POLICYMAKING IN AN INTEGRATED WORLD: FROM SURVEILLANCE TO . . .?

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The adequacy of multilateral surveillance and of the institutions charged with carrying it out has been cast into doubt by the series of escalating crises that has punctuated the 1990s. No one questions that domestic policies have important cross-border repercussions in a world of interdependent economies. No one questions the prima facie case for surveillance to foster a consensus on the nature of those repercussions, to encourage countries to adjust their policies to better take cross-border spillovers into account, and to monitor governments' compliance with the terms of their agreements. But the adequacy of existing mechanisms for discharging these functions has come under a cloud following the European currency crisis of 1992–93, the Tequila crisis of 1994–95, the Asian crisis of 1997, and the global emerging-markets crisis of 1998, and as a result of the inability of the official community to do much about either the causes or the consequences of financial crises.

These recognitions are evident in the drumbeat of criticism directed at the International Monetary Fund (IMF) and in calls to convene a new Bretton Woods Conference. But these same statements are revealing of the absence of agreement about how to strengthen surveillance and, in particular, to better avert and manage crises. Respectable voices call for

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expanding the IMF, shrinking the IMF, merging it with the World Bank and the Bank for International Settlements (BIS), spinning off its surveillance and lending functions to regional monetary funds, and even abolishing the institution. The vague and peculiar nature of the term "international financial architecture," used to denote the entity that is the object of this reformist effort, is further revealing of the lack of definition that characterizes the debate.

This paper marshals some suggestions of where to go from here. The first section focuses on surveillance qua surveillance. There I consider the need for a major push in the area of international standards as the centerpiece for multilateral surveillance in the twenty-first century, highlighting what I see as the shortcomings of official initiatives in this area. I then describe an idea for reforming the IMF to make it a more effective vessel for the surveillance function. The next section turns from crisis prevention to crisis management and considers how to make the Fund a more effective crisis manager and the prospects for expanding private sector burden-sharing when a crisis strikes. The third section discusses the role of policies toward the capital account and the exchange rate. The fourth is a skeptical aside on the economics and politics of regional funds. The final section, in concluding, sketches the policy agenda going forward.

Surveillance

The IMF has been criticized for expanding its surveillance and conditionality from the monetary, fiscal, and exchange rate policies that are its traditional bread and butter to prudential supervision, auditing and accounting, bankruptcy procedures, corporate governance, and competition policy, among other issues. Its intrusion into everything from the Suharto family's clove monopoly to Indonesia's national car program is attacked as invasive, unnecessary, and counterproductive (Feldstein 1998; Rodrik 1999). It is invasive because it interferes with the traditional prerogatives of sovereign states. It is unnecessary, in the view of the critics, because microeconomic and structural conditions are inappropriate for dealing with currency and financial crises that are essentially macroeconomic in nature. And it is counterproductive because different institutional arrangements are appropriate for different economic, legal, and cultural settings and because ignoring this, and trampling on national prerogatives, run the risk of provoking a populist backlash.

The Case for Standards[1]

The counterargument is that high capital mobility makes it impossible to fix the international financial system without first fixing the

[1] The arguments of this subsection are taken from Eichengreen (1999), where they are elaborated in much more detail.

domestic financial systems of countries active on international markets. International financial stability requires domestic financial stability, given the scope for financial problems to spill across borders. And domestic financial stability can only be attained through institutional reform. This is why Feldstein's conclusion, that the IMF should stick to giving advice on monetary and fiscal policies and avoid meddling in the other internal arrangements of countries, will not do.

Stabilizing a country's financial system requires institutional reforms extending well beyond policies toward external trade and payments. Few would question that creating a stable financial environment presupposes disclosure requirements for banks and corporations to make available the information required for market discipline to work, and prudential supervision to compensate for the shortcomings of banks' and firms' own risk-management practices.[2] In a world of information asymmetries and highly leveraged institutions, in which financial crises can spread contagiously, the international community has a common interest in seeing that all countries active on international markets adopt minimally acceptable domestic arrangements in these areas.

Some will argue that this is as far as the IMF and the international community should go in intruding into countries' internal affairs. I find it impossible to resist the conclusion that they must go further—that the need for domestic institutional reforms with implications for the stability of international financial markets extends beyond this point. It extends to the use of internationally recognized auditing and accounting practices, in whose absence lenders will be unable to accurately assess the financial condition of the banks and corporations to which they lend. It extends to effective creditor rights, in whose absence claimants will be unable to monitor and control the economic and financial decisions of managers. It extends to investor-protection laws to prevent insider trading, market cornering, and related practices, in whose absence securities markets will not develop. It extends to fair and expeditious corporate bankruptcy procedures, without which debt problems can cascade from borrower to borrower. Countries can satisfy these desiderata in different ways, but in a world of capital market integration there is no avoiding the need to satisfy them.

The fear, however, is that international pressure for reform will force all emerging markets to don what Thomas Friedman (1999) refers to as the "golden straitjacket," denying them the opportunity to design regulatory institutions sensitive to their distinctive economic, cultural, and legal traditions. This is where standards come in. International standards, which define criteria that must be met by all countries but permit them to satisfy them in different ways, offer a way of reconciling the common

[2] And to take systemic risk into account.

imperatives created by participation in international markets with the existence of diverse domestic economic systems and traditions.[3] The complaint that the IMF's structural interventions are arbitrary and capricious at least partly explains the backlash they have provoked; with the promulgation of standards, an objective set of criteria will exist, to which the Fund can refer when it demands structural reform.

