Reforming the International Financial System

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- *A series of financial crises in emerging-market economies during the 1990s was the catalyst for efforts to strengthen the international financial system.*
- *Such efforts have focused on two broad areas: crisis prevention and crisis management. Under crisis prevention, particular attention has been paid to the need for appropriate macroeconomic policies, including sustainable exchange rate regimes, prudent risk management by governments and lending institutions, sound domestic financial systems, and transparent national policies.*
- *Under crisis management, agreement has been reached on providing the International Monetary Fund (IMF) with access to additional resources for lending to countries experiencing financial crises. New lending facilities for countries that might need financial assistance have also been established at the IMF.*
- *It is also agreed that IMF money available to countries seeking assistance is limited, and that the private sector will consequently have to play a greater role than in the past in crisis resolution. Work continues on finding an appropriate balance between providing official assistance to countries in crisis and allowing debtors and private creditors to find their own solutions to debt problems.*
- *New international groups involving major emerging-market economies have been established to discuss global policy issues and to promote international financial stability.*

The Mexican peso crisis, which broke in December 1994, was the catalyst for major reform of the international financial system. Mexico's crawling-peg exchange rate system collapsed and, despite massive financial assistance from the international community, the country experienced a deep recession.[1] The Mexican crisis had repercussions throughout the world. Other countries in Latin America, such as Argentina, which shared many of Mexico's economic characteristics, experienced significant capital outflows (the so-called "tequila effect"). Some advanced countries, including Canada, also felt the side effects of the peso crisis as investors closely scrutinized the relative merits of countries as recipients of capital flows.

These events prompted the major advanced countries to re-examine the international financial system and to seek improvements that would reduce the frequency and virulence of financial crises. Such a major reassessment of the system had not occurred since the mid-1970s, following the collapse of the Bretton Woods system of fixed exchange rates. Endorsed by leaders at the Halifax Summit, work by the Group of Ten countries began in the summer of 1995. The goal was to ensure that the IMF had adequate resources to meet potential demands from member countries and that it could respond quickly to financial crises. The group also looked for new ways to prevent crises and to manage them when they did occur.

Two years later, fresh crises in emerging markets lent new urgency to the reform efforts. In late 1997, Thailand, Indonesia, and Korea, economies that had previously been considered well managed, experienced major financial crises in quick succession. Like Mexico, the three countries experienced sharp recessions and marked declines in the external value of their currencies.

1. Total international assistance to Mexico amounted to roughly US$40 billion.

Record financial-assistance packages were assembled by the IMF and the development banks, buttressed by additional short-term lending from industrial countries.[2] Other Asian economies were also affected, including Malaysia and the Philippines. During 1998 and early 1999, the contagion spread. In August 1998, Russia defaulted on its domestic obligations and floated the rouble, prompting investors to reassess their lending to all emerging markets. Yield spreads between emerging-market debt and U.S. Treasury debt soared, and a major hedge fund, which had speculated on interest rate spreads, ran into financial difficulties. In the autumn of 1998, Brazil, a major international borrower, sought financial support from the Fund and from the international community totalling approximately US$42 billion in response to significant capital outflows. Despite this assistance, Brazil was forced to float its currency in January 1999.

With some commentators calling the 1997–98 global financial crisis the worst in 50 years, policy-makers and market participants around the world redoubled their efforts to reform the "international financial architecture." Their efforts have focused on two broad areas: crisis prevention and crisis management.

This article outlines the issues regarding institutional and policy reform that have been discussed at the international level as well as the steps that have been taken to strengthen the international financial system. It follows an earlier *Review* article that examined the causes and timing of currency crises, a subject of considerable economic research in recent years (Osakwe and Schembri 1998).

Crisis Prevention

Measures to reduce the frequency of international crises have taken two broad forms. First, new international bodies have been created and old ones strengthened to help identify, discuss, and deal with problems in the global financial system in a timely fashion. Second, countries have taken various measures to reduce their vulnerability to financial crises. These measures have often been implemented with the assistance of international financial institutions.

