Mr White discusses the Asian crisis and the Bank for International Settlements

A paper presented by Mr William R White, Economic Adviser, Head of the Monetary and Economic Department, Bank for International Settlements, at the conference on "Asia and the future of the world economic systems", organised by the Royal Institute of International Affairs and held in London on 17-18 March 1999.

The Asian crisis, perhaps even more than the Mexican crisis which preceded it, has raised some fundamental issues about the workings of the international financial system. In the course of the Willard process[1] and in many other fora, the behaviour of private sector agents who are internationally active has been widely analysed with a view to devising prescriptions and policies that might reduce the incidence of destabilising activity on their part. The role of the public sector has also been an object of scrutiny, with the IMF and the World Bank receiving particular attention given the size of the public resources they command and their influence over the governments of emerging market economies. Before proceeding to the specific subjects on which I have been asked to comment by the organisers of this conference, it seems to me worth pointing out that the Bank for International Settlements has also been caught up in these deliberations, although the implications for us may be less significant than for others.

A. A new role for the BIS or an old one?

The most recent Communiqué issued by the Finance Ministers and Central Bank Governors of the Group of Seven[2] announced the establishment of a new Financial Stability Forum. The Forum will bring together representatives from each of the G7 countries,[3] the principal international financial institutions and the various international committees whose work focuses on financial stability. The objective would be to ensure a constant dialogue between all those in the public sector concerned about international financial stability, with a view to ensuring closer coordination of the work being undertaken and an enhanced (moral) authority for any decisions taken as to best practices in this area. The BIS will be represented in the Forum along with other international financial institutions, and many of the international committees also represented on the Forum meet regularly at the BIS. In addition, the BIS General Manager will serve (in his personal capacity) as the Chairman of the Forum and its secretariat will be based in Basle.

In some ways, both the process of consultation and the substance of the work being proposed are rather similar to what has been going on in Basle for many years.[4] As to the former, what is increasingly referred to as the "Basle process" involves groups of national officials coming together to discuss international issues of common interest with a view to reaching decisions about recommended forms of behaviour. The Basle Concordat[5] and the Basle Accord[6] are probably the best known examples of the genre. Once a consensus has been reached in such

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1 In response to a request by President Clinton at the APEC Summit in Vancouver, a meeting of representatives of 22 countries (G7 plus 15 significant emerging markets) was convened at the Willard Hotel in Washington on 17 February 1998. Subsequently, three working groups were set up which reported in October 1998 (see BIS/IMF/OECD/World Bank (1998a), (1998b) and (1998c)).

2 See Group of Seven (1999).

3 Each country would be represented by a senior official from the central bank, Treasury and a regulatory agency. With time, it is envisaged that representatives from emerging markets will also be included in the Forum.

4 See White (1998a).

5 See BIS: BCBS (1975).

6 See BIS: BCBS (1988).

fora, national officials must return to their home grounds, where sovereignty still reigns, and convince local lawmakers and commercial interests of the desirability of following the international norms agreed upon. Central bankers and regulators have followed such processes for years in Basle, and the new Forum will in a sense extend this process to include governments themselves. As to the latter, the work undertaken in Basle under the auspices of central bank Governors has a scope and substance which should ensure it makes a useful contribution to the deliberations of the Forum.

A useful conceptual framework for describing this work is a four-dimensional matrix, whose first two dimensions consist of a traditional flow-of-funds table with columns (the institutional sectors involved in the international financial system) and rows (the various markets). The third dimension is the infrastructure which supports the first two dimensions (payment and settlement systems, legal infrastructure, etc.), while the fourth dimension comprises the simultaneous clearing conditions in all the markets subject to sectoral budget constraints. In this conceptual framework, failures or shortcomings with respect to any of the first three dimensions will have implications for market clearing conditions which will in turn feed back on the real economy. It was the recognition that financial instability has such macroeconomic implications which led policymakers to coin the new phrase "macroprudential policies" — namely, policies designed to strengthen each dimension of the international financial system referred to above (institutions, markets and infrastructure) thus helping to limit the damage should some shock hit any part of the system.