Realism requires acknowledging that neither the IMF nor the G-7's newly created Financial Stability Forum possesses the competence and resources required to design detailed international standards in all the relevant areas. This is where my recommendations depart from those of the official community. I favor relying as heavily as possible on the private sector: on the International Accounting Standards Committee, the International Federation of Accountants, the International Organization of Supreme Audit Institutions, Committee J of the International Bar Association, and the International Corporate Governance Network, among others. Most of these self-organizing bodies include a full complement of emerging-market members; some also have subcommittees concerned with issues particularly relevant to emerging markets. The multilaterals should of course participate in the deliberations of these bodies as a way of taking "ownership" of the standards they set. But the private sector must take the lead.

Promulgating standards is one thing, enforcing them another. Effective market discipline will require someone to issue blunt assessments of national practice. Each self-organizing body should be encouraged to rate countries' compliance with its standards and to establish an electronic bulletin board where such information can be centralized. Hyperlinks should be provided to the Fund's own electronic bulletin board (as they already are, to a limited degree, for macroeconomic and financial data). Where the self-organizing committee is composed of national regulators, the rating function could still be privatized; it could be spun off to commercial concerns like Fitch-IBCA. If the assessments made by these private-sector bodies are subject to the kind of criticism presently levied at credit-rating agencies—namely, that changes in their evaluations lag changes in market conditions—then the IMF will have to take on the compliance-evaluation function itself. The best way for it to do so would be by publishing an annual report in which it rated each of its members' compliance in each of the relevant subareas (perhaps in conjunction with its annual or biannual Article IV consultations, and with help from the

[3] None of this is to deny that compromise will be required. Indeed, not just emerging markets but the United States itself will be forced to compromise for significant progress to be achieved. Thus, U.S. reservations about the adequacy of the currently proposed international accounting standards, whether parochial or even well justified, hardly encourage other countries to sign on to an agreement that it itself resists.

World Bank and the BIS).[4] But with lenders having a limited attention span, the IMF will have to reinforce market discipline by offering the carrot of concessionary interest rates on its loans to countries that comply and by conditioning its programs on steps to bring national practice into conformance.[5]

An Independent and Accountable IMF

Unfortunately one worries that the IMF, for the same reasons that it has been reluctant to criticize its members' exchange rate and macroeconomic policies, will hesitate to criticize them for failing to meet these newly promulgated international financial standards. The Fund, as a political animal, finds it hard to call its members to task. National governments, which are its shareholders and ultimately call the shots, find it hard to criticize other national governments. They are reluctant to point out shortcomings in national policies for fear of embarrassing foreign heads of state.

This is a specific instance of a more general problem—that IMF decisionmaking is excessively politicized. Excessive weight tends to be attached to national interests, interfering with the IMF's ability to pursue its broader social mandate. It has been argued, for example, that several of the Fund's recent programs, like those for Mexico, serve the interests of creditor countries by providing financial assistance that allowed foreign portfolio investors to be repaid at the expense of the taxpayers of the crisis country. Here the implication is that IMF policies were used to advance creditor interests, at the expense of future moral hazard and considerable cost to the Mexican taxpayer. It is similarly argued that in an effort to prop up a presumably reform-minded government and to keep extremists who could not be trusted with the country's nuclear capability from coming to power, the U.S. government arm-twisted the Fund into agreeing to continued disbursements for Russia in 1997–98, despite evidence that economic and financial reform there had gone off track. Again, the implication is that IMF policies were used to further U.S. security objectives rather than in the pursuit of financial stability, thus aggravating moral hazard rather than furthering reform. It is argued that

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[4] This would appear to be the British Government's preferred approach to this aspect of the international financial architecture. The Fund has begun to explore the feasibility of this task by carrying out a series of pilot reports ("experimental studies in transparency").

[5] There remains the question of whether these incentives will be enough. Only a fraction of IMF member countries are subject to a program at any point in time, and there are good reasons to question whether market discipline will be prompt and systematic in its application. This creates an argument for reinforcing these other incentives to comply by having national regulators key capital requirements for foreign lending to whether the IMF rates the borrowing country as in compliance with the relevant international financial standards.

the conditionality the Fund attached to its Asian programs, requiring the crisis countries to open their financial markets and distribution systems to foreign competition, served the interests of advanced industrial countries seeking market access more than the crisis countries themselves.

If the problem is that the Fund's decisions are distorted by the parochial concerns of national governments, then greater independence from those governments is the logical solution. The obvious way of achieving this is by amending the Articles of Agreement to enhance the independence of the Executive Board, as argued in de Gregorio et al. (1999). Executive Directors could still be appointed by national governments or groups of governments, just as central bank governors in some federal systems are appointed by state or regional governments. But if Directors are too inclined to take advice from those governments, then the Articles should be amended to discourage them from doing so. If the Statute of the European System of Central Banks prohibits members of the ECB Board from taking advice from their governments, in other words, why shouldn't the IMF's Articles of Agreement impose the same prohibition on Executive Directors?[6]

Many readers will object that doing so would vest too much power in an all-powerful board of monetary technocrats. This worry could be addressed by amending the Articles to give Directors an explicit mandate, and by insisting on greater transparency, notably by requiring more decisions to be taken on the basis of up-or-down votes and releasing the results. In addition, Directors should be required to explain their decisions, and the substance of Board discussions should be made public. If Directors have idiosyncratic objectives, greater transparency of decision-making will reveal their hidden agendas, which will in turn strengthen their incentives to pursue the Fund's mandate. Directors' ultimate constituencies will then be able to judge whether their representatives supported or resisted a particular Fund policy, and Directors, rather than going along to get along, will have an incentive to register their dissents.