New international groups

The global repercussions of the crises in emerging markets underscored the growing importance of these economies and the need to involve them in international discussions and decision-making. Thus, in 1998, seven emerging-market economies joined the G-10 and other advanced countries in providing the IMF with access to supplementary resources that it could draw upon in financial crises.[3] (See section on IMF resources.) As well, monetary authorities from over 20 emerging markets have become shareholders in the Bank for International Settlements (BIS) and actively participate in discussions among central banks held at that venue.[4]

Several new groups were also formed. The Financial Stability Forum (FSF) was established in the spring of 1999, following a report commissioned by the G-7 finance ministers and governors the previous year. The forum consists of national authorities responsible for financial stability in G-7 countries (supervisors, central banks, and finance ministries) as well as Australia, the Netherlands, Hong Kong, and Singapore, representatives of standard-setting bodies, and international financial institutions. The FSF identifies and assesses vulnerabilities in the international financial system, oversees initiatives to address systemic vulnerabilities, and improves coordination and information exchanges among national and international authorities. Working groups of the FSF, which have included representatives of emerging markets, have examined a range of issues including highly leveraged institutions, capital flows, offshore financial centres, deposit insurance, and key standards for sound financial systems.

Another important group established in 1999 is the Group of 20 (G-20). While G-7 finance ministers and central bank governors have met frequently since the 1980s to discuss international economic developments, the crisis in emerging markets underscored the need for similar, ongoing discussions among a broader, more globally representative, group of countries.

The G-20 membership includes finance ministers and governors from 19 countries and the European Union.[5] The IMF and the World Bank are also represented. The G-20's mandate is to discuss and review global policy issues and, more generally, to promote international

2. Total international assistance for Thailand, Indonesia, and Korea amounted to roughly US$17 billion, US$47 billion, and US$58 billion, respectively.

3. These seven are: the Hong Kong Monetary Authority, Korea, Kuwait, Malaysia, Saudi Arabia, Singapore, and Thailand.

4. These include: China, Russia, India, Brazil, Mexico, Argentina, South Africa, Korea, Malaysia, Thailand, Turkey, Singapore, and Hong Kong. Eastern European countries and the Baltic states are also represented.

5. Countries in the G-20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

financial stability. Issues discussed have included exchange rate regimes, standards and codes, debt management, and the role of the private sector in managing and resolving financial crises. With most systemically important countries represented directly, or indirectly, the G-20 can provide strong political support for global initiatives. It can also address issues that transcend any single international financial institution. Paul Martin, Canada's Minister of Finance, is the current chairman of the G-20.

In September 1999, the Interim Committee of the IMF, its principal advisory body, was transformed into the International Monetary and Financial Committee (IMFC). The committee's membership consists of IMF governors (typically finance ministers or central bank governors) of those countries that have been appointed or elected to the IMF's 24-member Executive Board. As was the case with the Interim Committee, the IMFC advises and reports to the IMF's Board of Governors on IMF-related issues, including the international monetary and financial system. The transformation of the Interim Committee involved more than just a name change. Its advisory role was strengthened with the introduction of a deputies' process. IMFC deputies from finance ministries and central banks now regularly meet before IMFC meetings to allow for greater debate and consensus-building among IMF members on key issues.

The recent crises in Asian countries demonstrated that low inflation and sound fiscal accounts were not sufficient to avoid a financial crisis.

Measures to reduce vulnerability

Efforts to reduce the vulnerability of countries to financial crises have been directed to many areas. This reflects the complexity of the problem and the value of a holistic approach to crisis prevention. The recent crises in Asian countries, for example, demonstrated that low inflation and sound fiscal accounts were not sufficient to avoid a financial crisis. Efforts to reduce vulnerabilities have involved a large number of players, including the national authorities of both advanced and emerging-market economies, international financial institutions, and international standard-setting bodies.

Macroeconomic policies

The first line of defence against financial crises is to ensure that a country's macroeconomic fundamentals are sound and that there is a policy framework that can deal with economic and financial shocks. Fiscal policy must be on a sustainable track, with monetary policy directed at achieving low and stable inflation. The choice of exchange rate regime is also extremely important. A common feature of all the crises in emerging markets during the 1990s was an unwillingness to adjust a fixed, or quasi-fixed, exchange rate in response to changing economic circumstances.

While no single exchange rate system is likely to be suited to all countries under all circumstances, there is growing support for the view that traditional pegged, or crawling-peg, exchange rate regimes are less sustainable than fully flexible systems, or "hard" exchange pegs (e.g., a currency board, dollarization, or currency union). Indeed, during the 1990s, the percentage of IMF members maintaining intermediate exchange rate regimes fell by roughly one-half (Fischer 2001).

Intermediate exchange rate systems are susceptible to crises for two main reasons. First, it is often politically difficult for a country to change its exchange rate regime without a crisis. During tranquil periods, there is no incentive to float, while during periods of stress, policy-makers are concerned that floating will damage their policy credibility.