It is more a product of historical circumstance than design that the Basle community comprises relevant committees of national experts[7] in each of the three defined areas. Within the first sectoral dimension is the Basle Committee on Banking Supervision (BCBS), whose work is by now well known. More recently Basle has also become home to the secretariat of the International Association of Insurance Supervisors (IAIS). An offer has also recently been made by the Swiss Government, with support from the BIS, to relocate the secretariat of IOSCO to Basle. But, in any event, that group (representing the international investment dealing community) interacts regularly with the Basle Committee and the IAIS in the form of the Joint Forum, the Secretariat of which is also located at the BIS. As for the second dimension of the matrix (markets), the Euro-currency Standing Committee (ECSC) has had a long record of deliberations, publications and data collection pertaining to the evolution of international financial markets and possible systemic implications. The third dimension is infrastructure, and in this domain the Committee on Payment and Settlement Systems (CPSS) has been increasingly active in recent years.[8] Finally, the way in which the market clearing conditions bring together the dimensions referred to above has recently been reflected in the renaming of the ECSC. Reflecting the new mandate given to it in February 1999 by the Central Bank Governors of the Group of Ten countries, this committee is now to be called the Committee on the Global Financial System (CGFS). This name is intended to emphasise a new focus on how those dimensions of the international financial system ultimately come

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[7] It is important to emphasise the concept of **national** experts. It is these people who provide the central input to all the decisions made by the committees and the documents they produce. The staff of the BIS, in particular those providing secretariat support to the committees, have as their primary function to support the cooperation of others. This makes the BIS quite a different type of organisation from both the IMF and the World Bank group, though perhaps less different from the OECD and the WTO.

[8] Issues having to do with the legal infrastructure underpinning the international financial system have also been of growing interest to the Basle community, although until now ad hoc procedures have been relied upon rather than a standing committee directed to such issues.

together in a market framework, and how steps might be taken to make that framework more stable.[9]

The active prospective involvement of the Basle community in the Financial Stability Forum is only one aspect of its response to the Mexican and Asian crises. The Monetary and Economic Department of the BIS, which traditionally provides analytical and statistical support to the work of the various Basle-based committees, will also focus more intensively on such issues. Moreover, with the establishment last year of the BIS Financial Stability Institute, there is now another vehicle for the practical dissemination of the best practices established both by the relevant BIS committees and other groups concerned with international financial stability. These are admittedly small contributions by a relatively small international financial institution, but they may go some way to helping avoid a repetition of the dramatic events we have seen in international financial markets since mid-1997.

The subject matter assigned to me today seems to fall neatly into two categories. The first of these (monitoring capital flows, currency boards and foreign exchange controls) has to do with resolving the so-called "impossible trinity" problem. Since a country cannot simultaneously have free capital flows, a fixed exchange rate and an independent domestic monetary policy, what should be given up? The second topic (reform of capital adequacy ratios, regulating the regulators) has inter alia to do with minimising the fallout when macroeconomic problems do emerge. How can regulation make the system more stable in principle and how can we assure that those principles are being applied in practice? The rest of this paper deals with these two issues. It will come as no surprise if I also choose to highlight the particular contributions which have already been made, or are in the process of being made, by the Basle-based committees in response to both the Mexican and Asian crises.

B. Monitoring short-term capital flows and responding to them

A belief that has recently grown in strength is that increased transparency on the part of all economic agents would sharply improve the functioning of markets and lead to greater financial stability.[10] It is hard to object to this at the level of principle, though it is disconcerting that much of the impetus for this belief comes from a misapprehension. It has been frequently asserted that the size of the inflows into the Asian countries later affected by the crisis would have been much smaller had individual investors been made aware of the aggregate exposure of these countries. It is hard to believe that the basic problem was a shortage of information given that the international financial statistics collected semiannually by the BIS and the OECD (based on banking statistics and trade credits) were widely available. These data clearly indicated both growing debt levels and a very high proportion of short-term debt in the case of many countries. Indeed, concerns based on these figures (albeit sotto voce) were raised as far back as 1995 in the quarterly publications of the BIS as well as in successive BIS Annual Reports.