Ultimately, a specific body must have the power to hold the

[6] Statutory independence may not be enough; effective independence may require an amendment to the Articles specifying that Directors will be appointed to multiyear terms of office and creating high hurdles to their dismissal. Their independence will be strengthened if they receive adequate compensation. (History suggests that this should not be a problem.) It may be desirable to include a provision barring them from moving laterally into government or finance for a specified period following their term on the Board (although enforcement of such a provision would not be straightforward). True independence may in addition require budgetary independence. All large international rescue packages in the 1990s have been cobbled together out of contributions from the IMF, other multilaterals, and national governments. Given the rapid expansion of international liquidity, IMF resources alone have not been enough. The Fund's dependence on financial supplementation from national governments would be another check on the institution's independent Directors. It may be desirable, therefore, to amend the Articles of Agreement to give the Fund the option of borrowing on the market, subject to the concurrence of a supermajority of the Board.

Executive Board accountable. The obvious candidate is the Interim Committee. Individual Directors or even the entire Board could be dismissed by a supermajority vote of the Interim Committee.[7] The French government, among others, has suggested vesting additional power with the Interim Committee as a way of reinvigorating the Fund. Making provision for the Interim Committee to hold Directors accountable is a way of achieving this goal without politicizing the activities of the Fund.[8]

Is this proposal realistic? More than a few readers will be inclined to dismiss it as quixotic. But who could have imagined a few years ago how many countries would have moved to establish independent central banks? In an age when some observers call for abolishing the IMF and others recommend creating a "true international lender of last resort," enhancing the independence of its Board is a limited reform. For those who recognize that financial markets are imperfect and acknowledge that those imperfections create the need for an institution to backstop the markets, but who at the same time worry that national agendas too often distort IMF decisionmaking, this is a logical way to proceed.

Crisis Response

Amending the Articles of Agreement to enhance the independence of the Board also speaks to the concern that the IMF is too inclined to provide support for unsustainable currency pegs and to let private investors off the hook. If the temptation is always to provide one more bailout now and worry about the consequent moral hazard later, then the solution—by analogy with Rogoff's (1985) argument for delegating monetary policy to conservative central bankers to offset the inflationary bias imparted by the time inconsistency of optimal policy—is to delegate decisionmaking to independent Executive Directors temperamentally disinclined to bail.

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[7] Requiring a supermajority (members of the Interim Committee holding 80 per cent of quotas and votes in the Fund, for example) would protect Directors against arbitrary dismissal and buttress their political independence but at the same time hold them accountable to their mandate and apply sanctions in the event of dereliction of duty.

[8] Other reforms of the Interim Committee may also be desirable. In fact, a variety of sensible proposals are already on the table (courtesy of the British and Italian governments, among others). In particular, strengthening the legitimacy of the Interim Committee and the Fund more generally may require updating quota and constituency systems to take into account ongoing changes in the world economy, from rapid economic growth in Asia (which should increase the representation of that region) to monetary unification in Europe (which, by eliminating balance-of-payments problems among its members, should reduce its representation). The IMF's review of quotas, now under way, provides an opportunity to take a first step in this direction.

Rules and Mechanisms for IMF Lending

Thoughtful Executive Directors, whether independent or not, need guidelines for how and when to intervene. I believe that two circumstances justify IMF intervention, and these in turn call for the creation of two different IMF facilities.

Moral hazard may always be with us, but the concern attached to it by observers of IMF policy waxes and wanes. Concern seems to have peaked following the Mexican and Asian crises, when the IMF relaxed its rules governing the size of rescue packages and disbursements reached unprecedented levels, as international investors (in what they referred to as the "moral hazard play") poured money into Russia in the expectation that, if debt-servicing difficulties developed, the Fund would respond with additional finance.[9] When Russia unexpectedly defaulted and investors took losses, this assurance was shattered. Commentators began to question whether the decisions of international investors were really so strongly distorted by the readiness of the IMF to backstop the market.[10] Moreover, the severity of the credit crunch that developed in the autumn of 1998 and the perceived threat to the stability of global financial markets made even the U.S. Congress, previously reluctant to agree to an increase in IMF quotas, recognize that moral hazard was not the sole consideration. Rather, sensible policy requires balancing moral hazard risk against meltdown risk.

Doing so means proceeding as follows. First, moral hazard must be limited by putting the genie of ever-bigger bailouts back in the bottle. Occasions when the IMF should assist a country experiencing a sudden reversal in capital flows will continue to occur. Such assistance may be justified to support demand and production and minimize the severity of the recession while resources are shifted from the nontraded- to the traded-goods sector. It may be justified to give the government the resources needed to recapitalize an insolvent banking system. It may even be justified to permit the government to repay selected foreign creditors whose goodwill is viewed as essential for the maintenance of credit market access. But the Fund cannot countenance ever bigger bailouts to pay off ever more numerous foreign creditors, or it will create a truly unsupportable moral hazard problem.

The solution is for the Fund to resume its earlier policy of loaning a country no more than 100 percent of quota in a year and 300 percent over three years.[11] In addition to addressing moral hazard, this would deal with the fact that the Fund's resources are chronically inadequate to

[9] A compendium of warnings to this effect is to be found in McQuillan and Montgomery (1999).

[10] See, for example, Institute of International Finance (1999).

[11] Except under exceptional circumstances, as detailed below.

underwrite its activities.[12] While multilateral assistance would still be there to help a government carry out its core functions, it would not always suffice to pay off all existing creditors, thus preventing the moral hazard problem from getting out of hand. Again, the Articles of Agreement could be amended to eliminate the facilities and provisions that allow exceptions to this rule. If the feeling of shareholders is that the growth of capital markets requires growth in IMF packages, then they should address this directly by using existing mechanisms to agree to a quota increase. In this connection, it would be important to change the way quotas are allocated, placing a higher weight on international capital transactions and a lower weight on current transactions.[13] But the bottom line is that loans for addressing *country* problems should be limited.

