compliance appears in the country rating reports by rating agencies.

Concentrating on enhanced macro-models and the issues concerning utilisation of confidential information have drawn the attention of private sector institutions away from a comprehensive and on-going monitoring of compliance with standards. Nonetheless, this chapter argues that there is a strong case to be made for private sector initiatives to generate comprehensive, timely,

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[3] The Financial Stability Forum Report (Washington, D.C.: The Financial Stability Forum, September 1999).

[4] As an example, the Council on Foreign Relations recently concluded "Roundtable on Country Risk in the Post-Asian Crisis Era: Identifying Risks, Strategies, and Policy Implications" summarizing work covered from October 1999 to September 2000.

[5] *The Financial Stability Forum Report*, (Washington, D.C.: the Financial Stability Forum, September 1999), p.7.

user-friendly information, based on public information only concerning country compliance with the standards in the 12 key policy areas.[6]

These particular standards are important because national experiences with recent crises have demonstrated that when a country came under financial stress and headed toward crisis, it usually resulted from a combination of macro-imbalances, market risks, and the effects of regional contagion. To the extent that there were deficiencies or a poor state of affairs in these key policy areas, the crisis, which was magnified in terms of exposure to risk and losses sustained, became more complex to manage and more difficult to resolve. Examples abounded in Asian financial crisis of 1997-98. Publication by the Thai government of heretofore-unreported foreign exchange forward sales changed the market perception that the country had abundant exchange reserves to one of an alarming near zero net reserve balance. The lack of a workable bankruptcy and corporate re-organisation regime in Indonesia has made it impossible to resolve the massive private-sector debt defaults and bring the country out of the crisis. Most recently, reports of the hidden $26 billion deficit in the Daewoo Group of Korea in its net worth has frustrated resolution of the debt problem of this conglomerate. This problem occurred because local accounting and auditing standards were deficient. In fact, numerous notable deficiencies existed in each of the key policy areas during this period, with widespread negative consequences.

Even though the private sector had some knowledge of standard deficiencies in many countries, they relied on an ability to anticipate macro-economic performance and trusted to the willingness and ability of governments to manage through crises. Painful experience made clear that these assumptions were fallacious. It can be argued that today governments' intent and

[6] Financial Stability Forum and the Compendium of Standards

capability to accept and comply with global standards have become the critical factor in determining the true and ultimate risk of taking on exposure of any kind by lenders and investors.

It is sometimes claimed that the standards articulated in the 12 keys policy areas are "Anglo-Saxon" in character, and therefore not relevant or applicable to many countries for one reason or another. While the characterisation of the standards is correct, the standards are appropriate because they represent the fullest elaboration of disciplines that should be observed to protect the *fiduciary responsibilities* of lenders and investors. Lenders and investors conduct their activities with third party resources—capital, deposits, borrowings, and fiduciary funds. They are accountable for the consequences of putting these resources at risk to earn a return. This standard applies to all markets. It applies to both domestic and cross border activities, covers both public and private sector activities, and transcends any cultural value system. Simply put, any party using funds sourced from third parties for any purpose has the obligation (legally and morally) to deploy those funds prudently, within the best attainable risk parameters. This is why the articulated standards are both right and deserving of compliance. In the long run, progress in standards compliance by countries in the global economy is the best path to improving the global financial architecture in terms of risk management and transparency. Also, improved risk management and transparency are the surest path to crisis prevention and the best option to managing crises in a timely and effective manner.

Now let us assume that the private sector has access to timely, comprehensive and usable public information concerning country compliance with standards. Why should this information be utilised in credit and allocation decisions, *as additional key inputs* to these processes? This question deserves specific answers. Firstly, no country in the world is in full compliance with the

12 recognised standards; regrettably, many countries have made no progress whatsoever in moving toward compliance. The important point is that any country, which moves from non-compliance toward compliance with these standards, improves its risk and transparency profile relative to lenders and investors.

Secondly, based on public information only, some countries have not stated any position on the adoption of and compliance with standards. Some countries have stated publicly that they will not adopt and/or comply with global standards as a whole or in part. Although some countries have stated that they are adopting and/or moving towards compliance with particular standards, they are silent as to their approach to the body of standards as a whole. Countries that articulate a public programme of implementing all standards signal a strong desire to improve their risk and transparency position versus global benchmarks. The significance of these responses is that it gauges a country's declared intent relative to the enactment and implementation of standards. Intent relative to the standards is an accurate proxy for a country's desire or lack thereof to be a full participant in the global economic system. We have learned that responsible country behaviour in the global community requires both the *willingness* to accept the responsibilities for investment and debt commitments as well as the *ability* to discharge these responsibilities.

Public silence on the standards by a country implies that that country either does not know about the standards or does not care about standards, an important point for investors and lenders to consider. Countries that publicly state their intention no to comply with standards, have serious reservations about becoming responsible members of the global economy. Countries that publicly communicate relative to specific standards but omit consideration of other standards or only state a view towards total compliance with standards lack comprehensive coherence in their efforts to adopt standards. Countries that express a coherent view of intent to adopt and comply with standards, actually commit themselves to be responsible members of the global economy. It is possible therefore to establish a country's *intent* or *lack thereof* from the sources of public information. Again this is a key point for market participants to consider in their risk assessment concerning the credibility of countries.

Thirdly, a publicly available profile of country attitudes and programmes relative to standards adds a significant additional dimension to the process of assessing country risks. It strongly enhances the conventional macro-analysis based models (which attempt to assess the ability of countries to service their debts). This enhanced public profile will be an important step forward the establishment of a more effective "market discipline" on countries. More effective market discipline is a powerful force for positive changes in the global economy.

Fourthly, a public profile of a country's positions on standards allows an explicit examination of specific important risks involved in conducting private investment and lending activity in that country. Since governments can no longer be relied upon to "bail-out" private investors and lenders, careful analysis and understanding of these risks becomes vital to risk management and investment decisions in private institutions. Lack of compliance with the macro-data standards for national macro-statistics and lack of transparency in fiscal and monetary policies imply that the private sector is exposed to hidden risks that can compromise, seriously and suddenly, the country's macro-performance. Non-compliance with international auditing and accounting standards means that risks are opaque in all institutions within a country. Lack of an appropriate bankruptcy regime means that workable restructuring or exiting from troubled investments/loans is nearly impossible, exposing private loans and investments to total write off. Absence of adequate corporate governance standards creates uncertainty concerning the quality of management of all institutions in a country. Non-compliance with international standards for regulating banks, insurance companies, securities companies and the payments mechanism makes it impossible to determine whether or not a country's financial system is safe and sound. The poor state of financial institutions in many Asian countries compounded the magnitude of each crisis to a major degree, and is responsible for the fact that in several countries (Indonesia, Korea, Japan etc.) the crisis remains unresolved.

Finally, private investors and lenders may be able to improve risk and transparency in the global financial system (which redounds to their direct material benefit), if they require accurate, timely information about standard compliance from counter-parties that are potential recipients of investments and loans from them, and if they can differentiate terms, pricing and allocation decisions to reward counter-parties that comply with the standards and to penalise those which do not. If private investors and lenders act in this manner, there will be the most powerful stimulus to compliance with standards. Compliance with standards will then be a critical factor (together with sound macro-performance) in determining the degree and terms of access of countries to private markets, which control the preponderance of resources they need to support their trade and development. This linkage is totally lacking today; if it can be achieved the global economy is more likely to be in a considerably better condition.