Perhaps reflecting the availability of such information, some non-bank financial institutions[11] and equity investors seemed to begin moving out of Asian markets much sooner than

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[9] Generally speaking, measures taken to strengthen individually each dimension of the system might be assumed to strengthen the system itself. Nevertheless, there might well be instances where a more comprehensive (cross-committee) approach might prove still more beneficial. The design of public sector safety nets is a good case in point.

[10] See BIS/IMF/OECD/World Bank (1998a) and BIS (1997), Chapter IV.

[11] See BIS (1998a), Chapter V.

internationally active banks, whose eventual response was both sharp and highly disruptive. Informal enquiries about the banks' behaviour would appear to indicate that a shortage of information about international exposures was not the basic problem. Indeed, while in some cases credit officers failed to detect the risk, in other cases the senior management of banks seems to have overridden the specific recommendations of their credit officers. While this may still have been sound strategic practice, given the limited exposure of individual large banks, the collective impact on the debtor countries was severe. This in itself would indicate that some form of market failure took place, though not necessarily one based on a shortage of information.

To say that a lack of information was not the heart of the problem is not to say that the available data were ideal. Indeed, after the Mexican crisis, the (then) ECSC made considerable efforts to improve the semiannual banking statistics collected by the BIS. Steps were taken to expand the number of reporting countries, and the reporting and publication lags were reduced from more than six to less than five months and still further reductions are planned. In addition, steps were taken to reclassify the exposure of national banking systems on the basis of "ultimate risk" to deal with the problem of loans booked by emerging countries in international financial centres. In another development, the Inter-Agency Task Force on Finance Statistics[12] has agreed to build on and replace the existing set of BIS/OECD external debt statistics with a new set[13] of debt statistics which is jointly issued by the BIS, IMF, OECD and World Bank. It brings together for the first time the best international comparative data currently available on external debt. This data will be published quarterly from 15 March onwards, on as timely a basis as possible. [14]

The monitoring statistics referred to above are drawn in very large part from the on-balance sheet positions of a limited number of (albeit important) creditor institutions. An obvious shortcoming is that they do not pick up the off-balance sheet positions of any institutions, nor the aggregate positions of non-regulated financial institutions.[15] The former problem can be rectified with time, under current legislation. However, the latter problem is thornier and is at the heart of the debate about the role of hedge funds in the Asian crisis. Many Asian-Pacific authorities (including representatives from Australia, Hong Kong and Malaysia) feel strongly that hedge funds set out systematically to destabilise their currencies and their financial markets.[16] However, other evidence is less compelling in support of this hypothesis[17] and, even if accepted, would not necessarily lead to the conclusion that such funds should be regulated. As the US authorities consistently point out, many other institutions also engage in highly leveraged position taking, including the proprietary trading desks of both regulated and unregulated institutions. The implication of this fact is that the authorities might have to

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[12] This Task Force, which is chaired by the IMF, comprises the BIS, the European Central Bank, Eurostat, the OECD, the United Nations and the World Bank.

[13] The data are not **new** in the strict sense because all of them have been published elsewhere before. Moreover, as indicated in the text, by far the largest part of the information is provided by the BIS international locational and consolidated banking statistics. For a description of the exact relationship between the BIS locational and consolidated banking statistics, see BIS (1998b), pp 32-43.

[14] These data can be found at *www.bis.org/publ/r_db9901.htm* or at *www.oecd.org/dac/debt*.

[15] Being drawn from creditor sources, they also fail to pick up securities issued in domestic markets and purchased by foreign investors. To date, this does not seem to have been a major drawback to the use of these creditor-based statistics.

[16] A common tactic, seen both in Hong Kong and later in South Africa, was for hedge funds to sell short the currency as well as a long-duration investment (e.g. shares and bonds) whose value was particularly sensitive to short-term interest rates. If the monetary authority supported the currency by raising interest rates, the speculators profited from the domestic play. If the monetary authorities let the currency slide, the profit was on the currency play.