Systemic problems, which pose a threat to the stability of global financial markets, are another matter. To address these problems, the Fund needs a "contagion window" to provide short-term emergency loans to countries with fundamentally strong policies at risk of being destabilized by adverse financial developments abroad.[14] It now possesses something along these lines in the form of its awkwardly named Contingent Credit Facility (established by the Executive Board at the end of April 1999). To access this facility, countries have to demonstrate that their policies are fundamentally sound, that they are suffering from events affecting international capital markets originating in other parts of the world, and that the problem is temporary. They will be allowed to access this facility more quickly than other IMF loans, and disbursements will be large and front-loaded. Repayment maturities will be short. Interest rates will be high, to discourage excessive recourse to the facility.

It is too early to tell whether the Contingent Credit Facility will be good, bad, or irrelevant. If the conditions for access are very tightly enforced, the CCF may never be activated, in which case it will prove irrelevant. If, on the other hand, those conditions are loosely enforced, it may turn out to be a serious engine for moral hazard. Thus, we need a Goldilocks policy, neither too hot nor too cold. To continue with the metaphor, the proof of the porridge will be in the eating.

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[12] This follows in part from the fact that only a fraction of the currencies in which countries subscribe are usable in the Fund's international operations. Presumably this problem will moderate as more countries graduate to the club of middle- and high-income members with stable finances and convertible currencies.

[13] The IMF has recently commissioned a study of how the allocation of quotas should be changed to better reflect changes in the world economy. Updating that formula would strengthen the legitimacy of returning to a quota-based policy of regular access.

[14] Note that this differs from existing General Arrangements to Borrow/New Arrangements to Borrow (GAB/NAB) arrangements, which govern IMF resources rather than IMF disbursements and may be activated to deal with the problems of a country that is the source of the threat to the international system rather than the victim.

Orderly Workouts

A credible commitment by the IMF not to automatically run to the rescue of a country that would otherwise find it impossible to keep current on its obligations presupposes the existence of a tolerable alternative mechanism for dealing with outstanding debts. It is easy to *say* that the Fund should no longer bail out governments and their creditors, but it is hard not to *do* so as long as other reasonable ways of addressing financial problems do not exist. The shortcoming of existing arrangements is that they make workouts excessively difficult. Many international bonds include provisions requiring the unanimous consent of bondholders to the terms of a restructuring agreement, creating an incentive for "vultures" to buy up the outstanding debt and hold the process hostage by threatening legal action. Unlike syndicated bank loans, most such bonds lack sharing clauses requiring individual creditors to share with other bondholders any amounts recovered from the borrower and thereby discouraging recourse to lawsuits.

Those who believe that countries may have to take occasional recourse to suspensions and subsequent restructurings argue that these provisions in bond covenants should be modified. Majority voting and sharing clauses would discourage maverick investors from resorting to lawsuits and other ways of obstructing settlements beneficial to the debtor and the majority of creditors alike. Collective representation clauses, which specify who represents the bondholders and make provision for a bondholders' committee or meeting, would allow orderly decisions to be reached. Use of such clauses was suggested in 1996 by the G-10 in its post-Mexico report and echoed in a series of recent G-22 and G-7 reports and declarations.[15] In February of this year the G-7 placed the issue on its work program for reforming the international financial system, with the goal of reaching a consensus by the Cologne Summit in June.

If this is a good idea, why then have the markets not done it already? One answer is moral hazard. Neither debtors nor creditors may wish to weaken the bonding role of debt by altering loan agreements in ways that might tempt borrowers to walk away from their obligations. Making it easier for debtors to restructure might cause investors to fear that the debtor was prepared to do so at the first sign of trouble and prompt them to liquidate their holdings of its securities, precipitating precisely the kind of bond-market crisis that the international policy community is concerned to avoid.

But if the bonding role of debt was the be-all and end-all, we would also abolish domestic bankruptcy procedures and reinstitute debtors' prison to prevent domestic borrowers from ever defaulting on their

[15] See Group of Ten (1996), Group of Twenty-Two (1998) and Group of Seven (1998), respectively.

obligations. In fact, in the domestic context we balance the temptation for debtors to walk away from their obligations against the efficiency advantages, for debtors and creditors alike, of clearing away unviable debt overhangs and restoring the financial health of fundamentally viable enterprises. The argument for collective action clauses in bond covenants is an argument for establishing a similar balance in the international bond market. Majority voting, sharing, and non-acceleration may make it easier to renegotiate defaulted debts, but if this permits a long deadlock to be avoided, investors will have no reason to shun bonds with these features.[16]

A better explanation for why the market has not solved the problem is adverse selection. It is an intrinsic feature of the capital market that lenders know less than borrowers about the latter's willingness and ability to pay. Hence, for the same reason that only patients who anticipate succumbing to a fatal disease will buy expensive life insurance, only countries that anticipate with high probability having to restructure their debts may wish to issue securities with these provisions. Left to its own devices, neither market may function. The danger is that adverse selection would render the market in these modified bonds illiquid and thereby impair the ability of emerging economies to borrow.