Second, a fixed exchange rate can act as an apparent guarantee to borrowers and investors, relieving them of the need to hedge themselves against adverse exchange rate changes. As long as an exchange rate peg is credible and foreign currency interest rates are lower than domestic rates, as is typically the case in emerging markets, there is an incentive for domestic borrowers in developing countries to borrow in foreign currency. However, should confidence in the government's ability to defend the exchange rate erode, a "race for the exits" can occur, ultimately leading to a currency crisis. In many emerging-market economies, the incentive to borrow in foreign currency was often magnified by underdeveloped domestic financial systems.

Given this market dynamic, a country with an open capital market essentially has two long-run choices: to introduce a flexible exchange rate (combined importantly with an accompanying domestic anchor for monetary policy), or to reinforce a fixed exchange rate

by introducing a currency board or adopting a common currency, thereby reducing, or eliminating, the prospect of a successful speculative attack.

Capital controls

The success of China, India, and Chile, which maintained capital controls during the 1990s, in avoiding the emerging-market crises, has given credence to the view that controls may be a useful additional tool for macroeconomic management in emerging-market economies. Particular attention has been paid to the Chilean experience, where the authorities introduced reserve requirements in the early 1990s that discouraged short-term capital inflows—the type of money typically viewed as the most at risk of flight should investor sentiment change. Studies of the Chilean case suggest that while such controls had limited success in reducing the overall size of capital inflows, they were effective in altering the composition of inflows away from short-term money in favour of longer-term funds (Valdés-Prieto and Soto 1998 or Cowan and De Gregorio 1998).

Critics of controls, however, point to other reasons for Chile's success. These include a healthy financial system, good macroeconomic management, and a significant degree of exchange rate flexibility. Previous experience has also shown that the effectiveness of controls erodes over time as market participants learn to circumvent them (Mathieson and Rojas-Suárez 1993). Indeed, the ability to evade controls is likely to have increased in recent years because of technological developments, financial innovations (especially derivatives), better communications, and broader economic linkages among countries. Controls may also impose other costs on the economy, for example increased corruption, expansion of the underground economy, and a reduction of capital to companies that don't have access to alternative sources of financing. Nonetheless, prudential controls on inflows into the banking system could be a useful temporary expedient in countries with fragile or undeveloped financial systems.

The case for controls on capital outflows is considerably less compelling. To the extent that they are effective, controls may reduce market discipline, allowing governments to pursue poor macroeconomic policies for extended periods. As with controls over capital inflows, controls on outflows erode over time. Indeed, experience during the 1970s and 1980s has shown that such controls were ineffective in limiting capital flight from developing countries. Moreover, such controls may lead to reduced capital inflows if potential investors worry about their ability to remove their funds in the future. Nevertheless, temporary controls on capital outflows may be helpful in times of severe financial crisis, providing an opportunity for governments to implement necessary changes in domestic policy.

Sound domestic financial systems

One distinguishing characteristic of the recent financial crises in emerging markets was the prominent role played by domestic financial institutions. In most cases, the magnitude of the crisis was exacerbated by weak banking systems. While the causality between balance-of-payments crises and banking crises can run in both directions, a banking crisis often precedes a balance-of-payments crisis (Kaminsky and Reinhart 1996).

Given these linkages, the international community has focused on strengthening financial systems in both emerging-market economies and advanced countries. Particular emphasis has been placed on establishing internationally accepted codes and standards of best practices to help guide authorities in such efforts. To date, roughly 60 such standards have been developed, the bulk of which focus on various aspects of financial regulation and supervision (Financial Stability Forum 2000a).

While a large number of international institutions have been involved in helping to develop codes and standards, including the IMF, the World Bank, and the BIS, the Basel Committee for Banking Supervision has taken the lead. Following up on a call by G-7 leaders at the Lyons Summit in 1996, the Basel Committee developed 25 Core Principles for Effective Banking Supervision (Basel Committee 1997). These principles, which were developed in consultation with non-G-10 supervisory authorities and released in 1997, cover seven broad headings including preconditions for effective supervision, licensing and structure, prudential regulations, methods of ongoing supervision, information requirements, powers of supervisors, and cross-border banking. Comparable principles were subsequently developed for securities supervision by the International Organization of Securities Commissions (IOSCO) and for insurance supervision by the International Association of Insurance Supervisors (IAIS).