[17] See BIS (1998a), Chapter V.

regulate this kind of activity at all types of institutions, in turn raising the issue of how to prevent it from simply moving offshore.

What does seem to have been agreed in the international community is that it would be desirable to have more information about the activities of highly leveraged investors who are internationally active. Not only does this seem prima facie a good thing, but some authorities also consider such information a fair counterpart to the provision of more information by public sector authorities about their own off-balance sheet activities.[18] Currently, three avenues are being actively explored within the Basle community. The Basle Supervisors are primarily concerned about the health of banks and wish to be assured that the loans made to highly leveraged institutions are subject to the proper kind of credit analysis. A subgroup of the BCBS (the Brockmeijer working group) has already published two documents, one outlining deficiencies in past banking practices and the other suggesting guidelines for good practice in the future.[19] The CGFS has two initiatives under way. One is a reprise (under the same chairman) of the 1994 Fisher Report[20] which acted as a catalyst for enhancements to disclosure practices by financial institutions in relation to market and credit risk exposures arising from their trading activities, including those involving off-balance sheet instruments. The primary objective of this exercise is to encourage further improvements in disclosure so as to ensure that market participants have an adequate basis for an appreciation of the risks they are running in dealing with, investing in or lending to, financial institutions. The second CGFS initiative is to examine what kind of aggregate information about exposures would help to improve the functioning of markets, taking as a starting-point the BIS international banking statistics.

Having adequate knowledge about short-term capital flows is one thing. Establishing an exchange regime to minimise their disruptive effects, while maintaining their longer-run efficiency benefits, is quite another. As already stated, a country cannot have completely liberalised capital flows (assuming a high degree of substitutability between domestic and foreign assets), a fixed exchange rate regime and an independent monetary policy. The events in Asia and more recently in Latin America have highlighted the need for trade-offs, but have not provided guidance as to optimal solutions. Indeed, what is of particular interest is how quickly opinions have reversed about the desirability of specific options. This in turn raises the fundamental issue of how much any of us really understand.

Consider first the issue of capital controls. It was less than two years ago that the IMF was vigorously pursuing the issue of revising Article VIII of the Fund's statutes to allow the Fund to promote actively the liberalisation of the capital account in emerging market economies.[21] Today, there is a much greater willingness to recognise that some capital controls may have a

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[18] One feature of the Asian crisis was that a number of governments supported their currencies extensively using forwards and other forms of off-balance sheet intervention. This information was hidden from the public and, when revealed, indicated that the true level of reserves was much less than thought. This contributed to the aura of panic and the sudden desire on the part of creditors to withdraw. To provide an example of proper behaviour in this regard, the G10 countries agreed to adhere to a template on foreign exchange exposure drawn up by a subgroup of the ECSC. This template will serve as the basis for the statistics to be submitted to the SDDS database operated by the IMF.

[19] See BIS: BCBS (1999a) and (1999b).

[20] See BIS: ECSC (1994).

[21] It is worth reminding ourselves that the postwar Bretton Woods agreements were designed to discourage such flows. Keynes and others were concerned that capital flows would cause problems which would lead countries to retaliate in the form of trade protectionism. Since, in light of the experience of the 1930s, the fear of protectionism was of primary concern, it was considered at that time to be an acceptable trade-off to give up the benefits of a more open capital account.

useful role to play. References are frequently made to the Chilean experiment and their careful use of controls over short-term capital inflows. Concerns about a possible prolongation of the current crisis through a devaluation of the Chinese renmimbi are assuaged through reference to the fact that China still has capital controls. Even the Malaysian experiment, as flawed and potentially dangerous as it was,[22] does not seem to have had the dire consequences predicted by many at the time. A consensus also seems to be forming that, if controls are required to deal with a crisis, they should be directed to incoming capital only, should favour longer-term over shorter-term inflows, and should be accompanied by clear indications as to when they might be removed. Note that the new consensus does not extend to questioning the longer-term benefits of international capital flows.