The G-10's 1996 report, where the idea of collective action clauses was first mooted, said little about this dilemma. While acknowledging the first-mover problem and suggesting that official support for contractual innovation should be provided "as appropriate," it failed to specify concrete steps to be taken by the authorities. The G-22 subsequently recommended that unnamed governments, presumably those of the United States and United Kingdom, should "examine" the use of such clauses in their own sovereign bond issues. The G-7 recommended that its members should "consider" them. Treasury Secretary Rubin, in a speech designed to set the tone for the Interim Committee's April 1999 meeting, reiterated that the international community should "encourage" their broader use.[17] But the official community needs to do more than examine, consider, and encourage. Given the adverse selection problem, progress is unlikely without the introduction of legislation and regulations in the creditor countries. And without progress on this front, the international community will lack credibility when it insists that it will not automatically run to the rescue of crisis-stricken countries.

[16] To be sure, this is no panacea. Private placements would not be affected. New provisions could be added to existing loans only through a voluntary exchange of existing bonds for new ones. Not only might some bondholders resist, but any one country that attempted to first carry out the exchange might be seen as signaling that it was contemplating imminent default and precipitate a crisis. The average term to maturity of international bonds may be on the order of five years, but some have as long as 20 years to run. All this means the incorporation of sharing, majority-voting, non-acceleration, and minimum-legal-threshold provisions into bond covenants will be slow. But slow progress is better than no progress.

[17] See Rubin (1999).

The way forward would be for the IMF to urge its members to make the inclusion of majority-representation, sharing, non-acceleration, minimum-legal-action threshold, and collective-representation clauses to international bonds a condition for admission to domestic markets. It should provide an incentive for countries to do so by indicating that it is prepared to lend at more attractive interest rates to countries that issue debt securities featuring these provisions.[18] U.S. and U.K. regulators, for their part, could make the admission of international bonds to their markets a function of whether those bonds contain the relevant sharing, majority-voting, minimum legal threshold, and collective representation provisions. They could include these same provisions in their own debt instruments.

Short-term bank credits are a thornier issue. They tend not to be governed by contracts, making it harder to deal with them by contractual innovation. Litan et al. (1998) have suggested somehow requiring countries to pass legislation that would provide for an automatic reduction of the principal of all foreign currency loans extended to banks in their countries that are not rolled over in the event of a crisis. Foreign creditors could get still out, but only at a loss. The prospect of that loss would strengthen their incentive to stay in, to address their collective action problem, and to restructure the debt.

The danger is that this approach could precipitate the very crises that the authorities are concerned to avoid. Banks anticipating that they might wish to get out in the near future but that they could do so only at a loss would scramble out today. A government decree that all foreign bank credits had to be forceably rolled over or written down would be much more disruptive to the markets than collective action clauses in individual bond contracts, which would come into play at the discretion of the individual borrower(s) and lender(s).

The problem remains of what to do about short-term bank-to-bank credits, whose flightiness can threaten the stability of the domestic banking system. Gaining voluntary agreement of the banks to roll over their credits, as in Korea at the end of 1997, is desirable when possible, but possible it will not always be.[19] The best solution, I will argue, is to avoid

[18] The Fund has recently signaled its willingness to do so by mentioning the adoption of collective action clauses as one of the criteria that it will consider when determining whether or not countries qualify for its Contingent Credit Facility.

[19] The special circumstances that made this possible in Korea are unlikely to be replicated. Korea had the advantage of a newly elected democratic government committed to pushing through economic reforms. Where the government has less credibility and concerted lending is seen as relieving the pressure for economic adjustment and reform, foreign creditors may not be so inclined to stay in. In addition, the sovereign guarantee extended first to Korean banks and then to the bonds into which the bank credits were converted was viable only by virtue of the sovereign's relatively light debt load, an advantage that not all governments will enjoy.

excessive dependence on short-term foreign credits in the first place. I now develop this point.

Policies Toward the Exchange Rate and the Capital Account

The single most robust leading indicator of crisis risk in emerging markets is short-term external debt, the short-term external debt of the banking system in particular.[20] Short-term debt is liquid, and if investors choose to liquidate it, serious financial problems can arise. When the debt in question is debt of the banking system, whose assets are relatively illiquid (by definition, since banks are in the business of providing intermediation services to segments of the economy about which publicly available information is least complete), the result can be bank runs and banking crises. The consequences are especially disruptive in developing countries, where the informational prerequisites for securitized markets are lacking and banks dominate the market in intermediation services.

Policies Toward the Capital Account

Central banks and governments address this problem by providing deposit insurance and lender-of-last-resort services. But the central bank cannot print the foreign exchange needed to pay off foreign depositors. This is where IMF loans come in, of course, but it is also where they create moral hazard. The dilemma is stark: The expectation of large IMF support packages will encourage an excessive dependence on short-term foreign funding, but the absence of large IMF support packages will leave the lender of last resort powerless in the face of flight by foreign-currency depositors.

In the best of all worlds, banks would internalize these risks, hedging their exposures and avoiding excessive dependence on risky short-term foreign funding. In a second-best world, domestic regulators would require them to limit their exposures, close their positions, and manage their risks. But in the real world, where too few banks can adequately manage risk and too few regulators have the capacity to correct these deficiencies, it may be necessary to intervene directly with policies designed to prevent excessive reliance on short-term foreign funding.

Capital requirements can be used on both the borrowing and lending sides to apply appropriate incentives, although there are reasons to worry about their effectiveness in politicized environments where capital is all too rarely written down. Holding-period taxes à la Chile can be used to

[20] For evidence, see Frankel and Rose (1996) and Rodrik and Velasco (1999). Note that these authors define crises in entirely different ways but reach very similar conclusions.

lengthen the maturity structure of the debt, but to work they must be universal in coverage.[21] The lesson of Thailand is that simply requiring the banks to close their positions may only encourage them to shift the foreign-currency exposure to corporates, who are no better able to handle it. The bottom line is that short-term, foreign-currency-denominated debt is a time bomb waiting to explode, and that holding-period taxes on all capital inflows are the appropriate way of defusing it, until which time markets deepen and risk-management (and regulatory) practices develop to the point where the private sector (and the regulators) can be relied on to manage the risk.