In 1999, a working group of the Basel Committee released a followup report that examined the adequacy of the core principles in light of the Asian crisis. Among other things, this report contended that some creditor banks may have increased their exposure to

private borrowers under the assumption that their loans would be protected by an implicit government guarantee, which led them to take on larger exposures than they would have done otherwise. The report also underscored the importance of sound liquidity and credit-risk management by banks and argued that the interrelationship of various types of risks—especially liquidity risk and market risk—and the speed and extent to which financial crises spread from one country to another, had been underestimated during the Asian crisis (Bonte et al. 1999). This further underscored the importance of strong risk-management systems. Following the near-collapse of Long-Term Capital Management, a major U.S. hedge fund, in September 1998, the Basel Committee issued additional guidelines in early 1999, which emphasized that effective management of counterparty risk was essential for prudent banking (Basel Committee 1999a).[6]

Work also continued on updating the capital-adequacy framework for internationally active banks, which was originally introduced in 1988. The Basel Committee's revised framework was released for public consultation in late 1999. The framework was based on three pillars: (i) minimum regulatory capital, (ii) supervisory reviews of an institution's capital and assessment process, and (iii) market discipline (Basel Committee 1999b). The Basel Committee also proposed a new system for weighting risk based on external credit assessments. For certain sophisticated banks, the committee suggested that internal ratings could be used, subject to guidelines and supervisory approval. The upshot of these changes would be to reduce the amount of capital that banks would be obliged to hold against loans to high-quality corporations and to increase the amount of capital required against loans to low-quality borrowers.

A second consultative document on the Basel Capital Accord was released in mid-January 2001 for public comment by the end of May. It is envisaged that the new accord will be finalized by the Basel Committee by the end of the year, with implementation expected in 2004.

The development of safe and efficient payments systems for the transfer of funds between financial institutions—an essential feature of an effective financial system—has been another area of considerable international co-operation. In 1998, the Committee on Payment and Settlement Systems at the BIS established a task force on payments systems and practices. This task force was composed of representatives from the central banks of advanced countries (including the Bank of Canada) and emerging-market economies, the IMF, the BIS, and the World Bank. Following public consultations, guiding principles for systemically important payments systems were published in January 2001 (Committee on Payment and Settlement Systems 2001). The report's 10 core principles are seen as being particularly helpful for emerging-market economies that are trying to improve existing systems in order to cope with growing domestic and international capital flows.[7]

Given the large number of internationally accepted codes and standards, the limited resources of many emerging markets, and differing priorities among countries, it has been necessary to prioritize. To concentrate efforts on those deemed to be most important for financial stability, a task force of the Financial Stability Forum recently established a list of 12 key codes and standards for sound financial systems. In addition to dealing with financial regulation and supervision, they cover macroeconomic fundamentals (fiscal policy, monetary policy, and data dissemination) as well as institutional and market infrastructure (insolvency, corporate governance, accounting, auditing, payments and settlement systems, and market integrity).

To assist emerging-market economies to develop the necessary supervisory expertise, international financial institutions and national supervisory authorities have provided considerable technical assistance. In 1999, the BIS, in conjunction with the Basel Committee, established the Financial Stability Institute with a mandate to help supervisors improve and strengthen their financial systems. The institute works closely with the Toronto International Leadership Centre for Financial Sector Supervision, which was founded in 1998 with financial support from the Government of Canada and the World Bank.

6. Hedge funds themselves have also been the subject of considerable discussion, particularly their activities leading up to and during the Asian crisis. Although such funds were active in some countries, the consensus is that they did not play a pivotal role. Domestic financial and non-financial institutions were typically "first off the mark" to sell Asian currencies (Eichengreen and Mathieson 1999). Nonetheless, concern about the activities of hedge funds has promoted debate over the merits of increased regulation of such funds as well as greater public disclosure of their balance sheets. Most reports on the activities of hedge funds (e.g., by the Basel Committee or IOSCO) have come out against direct regulation, at least for the time being, waiting to see whether other indirect measures can effectively improve credit-risk management and moderate the amount of leverage in the global financial system.

7. See "Core Principles for Systemically Important Payments Systems and Their Application in Canada," by Clyde Goodlet in this issue of the *Review*, p. 19.

The G-20 countries have agreed on the importance of standards and codes to address weaknesses in financial systems, have endorsed the work of the Financial Stability Forum, and have encouraged continued work on incentives to promote implementation. The IMF reviews countries' adherence to international codes and standards in the context of its regular assessments of its members' economic policies and prospects. Reports on the Observation of Standards and Codes are now published. The Fund works closely with the World Bank and with other bodies that set international standards.

