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REFORMING THE GLOBAL FINANCIAL ARCHITECTURE

August 1998

ECONOMIC PERSPECTIVES
An Electronic Journal of the U.S. Information Agency

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REFORMING THE GLOBAL FINANCIAL ARCHITECTURE

In the 1990s financial markets have become truly global, a development that offers both great promise and great peril.

Countries throughout the developing world and the former communist bloc have embraced the market-based policies of the industrialized nations of the West, a change that has brought extensive privatization of state-owned banks and companies, the creation of new stock and bond markets, and the opening up of economies to all kinds of foreign investment and foreign capital.

But successive and severe financial crises in countries that were thought to be performing well and that were attracting considerable amounts of private foreign capital have cast a shadow over the new global financial system. First there was the crisis in Mexico in 1994-95, and now in Asia. Financial turmoil threatens other countries as well.

These crises revealed severe deficiencies in the financial systems of individual countries and in the world financial architecture itself.

At the Group of Seven (G-7) industrial nations summit in Birmingham, England, in May 1998, the leaders called on their finance ministers to develop new approaches for strengthening the global financial architecture, with particular emphasis in four areas: increasing transparency of countries' data and economic conditions, helping countries prepare for global capital flows, strengthening national financial systems and ensuring that the private sector takes responsibility for its decisions when crises strike.

This issue of *Economic Perspectives* looks at the proposals to reform the global financial architecture.

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ECONOMIC PERSPECTIVES

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❑ PERSISTENCE OF ASIA CRISIS UNDERLINES NEED FOR REFORMS

An interview with Caroline Atkinson, deputy assistant secretary of the Treasury for international monetary and financial policy

The economic and financial crisis in Asia has been worse than expected, but there are signs that reform measures are having an impact, says Caroline Atkinson, deputy assistant secretary of the Treasury for international monetary and financial policy.

Two countries that have been at the center of the crisis, South Korea and Thailand, have seen markets respond to their commitment to and implementation of reforms, Atlkinson says. Nonetheless, major structural changes are needed for the affected countries to recover their previous high growth rates, she says.

Meanwhile efforts are under way in several international fora to develop proposals for reforming the global financial system to make future crises less severe, says Atkinson. "These are very difficult, complex issues, and I think there has been a remarkable amount of progress on ways to address them."

This interview was conducted by USIA Economics Writer Warner Rose

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QUESTION: *What is the situation in Asia now?*

ATKINSON: On the one hand I think it is fair to say that the crisis has been worse than most people would have expected a year ago. The impact on these economies' growth rates has been greater than people expected. The Thai, Indonesian, South Korean and Malaysian economies are all forecast to shrink this year — in the case of Indonesia by as much as 12 percent. On the other hand I think that if this was unexpected, it was partly because people did not understand the depth of the structural reform that was required in order to make further growth and rapid expansion possible.

The crisis in Asia reflected rather different problems compared to previous economic crises — such as in Mexico — because it centered on the need for structural reform, in particular, the impact of weak financial systems. So a very major change was required in order to set incentives right, in order to rebuild and to strengthen financial systems, and in order to rebuild and strengthen the corporate structure.

Q: *What progress has been made?*

ATKINSON: It is important to understand that the financial systems in the Asian countries had been often subjected to directed and connected lending. In other words, loans were not always made on the basis of credit risk assessments. A lot of nonperforming loans were not properly measured as nonperforming, and banking systems were weak. Korea, Indonesia, and Thailand are all now undergoing major restructuring of their financial sectors. In Korea there is also a restructuring of the corporate sector, which was very heavily indebted and had begun to show problems of bankruptcies in early 1997. In another area of structural reform, these economies have been opened up more to foreign investment. In Korea in particular, there was very restricted access for foreign capital to long-term investments in the financial system and other parts of the economy, which has changed.

All of these reforms have been supported by the International Monetary Fund, the United States and the Group of Seven (G-7) industrial nations. In both Korea and Thailand in particular, the markets have responded to the commitment to reform and the implementation of reform by the new governments of both of those countries. The interest spreads on their debt, the ability to access external funds and their exchange rates have stabilized. In the case of the Korean won, there has been a quite significant appreciation this year. All of which is evidence of stabilization and a positive response to reform in those cases.

Q: *How has the crisis affected investor confidence in emerging markets in general?*

ATKINSON: Most of the emerging markets have been affected in the sense that after the Asian crisis, investors took a hard look at all of the emerging markets. The spreads on the emerging markets' debt, in many cases, widened.

Q: *But are there dangers?*

ATKINSON: There is this sense that there could be, as the Secretary of the Treasury Robert Rubin says, a low probability of a high-risk event, of a spreading of the crisis. And that is why it is particularly important to make sure that the IMF is funded adequately. As you know the IMF, which has played a major role in stabilizing these economies and in providing temporary financial assistance, not just in Asia but also in Russia, now has a historically low level of available resources. It is urgent for Congress to act to increase its funding.

Q: *But some argue that the IMF itself contributed to the crisis by providing funding, thereby letting investors know that even if they made a bad investment decision, the IMF would step in and bail them out.*

ATKINSON: I think this "moral hazard" issue is an important one. But I think that there are several misconceptions about it. It is not the case that private creditors have been unscathed by this crisis. Part of why there are concerns about emerging markets is that people are concerned about the risk of loss. A number of investors have taken losses, or are preparing to take losses.

The other argument, which I call the fire department argument, is a slightly different one. You could argue that some people would be a bit more careful if they knew that there was not going to be a fire department to help them. But if you don't have a fire department you might have a few people who are more careful and fewer fires that start, but those that start would be much more dangerous.

Q: *The issue of reforming the global financial architecture is being addressed in various fora. What is the status of this effort?*

ATKINSON: The United States had a meeting in April with the finance ministers and central bank governors of 22 governments and set up working groups looking at three areas in particular. First there is transparency and accountability, where there is a focus on trying to improve data on issues such as financial reserves and debt, the information that will be provided by the IMF's Special Data Dissemination Standard, and the analysis and publicity the IMF gives to data about countries, such as in the Press Information Notices, or PINS, that are issued after the countries complete consultations with the IMF. Second is strengthening financial systems, where there is a broad effort to come up with principles for countries to adopt in order to strengthen their financial systems and incentives for them to do so; third is concerned with adequate burden sharing at times of crisis with the private sector, and that addresses the moral hazard issue. That is perhaps the most difficult one.

There are a lot of places where the same issues are being studied, the G-22, the G-7, the IMF's policy-making interim committee, the World Bank and in private sector organizations. I expect that there will be more progress reports in September/October at the time of the annual meetings of the World Bank and IMF.

There are a lot of measures that are under consideration that would all help to strengthen the international financial system and make sure that when there is a crisis it is less severe and that it can be dealt with in an appropriate way.

These are very difficult, complex issues, and I think there has been a remarkable amount of progress on ways to address them. ❑

❑ THE IMF AND REFORMING THE GLOBAL FINANCIAL ARCHITECTURE

An Interview With Karin Lissakers, U.S. Executive Director, International Monetary Fund

The financial crises in Asia and elsewhere have underlined the need for governments to make public accurate and timely economic information and to properly supervise their banking systems, says Karin Lissakers, the U.S. Executive Director on the International Monetary Fund's 24-member executive board, which oversees the Fund's day-to-day operations.

The IMF is seeking to assist these activities as part of a broader effort to reform the global financial architecture that includes encouraging the use of a uniform standard for financial data and a new emphasis in IMF programs on financial sector reforms, says Lissakers.

This interview was conducted by USIA Economics Writer Warner Rose.

QUESTION: What is the IMF's role in the process initiated by the Group of Seven (G-7) industrial countries to reform the global financial architecture?

LISSAKERS: The beginning of the architecture initiative goes back to the G-7 Summit in Naples in 1994, when President Clinton said we needed to examine whether the institutional basis for international economic cooperation that was created in the waning days of World War II could meet the needs of a modern global economy. The debate intensified after the Mexico financial crisis in 1994 and 1995 and the current Asian financial crisis.

The IMF plays a central role in the architecture debate for a number of reasons, notably its almost universal membership — 182 member countries — and its mandate to safeguard the soundness and the stability of the international monetary system.

In that context, the IMF conducts an annual economic policy consultation and surveillance with every one of its member governments. In these annual reviews, known as Article IV consultations, the IMF engages in a broad policy dialogue with member governments, trying to address and anticipate specific problems. The member governments are obliged to accept this surveillance.

If you take the main elements of focus in the architecture debate at the moment — transparency and accountability, strengthening financial systems, and engaging the private sector in the management and resolution of the economic crisis — the IMF is actively involved in all three.

In the transparency and accountability area, there are three elements. One is the transparency of member governments' own economic activities — both the management of their own resources and their economic policies. Second, there is the transparency of the IMF's interaction with its member governments. And third, there is the transparency of the private financial sector in a global market. There are clear shortcomings in each of these areas.

The United States has pushed very systematically and aggressively for the IMF to be more insistent that countries give the Fund accurate and timely data on their main economic and financial indicators because countries have been very laggard in that department.

Also, there has been a recognition of the rapidly growing importance of private financial market activity to the stability of the monetary system. The United States has pushed hard for acceptance of the concept of transparency through markets.

The IMF, after the Mexico crisis, created a new voluntary data standard for members by which governments would disclose information publicly to the markets, to their own people, to whomever.

Q: How does this disclosure program work?

LISSAKERS: At present, countries meet the IMF's standard, known as the Special Data Dissemination Standard, or SDDS, on a voluntary basis. To be identified as an SDDS subscriber, first, one has to be able to certify to the IMF specific characteristics of the data one provides, such as the coverage and how often it is reported and updated. Key data, like foreign exchange reserves, need to be reported on a regular, predictable, and timely basis to be useful to users.

Second, all these data must be accessible by the public. Third, the data must be gathered, assembled, and conveyed in credible way. The data points are listed on the IMF's Web site.