More generally, this perspective suggests that caution should be the watchword when opening the capital account, at the short end in particular. The worst of all possible policies were those followed by Thailand and South Korea before the crisis; they encouraged bank borrowing abroad at the expense of other foreign borrowing and short-term foreign funding over inward foreign direct investment and corporate bond flotations. The now standard lesson from the Asian crisis—that exposing badly regulated banks to an open capital account is akin to offering a recovering alcoholic a drink—implies the need to upgrade bank regulation but also to "go slow" in opening the capital account.

Policies Toward the Exchange Rate

The other way to discourage banks and corporates from developing an excessive dependence on short-term, unhedged foreign debt is by pursuing policies of greater exchange rate flexibility. Allowing the exchange rate to fluctuate is the only credible way of encouraging agents to hedge their exposures. A pegged rate provides an irresistible incentive for the private sector to accumulate unhedged foreign debts. To defend the peg, the government is inevitably forced to insist that there is absolutely no prospect that it will change. How many CFOs will then be rewarded for purchasing costly exchange-rate insurance before the fact? If the currency is allowed to fluctuate on a day-to-day basis, banks and

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[21] The Chilean authorities discovered, among other things, that limits on bank borrowing abroad simply encouraged the mining companies to borrow for the banks and on-lend the proceeds. The debate over the effectiveness of these taxes is enormous. Some critics complain that evasion remains a problem. Others observe the lack of evidence that Chile's taxes limited the overall level of foreign borrowing. The second objection can be dismissed on the grounds that the goal was never to limit the overall level of foreign borrowing but to alter its average maturity, and on the maturity front the evidence is compelling (see Hernandez and Schmidt-Hebbel (1999) for the definitive analysis). As for the first objection, it is important to recall that such a measure, to effectively lengthen the maturity structure of the debt, need not be evasion free. The last word on this subject should go to Chile's finance minister, who has asked (I paraphrase), "If these capital-import taxes are so easily evaded, then why do we have so many non-interest-bearing foreign deposits at the central bank?"

firms will learn the importance of using forward and futures markets to purchase insurance against currency swings.[22] Then, when the exchange rate does move by an unexpectedly large amount, they will not be thrust into bankruptcy by the increase in the cost of servicing short-term foreign debts. A currency crash will not automatically mean a financial crash, as it did in Indonesia in 1998, for example, and the greater stability of the domestic financial system will in turn stabilize the exchange rate.

All of this assumes the existence of an active interbank market in currency forwards and an exchange-based market in futures. Greater exchange rate flexibility provides an incentive for the development of these markets, although prudent governments will use their regulatory powers to provide further encouragement. This is one illustration of how the adoption of a more flexible exchange rate should encourage the development of a more resilient, crisis-resistant financial system.

The other side of this coin is more limited access to foreign capital. A fluctuating currency makes it less attractive for foreign investors to lend, especially in the currency of the borrowing country. Capital flows, especially short-term portfolio capital flows, are reduced.[23] This effect is apparent in the strikingly low correlation of savings and investment in particular regions of larger countries, in contrast to the much higher correlations for countries as a whole.[24] Another way to put the point is that a fluctuating (or potentially fluctuating) currency, which discourages foreign investors from lending in the currency of the borrowing country, also limits the ability of banks and firms to hedge their foreign-currency exposures in the aggregate. They can reshuffle those exposures so as to avoid dangerous concentrations, but the overall level of foreign-currency exposure is a given. Greater exchange rate flexibility, which creates an incentive to hedge these risks, shows up in a lower overall level of foreign borrowing.

Some countries may therefore want to go all the way in the other direction, to dollarization or the creation of a currency board, to obtain

[22] Montiel (1999) cites Colombia and Chile in the early 1990s as examples of cases where greater exchange rate flexibility worked to discourage short-term, unhedged foreign borrowing. To be clear, the argument is not that central banks and governments should follow policies of benign neglect toward the exchange rate. Freely floating rates are unattractive to most emerging markets, since their economies are small, their financial markets are shallow, and their exports are disproportionately concentrated in a few commodities. Governments may still want to intervene to damp down currency fluctuations. My argument is that they will have to learn to intervene less and that countries with open capital markets will have to avoid orienting monetary policy around an explicit exchange rate target, which ends up creating one-way bets for currency speculators. I return to the currency-board exception below.

[23] For evidence, see again the case studies discussed by Montiel (1999) and the econometrics of Bachetta and van Wincoop (1998).

[24] Bayoumi and Rose (1993) provide evidence of this for the regions of the United Kingdom, while Bayoumi (1997) does the same for the regions of Canada.

freer access to capital flows. Making dollarization or a currency board work means installing a battery of supportive domestic policies. The banking system must be internationalized to compensate for the absence of a lender of last resort. The labor market must be made more flexible to compensate for the absence of the exchange rate as an instrument of adjustment. Countries that adopt these policies will enjoy freer access to foreign lending as a result. But the number that are able and willing to go "whole hog" is likely to remain few.

The story would be different were it possible for Mexico or Argentina to obtain a seat on the Federal Reserve Board and exert at least some influence over the stance of their monetary policy. Knowing that they retained at least some say over their monetary destinies, Mexicans and Argentines would be more inclined to embrace dollarization. But the day when the United States is prepared to grant Mexico or Argentina a seat on the Federal Open Market Committee, or even extend U.S. bank regulation and limited lender-of-last-resort services to another country, is still very far away.