When we turn to the issue of exchange rate regimes, a similarly rapid change of views seems to have occurred. Prior to the Russian and Brazilian crises, a constant refrain was that countries using a fixed exchange rate regime to stabilise inflationary expectations also needed an "exit strategy". This last point was in recognition of the fact that real exchange rates tend to rise during a disinflationary process, leading to a deteriorating current account which in turn undermines the credibility of the fixed rate regime. Since the onset of the Brazilian crisis, we have been hearing an increasing number of references to the desirability of imposing a currency board in Brazil. Going even further down this path, the Argentinians, who already have a currency board, have hinted at dollarising the economy if the Argentine peso comes under further attack. Both suggestions have validity to the extent that dedication to an "immutable" fix reinforces the credibility of the regime and leads to a stronger domestic currency and lower interest rates.[23]

Yet, such policies are also the very antithesis of the exit policies of such recent fashion. The question remains unanswered as to what will happen if the current account continues to deteriorate under such a regime and the unemployment rate continues to rise because of excessively high domestic labour costs? Since domestic legislatures are always sovereign, fears would remain that the exchange regime policies could be reversed. At the very least, a substantial credit risk premium might be expected to remain for borrowers from such countries, at least until they set their "house" in order. This having been said, it remains within the realm of the possible that a combination of initial sharp currency depreciation, imposition of a still more credible exchange rate regime, sticky domestic wages (even as prices rise) and fiscal probity might be sufficient to deal with the longer-term competitiveness problem.[24]

What is also surprising in light of the Asian experience is that the merits of voluntarily adopting a regime of floating, the polar extreme to the immutable fix, has not received more attention.[25] This is particularly surprising given the (albeit questionable) hypothesis that most

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[22] The greatest danger arising from the unilateral Malaysian imposition of controls on outgoing capital was that it would increase investors' fears that the same policies might be followed elsewhere. In practice, it took the Russian default and effective declaration of non-convertibility to initiate a withdrawal of international investors from emerging markets more generally.

[23] The gains could be particularly great for Brazil since the government's internal debt is large and very short-term. Thus, lower interest rates lower debt service and the deficit and this presumably would make the currency stronger contributing to a virtuous circle of lower interest rates in turn. The stronger currency would pay a further dividend in that a significant proportion of the government's internal debt service is indexed to the US dollar. This highly interactive and non-linear system could also operate in reverse were confidence not to return.

[24] Szapáry (1998) makes similar observations with respect to eastern Europe.

[25] In the Financial Times of 22 February 1999, reporting on the G7 meeting of Finance Ministers and Central Bank Governors on the preceding weekend, 28 items were listed as being on the G7 timetable for reform of the international financial system. The only reference to exchange rates was "Considering necessary elements for

Asian countries suffered enormously from pegging their currencies too tightly to the US dollar. In the early 1990s, as the dollar weakened against the yen, pegged Asian currencies became over-competitive. This led to massive capital inflows (especially from Japan), domestic overheating and an unprecedented increase in production capacity in many areas. The fact that the peg against the dollar was considered inviolate also encouraged domestic residents (including banks) to borrow abroad in foreign currencies at low interest rates. All of these tendencies were to create major problems later, problems which might have been avoided had the domestic currencies been allowed to appreciate in the face of capital inflows. Later (from early 1995), dollar strength against the yen coincided with a period when the prices of products extensively produced in Asia were already under pressure globally. The combination proved unsustainable and the peg had to be given up on the downside in an environment of full-blown crisis with attendant (and domestically painful) requirements for both fiscal and monetary tightening.[26]

There is, of course, no single right answer to the choice of an exchange rate regime either for emerging or industrial economies.[27] The right answer for a single country depends on that country's particular circumstances. However, clarifying the criteria for making choices would now seem a particularly ripe area for fruitful analysis in the case of emerging market economies. Clearly, some important mistakes have recently been made in this area. And the wide variety of recommendations being made to different countries by academics and others argues for an assessment of the criteria on which those recommendations are being made.

C. Improving international banking regulation and supervision

Regulation and supervision are not the same. The former has to do with setting out rules, while the latter has to do with ensuring that the behaviour of financial institutions is overseen and that the rules are followed. We must distinguish as well between principles and practices in both areas. For example, it has been relatively easy[28] to lay out certain Core Principles of Banking Supervision, but the next stage of ensuring their global implementation will be much more difficult and time-consuming. In light of some of the banking problems which emerged in Mexico and more recently in Asia, let us consider some recent advances in the area of international banking regulation and supervision.