In addition to information on the financial condition of the government, countries must also provide certain information on central bank obligations, on the growth of the economy, on inflation, on price changes, and so forth. The IMF is currently reviewing the data standard, and I expect there will be more emphasis on data that cover the condition of the private financial sector in the future.

What is important about the data standard is precisely the word "standard." The IMF has pushed hard to get some standardization of data so that when you talk about a certain data point, it means the same thing whether it is Germany or Indonesia or the United States that provided the data.

Q: How many countries have agreed to participate in the SDDS?

LISSAKERS: Forty-six of the IMF's 182 members have so far indicated they will participate in the standard. There is a transition period. So one does not have to meet all of the data points at the outset. Eventually, however, the data will be constantly updated and constantly available.

We would like to see better data made available on external indebtedness. That is a problem. But it is a challenge for any country, including the industrial countries, to collect and disseminate that data in a timely manner when one is dealing with private sector foreign obligations or when the identity of the holder of the claim or the issuer of the debt is not automatically available.

The other important part of the transparency issue has to do with member countries' policy-making. We have just issued a code of good practices on budget policy and fiscal policy, of which key elements are that budgetary management be totally transparent, that budgets be accurate and comprehensible accountings of government revenues and government expenditures, and that this information be made public.

Q: You stress transparency of member country economic data. But critics of the IMF charged that the Fund itself lacks transparency in its own data and operations.

LISSAKERS: Regarding the transparency of the IMF's interaction with member governments, we have gotten the IMF to publish many more of its documents, such as its Letters of Intent with countries that are getting Fund-supported, Fund-financed adjustment programs. One can now find the details of Korea's, Indonesia's, and Thailand's commitments to the IMF under these programs on the Internet. That is very new.

Traditionally, countries negotiated in secret and kept their specific commitments to the IMF secret, as did the IMF. This was done for several reasons. For one, much of what the IMF deals with is market-sensitive information, such as exchange rate policy, which is the centerpiece of the IMF's program with any country. But it was also convenient for governments to hide behind the Fund when they were undertaking politically difficult adjustment programs. They could blame the Fund for everything.

Q: Specifically, how can the IMF play a role in strengthening financial systems and engaging the private sector, two other areas of financial architecture reform?

LISSAKERS: They are related.

When one deregulates financial markets, one needs to be sure that the institutions that suddenly have fewer constraints on their lending and financing activities know what they're doing. When one opens up internationally and liberates capital movements, banks may be tempted to take risks that they cannot evaluate or handle. And they can accumulate liabilities that, in the end, they cannot meet. We have certainly seen some of that in Asia.

So it is very important that banks and other financial intermediaries in any country that is opening up to the world markets be well supervised and well managed and that exposures be identified clearly and that losses be identified early and dealt with.

Historically, the IMF did not have systematic oversight of the quality of financial sector supervision and regulation.

It was not a standard feature in our Article IV surveillance. It is now.

Again, this is an initiative that started in the wake of the Mexico crisis. It has taken time to build up the staff's capacity to do this for all the member countries and to get governments to accept the need to include it in Article IV surveillance. It is fair to say that we were not fully on top of the low quality of banking supervision and bank management in some of the Asian countries that have gotten in trouble. The accumulated, nonrecognized losses were much bigger than we had understood.

Q: And engaging the private sector?

LISSAKERS: This third focus of debate involves the moral hazard issue. There is the argument that when the IMF or other official creditors step in to deal with a crisis, they are in effect bailing out the private creditors and letting them get away scot-free.

A lot of the argument is overdrawn because, certainly, if one looks at the Asian crisis, one will see that few investors, if any, have gotten away scot-free. Equity investors have taken a bath. A lot of the currency traders have lost a bundle of money. Banks are rescheduling their claims on Asia.

But there is a question of process. How does one engage the private creditors in a constructive way very early in the process, at the outset of the crisis, particularly when one is dealing with nonbank creditors who are not so easily identified. There have been discussions about having covenants in international bonds issues that would provide in the instrument itself for procedures in the case of a default event.

Q: What was the role of the interlocking relationship between governments and deregulated banks in the Asian crisis?

LISSAKERS: The lack of transparency certainly played a major role. It is not clear that the Asian authorities themselves really knew what the banks were doing. There was a tradition of government-directed bank lending that carried an implicit government guarantee in the event of trouble.

Certainly, the financial intermediaries and those taking on the obligations could reasonably assume that if the government was telling them to do this, then if there was a problem the government would take care of it, even if that was not the explicit intention of the policy.

The IMF, in its policy dialogue, has tried to raise the awareness of member governments to the risks, has tried to convey the need to work more closely with other regulatory bodies and organizations like the Basle Committee on Banking Supervision, which has been working to develop standards of good banking management and good banking supervision that will be accepted around the world.

Q: Why was the Asian crisis not better anticipated?

LISSAKERS: It is important to differentiate between the three crisis countries. There were certain similarities, such as the interlocking relationship among government, industrial conglomerates, and banks, most acutely so in Korea. But there were also some significant differences.

Thailand was an acute case of overheating and asset inflation, with a very rapidly expanding foreign debt. The Thais' difficulties were conventional problems that we had identified and that we had anticipated. We had cautioned the Thai authorities — we had warned them very, very forcefully in every way we could for quite a long time before the crisis broke — that they were headed for trouble. We were not as public in our criticism as we may be in the future.

We did not know how serious the balance-of-payment situation was becoming because we did not know that Thailand was taking large forward positions on the foreign exchange markets. Under the data standard we have, Thailand was not required to report the forward contracts. They reported gross foreign exchange reserves, but in fact they had already sold most of their reserves forward.

This was one of the weaknesses of the data reporting standard. And I would expect a change in that. The crisis countries are now reporting net reserves.

In the Korean case, there was certainly some overheating. But Korea had actually slowed, cooled off the economy a bit in 1997. Korea's overall foreign debt is not extraordinarily large. What we did not watch as closely as we should have was the accumulation of short-term foreign obligations by Korean banks.

And we did not have a clear picture of the overall condition of the banking system because the banking authorities' supervisory and accounting standards did not accurately reflect the true condition of the Korean bank balance sheets.

In both Korea and Thailand, the authorities thought they could deal with the pressures on the exchange rate and on their reserves by themselves. And so they kept spending down their reserves until they were basically broke when they came to the IMF.

Q: And Indonesia?

LISSAKERS: In the case of Indonesia, there was some of all of the above. Indonesia did not exhibit a real estate bubble or such acute overheating as you had in Thailand. There was not the accumulation of short-term bank obligations. Most of the debt was corporate indebtedness.

But you had a political backdrop that created a lot of uncertainty and loss of confidence. I do not think one can accurately assess how much of what happened in Indonesia was the results of politics and how much was economic.

Q: How did other economic circumstances in the region figure into the Asian crisis?

LISSAKERS: Obviously, the sharp depreciation of the yen has put enormous pressure on the other countries in the region, as has the weakness of the Japanese banking system, because they are major creditors to Asia.

European banks also had very large exposures. And I do not think we fully comprehend how banks' derivatives contracts play into the crisis, and particularly the contagion.

The run up to the crisis was also a period of expansive international liquidity and of declining interest rates in the major currencies. So with ample market liquidity, lots of investors looking for higher yields and not looking too closely at the risks they were taking on — all this fed a certain complacency on the part of policy-makers in the emerging market countries. One had hubris on both sides.

Q: How has the Asian crisis changed the focus of IMF assistance?

LISSAKERS: It was very clear in the Asian cases that the sort of standard macroeconomic fix of cutting budget deficits and tightening monetary policy would not, in and of itself, address the underlying problems. All the crisis governments had been running either balanced budgets or substantial surpluses. So the root of the balance-of-payments problem was not a fiscal imbalance but rather structural problems.

In Indonesia, these included the whole system of special privileges and subsidies, tax breaks, and oligopolies and monopolies to favored family members and friends of the government. In Korea, as President Kim Dae Jung recognized, it was the whole chaebol/bank structure. And in Thailand, there was a need for some rationalization of "mega" infrastructure projects and also consolidation of the banking system.

The IMF is focusing much more on structural issues than in the past. Financial market soundness, financial institutional soundness, and supervisory quality will be key components of our structural surveillance in the future.

The IMF will seek to be more effective in our surveillance activities. Most of our lending programs are not crisis lending programs but anticipatory, preventive lending programs to give a member time to take corrective action before major balance-of-payments difficulties develop. ❑

❑ INCREASING FINANCIAL TRANSPARENCY IN A GLOBAL ECONOMY

By John T. Bennett, an economist and former president of the Korea Economic Institute

A lack of information that makes judgments on countries' current economic and financial conditions uncertain increases the risk and costs of business, says John T. Bennett, a consulting economist and president of the Korea Economic Institute from 1982 to 1989.

An important tool to make these conditions more transparent is the International Monetary Fund's Special Data Dissemination Standard (SDDS), says Bennett.

The SDDS requires that participating governments provide a broad range of economic data that is made public on the IMF's Web site, says Bennett, who served in the U.S. Foreign Service for 26 years.

When the Korean government finally asked the International Monetary Fund (IMF) for help last fall, one of the most critical issues was estimating the amount of short-term foreign debt coming due in the next year. No one knew. It took several weeks before a reasonably accurate figure was arrived at, and even that was disputed for a time.

This uncertainty added greatly to the sense of risk foreign lenders and investors felt about their investments in Korea. It also affected Koreans who began to see holding their own currency as a risky investment. Those who could, exchanged their Korean won for U.S. dollars and Japanese yen. This caused a sharp depreciation in the won's value, leading to further serious problems, such as rising prices of imports, higher interest rates, business and bank failures, and unemployment.

The lack of reliable basic data on the national economy has produced similar results in all of the Asian economies now having difficulties. But this is not new. A lack of information led to the crisis in Mexico in 1994 and to innumerable previous crises. Financial crises regularly occurred in market economies, but just infrequently enough for people to forget.