Debt management

A broad international consensus has also emerged regarding the importance of prudent asset-liability management, with a particular focus on the balance sheets of governments and the financial system (Financial Stability Forum 2000b).

Of course, prudent government debt management starts with a fiscal policy that is on a sustainable track. A rising level of government indebtedness as a proportion of national income will eventually threaten financial stability. But care must also be taken to avoid excessive reliance on short-term borrowing, particularly in foreign currency, and on the "bunching" of debt payments. Governments must also consider contingent claims upon them, such as sovereign guarantees of private sector debts.

The nature of a government's liabilities and its ability to borrow in international capital markets will also affect the management of a country's foreign assets. Countries with a high proportion of liquid liabilities and a low international credit rating should hold more international reserves than countries with a high credit rating and few maturing liabilities. By the same token, countries pursuing a fixed exchange rate regime also need to hold more reserves.

In assessing a country's vulnerability to financial crises, it is useful for the government to also be aware of the activities of the other principal players in the economy, particularly financial institutions. While such institutions are subject to regulatory and supervisory oversight and manage their own liquidity, in a crisis, governments may be called upon to provide their financial institutions with foreign currency support (e.g., Korea in 1997–98). To facilitate the monitoring of external exposures, the establishment of a national balance sheet of a country's external assets and liabilities, breaking out key sectors, might also prove useful. Care would have to be taken, however, to avoid moral hazard. Such a situation could arise if market participants came to believe that the risks that they incur were being moderated by the actions of government. Guidelines on good practices in public debt management are currently being developed by the IMF and the World Bank in collaboration with national debt-management experts.

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The development of domestic financial markets, both bond markets and banking systems, has also been widely supported as a way of reducing the vulnerability of emerging-market economies to financial crises. Evidence suggests that the domestic financial sector plays a critical role in ensuring that capital inflows contribute to higher economic growth (Bailliu 2000). In the absence of an adequate domestic market, borrowers have limited options. Either they borrow short-term money in domestic currency and risk being unable to roll over their loans at affordable interest rates in the event of a financial crisis, or they borrow longer-term money in foreign currency and risk being unable to service their debts in the event of a devaluation of the domestic currency because of the increased cost in domestic currency.

Enhanced transparency

While the necessity of reliable, timely economic and financial data has long been recognized for the efficient operation of markets, the Mexican peso crisis underscored the importance of increased transparency. A thorough understanding of economic conditions in countries helps in two ways. First, a stream of timely, accurate data helps investors adjust to new information more smoothly. Second, accurate data reduce the risk of contagion. As noted earlier, several countries were adversely affected by the 1994 peso crisis because they were thought to be similar to Mexico—the so-called "tequila effect." Better information can help markets to distinguish risk levels among countries.

Internationally accepted standards for the dissemination of data were established in early 1996 when the IMF introduced the Special Data Dissemination Standard (SDDS). This standard was established to guide member countries "that have, or that might seek, access to international capital markets in the provision of their economic and financial data to the public" (IMF Web site). To date, 47 countries have subscribed to the standard, which covers four broad dimensions—the data themselves (i.e., coverage, frequency, and timeliness), public accessibility, the integrity of the data, and their quality. Data covered by the standard include output, prices, the fiscal accounts, and the external accounts. In response to shortcomings that became apparent as a result of the Asian crisis, the SDDS has recently been enhanced by the inclusion of information on international reserves and liquidity management.

The IMF maintains an electronic bulletin board that describes the dissemination practices of countries that subscribe to the standard. Many countries, including Canada, provide hyperlinks between this bulletin board and sources that provide national data.

In December 1997, a less-demanding General Data Dissemination System (GDDS), open to all IMF members on a voluntary basis, was also established. In addition to the macroeconomic, financial, and external data covered by the SDDS, the GDDS also includes information related to population, education, poverty, and health. Unlike the SDDS, the GDDS is less prescriptive and does not set deadlines for participants to meet certain objectives with respect to data quality.

Enhanced economic surveillance

The International Monetary Fund is the world's leading economic surveillance institution. Through its "Article IV" consultations with member countries, it regularly reviews and comments on the economic developments, policies, and prospects of its members. Following the Asian crisis and an extensive external review (IMF 1999), the IMF took steps to strengthen its surveillance practices. Working with other international financial institutions and competent professional bodies, the IMF has broadened the scope of its surveillance. It now pays more attention to developments and trends in capital accounts, including the risks of reversals in capital flows, policy interdependence and contagion, and the health of domestic financial sectors. The Fund also participates in regional surveillance exercises such as the "Manila Framework" meetings of countries on the Pacific Rim.