Perhaps the best-known of all the international banking **regulations** are the Basle Capital Adequacy Ratios. These ratios are now being re-examined by the BCBS with a view to having a consultative document in the public domain in April 1999. While developments (such as securitisation and advances in credit risk modelling practices) in industrial countries gave the main impetus for this review, the re-examination was also motivated by the Mexican and Asian developments. In particular, it has been pointed out by some analysts that the preferential treatment of bank loans made to counterparties in countries which are members of

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maintaining sustainable emerging market exchange rate regimes". Martin Wolf in the Financial Times has also drawn attention to this puzzle of omission.

[26] One reason why countries may currently hesitate to adopt floating is that they confuse what might happen under such a voluntary regime with what did happen (effectively an uncontrollable depreciation) when countries were forced off their previous peg.

[27] These issues bring us back to the literature on optimal currency areas pioneered by Robert Mundell. Many of the pertinent criteria for joining such an area (a **truly** immutable fix) were revisited in the period leading up to the introduction of the euro.

[28] The operative word here is "relatively" since the background documents on which the Core Principles were based took over 15 years to agree upon and the Core Principles themselves took over a year to draft.

the OECD[29] may have contributed to both Mexico and Korea attracting more short-term capital than was healthy. Further, it has been suggested that the low capital requirements imposed on short-term interbank loans also shifted lending into such categories, increasing the likelihood of a sudden and dangerous reversal.

Without wishing to deny these suggestions, it is important to note that there are alternative (perhaps even complementary) explanations of the behaviour of internationally active banks in the Asian crisis. An important consideration, affecting Japanese and continental European banks in particular, appears to have been the search for return abroad in light of heightened competition and shrinking margins at home.[30] While acceptance of this explanation might also have implications for a revision of the Capital Accord, the implications would be of a decidedly different nature.[31]

A second factor which may have influenced bank behaviour was the existence of safety net provisions provided by public sector entities, both domestic and international. For example, consider the case of Korea. Once it became clear the domestic authorities would not let Korean banks fail, interbank loans funded from abroad bore Korea's sovereign credit status. Moreover, given that the loans were short-term and denominated in dollars or yen, there was no explicit won currency risk. Finally, in light of the Mexican, Thai and other international rescue packages, there was a perception that there was no liquidity risk either. In such circumstances, it was perhaps not surprising that internationally active banks were willing to lend as much as they did at ever narrowing risk spreads. This interpretation of events has public policy implications with respect to safety nets, as much as they do for the specification of capital adequacy ratios.

Developments in international banking and capital markets in the years spanning the Mexican and Asian financial crises contributed to a desire to revisit the credit risk baskets in the Capital Accord, and indeed the whole approach to credit risk which underlies that Accord. The biggest losses in banking traditionally arise from credit risk. The Basle Supervisors will, as noted, be issuing a consultative document with a view to having a revised Capital Accord as soon as possible. They will also soon be issuing a paper which investigates the potential use of in-house credit models to replace or augment more traditional regulatory measures of capital requirements. While the problems inherent in this approach are even more daunting than in the use of such models to evaluate exposure to market risk, technology is advancing so rapidly that it merits keeping an open mind.

Applying capital ratios in practice is also not as simple as one might like, in large part because there continues to be much uncertainty about the accounting definitions which underlie these calculations. This certainly applies in many emerging markets, and this fuzziness perhaps explains why there seems to be no clear relationship between actual movements in capital

[29] This so-called "Club Rule" was originally adopted after lengthy consideration failed to reveal an acceptable alternative.

[30] Similar forms of behaviour, otherwise known as "irrational exuberance" or "excessive optimism" have been seen in a large number of different markets across the world in recent years. Some discussion of the underlying forces at work is provided in the *BIS 67th Annual Report* (see BIS (1997), pp 3-4 and Chapter VIII). See also White (1998b) and the French and Belgian contributions in BIS (1999).