Following the 1994-95 Mexican crisis, the IMF called on its members — now 182 countries — to provide more complete and accurate data on their economies and international obligations. The IMF in 1996 launched the Special Data Dissemination Standard (SDDS), which sets basic criteria for data that member countries will provide on economic and financial conditions for public dissemination on the Fund's Internet Web site. It also created the General Data Dissemination System (GDDS) to help countries improve their collection and publication of data.

The new data are a great improvement over what was previously available, and the IMF is currently soliciting suggestions from all parties for how the system can be further improved. The benefits will depend on how many countries meet the standards for providing the data and how well the world uses the additional information.

G-7 CALLS FOR IMPROVED DATA

Although the process of creating the new system was well under way by 1997, there were not enough data available at that point to call attention to the growing problems in Asia. The Asian crisis led the Group of Seven (G-7) major industrial nations, at their Birmingham, England, summit in May of this year, to call for significant improvements in the IMF's collection of statistics.

The G-7 statement characterized increased transparency — more and better information about economic conditions — as a crucial part of the effort to reform the global financial architecture. It made three recommendations to improve transparency:

• That IMF members publish more accurate financial data and that the IMF identify those that fail to meet its Special Data Dissemination Standard.

• That the IMF adopt a code of good practice for financial and monetary policy similar to that on transparency in fiscal policy.

• That the IMF publish more information about its members and their policies and about its own decision making.

In addition, the G-7 made several other recommendations to strengthen the global financial system. They concerned better data on global capital flows, strengthened national financial systems, and greater private sector lender responsibility for loss in order to diminish moral hazard.

THE HIGH PRICE OF RISK

Markets work only when they have information. The better the information, the better the functioning of the markets. Poor information adds risk.

The problems caused by poor information occur at many levels, all of which affect the riskiness of foreign investment. Economists make a distinction between risks that can be insured against and those that cannot. In the former, loss occurs with a more or less known frequency, and precautions can be taken either by setting aside reserves or by buying insurance. Risk is a clear and certain cost of business. Uninsurable risk is so unpredictable that the bad events inevitably come as a surprise. They occur infrequently, but when they happen, the consequences can be catastrophic.

Unpredictable risk greatly increases the cost of doing business. It tends to keep prices high by reducing competition — only the most adventurous are willing to risk it, so supply is limited and sellers can charge high prices. It is a public service, therefore, to reduce such risk.

While unpredictable risk cannot be insured against, the system can be designed to reduce it. This is what the IMF is charged with doing now. The IMF's objective in developing the GDDS and the SDDS is to reduce risk by publishing a standard set of information on an economy, with data that meet widely accepted criteria for accuracy, are made public regularly, and are timely.

That seems rather obvious, and yet it had not previously been done, partly because it was not considered necessary; markets were thought to be working well enough already. Also, governments thought such data would limit their freedom to make economic policy. For example, if an economy were getting into trouble and that became widely known, interest rates would rise and it would be more difficult to borrow abroad. But data meeting the SDDS would preclude governments from hiding conditions.

THE LESSONS OF PAST CRISES

The Mexican and Asian experiences have made it very clear that, to lessen the chance of crises, a broader set of better data is necessary. After Mexico, people thought government borrowing was the culprit. After Asia, we know that private borrowing must be watched as well — that the market makes mistakes, sometimes big ones. The SDDS will require data on private borrowing, so that lenders can be more certain about the risks they face.

Asia taught another lesson as well. People generally thought that short-term loans would be sought only when the purpose of the loan was short term. For example, short-term money was appropriate for financing exports because the funds to repay the loan would be generated before it was due.

But short-term money can be cheaper than long-term, so at times, such as prior to the crisis in Asia, there is a powerful incentive to borrow short and re-lend long. Borrowers and lenders were abetted in this in the period leading up to the crisis by government support of the exchange rate and by government guarantees of repayment. But government intervention is unlikely to be permanent because governments can lose the capacity to make good on their guarantees. Hence, the IMF is asking for better data on all foreign obligations of an economy, making overlending less likely.

Problems in the global financial system occur in other ways as well. Banks in several Asian countries had large amounts of non-performing loans; borrowers were unable to pay the agreed interest or repay the principal. Lenders may have thought they were protected by the bank's equity, but the non-performing loan portion of its assets may have exceeded its equity. In some countries, lenders knew that bank borrowers were in poor shape but lent anyway on the understanding that the government would cover the loan if need be. To avoid such occurrences, the IMF is seeking better data on the obligations, domestic and foreign, of members' financial systems.

Excessive borrowing made companies vulnerable as well. Asian companies often have four or more times their equity in loans, compared to American companies' average of loans equal to twice equity. This makes it difficult for the Asian companies when the business cycle reduces sales and profits. They lack the funds to service their debts. With equity financing, which is the norm for American firms, companies can simply reduce the dividend, giving them greater ability to ride out a crisis. Asian countries, however, financed much of their expansion with bank credit because their equity markets were underdeveloped and would have slowed their growth. Savers put money in banks because interest rates were high and the government guaranteed them.

NEED FOR GOOD ACCOUNTING

A last form of information crucial to transparency is company accounts that meet world standards. What lenders always want is the truth about a company. The problem is that while accounting looks precise, ultimately the lender must make a judgment call. Here individual governments play the role of deciding what information should be required that will facilitate good judgments. Even in the most advanced developed countries, accounting can be problematic. The United States has the Financial Accounting Standards Board, which over the years has substantially improved the quality of U.S. companies' accounts. Fraud still occurs, but less frequently and with less damaging results than previously. And even with the best information, lenders can make mistakes. Nevertheless, the market now generally knows when a company is in trouble.

Globalization — the spread of competition in individual industries to include more and more countries — is generally seen as good because it raises living standards everywhere. Still, it has costs: when things go wrong, the effects quickly spread around the world. Global competition brings a requirement for financial accounts that meet international standards. The combination of better accounts and reduced company debt leverage will make lenders more confident of their risk judgments, lowering borrowing costs.

The improved data made available by the IMF will not be read solely by individual lenders, who sometimes exhibit irrational exuberance. The IMF, ministries of finance, bank regulators, and ratings agencies such as Moody's will all be paying attention so that dangerous conditions are not likely to be ignored. We cannot expect to eliminate all the risk, but a substantial reduction will greatly help to avoid such sharp swings as occurred in the Asian crisis.

The quest for transparency, at least on a global basis, is recent. It arose because economies have become increasingly interdependent, not just with trade in goods and services but in cross-border investment and lending. Everyone in the world can benefit from this trend, but the benefit can evaporate if the risks of such transactions are high and unpredictable. ❑

❑ PREPARING FOR INTERNATIONAL CAPITAL FLOWS

By J. Bradford De Long, professor of economics, University of California at Berkeley

The free flows of international capital have been enormously beneficial for developed and developing countries alike but they also pose risks, says J. Bradford De Long, a University of California at Berkeley professor and former Treasury Department official.

"Countries that seek to take advantage of the large benefits of global capital flows need to make sure that they do not destroy their own ability to handle crises," says De Long, who served as Deputy Assistant Secretary of Treasury for Economic Policy from 1993 to 1995.

This will require vigilance against the accumulation of foreign currency-denominated debt, which can be a catastrophic burden if the country has to devalue its currency, and the creation of a good banking supervisory system with the power to close down insolvent or nearly insolvent banks, De Long says. Most important, however, is a well-capitalized International Monetary Fund that can lend assistance in times of emergencies, something that only the developed countries can provide, he notes.

Back in the 1890s and 1900s, international capital flows were of great benefit to the world. Flows of money and investment from the center to the periphery of the world economy allowed investors in the capital-rich core to earn higher rates of return than they would have otherwise. The flows also allowed workers in the resource-rich periphery access to the fixed and working capital they needed to multiply their productivity — and their wages.

In the 1920s and 1930s, international capital flows, interacting with attempts to restore the pre-World War I monetary order, did great harm to the world economy. Rational and less-than-rational fears of heightened taxation, of devaluation, and of depression caused country after country to suffer large-scale capital flight, as international investors sought to put their wealth in safe havens: first Britain, and then, as Britain began to look shaky, the United States. Central bank and finance ministry beliefs that long-run growth required holding on to the gold standard — keeping their currency worth a fixed and set amount of gold — led them to induce recessions in order to maintain that standard. In the end, the maintenance of the gold standard proved impossible. The political will to keep the gold value of the currency and the exchange rate constant dissipated as unemployment deepened in the Great Depression. The only thing that the combination of international capital flows and government commitment to the gold standard did was to make the Great Depression much greater than it otherwise would have been.

The architects of the Bretton Woods system that governed international monetary arrangements in the 1950s and 1960s had lived through the 1920s and 1930s. They were eager to embrace controls on international capital flows. They saw the freer flow of capital as bringing little more than trouble: destabilizing speculation, irrational capital flight, and the potential for chains of contagious panic like those that had brought on the Great Depression. Stable, if not actually fixed, exchange rates (so that world trade could develop and expand) and governments committed to preventing serious depressions at home seemed much more important than encouraging the free flow of international capital.

BALANCING BENEFITS AND PROBLEMS

But with the breakdown of the Bretton Woods system in the 1970s, the political retreat from social democracy in the 1980s, and the fading of the memory of the Great Depression, the pendulum swung back once again. The second and third generations of post-World War II economists regretted the fact that capital controls kept people in industrial countries with money to lend away from people in developing countries who could make good use of the money to expand economic growth. They noted that capital controls were not working effectively anyway as ingenious investors found more and more ways around them. The balance of opinion shifted to the view that the world economy was sacrificing too much in the way of economic growth to be worth whatever reduction in instability capital controls produced.

So now we have all the benefits of free flows of international capital. These benefits are enormous. The ability to borrow from abroad kept the Reagan deficits from crushing U.S. economic growth like an egg, and it has enabled successful emerging market economies to double or triple the speed at which their productivity levels and living standards converge with those of the industrial core.