To strengthen its surveillance of financial systems, the IMF, in collaboration with the World Bank, launched the Financial Sector Assessment Program (FSAP). Such assessments identify the strengths, weaknesses, and risks of members' financial systems. These assessments, which feed into the IMF's regular surveillance process, are conducted by teams composed of staff from the IMF and from other international bodies, as well as national supervisors and central banks. Canada was one of the first countries to undergo such an assessment (IMF 2000b). Canadian experts, including representatives from the Bank of Canada, have participated in assessments of other countries.

As already noted, the IMF has also assumed a leading role in monitoring country compliance with internationally accepted codes and standards.

In an effort to strengthen its surveillance activities and provide more information to markets about Fund programs and their underlying assumptions, the IMF has also become more open regarding the policy recommendations and programs negotiated with member countries. Since mid-1997, the IMF has been releasing public information notices (or PINs) on the conclusions of Article IV discussions at the Executive Board. Letters of intent and policy-framework papers issued by members are now also routinely released to the public. In June 1999, a pilot project was launched for the voluntary publication of reports of Article IV consultations with countries. The IMF's report on Canada, as well as the statement by the IMF mission to Canada on Canadian economic policies, is published regularly. [8]

Crisis Management

No matter how effective preventive measures are, financial crises will occur. Efforts to improve crisis management have taken two tracks. The first involved ensuring that the IMF has the necessary financial resources and lending programs, as well as the ability to respond quickly to crises. The second involved finding new and better ways of dealing with financial crises.

IMF resources

After the Mexican peso crisis, work began to ensure that the Fund's own resources were adequate, given the expansion of the global economy and increased capital mobility, and that it had access to sufficient supplementary resources in the event that its own

8. For information on the 2001 Report and Mission Statement, see the Department of Finance's Web site, press release, 1 February 2001 and the IMF's Web site.

resources were not enough to deal with a potentially systemic financial crisis. At the Halifax Summit in June 1995, G-7 leaders called for a doubling of the SDR17 billion available to the IMF under the General Arrangements to Borrow (GAB) to respond to financial crises.[9] Following lengthy negotiations, the New Arrangements to Borrow (NAB) were approved by the IMF's Executive Board in early 1997 and came into force in November 1998. Under the NAB, 25 participating countries and monetary authorities agreed to provide up to SDR34 billion in supplementary resources to the IMF to help it "forestall or cope with an impairment of the international monetary system or to deal with an exceptional situation that poses a threat to the stability of that system."[10] The establishment of the NAB did not replace the GAB, which remained in force. However, the NAB became the arrangement of first recourse.

The GAB was activated during the summer of 1998 to help finance the IMF's loan of SDR8.5 billion to Russia. This was the first time in 20 years that the GAB had been activated. Following its entry into force, the NAB was activated in December 1998 to help finance the IMF's loan of SDR13 billion to Brazil.

The Fund has also taken steps to increase its own resources. A 45 per cent quota increase, raising the Fund's total quotas to SDR210 billion, took effect in January 1999.[11]

Emergency-financing mechanism

Events surrounding the Mexican peso crisis in late 1994, underscored the need for rapid response by the IMF in a world of increasingly mobile capital. In September 1995, the Executive Board agreed to an "emergency financial mechanism" that allowed for an accelerated approval procedure for IMF financial support in special circumstances. The possibility of spillover effects (e.g., contagion) would also be considered. The emergency-financing mechanism is expected to be used only rarely. To qualify for accelerated IMF support, a member must be willing to negotiate quickly with the Fund and to introduce strong measures to deal with the crisis. A requesting member's past behaviour, in particular its willingness to co-operate with the Fund, would also be taken into consideration (IMF 1996).

New lending facilities

Redesigned lending facilities that are better able to deal with financial crises, have also been introduced, while obsolete facilities (e.g., the Buffer Stock Financing Facility) have been eliminated. In 1997, the Supplementary Reserve Facility (SRF) was established to provide additional liquidity to members experiencing a financial crisis resulting from "a sudden and disruptive loss of market confidence," such as Mexico experienced in 1994 and emerging markets faced in 1997–98 (IMF Web site). While no specific limit has been set on the amount of assistance that a country might receive, loans under the SRF must typically be repaid within 18 months. An interest surcharge over and above the usual cost of borrowing is also levied. The short maturity and higher-than-normal interest rate reflect the extraordinary nature of SRF borrowing and the expectation that the borrowing country will take immediate steps to calm financial markets and reverse the outflow of capital. This facility was used by Korea and Brazil in 1998.