[31] Such global tendencies towards enhanced competition seem likely to be further encouraged by the introduction of the euro in continental Europe, the prospective demise of Glass-Steagall in the United States and the introduction of "Big Bang" in Japan. Such trends might imply that capital ratios should on average be higher than they have been.

ratios and subsequent crises.[32] Yet it must be said that there remain problems in certain industrial countries as well, with Japan being a particularly important example even if progress has been made recently. There continue to be important international differences in the provisioning for future losses and the definition of non-performing loans. Moreover, what counts as capital has also been changing as financial institutions have creatively issued new liabilities which may or may not be a charge on future earnings. Both these issues have been actively addressed[33] by the Basle Committee, though more work will be necessary to attain truly harmonised global standards.

Considering now the principles of banking **supervision**, the preparation of the Core Principles of Banking Supervision was an enormous step forward in at least four ways. The Principles were comprehensive; they addressed all banks and not just those which are internationally active; they were drawn up in association with representatives of emerging markets; and they were designed to provide a checklist of good practice, not only by national supervisors but also other interested parties in both the public and private sectors.[34] Moreover, the dissemination of these Core Principles has already had an influence extending far beyond the Principles themselves, in that the process is serving as a model for the creation of similar sets of core principles in a wide range of other areas. The IAIS (insurance) has already laid out a set of core principles as has IOSCO (investment dealers), and the CPSS (payment and settlement systems) is in the process of doing the same. Finally, a perusal of the various recommendations of the working groups associated with the Willard process indicates that core principles and international standards of best behaviour have become the flavour of the month.[35] Whether all these principles can be effectively transformed into action in all of these areas having a bearing on financial stability remains to be seen.

Turning principles of good behaviour into good practices in the financial area will certainly not be an easy task. Principles provide guidelines of behaviour, but what is also required is an incentive system to ensure that actions follow words. At the present time, four complementary sets of processes in the supervisory area look promising: a code of transparency for national supervisors; peer pressure; tightened residency requirements; and market discipline. The first three of these provide incentives for national supervisors to enforce the Core Principles. The fourth provides incentives for owners and managers of banks to act in accordance with these Principles. While the specifics of the processes pertain to implementation of best practice in the area of banking supervision, similar incentives might be applicable in other areas as well.

The first process, directed, inter alia, to ensuring implementation of the Core Principles of Banking Supervision, has been the preparation of another code — namely, a Code of Good Practices on Transparency in Monetary and Financial Policies. This Code, which is being put together by the IMF in association with the BIS and relevant international committees of regulators, deals in part with the need for transparency in the formulation and conduct of all

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[32] See Lindgren et al (1996), who conclude that capital ratios had no systematic predictive power in emerging market banking crises.

[33] See BIS: BCBS (1998).

[34] It is also worth noting that these Principles are not cast in stone but will have to be constantly revisited, and revised. This implies an ongoing iterative process between the Basle and emerging market Supervisors, who drew up the Principles, and others (in particular the IMF) who will be seeking to apply these Principles in the field.

[35] At the BIS, the CGFS has, as noted, recently proposed a template, agreed with the IMF, for providing information about national foreign exchange reserves and contingent assets and liabilities affecting them. The CGFS is also looking into the possibility of preparing a set of good practices for the establishment of well functioning markets; this would be a follow-up to a "Report by a Study Group on market liquidity" which is currently being revised prior to publication.

policies (deemed Financial Policies) having implications for financial stability. If information about how the supervisors are behaving is a necessary condition for ensuring that the banks are behaving properly, this Code of Transparency seems a useful initiative. The Code of Transparency is still in the process of being finalised, but in its current form it is based upon a sensible if (to some) radical framework. Akin to what is increasingly being accepted in the realm of monetary policy, the draft Code suggests there should be transparency with respect to the supervisors' mandate, the effectiveness of their powers, and their democratic accountability to other bodies. In effect, this Code of Transparency tries to ensure that the supervisors do their job in implementing the Core Principles.