But the free flow of financial capital is also giving us one major international financial crisis every two years. The root cause of the crises is the sudden shift in international investors' opinions. Like a herd of not-very-smart cattle, they all were going one way in 1993 or 1996; then they turned around and are all going the opposite way today. Economists will dispute which movement was or is less rational. Was the stampede of capital into emerging markets an irrational mania disconnected from fundamentals of profit and business, or is the stampede of capital out of emerging markets today an irrational panic? The correct answer is probably "yes" — the market was manic, it is now overly pessimistic; the sudden change in opinion reflects not a cool judgment of changing fundamentals but instead a sudden psychological victory of fear over greed.

So what is to be done?

Countries that seek to take advantage of the large benefits of global capital flows need to make sure that they do not destroy their own ability to handle crises. In the current international monetary system, it is assumed that one reaction to a crisis will be a devaluation. Since the world economy has signaled that it is no longer willing to pay as much for a country's capital or goods as before, a devaluation is a way of reducing the price of a whole nation's goods, the analogue to a firm cutting its prices in response to falling demand. But devaluation does little good if the value of the debts owed by a country in crisis rise as the currency falls in value. This is what happens if the banks and firms in a country that is devaluing have borrowed not in their local currency but in the major international currencies — U.S. dollars, pounds, yen, or marks.

Thus, the first thing that a country seeking to take advantage of international capital flows must do is establish a system to detect and penalize home-country institutions and firms that borrow in money-center currencies. A large amount of such borrowing is what turns a shift in the confidence of foreign investors from an annoyance to a catastrophe. Governments in countries that borrow heavily from abroad should discourage and curtail their citizens (and themselves) from borrowing directly in the international currencies, such as yen, dollars, pounds, and marks.

The second thing that must be done is the creation of a good system of domestic banking regulation: a system that will detect — and close down — financial institutions that are insolvent or nearly insolvent, and that thus have strong incentives to make risky but uneconomic investments. After all, if a firm is already insolvent, any further investments it makes are "heads, we win; tails, our creditors lose" propositions. Only if the financial system can be kept well-capitalized and solvent will the inflow of foreign capital generate productive and profitable investments.

But most of all there needs to be sufficient international liquidity to handle the kind of large-scale financial crisis that springs from a sudden shift in the degree of optimism of investors in the industrial core. There needs to be a well-capitalized International Monetary Fund (IMF) to make structural adjustment loans to countries willing to adopt policies that will generate future export surpluses. There needs to be a willingness on the part of creditor countries to accept flows of imports from developing countries that are the counterparts of financial flows.

IMPORTANCE OF IMF AND G-7 SUPPORT

And it is from this perspective that recent political developments are very troubling. It is not that there is anything wrong with the conclusions of the Birmingham Group of Seven (G-7) summit of industrial country leaders: they are all good ideas. But in our current international financial system, sudden changes in investors' sentiment will generate large shifts in hot money around the globe — and there must be sufficient reserves in the G-7 and the IMF to neutralize the effects of such shifts, and there must be the willingness on the part of the G-7 and the IMF to use their reserves when necessary.

Yet congressional leaders in the United States — who must appropriate new money for the IMF — appear to scorn the Fund as an alien and untrustworthy institution, rather than as one of the key instrumentalities in maintaining the extraordinarily successful international economic order that the Truman administration put into place at the end of World War II. The internationalist consensus that dominated the U.S. government since the end of World War II appears to be gone.

Only by the skin of its teeth — and by a very creative reading of the legislative mandate governing use of the U.S. government's Exchange Stabilization Fund — did the U.S. Government contribute to the successful resolution of Mexico's peso crisis in 1995. There is no guarantee that there will be more congressional realization of America's national interest in a prosperous world economy in any future crisis.

Thus, from the perspective of any developing country preparing for international capital flows, the most important thing that needs to be done is completely outside its power: the creation of an IMF and a G-7 that can provide support to deal with international financial crises in the absence of U.S. leadership.

Charles Kindleberger, a noted economist and historian, thought that, at the deepest level, the cause of the Great Depression was that Britain could no longer and the United States would not take responsibility for dealing with international financial crises. It is hard to escape the conclusion that we are about to enter an era in which once again the United States will not take responsibility. And as in the 1920s, no other institution or coalition that could take over the role of managing the world economy is visible. ❑

❑ REDUCING MORAL HAZARD: INTRODUCING MARKET SIGNALS TO BANKING SUPERVISION

By Charles W. Calomiris, Paul M. Montrone Professor of Finance and Economics, Columbia Business School

Getting the private sector to take responsibility for its bad investment decisions in international financial crises will require curtailing the domestic and global banking "safety nets" that have created a dual moral hazard by subsidizing both borrower and lender risk, says Charles W. Calomiris, a professor of economics and finance at the Columbia Business School.

The only really effective way of accomplishing this is to inject market discipline into the banking supervisory and regulatory process, says Calomiris, who is director of the American Enterprise Institute's Project on Financial Deregulation.

He offers methods that would bring market signals and market penalties into banking supervision and regulation.

The severe financial crises — such as Mexico's in 1994-95 and Asia's last year — that have accompanied the great expansion of global capital flows witnessed in recent years have prompted questions as to why so many private investors made clearly risky investments and to what extent governments encouraged this.

The central goal in reforming the global financial architecture, to reduce the incidence of crises, is to ensure that the private sector — borrowers and lenders — bears its share of the burden for bad decisions that help bring on the crises. Toward that end, government subsidies for financial risk-taking must be curtailed — thereby addressing the key problem of "moral hazard."

Most of the increased capital flows, it should be noted, have benefited the world economy, especially emerging economies seeking investment to finance development and raise living standards. The kinds of flows, however, differ greatly. Some — such as short-term foreign-currency-denominated bonds and deposits — sometimes have helped turn difficult situations into financial crises. The fact that some subsidies for risk-taking encouraged these kinds of investments points out the need for reform.

On the borrower side, subsidies for risk-taking are usually in the form of explicit and implicit government guarantees extended to the banks and to the industries taking on debt that they will be protected if problems develop. Banks have been at the center of the financial crises in the emerging economies. Guarantees to banks, particularly recently privatized banks, have encouraged excessive risk-taking and the accumulation of bad loans. The privatization of state banks, in many cases, created new "quasi-public" banks with an implicit claim to public resources that meant, in reality, that the new owners kept the profits while the governments covered any losses. This was a formula that encouraged banks to take on extreme risks.

In addition, the nature of the privatizations meant that a small, politically influential group of owners — an oligarchy really — had an interest in encouraging permissive banking supervision and bailouts. The broader interest of a sound economy was diffused among the general population.

On the lender side, the International Monetary Fund (IMF) and the industrial nation finance ministries that back it have helped subsidize risk-taking, even if not intending to do so. The IMF provides emergency loans to help "stabilize" the economies of countries in crisis. These loans ensure that foreign banks will avoid loss; they also serve to bridge the period until the recipient government can implement higher taxes — which will be borne largely by the middle class — to raise the revenues needed to bail out the businesses and banks — controlled by the politically influential oligarchs — that caused the crisis. The IMF programs that countries must implement to get the emergency loans usually entail conditions for banking reform. However, truly changing the way a national banking system operates takes years of persistent effort, much longer than the time the IMF is going to be on the scene.

Proposals for financial system reform must address the costs of domestic and global banking "safety nets" — the guarantees that have created the dual moral hazard of subsidizing borrower and lender risk. There is much talk about improving banking supervision and regulation and increasing transparency by requiring better and more timely data. These alone are not enough. Actually eliminating moral hazard and getting the private sector to take responsibility for its bad decisions will require measures to reduce the safety net subsidies by injecting market discipline into the supervisory and regulatory process.

PROPOSAL FOR REFORM

My proposal for reform is based on three pillars that are offered in the context of two pragmatic axioms.

The first axiom is that the solution must take into consideration the political difficulties of rolling back — much less eliminating — financial safety nets. Some will remain. Any solution has to work within them.

The second axiom is that there is no way any government agency can be created to serve as an effective substitute for market discipline. This is a crucial point. It may be possible to design government banking supervisory agencies that are empowered (de jure) to enforce regulations and to close down banks. But in crisis after crisis, these agencies have shown that while they didn't lack information, they did lack the political will to do what they were created to do. Government supervision and regulation, without any external market-derived pressure, are bound to fail. Any solution must contain features that will provide the crucial market signals and market penalties, thereby making government action more credible and removing the capacity of government officials to deny that a problem exists.

So within this context, I suggest the following three pillars for reform:

• Supervisory and regulatory reform: To be effective as part of the supervisory and regulatory apparatus, market signals and market penalties must be clearly and credibly specified in advance. I offer the following proposal for achieving that end.

Bank regulators would require that a bank issue uninsured subordinated debt equal to 2 percent of its noncash assets in the form of dollar-denominated certificates of deposit. The yield of these certificates, which would be marketed to foreign investors, could be no greater than 5 percent over comparable maturity government instruments.

For bank regulators, the crucial feature of these certificates is that they are uninsured and subordinated debt. When a bank starts defaulting, holders of insured deposits have the priority claim in any liquidation proceeding. Holders of uninsured subordinated debt are far back in line. Bank regulators and everyone else would be able to see if there is market confidence in the bank by how well these certificates are selling. If the bank was unable to float the debt, then the government cannot cover up the fact in its supervisory accounts. In the face of market concerns over the riskiness of holding the certificates, the bank's lending would have to contract alongside the decline in outstanding subordinated debt, or its capital would have to be increased to reduce the riskiness of the subordinated debt. Either way, bank risk-taking would be reined in. Argentina, beginning earlier this year, implemented regulations that included part of this proposal by requiring that banks issue uninsured subordinated debt equal to 2 percent of their outstanding deposits.

• Capital flows: Government policies should encourage "good" capital flows, which include foreign direct investment, bond and stock market investments, and lending by local branches of global banks — what I called "local global banking." This is already being done by international banks such as Citibank and Santander. These banks have established presences in emerging economies, make loans in local currencies, and have experience in managing local risk.