In 1999, the IMF introduced Contingent Credit Lines (CCL). These allow member countries whose economies are judged to be fundamentally sound to establish precautionary lines of credit with the IMF to protect themselves against a potential financial crisis caused by contagion. Such arrangements are expected to be in the range of 300 to 500 per cent of quota. Loans under the CCL would have the same maturity as loans under the SRF. To be eligible for a contingent line of credit, a country must, among other things, have received a positive assessment from the Fund at its previous Article IV consultation, be implementing policies that are unlikely to give rise to balance-of-payments problems, be maintaining constructive relations with its private sector creditors, and be ready to submit a satisfactory economic and financial program aimed at restoring market confidence. In late 2000, steps were taken to enhance the attractiveness and

9. The General Arrangements to Borrow were established in 1962 between the IMF and a group of industrial countries, which, as members were added, became known as the Group of 10 countries (G-10). The GAB was initially intended to provide additional resources to the IMF in support of the then-prevailing system of fixed exchange rates. An SDR, or special drawing right, represents a basket of currencies consisting of the U.S. dollar, the euro, the Japanese yen, and the pound sterling. At year-end 2000, one SDR was worth CAN$1.95.

10. See IMF Press Release No. 98/57, "IMF's New Arrangements to Borrow Enter into Force." NAB participants include Australia, Austria, Belgium, Canada, Denmark, the Deutsche Bundesbank, Finland, France, the Hong Kong Monetary Authority, Italy, Japan, Korea, Kuwait, Luxembourg, Malaysia, the Netherlands, Norway, Saudi Arabia, Singapore, Spain, the Sveriges Riksbank, the Swiss National Bank, Thailand, the United Kingdom, and the United States. Canada's share is SDR1,396 million.

11. Quotas are the IMF's main source of funds and represent capital subscriptions paid by member countries. Only a portion of these quotas is readily available for IMF lending. The Fund's usable resources consist of its holdings of SDRs and currencies of member countries that are viewed as having relatively strong balance-of-payments and reserve positions.

effectiveness of the CCL. The interest rate surcharge was reduced, and the initial drawing on a CCL, equivalent to one-third of the amount of the line of credit established, became more automatic. Despite these recent modifications, no CCLs have yet been established.

Private sector involvement

Of all the issues related to the reform of the international financial system, perhaps the most contentious has been the role of the private sector in the management and resolution of financial crises. While there is universal agreement that investors should bear the risks as well as the rewards of their lending decisions, and that debtors should repay their debts fully and on time, there is considerably less agreement on what should happen when a sovereign borrower faces a financial crisis and on the respective roles of the private and official sectors in crisis resolution.

Some argue that the IMF should become a fully fledged international lender of last resort. Underpinning this recommendation is a view that there are market failures, that capital flows are very volatile, that investors are subject to financial panics, and that crises are contagious. In such a world, an international lender of last resort could help mitigate not only the effects of such instability but, by its very existence, mitigate the instability itself (Fischer 1999). The analogy is typically drawn between the IMF lending to a country and a central bank lending to illiquid, but solvent, financial institutions.

Others, however, contend that the IMF itself (and official lending in crisis situations generally) is part of the problem and should be abolished (e.g., Friedman 1998, Schwartz 1998, and Calomiris 1998). They argue that official financial support for countries in crisis allows private creditors to get their money out intact or with reduced losses. More generally, they claim that the presence of an international lender, such as the IMF, gives rise to serious problems of moral hazard, which would only be exacerbated if the Fund were to become a true international lender of last resort. When there is a lender of last resort, lenders have less need to assess and monitor foreign borrowers, which potentially leads to an increase in risky behaviour and, consequently, more financial crises. Indeed, these observers partly attribute the surge in lending to emerging markets during the 1990s, as well as the subsequent financial crises, to a belief on the part of private lenders that loans would be backstopped by official lending.

The international community has steered a middle course between these two extreme views, acknowledging that financial markets are not perfect and that the IMF has a significant financial role to play in dealing with international crises, especially those that may pose a risk to the stability of the international financial system. Moral hazard is, however, recognized as a real concern, and official money is limited. There is, consequently, little alternative but to involve the private sector in crisis management and resolution.