As noted above, transparency may be a necessary condition to ensure that supervisors carry out effectively their task of implementing the Core Principles. But it is hardly a sufficient condition. While the IMF will be monitoring compliance with the Code of Transparency (and also the implementation of the Core Principles themselves[36]), the influence the IMF can exert may be relatively limited unless the country in question has an active programme with the IMF. One complementary suggestion that might be helpful is the exercise of "peer pressure" on national supervisors. Indeed, given that effective banking supervision is often resisted by the political authorities (because of connected lending and other reasons), Central Bank Governors and Finance Ministers from developed countries might usefully try to put similar pressure on their counterparts in emerging markets.[37] In a similar if more extreme vein, a third suggestion would be to limit more aggressively the "right of establishment" in the world's major financial centres. In effect, banks without an adequate supervisory framework in their own country would not be able to conduct an international banking business. This may seem radical, but has been a dictum among industrial countries since the 1975 Basle Concordat.[38]

As well, some still more practical issues having to do with the incentives given to supervisors cannot be overlooked. Supervisors must be paid adequately to prevent a constant haemorrhaging of staff to the private financial sector. Other working conditions must be suitably attractive, including personal legal protection from litigation arising from official decisions. And lastly, supervisors must be properly trained and their training continuously updated to reflect new circumstances created by a changing financial world. The establishment at the BIS of the Financial Stability Institute will go a small way to helping in this last regard. However, the personnel challenge is huge and many years of intensive efforts will be required to respond to it adequately.

The last set of incentives applies to the owners and managers of banks. Aside from effective supervisory pressure, how can they be induced to behave in ways which are consistent with appropriate corporate governance and effective risk management? The first and most obvious point is that they should suffer in light of inappropriate behaviour. This implies that the owners should have their own capital at stake and that managers should be treated as the stewards of that capital. What is also increasingly needed is for market discipline to be used to get the attention of owners and managers. Financial institutions which are thought to be badly

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[36] It is possible that the IMF and World Bank will also play a role in implementing "Codes" elaborated by other Basle-based committees.

[37] *Financial stability in emerging market economies* by the Group of Ten (see Group of Ten (1997)) contained a number of practical recommendations as to how financial stability might be promoted. A meeting of Central Bank Governors and Finance Ministers from both industrial and emerging markets took place in Hong Kong in October 1997 with a view to exerting pressure of this sort. Sadly, most industrial countries were represented only by lower-level officials.

[38] See BIS: BCBS (1975).

managed, or willing to take excessive risks, should have to pay a market price for this; funds should be available only at a premium; collateral requirements should be onerous and share prices should be marked down. Moreover, a similar price should be exacted from firms which release too little information to allow judgements to be made in this regard.[39] Hence the focus on public disclosure.

A last word is also warranted on the role of rating agencies. The activities of these firms have expanded enormously in recent years and their interest in financial institutions has increased commensurately. In light of the recent experience with both sovereign and private sector ratings in East Asia, no one would contend that all ratings have been perfect. Yet it is the very difficulty of the task of assessment that leads one to conclude that professional and specialised efforts in this area are warranted. Ratings increasingly complement, and sometimes even replace, in-house credit risk assessments, and they clearly have the capacity to affect market prices of debt and equity. Ratings thus provide information which helps markets to impose discipline on the owners and managers of financial institutions, and this market discipline serves as a useful complement to internal discipline and the discipline imposed by the supervisory and regulatory authorities.

While this last statement might seem at first glance to recommend a surfeit of disciplinary sources, the costs of recent financial crises indicate that efforts directed to crisis prevention have thus far been clearly inadequate. On the presumption that markets are normally efficient, market discipline should normally be relied upon. At the same time, the supervisory and regulatory authorities must recognise that market failures do occur and should focus their efforts on how such failures might be redressed. The BIS, whether in its old role or some new one, hopes to continue to make a material contribution to these efforts to encourage financial stability.

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[39] See BIS: ECSC (1994). This is also a rationale behind, for instance, the *Disclosure framework for securities settlement systems* by the CPSS and IOSCO (see BIS: CPSS (1997)).

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