• Recapitalizing domestic banks: There may be a legitimate need for a government to have a procedure for recapitalizing its domestic banks if only because politics will require it. But to ensure that such bailouts are cost-effective, they, too, must employ credible market signals when determining how assistance is allocated within the banking system.

DEALING WITH TROUBLED BANKS

With respect to bank recapitalization policy, I have proposed the following procedure for the Japanese government to deal with its troubled banks. It is applicable to other countries.

To begin the process, the government offers to purchase preferred stock (a claim on bank assets that is senior to common stock but junior to bank debt) from a qualifying bank that is seeking assistance, on the following conditions:

• A bank that qualifies and gets the assistance must pay no common stock dividend during the period (say, three years) during which the government is holding the preferred stock. There would be no preferred stock dividend paid to the government (implying a significant subsidy from the government on preferred stock issues).

• To qualify, a bank would have to issue new common stock on a simultaneous matching basis with the government's purchase of preferred stock. Purchasers of the common stock should not be connected with or related to the bank. How the new common stock issue fares will determine whether the bank can qualify for the preferred stock subsidy. Deeply insolvent banks would be unable to issue stock even in the presence of the subsidy, and thus would not qualify. Those banks would be shut down. Moderately insolvent banks would qualify and be recapitalized.

• Qualifying banks would be given six months to satisfy the new 2 percent subordinated debt requirement outlined above in the discussion of supervisory and regulatory reform.

This approach provides a way for regulators to gain information from the markets as to which banks are worth saving and which are not (through the matching requirement), and to ensure ongoing market discipline through the use of subordinated debt. It also provides powerful incentives for banks to improve their disclosure policies and the transparency of their accounts, since they will have to appeal to market perceptions when issuing their new stock and subordinated debt.

Introducing market signals and market penalties in the reform of banking and financial systems is the only credible route to eliminating the core problem of moral hazard. This way, domestic banks and global capital markets can again be relied upon as a source of stable finance. ❏

❑ INCENTIVES AND THE PROMOTION OF INTERNATIONAL FINANCIAL STABILITY

By Representative Jim Saxton, Chairman, Joint Economic Committee

Crucial to any effort to reform the international financial architecture is the need to reduce incentives borrowers and lenders have to engage in risky ventures with the expectation of being bailed out if they fail, says Representative Jim Saxton, chairman of Congress's Joint Economic Committee.

This problem, known as moral hazard, exists in developed countries, but is significantly more virulent in emerging markets, he says.

The New Jersey Representative says the International Monetary Fund (IMF) contributed to the problem, if inadvertently, through its assistance which "often supports and encourages the proliferation of these incentives."

Limiting funding for the IMF "is one possible approach to curtailing bailouts as well as expectations of future bailouts and hence to limiting moral hazard," Saxton says.

Serious proposals to reform the international financial "architecture" presuppose we know something about the fundamental causes of our current international financial problems. Only with such knowledge can we implement forward-looking preventive measures rather than merely reacting to events. Most analysts of our current financial problems agree that risk-enhancing incentives that promote moral hazard contributed to the current international financial crises. Such luminaries as Federal Reserve Chairman Alan Greenspan, Bundesbank President Hans Tietmeyer, and even the International Monetary Fund's Michel Camdessus have made statements endorsing this view.

Moral hazard develops when borrowing and lending entities not only have incentives to engage in risky activities but also expect to be bailed out should their risky ventures fail. Risk-enhancing structural change in the financial environment and public risk subsidies are important ingredients of this mix. These perverse incentives are further magnified when owner-contributed capital is depleted. Analysts agree that these kinds of perverse incentives plagued the U.S. savings and loan and banking industries in the 1980s and early 1990s encouraging highly risky business practices that eventually led to enormous — but largely government-insured — losses.

But the problem is significantly more virulent in today's emerging market economies for a number of important reasons. This problem must be recognized and addressed before meaningful reforms can be successfully implemented.

RISK-INCENTIVES IN EMERGING MARKETS

The same risk-enhancing structural changes impacting financial institutions in the U.S, such as liberalized product restrictions without proper supervisory support, also affect many emerging economies' financial institutions. But in emerging markets additional factors are at play; liberalization of capital controls and moves to privatize heretofore government-controlled financial institutions make the structural change occurring in these countries even more significant. These changes often occur in emerging economies in an environment with low levels of owner-contributed equity capital partly because of previous state ownership as well as restrictions on both domestic and foreign ownership of financial institutions.

Combining this structural change with overly generous public risk-subsidies, often without an adequate supporting supervisory framework, provides all the ingredients for significant perverse incentives promoting both excessive risk taking and crisis-prone financial systems.

Further exacerbating this situation is the fact that emerging economies' banking sectors are usually larger as a share of total financial activity simply because their bond and equity markets are relatively underdeveloped. Factors causing banking crises in these countries, therefore, likely will create broader financial havoc than would be the case in the U.S. or other developed economies. And because emerging economics tend to be smaller and more open relative to larger economies such as the U.S., the potential impact of perverse incentives on mobile, international capital and foreign exchange rates in these economies can be significant.

INCENTIVES AND THE IMF

Expected and actual IMF bailouts work to solidify and fortify these perverse incentive structures in a number of ways. Since the IMF lends to countries promoting risk-taking incentives, that lending often supports and encourages the proliferation of these incentives. This is especially the case when, as currently, IMF lending works to help insolvent — that is bankrupt — banks, rather than illiquid banks — those with temporary cash shortages. Moreover by effectively creating another (international) layer of government guarantees, IMF leading serves to foster additional risk taking, particularly by large international financial institutions. IMF bailouts, after all, importantly shield these institutions from the high risk of lending to emerging economies with vulnerable banking systems. What emerging-market economies are left with, therefore, is a highly vulnerable, risk-subsidized financial system particularly exposed to foreign exchange risk. In short, IMF lending promotes both risk-taking incentive structures and foreign exchange mismatches in emerging economies.

Two features of current IMF practices serve to worsen this problem. First, it is well established that the IMF lends at subsidized interest rates, further encouraging risk-taking activity and thereby aggravating these perverse incentives. Second, the well-known secretive, non-transparent nature of the IMF works to inhibit objective reporting and a clean airing or clarification of IMF risk-subsidizing activities. To this extent, such insularity works to perpetuate perverse incentives and risk-enhancing activity.

WAYS TO LIMIT PERVERSE INCENTIVES

Recognizing these perverse incentives is a necessary first step in shaping successful reform of the international "architecture". These incentives must be taken into account, corrected, or at least minimized before a genuinely reconstructed stable financial "architecture" can be assembled. If perverse incentives remain in place, any reform attempt will most likely prove unsuccessful. Accordingly, adopting policies to limit risk-enhancing incentives should be high on the reform agenda since minimizing them will work to stabilize the international financial system and limit both the number and severity of financial crises.

Circumscribing the above-cited perverse incentives at the domestic level, of course, is most essential to such reform. Whenever possible, public subsidization of risk should be limited. Measures to ensure that both profits and losses are privatized are appropriate. But reform at the international level is needed as well. International organizations like the IMF, which inadvertently work to promote perverse incentives, merit particular attention. Limiting additional funding to the IMF is one possible approach to curtailing bailouts as well as expectations of future bailouts and hence to limiting moral hazard. Such moral-hazard-limiting measures work to stabilize international financial markets and hence are not "isolationist" as the pro-IMF-funding advocates are prone to claim. On the contrary, limiting moral hazard promotes stabilizing incentives and hence a healthy international financial system.

But funding restraint is not the only moral-hazard reducing change impacting the IMF that can be considered. Moving toward lending rates that are market-based and adjusted for risk also would help lessen moral hazard. Furthermore, reforms requiring the IMF to be significantly more open and transparent in a number of ways also would work to expose risk-subsidizing practices. These reforms are key features of the IMF Transparency and Efficiency Act of 1998 (H.R. 3331), a bill I introduced to secure such reforms.

In a longer-term time frame, IMF objectives should be clarified and limited to providing liquidity-type (non-subsidized) loans to tide countries over short-term, temporary adjustment problems. This action would both minimize moral hazard and promote stable markets.

OTHER U.S. POLICY

In addition to rectifying economic incentives, U.S. policy can make further contributions to securing international financial stability. Federal Reserve monetary policy, for example, should focus on price stability as its primary policy objective. My advocacy of this monetary policy objective has been resounded not only at Joint Economic Committee monetary policy hearings, but also in price stability legislation I have sponsored (H.R. 2360).
Price stabilizing monetary policy on the part of the United States can significantly contribute to both world price and financial market stability, given the dollar's important role as the world's key reserve currency. As the monetary authority of the world's reserve currency seeks to promote price stability, it should pay special attention

to the value of the U.S. dollar as one important (market price) indicator or policy guide in securing the price stability goal. Such an approach will work not only to promote price stability, but also helps to foster more stability in the foreign exchange market.

Fostering global price stability and securing stabilizing financial incentives would be a substantial contribution to promoting international financial stability. ❑

❑ EMERGING ECONOMIES NAVIGATING IN A SEA OF GLOBAL FINANCE

By Paul A. Volcker, former chairman of the Federal Reserve Board of Governors

Global capital flows have greatly benefited emerging markets, but can also overwhelm them, says Paul A. Volcker, former chairman of the Federal Reserve Board of Governors.

Global investment institutions offering highly mobile money can make investments marginal in size for them but capable of spurring booms in the receiving country, he says.

"Sooner or later investment is likely to run ahead of needs and be misallocated," says Volcker, producing real estate booms, exchange rate appreciation and other dangerous conditions. Then, concerns about the "sustainability" of the boom emerge, money inflows slow or stop, and all the problems seen during the last year in Asia start to appear.

One of the by-products of the Asian financial crises is a renewed discussion of how to deal with capital flows, Volcker says.

Flows of funds and their valuation in free financial markets are influenced as much by perceptions as by objective reality — or perhaps more precisely, the perception is the reality. The herd instinct is strong. Only in hindsight do episodes of strong "overshooting" or "undershooting" become evident, and the reversals are typically sudden.