The IMF has a significant financial role to play in dealing with international crises, especially those that may pose a risk to the stability of the international financial system.

Sachs (1995) proposed the establishment of a formal International Bankruptcy Code or court that would facilitate a stay on payments, the provision of new working capital, and a reorganization of old debts. Chapter 11 of the U.S. bankruptcy code was suggested as a model. This chapter provides an alternative to liquidating a failing corporation by maximizing the value of the company's assets to the benefit of creditors and shareholders.

Following the Mexican peso crisis, the G-10 studied such formal mechanisms to address sovereign liquidity crises. While they were seen as having considerable appeal, the analogy with corporations was seen as flawed, since countries are sovereign. Unlike its domestic counterpart, an international court could not introduce new management or take possession of a country's assets. There were also significant practical difficulties, including diverse bankruptcy legislation and practices. It was also felt that many of the results of a formal international bankruptcy mechanism could be achieved in principle through informal mechanisms.

Both the 1996 G-10 report and a subsequent 1998 report of an ad hoc international (G-22) working group argued that a temporary debt standstill, possibly accompanied by exchange controls, might be required to stop the hemorrhaging of capital from a country in crisis and to allow time for the debtor to implement economic measures and negotiate a restructuring of

its debts. Standstills could also help by arresting a rush to the exits based on self-fulfilling creditor expectations. In such circumstances, standstills could be positive for both the debtor and its creditors.

The reports also stressed the merits of finding a voluntary co-operative solution; for example, through negotiating a voluntary rollover of maturing credits or an extension of maturities. There was also considerable support for ongoing dialogue between debtors and their creditors in both good and bad times. Better communication would allow problems to be addressed at an early stage rather than in a crisis atmosphere. With the growing importance of bond financing by countries, greater use of collective-action clauses was also recommended to expedite debt restructurings in the event of a financial crisis. Such clauses would facilitate, for example, majority voting by bondholders and the collective representation of bondholders in negotiations with a debtor in distress.[12]

This informal approach has been broadly accepted by the international community, and a framework for dealing with financial crises is emerging. Building on earlier work by the G-7 finance ministers leading up to the 1999 Köln Summit, the International Monetary and Financial Committee of the IMF agreed in April 2000 that any approach adopted by the international community should be flexible enough to deal with diverse cases (G-7 1999 and IMF 2000a). The committee also noted that there was a wide range of possible responses to financial crises. In some cases, official financing and policy adjustment would be sufficient to permit a country to regain market access. In other cases, "voluntary approaches" might be needed to overcome creditor-coordination problems, while "comprehensive debt restructuring" might be required in those cases where it was unrealistic to expect full market access to be restored. These points were reiterated by the committee at its September 2000 meeting. It also noted that "a temporary payments suspension or standstill may be unavoidable."

12. Canada announced that it would adopt collective-action clauses in its foreign currency bond issues in April 2000. The specific clauses adopted by Canada cover collective representation, majority action, and the non-acceleration of payments.

Despite this broad consensus, views differ on the appropriate balance between a clear framework for private sector involvement in crisis resolution to help condition market expectations and reduce uncertainty, and the need for flexibility that recognizes that all crises are different. In other words, to what extent should there be rules or discretion?

To help advance this debate, the Bank of Canada and the Bank of England have collaborated closely on developing an integrated, but flexible, framework for international crisis management, involving both the IMF and the private sector. A key element of this framework is a presumption that limits on official lending to countries in crisis would apply under most circumstances. The proposal also recognizes the desirability of debtors and their creditors finding a voluntary solution to a financial crisis. However, it underscores the value of an orderly and temporary standstill as a circuit breaker in the event that a voluntary solution cannot be found. The joint work of the Bank of Canada and Bank of England has prompted considerable interest and debate within a number of international forums. Discussion on the respective roles of the official and private sectors in crisis resolution continues.

Conclusion

During the last four years, policy-makers, academics, and market participants have made considerable efforts to strengthen the international financial system, balancing the need for efficiency on the one hand, with safety and stability on the other. Differing views remain in certain areas, however, especially on the extent to which rules should exist to govern the expected actions of the private and official sectors in the event of a crisis and the need for discretion to tailor the response to the crisis. It will also take time for countries to implement the many codes and standards that have been developed. Nonetheless, considerable strides have been made, which in time should help to reduce the severity, scope, and frequency of financial crises. Moreover, when crises do occur, improved management techniques should facilitate their resolution, permitting countries in distress to return quickly to capital markets.

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