If the United States is not prepared to enter a monetary union with Argentina, then the latter may instead wish to contemplate one with Brazil, Uruguay, and Paraguay. Importing Brazilian monetary policy may be no bargain, but a common monetary policy for Mercosur, like a common monetary policy for Europe, has the potential to create a more stable monetary zone by virtue of the custom union's sheer size and economic diversity.[25] Through one avenue or another, some countries will eventually resolve their dilemma through monetary unification. But if one lesson is to be learned from Argentina's recent attempt to encourage the United States to contemplate this option, it is that the day when the political and economic prerequisites exist for more European-style monetary unions remains very far away. Monetary unification may be the vision of the future, but more flexible exchange rates are the reality for today.

Regional Monetary Funds

The idea of an Asia Fund to supplement the IMF was advanced by the Japanese government following the outbreak of the Asian crisis; it has been developed further by a number of academics and officials.[26] At least four rationales for the approach can be distinguished. While I analyze them in the Asian context, the conclusions are more general.

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[25] In other words, a larger, more economically diversified monetary zone would be less vulnerable to the world-price shocks that have traditionally destabilized Latin American economies heavily dependent on exports of a few primary commodities.

[26] See Ito, Ogawa, and Sasaki (1999).

First, peer pressure may work better at the regional level. Europe, where mutual surveillance has a long history and a procedure by that name has been enshrined in the Maastricht Treaty, is frequently cited as a case in point. But in contrast with Europe, Asia (like most other regions) lacks institutions with track records comparable to those of the EU's Monetary Committee and Ecofin Council. Nor do Asian countries appear ready to negotiate an international treaty that makes provision for serious sanctions and fines like those of the Maastricht Treaty for countries that fail to adjust their domestic policies. More fundamentally, Asia lacks the tradition of integrationist thought and the web of interlocking agreements that work to encourage monetary and financial cooperation in Europe. Asia has no counterpart to the social and political "pillars" of the Maastricht Treaty to support the application of peer pressure. No wider web of political and diplomatic agreements exists, to be placed at risk by a failure to cooperate on monetary and financial matters.

A second argument is that, because economic structures and conditions vary by region, neighboring countries have a comparative advantage in diagnosing their distinctive economic problems and crafting appropriate solutions. All Asian economies have bank-based financial systems and highly geared corporate sectors, which the IMF overlooked, the argument goes, when prescribing interest-rate hikes to deal with the crisis; an Asia Fund would not have committed such an egregious error. This argument seems to me to greatly exaggerate both structural similarities within the region and the ability of policymakers to gain insight into conditions in neighboring countries from local experience. It is hard to think of three more structurally different economies than Japan, Indonesia, and China, for example.

Third, and related to the preceding, it is argued that the creation of regional monetary funds will intensify competition in the market for ideas. If countries in crisis could appeal to both the IMF and a regional monetary fund whose assistance was conditioned on different policy actions, then a genuine market in ideas would develop, and only institutions giving sound advice would be able to retain a customer base. If it has a poorer understanding of the roots of the Asian crisis and what measures should be taken to address it than experts employed by the Asia Fund, the IMF will lose business to its regional competitor. Unfortunately, the analogy with market competition is questionable. In a competitive economy, the firm with the best ideas produces the best product, makes the most profits, and ends up dominating its market. It is not clear that the same is true of the market in policy advice and official financial assistance. Intergovernmental organizations do not behave like profit-maximizing firms. A multilateral that offers inferior advice does not necessarily end up losing market share and "filing for bankruptcy." The IMF is paid before other creditors, whether its advice is good or bad. It does not follow that a regional fund that lent to governments at

unrealistically low interest rates would be driven out of business, since it would more likely than not have its coffers replenished by the high-income countries that were its principal shareholders.

Fourth and finally, the fact that the cross-border repercussions of policies are disproportionately regional is seen as justifying a regional response.[27] Because Asian countries are so heavily export-oriented and sell into the same markets, they may need additional intergovernmental credit lines to deal with shared trade-related risks. Because their bank-based financial systems send few price signals (compared to securitized markets), they may be disproportionately vulnerable to contagious bank runs and currency crises, thus justifying the creation of a regional monetary fund. In the same way that a community targeted by burglars may wish to create a neighborhood watch to supplement the municipal police force, countries in a region exposed to common risks may wish to create a fund empowered to provide additional financial assistance to one another.

While analytically sound, this argument is likely to be of limited practical relevance. The problem pointed up by the Asian crisis is not that multilateral financial assistance is too little; to the contrary, the IMF's packages were of unprecedented size. To be sure, authors like Radelet and Sachs (1998) have criticized IMF assistance as tardy and tranched. (The Fund doled out its assistance a drop at a time, as the stricken government showed signs of complying with its conditions.) But it is unrealistic to assert that a regional fund would behave differently. Governments are not willing to extend unlimited support to their foreign counterparts, even when they are the governments of neighboring countries, without evidence that the latter is prepared to undertake the adjustment measures needed to pay the money back. Even in Europe, where the EMS Articles of Agreement technically committed strong-currency countries to provide unlimited support to their weak-currency counterparts, the former have in practice refused to freely underwrite the financial needs of the latter. In any case, ever bigger bailouts, whether supplied by the IMF or a regional monetary fund, are not a sustainable way of coping with financial crises. For those who take the moral hazard problem seriously, the task at hand is rather to provide an alternative approach to crisis management and resolution.

Thus, while the idea of regional funds to supplement the crisis-prevention and crisis-management functions of the IMF has intuitive appeal, closer scrutiny reveals serious problems with the approach.