This has always been true. The resulting volatility can ordinarily be accepted as a small price to pay for the immense benefits that broad and active financial markets can bring. That is certainly true for large and well-diversified economies, with sturdy financial structures. They typically have the resiliency to ride out the storm with limited and temporary damage.

The situation is more difficult for emerging economies. By definition, these economies and their financial institutions are tiny relative to the size of international markets. To put that in perspective, the entire banking systems of Indonesia or Thailand or Malaysia are comparable to one good-sized regional bank in the United States. Their entire gross national products are smaller than the funds controlled by the largest U.S. financial institutions, including large mutual fund families and other investors caught up in intense competition to out-perform their competitors.

CAPITAL FLOWS SPUR ECONOMY

There is no need to review in detail the enormous growth in the supply of financial capital or the irreversible changes in technology that permit money to move around the world almost instantaneously with much smaller transaction costs. At the same time, the organization of the markets — away from traditional commercial banks toward a variety of more transactionally oriented institutions — has made them both more impersonal and more fluid.

One result has been a capacity and willingness to reach out for more exotic high-yielding investments. The private sectors of emerging economies, with their strong growth potential, have become prime targets.

These countries have in recent years become converts to the basic philosophy that more open markets for capital, as well as for goods, will bolster growth. One manifestation is their greater willingness to accept direct investment. Its longer-term orientation and technological and managerial components have been mutually beneficial. But there have been strong incentives to accept and encourage portfolio capital as well, where the benefits to the economy are more indirect and the potential risks greater. And much of that investment can be moved on very short notice — at least until a crisis shuts down the market.

The process for a time is self-reinforcing. The inflow of foreign money helps to spur investment, to strengthen directly or indirectly export capabilities, and to sustain high rates of economic growth. By supporting a strong exchange rate, inflation is contained and a sense of stability reinforced. Profit opportunities for local banks and other financial institutions blossom as they intermediate the flow of funds. And the apparent success of the early investors encourages more to join, allocating amounts that from their individual perspectives may be marginal.

The difficulty is that what may be marginal to the increasing numbers of investment institutions with mobile money can, in its totality, be overpowering to the small receiving country. With money so freely available from abroad, banks will lend aggressively. Sooner or later investment is likely to run ahead of needs and be misallocated by governments or private investors. In these circumstances, a real estate boom will be almost inevitable, and, whatever the particular exchange rate regime, the real exchange rate will appreciate, undercutting trade competitiveness.

Sooner or later some event, internal or external, political or economic, will raise questions about the sustainability of it all. The capital inflows slow or stop. The exchange rate comes under pressure, inducing capital flight. Reserves are depleted, the exchange rate sinks way below what was thought to be reasonable, inflationary forces rise, interest rates double and re-double, and a crisis is at hand.

In one sense the pattern is all too familiar. But there is a large difference from most earlier experience when the source of the crisis could be traced to irresponsible macroeconomic policies — loose budgets, excessive monetary expansion, an escalating wage/price spiral — the kind of thing toward which International Monetary Fund (IMF) rescue programs were typically and effectively directed in the past. The present situation is more complicated. It involves deep-seated questions about the operation of the global financial system, as well as macroeconomic discipline. And it has become increasingly clear that simply providing escalating amounts of short-term financial resources cannot provide a satisfactory approach — certainly not without providing creditors with a degree of assurance that would raise large questions of moral hazard.

The IMF and the official financial community clearly have been faced with difficult circumstances beyond the well-trodden approach of macro discipline and the provision of short-term credit. In such circumstances, one can empathize with the urge to deal aggressively with matters of internal reform. But there are limits and dangers to that approach, perceptual and political as well as economic.

One is the extreme difficulty of changing ingrained habits of government and business that are rooted in deep-seated cultural patterns. Ordinarily, it is a slow process, and there cannot be any assurance that radical change imposed in a crisis will not exacerbate uncertainty and dislocation; the contagious runs that followed the sudden closing of some Indonesian banks is one case in point. To the extent that “reforms” are, or appear to be, imposed from abroad, the risk of a counterproductive backlash is increased.

More important in the present context, we have to deal with the simple fact that countries with strong banks, honest and democratic governments, relatively transparent accounting systems, and experienced regulators have not been immune to banking crises. The list is long, and it includes the United States.

SMALL ECONOMIES AND VOLATILE MARKETS

But small and open economies are inherently vulnerable to the volatility of global capital markets. The visual image of a vast sea of liquid capital is apt — the big and inevitable storms through which a great liner like the U.S.S. United States of America can safely sail will surely capsize even the sturdiest South Pacific canoe.

The natural defense is to seek the shelter of larger, inherently more diversified and stable ships. With heroic effort, Argentina has effectively adopted the dollar as a parallel currency, and only one sizable private bank remains without substantial foreign ownership and interest. In Mexico, where resistance to foreign ownership of banks was a major issue only a few years ago in the NAFTA (North American Free Trade Agreement) negotiations, four of the five largest banks today have important foreign capital. Thailand, strongly protective of its banks and finance companies before the crisis broke, now eagerly seeks foreign participation. On the other side of the world, in Eastern Europe, foreign ownership of banks is becoming commonplace.

In the nonfinancial world, there can’t be much doubt that similar forces are at work. Distressed industrial and commercial firms will naturally look more favorably on injections of capital from abroad, whether by means of joint ventures or outright sale. Without doubt, to large and diversified international companies, this is a buying opportunity.

To put the point more generally, the economic logic of living in a world of global capital markets is much more integration, with the crisis force-feeding the existing tendency. The obvious counterpoint is a growing lack of autonomy in economic management, easily perceived as an affront to sovereignty. That potential for political resistance will be all the greater if the changes seem to be forced not by economic logic and national decision but by external forces with their own agenda.

One thing is sure. If a country wants to participate in open markets for goods and other services, it can't feasibly opt out of world financial markets. The fact is, finance is intertwined with trade and investment. There are so many ways for funds to flow, and so many incentives to circumvent controls, that effective insulation cannot be achieved without stifling growth.

BALANCING RISKS AND OPPORTUNITIES

So what can we do to better balance the opportunities and risks of global financial markets?

For one thing, justified skepticism about the efficacy of controls does not mean we need to frown on more limited efforts to restrain inflows of potentially "hot money." Some countries, with Chile the leading case in point, have developed techniques to restrain those flows that are broadly consistent with the basic desirability of encouraging prudence in banking practices.

A much more fundamental and difficult matter is exchange rate management. Not so long ago, there was considerable sympathy for the use of a stable exchange rate for smaller, inflation-prone countries as a key policy objective and an anchor for expectations. In the aftermath of crises, criticism has mounted that exchange rates were too rigid, that something much closer to free-floating rates would have helped protect against volatile capital flows.

The reality is that, left to the market, exchange rates of small and open economies are likely to be prone to wide and disturbing fluctuations. That is why the natural instinct is to seek shelter by maintaining a stable relationship with close trading partners or one of the major world currencies. In the industrialized world, the ultimate expression of that instinct is the drive toward a common currency in Europe. Another manifestation is the new interest in currency boards, accepting the loss of monetary sovereignty.

Much more common are compromise approaches formally or informally setting a range of values around a reference currency or a basket of currencies. Quite a few countries have managed such arrangements for considerable periods. There will, of course, be strains in the face of volatile capital markets and all the pressures and uncertainties in real economies. That is all the more true in Asia, where trading and financial patterns are so widely dispersed among North America, Japan, and Europe. The choice of an appropriate anchor currency is not obvious.

Those difficulties are compounded when the major world currencies are themselves highly volatile. One precipitating factor in the Asian crisis was the large depreciation of the yen. With its currency loosely linked to the dollar, Thailand's competitive position was sharply and unexpectedly undercut. But the solution is not so clear.

With fluctuations in the yen/dollar rate in a range of 50 percent or more over the space of a year or two, Thailand, or any similarly situated country, faces an insoluble dilemma. Both Japan and the United States are important markets and sources of finance. But stability against one currency is volatility against the other. Attempts to split the difference, even if practically feasible, can't escape competitive distortions.

One of the few constructive by-products of the Asian crisis is that, finally, questions are again being asked about the design — or, more accurately, the absence of design — of the exchange rate system. For years, the "Big Three" (Germany, Japan, and the United States) have been reassuring each other that the recurrent volatility among their exchange rates would settle down — or if not, it didn't really matter much any way. Today, that air of insouciance is harder to maintain.

POLITICAL AND ECONOMIC IMPERATIVES

It's a frustrating time, analytically as well as practically, in dealing with the unprecedented problems of emerging Asia. Criticism and unhappiness about the role of the IMF and the other major players in international finance has been inevitable. The Fund itself appears to recognize the need for stepping back and for assessing with a fresh mind the challenges posed by the new world of global finance. The fact is, new approaches are needed.

There should also be no doubt about what is at stake. If, a few years down the road, the turbulence of markets persistently undercuts strong and consistent growth in emerging markets, then temptations to reject the ideology of open markets and multilateralism will increase. The kind of open, benign regionalism characteristic of much of today's trading world could turn malignantly inwards, with all that implies for political conflict as well as economic tension.

Plainly, the United States is the single most influential actor in all of this. The danger lies in a certain arrogance — a tendency in the U.S. Congress particularly to pull back from international economic leadership in the illusion that we can be secure in our own strength, lulled by the performance of our economy and booming financial markets.

Even the United States is not, and cannot be, an economic or political island. The simple fact is we need to work within and through international organizations — organizations that we largely created — if we want our vision of open markets and political consensus to prevail. There is another imperative. In our insistence that the beleaguered economies of Asia take tough steps to reform their own economies, the United States must recognize the need to keep its markets open. That happens to be in our immediate economic interest, helping to maintain price stability in the midst of vigorous growth. More fundamentally, the United States must demonstrate by its own actions that its advocacy of open trade is a lasting commitment, for fair weather and foul. ❑

NET PRIVATE CAPITAL FLOWS TO EMERGING MARKETS, 1984-1997

(in 1,000 millions of U.S. dollars)

Emerging markets	**1984-89***	**1990-96***	**1994**	**1995**	**1996**	**1997**
Total net inflows:	15.2	148.1	160.5	192.0	240.8	173.7
of which were:						
direct investment	12.9	63.1	84.3	96.0	114.9	138.2
portfolio investment	4.7	54.1	87.8	23.5	49.7	42.9
Asia						
Total net inflows:	13.0	55.9	63.1	91.8	102.2	38.5
of which were:						
direct investment	4.5	32.2	43.4	49.7	58.5	55.4
portfolio investment	1.5	6.8	11.3	10.8	10.2	-2.2
Western Hemisphere						
Total net inflows:	-0.2	45.7	47.4	35.7	80.5	91.1
of which were:						
direct investment	5.3	18.7	24.3	25.3	36.9	51.2
portfolio investment	-0.9	29.9	60.6	-0.1	25.2	33.5
Middle East and Europe						
Total net inflows:	1.7	25.2	15.5	14.8	20.7	16.1
of which were:						
direct investment	1.1	3.0	4.2	5.1	4.3	5.1
portfolio investment	4.4	12.8	12.5	8.4	7.9	6.8
Africa						
Total net inflows:	3.6	4.4	10.6	13.8	4.5	8.9
of which were:						
direct investment	1.1	2.9	3.6	4.2	5.3	7.7
portfolio investment	-0.8	-0.2	0.5	1.4	-0.3	2.6

*Annual averages
Source: International Monetary Fund

❑ IMF'S SPECIAL DATA DISSEMINATION STANDARD (SDDS) AND GENERAL DATA DISSEMINATION SYSTEM (GDDS)

The International Monetary Fund is encouraging its 182 members to make comprehensive and timely data about national economic and financial conditions publicly available on the IMF's Dissemination Standards Bulletin Board (DSBB) Web site (http://dsbb.imf.org).

The information that appears on the IMF Web site should meet the requirements for detail and timeliness set by the Fund's Special Data Dissemination Standard (SDDS), which was officially launched in April 1996. The SDDS is for countries that either already have, or seek to have, access to international capital markets. Although participation is voluntary, to date 46 countries have agreed to the SDDS requirements, and their economic and financial data appear on the IMF Web site. The countries have a transition period that extends to the end of 1998 to bring their data fully up to SDDS level.

The primary mission of the General Data Dissemination System (GDDS), formally established in December 1997, is to help countries improve the quality of the data they compile and make public. This includes assistance in preparing economic, financial, and socio-demographic data that are comprehensive, timely, accessible, and reliable.

Following are excerpts from the introductory information on the SDDS and the GDDS obtained from the IMF Dissemination Standards Bulletin Board Web site. More complete information and the data itself are available at the site.

SDDS OVERVIEW

Purpose: The Special Data Dissemination Standard (SDDS) was established by the International Monetary Fund (IMF) to guide members that have, or that might seek, access to international capital markets in the provision of their economic and financial data to the public. Both the General Data Dissemination System (GDDS) and the SDDS are expected to enhance the availability of timely and comprehensive statistics and therefore contribute to the pursuit of sound macroeconomic policies; the SDDS is also expected to contribute to the improved functioning of financial markets.

Subscription: Subscription to the SDDS was opened in early April 1996 by a letter from the IMF's managing director to all IMF members and governors. Although subscription is voluntary, it carries a commitment by a subscribing member to observe the standard and to provide certain information to the IMF about its practices in disseminating economic and financial data. A member country's subscription, which can be made at any time, is to be communicated in writing to the Secretary of the IMF. To date, there have been 46 subscriptions to the SDDS.

The dimensions and monitorable elements of the standard: The SDDS, in taking a comprehensive view of the dissemination of economic and financial data, identifies four dimensions of data dissemination:

- The data: coverage, periodicity, and timeliness;
- Access by the public;
- Integrity of the disseminated data; and
- Quality of the disseminated data.

For each of these dimensions, the SDDS prescribes two to four monitorable elements — good practices that can be observed, or monitored, by the users of statistics.

The data dimension lists 17 data categories that provide coverage for the four sectors of the economy, and it prescribes the periodicity (or frequency) and timeliness with which data for these categories are to be disseminated. In recognition of differences in economic structures and institutional arrangements across countries, the SDDS provides flexibility. Certain categories are marked for dissemination on an "as relevant" basis. Further, some data categories or components of data categories are identified as encouraged rather than prescribed. With respect to periodicity and timeliness, a subscribing member may exercise certain flexibility options while being considered in full observance of the SDDS.

The monitorable elements of the SDDS for access, integrity, and quality emphasize transparency in the compilation and dissemination of statistics.

• To support ready and equal access, the SDDS prescribes (a) advance dissemination of release calendars and (b) simultaneous release to all interested parties.

• To assist users in assessing the integrity of the data disseminated under the SDDS, the SDDS prescribes (a) the dissemination of the terms and conditions under which official statistics are produced and disseminated; (b) the identification of internal government access to data before release; (c) the identification of ministerial commentary on the occasion of statistical release; and (d) the provision of information about revision and advance notice of major changes in methodology.

• To assist users in assessing data quality, the SDDS prescribes (a) the dissemination of documentation on statistical methodology and (b) the dissemination of component detail, reconciliations with related data, and statistical frameworks that make possible cross-checks and checks of reasonableness.

Consistent with this comprehensive view of data dissemination, dissemination itself is broadly defined to include electronic dissemination in addition to the more traditional formats.

Transition period: A transition period for the implementation of the SDDS began with the opening of subscription in early April 1996 and will end on December 31, 1998. During this period a member may subscribe to the SDDS even if its dissemination practices are not fully in line with the SDDS at that time. This period gives subscribers time to adjust their practices, according to a plan that is to be presented, to bring them into line with the standard. During the transition period, the IMF will also elaborate more fully certain operational aspects and review the content and procedures of the SDDS with a view to making any adjustments needed in the light of experience.

Metadata: A subscriber is expected to submit information about its data and its dissemination practices — its metadata — to the IMF for presentation on an electronic bulletin board. The metadata are to be submitted to the IMF within three months of subscription, except those relating to summary methodologies (for which more time is provided). Subscribers' metadata are reviewed by the IMF for comprehensiveness and international comparability. The responsibility for the accuracy of the metadata, including timely updates, and for the economic and financial data underlying the metadata rests with the subscriber.

The role of the bulletin board: The Dissemination Standards Bulletin Board (DSBB) will be maintained by the IMF. SDDS metadata are useful in their own right, and their presentation on the DSBB will facilitate monitoring of observance of the standard by the financial markets and other data users. The DSBB now provides hyperlinks between the SDDS metadata and actual country data for 16 countries.

A member's presence on the DSBB as a subscriber to the SDDS will indicate that it intends to observe certain tenets of good statistical citizenship. Subscribers will not be removed from the DSBB during the transition period except for egregious nonobservance. After the transition period, serious and persistent nonobservance will be cause for removal. Procedures for removal, which could involve a panel of independent experts and would require a decision by the IMF Executive Board, will be elaborated fully during the transition period.

DATA CATEGORIES

The following data categories are required or encouraged by the IMF's Special Data Dissemination Standard. The list is organized by sector (real, fiscal, financial, external).

[Note: At the IMF DSBB Web site, more information about what the SDDS specifies for each item of this list and what subscribing countries are providing is available from links on the Data Categories page: (http://dsbb.imf.org/category.htm).]

CATEGORIES:

Real sector
• National accounts
• Production indices
• Forward-looking indicators (encouraged)
• Labor market
 - Employment
 - Unemployment
 - Wages/Earnings

• Price indices
 - Consumer prices
 - Producer prices

Fiscal sector
• General government or public sector operations
• Central government operations
• Central government debt

Financial sector
• Analytical accounts of the banking sector
• Analytical accounts of the central bank
• Interest rates
• Stock market: Share price index

External sector
• Balance of payments
• International reserves
• Merchandise trade
• International investment position
• Exchange rates

Population

COUNTRIES PARTICIPATING IN THE SDDS

As of July 1998, the following governments have subscribed to the SDDS; an asterisk in front of the name indicates subscribers for which metadata are posted on the SDDS:

Argentina, * Australia, Austria, * Belgium, * Canada, * Chile, * Colombia, * Croatia, * Czech Republic, Denmark, * Ecuador, El Salvador, Finland, * France, * Germany, * Hong Kong, China, * Hungary, * Iceland, * India, * Indonesia, * Ireland, * Israel, * Italy, * Japan, * Korea, * Latvia, * Lithuania, * Malaysia, * Mexico, * Netherlands, * Norway, * Peru, * Philippines, * Poland, * Portugal, Singapore, * Slovak Republic, Slovenia, * South Africa, * Spain, * Sweden, * Switzerland, * Thailand, * Turkey, * United Kingdom, * United States

GENERAL DATA DISSEMINATION SYSTEM (GDDS)

Note on the General Data Dissemination System: The IMF Executive Board approved the establishment of the General Data Dissemination System (GDDS or General System) at its meeting of December 19, 1997. This step concluded an important stage in the Fund's work begun in October 1995, when the Interim Committee endorsed the establishment by the Fund of standards to guide members in the dissemination to the public of their economic and financial data. Those standards were to consist of two tiers: the GDDS, which would apply to all Fund members, and the Special Data Dissemination Standard (SDDS), which would be for member countries having or seeking access to international capital markets. The SDDS was approved by the Executive Board on March 29, 1996.

The primary focus of the GDDS is on improvement in data quality. This stands in contrast with the SDDS, where the focus is on dissemination in countries that generally already meet high data quality standards. Against this background, the GDDS is one of the most important strategic projects for the Fund in the area of statistics, where a long-standing objective has been the improvement of data and statistical practices among the membership. It is hoped that the GDDS will also be a valuable resource for bilateral and multilateral providers of technical assistance, and that the GDDS can provide the basis for enhanced cooperation with other providers of technical assistance.