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[27] The evidence and its implications are pursued in Rose (1998).

Where We Stand

In my 1999 book, I argued that the new international financial architecture should be organized around four pillars: international standards for financial arrangements and practices; Chilean-style taxes on short-term foreign borrowing as a form of prudential regulation to be imposed until countries have brought other forms of banking-sector supervision up to world-class levels; greater exchange rate flexibility for the majority of emerging-market economies; and collective-action clauses in loan contracts to create an alternative to ever-bigger IMF bailouts. All four elements have to be adopted simultaneously, I argued, to make the world a safer financial place. The good news is that all four elements are on the policy agenda. (See Table 1.) Each of them has been embraced by either Europe or the United States. The bad news is that all four elements have not been embraced by *both* Europe and the United States.

International standards are one element on which everyone agrees, although there is not yet the necessary commitment to working with the private sector on their promulgation or agreement on steps to encourage compliance. The United States has endorsed greater exchange rate flexibility for emerging markets and has expressed sympathy for the use of Chilean-style capital-inflow taxes.[28] But it is still reluctant to do more than utter some encouraging words to bring about the introduction of collective action clauses into loan agreements. Without the addition of renegotiation-friendly provisions to loan contracts, the IMF cannot credibly promise to stand aside when a country is pushed to the brink. And if the IMF cannot credibly refuse to organize a financial rescue, then the incentives for emerging markets to adopt greater exchange rate flexibility and short-term inflow taxes will remain weak.

European policymakers, for their part, are more concerned about private sector burden-sharing. They are less reluctant to legislate and regulate the introduction of new provisions in loan contracts (Jones 1999). But given their own experience, they are less understanding of the need for exchange-rate flexibility. And without greater exchange-rate flexibility, the temptation to engage in excessive short-term foreign borrowing will remain, and the adverse financial consequences of large exchange-rate changes, when they come, will be all the more devastating. Again, asserting that the IMF could simply stand aside and let events play themselves out is not credible.

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[28] The U.S. position was previewed by Secretary Rubin in his April 21st, 1999, speech, in which he attempted to signal a new toughness on the need for greater exchange rate flexibility (the headline in the next day's *Financial Times* was "US Urges End to IMF Funds to Back Pegged Currencies"), and a new sympathy for the use of capital-import taxes. ("Mr. Rubin also went further than previously in accepting that a Chilean-style tax on short-term capital inflows could be appropriate," the *Financial Times* correspondent wrote.)

Table 1
G7 Timetable for Reform of the International Financial System

By Spring 1999 meetings of IMF, World Bank, and G7:

- G7 compliance with IMF good practice code on fiscal transparency
- G7 report on strengthening national financial regulation, particularly of highly leveraged institutions
- IMF to complete manual for implementing fiscal transparency good practice code and to start monitoring code's implementation
- IMF (supported by BIS and others) to complete code of best practice for monetary and financial transparency
- IMF to strengthen data dissemination standards
- Early findings of BIS committees on disclosure standards for private sector financial institutions and international capital flows
- World Bank/IMF interim report on establishing insolvency and debtor-creditor regimes
- IMF to report on progress of its policy to lend to countries in arrears to their other creditors
- World Bank interim report on development of principles of best practice in social policy
- IMF to report on proposals for it and other international financial institutions to publish more information
- IMF to report on progress towards formal evaluation mechanism for assessing its own effectiveness

At G7 Spring meeting: Discuss progress on:

- Proposals to strengthen World Bank and IMF's Interim and Development Committees
- Examining scope for stronger prudential regulation in industrialised countries and emerging markets
- Considering necessary elements for maintaining sustainable emerging market exchange rate regimes
- Developing new crisis response, including new forms of official finance and ways to include private sector
- Strengthening IMF's crisis prevention and response procedure
- Policies to protect the most vulnerable in society

By OECD Ministerial meeting in May:

- OECD to complete code of principles for sound corporate governance

By G7 Cologne summit in June:

- G7 to convene first meeting of Financial Stability Forum
- G7 consensus on how to proceed on strengthening national financial regulation, particularly of highly leveraged institutions
- G7 consensus on how to promote more collective action clauses in bond issues

By end June 1999:

- G7 to disseminate information on government and central bank foreign exchange liquidity position

By IMF/World Bank Annual Meeting in October:

- IMF and standard-setting bodies to prepare strategy for implementing accounting, corporate governance, data, and monetary and fiscal policy transparency standards. Joint paper on this by IMF and World Bank
- IMF to finalise structure for transparency reports

By end 1999:

- G7 report on private sector compliance with corporate governance and accounting transparency standards

By January 2000:

- G7 to comply with strengthened IMF data dissemination standard

Others:

- G7 compliance with best practice code on monetary and financial policy transparency, once code is agreed
- IMF to continue policies of trade liberalisation, eliminating soft loans by states to favored industries and non-discriminatory insolvency regimes

Source: *Financial Times*, February 22, 1999, p. 5.

Thus, the task for the short term is to reconcile these differences within the G-7 and to bring the emerging markets into the architecture dialogue. Looking further into the future, it is possible to envisage more radical reform at both the national and international levels. Some countries may want to contemplate dollarization, so long as they are truly prepared to put in place the entire constellation of economic and financial policies needed for it to work. They may want to contemplate the formation of monetary unions, so that those who wish to eliminate the problem of exchange-rate risk are not reduced to the status of passengers who are permitted to ride in the car but never to drive. They may want to amend the Articles of Agreement of the IMF to create a Fund capable of making credible commitments and of carrying out its mandate without succumbing to political pressures. But these are reforms for the future, to be undertaken after completing the tasks at hand.

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