The General System's purposes are: (1) to encourage member countries to improve data quality; (2) to provide a framework for evaluating needs for data improvement and setting priorities in this respect; and (3) to guide member countries in the dissemination to the public of comprehensive, timely, accessible, and reliable economic, financial, and socio-demographic statistics. The framework takes into account, across the broad range of countries, the diversity of their economies and the developmental requirements of many of their statistical systems. The framework is built around the same four dimensions as the SDDS — data (coverage, periodicity, and timeliness), quality, access, and integrity — and is intended to provide guidance for the overall development of economic, financial, and socio-demographic data. Within this context, the GDDS is oriented to benefit three groups: (1) participating countries would benefit from the process of evaluating their statistical systems and of formulating plans for improvement; (2) multilateral and bilateral providers of technical assistance would benefit from having a framework for assessing the quality of data, for helping set priorities for improvements, and for organizing technical assistance activities; and (3) the data user community would benefit from detailed information about the statistical systems and practices of participating countries.

The GDDS shares several features with the SDDS, particularly the emphasis on the four dimensions. However, the GDDS differs from the SDDS in a number of respects. In addition to its primary focus on improvements in data quality, the GDDS, by including socio-demographic data dissemination, has a broader scope. The GDDS is less prescriptive with regard to periodicity and timeliness of data dissemination, and it recognizes that improvements in data production and dissemination practices may only be achieved in the long run.

The data dimension in the General System will be linked closely to the quality dimension, within which plans for improving data quality will form an integral part of the system. The data dimension of the GDDS addresses the development, production, and dissemination of two interrelated classes of data: (1) comprehensive frameworks for each of the four economic and financial sectors (real, fiscal, financial, and external); and (2) indicators for each of the four sectors, as well as a range of socio-demographic indicators. The GDDS contains, for both comprehensive frameworks and indicators, core categories that are recommended as first priorities and encouraged categories that are extensions from the core and that comprise a link with the data coverage, periodicity, and timeliness of the SDDS. The focus for the access and integrity dimensions is on the development of policies and practices in line with the objectives of dissemination of readily accessible and reliable data. The elements covered in these dimensions are the current practice of data compiling and disseminating agencies in few potential GDDS countries.

In addition to work with countries, the GDDS reflected extensive discussions with other international and regional agencies. There was widespread support for an initiative that focused on improvements in data quality and that recognized that a long-term time frame was necessary to achieve improvements in many areas. The specifications for data coverage, as well as the focus on access and integrity, were generally supported, and the inclusion in the GDDS of socio-demographic indicators was welcomed.

Member countries may implement the General System voluntarily by electing to participate in the General System. Participation consists of three elements: (1) committing to using the GDDS as a framework for statistical development; (2) designating a country coordinator; and (3) preparing metadata that consist of descriptions of current practices and plans for short- and long-term improvements in these practices. These metadata will be disseminated by the Fund through an electronic bulletin board on the Internet.

A phased implementation of the GDDS will focus first on education and training and subsequently on direct work with countries. The training phase of about 18 months will consist of completion of a GDDS module of the Guide to the Data Dissemination Standards and presentation of up to eight regional seminars/workshops on the GDDS.

After the training phase is completed, a period of intensive country work will take place. In certain aspects of the country work, participation of experts from other international agencies would be welcome. Fund staff will continue consultations with international agencies throughout the implementation of the GDDS. ❑

❑ BASLE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Following is the press statement of the Basle Committee on Banking Supervision of the Bank for International Settlements marking the release of the "Core Principles for Effective Banking Supervision." The press statement, released on September 22, 1997, outlines the work of the committee and lists 25 principles of effective supervision. The full 46-page text of the Core Principles is available on the Bank for International Settlements Internet site at http://www.bis.org/publ

PRESS STATEMENT

The Basle Committee on Banking Supervision, with the endorsement of the central bank Governors of the Group of Ten countries, is today releasing the Basle Core Principles for Effective Banking Supervision. This document, which is a revised version of a consultative paper released in April 1997, establishes a set of twenty-five basic Principles which the Basle Committee believes must be in place for a supervisory system to be effective.

The Basle Core Principles have been drawn up by the Basle Committee in close collaboration with the supervisory authorities in fifteen emerging market countries and have benefited from broad consultation with many other supervisory authorities throughout the world.

The Principles represent the basic elements of an effective supervisory system. They are comprehensive in their coverage, addressing the preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking.

The Basle Core Principles are intended to serve as a basic reference for supervisory and other public authorities worldwide to apply in the supervision of all the banks within their jurisdictions. Supervisory authorities throughout the world will be invited to endorse the Core Principles, not later than October 1998. Endorsement will include an undertaking to review current supervisory arrangements against the Principles. The speed with which changes can be introduced will vary, depending on whether the supervisory authorities already possess the necessary statutory powers. Where legislative changes are required, national legislators are requested to give urgent consideration to the changes necessary to ensure that the Principles can be applied in all material respects.

NOTES FOR EDITORS:

1. The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

2. The Basle Committee has been working to improve banking supervision at the international level for many years, both directly and through its many contacts with banking supervisors in every part of the world. In the last year and a half, it has been examining how best to expand its efforts aimed at strengthening prudential supervision in all countries by building on its relationships with countries outside the G-10 as well as on its earlier work to enhance prudential supervision in its member countries. In April 1997 the Committee released two documents:

— a draft comprehensive set of Core Principles for effective banking supervision (The Basle Core Principles); and,

— a Compendium (to be updated periodically) of the existing Basle Committee recommendations, guidelines and standards most of which are cross-referenced in the Core Principles document.

Both documents, with the endorsement of the G-10 central bank Governors, were submitted to the G-7 and

G-10 Finance Ministers in preparation for the Denver Summit in the hope that they would provide a useful mechanism for strengthening financial stability in all countries. They were welcomed by Ministers at the Summit and the Committee was encouraged to continue its work.

3. The document now being issued is a revised version of the April 1997 document. There are still twenty-five Principles and only a few contain changes of substance. Other changes to the document are mostly textual in nature.

4. In developing the Principles, the Basle Committee has worked closely with non-G-10 supervisory authorities. The document has been prepared in a group containing representatives from the Basle Committee and from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Nine other countries (Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore) were also closely associated with the work. The drafting of the Principles benefited moreover from broad consultation with a larger group of individual supervisors, both directly and through the regional supervisory groups, as well as with the International Monetary Fund and World Bank.

5. The document calls on national agencies to apply the Principles in the supervision of all banking organisations within their jurisdictions. The Principles are minimum requirements and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries.

6. The Basle Core Principles are intended to serve as a basic reference for supervisory and other public authorities in all countries and internationally. It will be for national supervisory authorities, many of which are actively seeking to strengthen their current supervisory regime, to use the attached document to review their existing supervisory arrangements and to initiate a programme designed to address any deficiencies as quickly as is practical within their legal authority.

7. The Principles have been designed to be verifiable by supervisors, regional supervisory groups, and the market at large. The Basle Committee will play a role, together with other interested organisations, in monitoring progress made by individual countries in implementing the Principles. It is suggested that the IMF, the World Bank and other interested organisations use the Principles in assisting individual countries to strengthen their supervisory arrangements in connection with their work aimed at promoting overall macroeconomic and financial stability.

8. Supervisory authorities throughout the world are encouraged to endorse the Basle Core Principles. The members of the Basle Committee and the sixteen other banking supervisory agencies that have participated in their drafting all agree with the content of the document.

9. The Basle Committee believes that achieving consistency with the Core Principles by every country will be a significant step in the process of improving financial stability domestically and internationally. The speed with which this objective will be achieved will vary. In many countries, substantive changes in the legislative framework and in the powers of supervisors will be necessary because many supervisory authorities do not at present have the statutory authority to implement all of the Principles. In such cases, the Basle Committee believes it is essential that national legislators give urgent consideration to the changes necessary to ensure that the Principles can be applied in all material respects. The need for new legislation will be taken into account by the Basle Committee in monitoring progress towards implementation.

10. The Basle Committee will continue to pursue its standard-setting activities in key risk areas and in key elements of banking supervision as it has done in documents such as those reproduced in the Compendium. The Basle Core Principles will serve as a reference point for future work to be done by the Committee and, where appropriate, in cooperation with non-G-10 supervisors and their regional groups. The Committee stands ready to encourage work at the national level to implement the Principles in conjunction with other supervisory bodies and interested parties. Finally, the Committee is committed to strengthening its interaction with supervisors from non-G-10 countries and intensifying its considerable investment in technical assistance and training.

11. The twenty-five Core Principles are set out below.

PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

1. An effective system of banking supervision will have

clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

LICENSING AND STRUCTURE

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

PRUDENTIAL REGULATIONS AND REQUIREMENTS

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature

and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

INFORMATION REQUIREMENTS

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

FORMAL POWERS OF SUPERVISORS

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

CROSS-BORDER BANKING

23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision. ❑

KEY U.S. GOVERNMENT CONTACTS AND INTERNET SITES

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Washington, D.C. 20220 U.S.A.
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http://www.ustreas.gov/press

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2201 C Street, N.W.
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http://www.state.gov/www/policy.html

U.S. Information Agency
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Basle Committee on Banking Supervision (Documents)
Bank for International Settlements
http://www.bis.org/publ/pub_list.htm#BS

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Dissemination Standards Bulletin Board
International Monetary Fund
http://dsbb.imf.org

Special Data Dissemination Standard database
International Monetary Fund
http://dsbb.imf.org/sdds.htm

World Bank
Economic Development Institute
Regulatory Reform and Private Enterprise Division
Banking and Finance program Web site
http://www.worldbank.org/html/edi/banking

New York University, Stern School of Business
Comprehensive listing of articles, documents, etc. on Asian economic crisis and global impact compiled by Nouriel Roubini, associate professor of economics
http://www.stern.nyu.edu/~nroubini/asia/AsiaHomepage.html

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