COMMENTS ON THE REPORTS ON THE INTERNATIONAL FINANCIAL ARCHITECTURE

Report of the Working Group on Transparency and Accountability

Report of the Working Group on Strengthening Financial Systems

Report of the Working Group on International Financial Crises

August 1999

Reports on the International Financial Architecture

SYNOPSIS OF COMMENTS

In response to the international financial crisis that began in Asia and subsequently spread to other continents, finance ministers and central bank governors from a number of systemically significant economies commissioned three reports on strengthening the international financial architecture.[1] The first report focused on enhancing transparency and accountability, the second on strengthening financial systems, and the third on managing international financial crises. The reports were published in October 1998, and interested parties in the private and official sectors were invited to provide comments.

Written comments were received from a number of interested parties, including non-governmental organisations, public sector officials, academics and students. In addition, some individuals, groups and private firms responded to the reports' recommendations through their own studies, without explicitly providing comments to the secretariat. The concerns and suggestions of those who provided written comments as well as those whose studies have come to the attention of the secretariat are summarised below (see the annex for a list of contributors).

Two themes emerged from the comments and suggestions. First and foremost, interested parties suggested that the reports gave inadequate consideration to the challenges posed by capital account liberalisation, and more specifically to the case for controls on short-term capital inflows. Prudential controls on capital inflows were seen as particularly important for maintaining financial stability in countries with underdeveloped financial systems. Second, further consideration was needed of incentives to implement international standards. Monitoring compliance through, for example, Transparency Reports was welcomed, but some interested parties suggested that sanctions may also be needed, such as conditioning access to financial assistance from the International Monetary Fund (IMF) on a country's adherence to international standards.

In many areas, comments and suggestions from interested parties foreshadowed initiatives by the official sector to follow up on and further develop the

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[1] Representatives from finance ministries and central banks of the following economies participated in the working groups that prepared the reports: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, the Netherlands, Poland, Russia, Singapore, South Africa, Sweden, Thailand, the United Kingdom and the United States.

reports' recommendations. Where relevant, recent and current initiatives by the official sector are footnoted.[2]

CONCERNS ABOUT THE PROCESS

Interested parties expressed support for efforts to reform the international financial architecture and welcomed the opportunity to comment on the reports. A few suggested that the focus of the reports was too narrow and that the reports should have abstracted from current institutional arrangements to analyse the areas where market failures exist and what could be done to address these failures. A related comment was that the reports should have looked for commonalities between crises in emerging market economies and those in industrial countries and, based on this more general approach, assessed the causes of instability in the international financial system. Nevertheless, it was generally recognised that a radical reform of the international architecture was neither feasible at the current juncture nor perhaps even desirable.

A number of concerns were raised about the process by which the reports were prepared and disseminated. First, the exclusion from the consultation process of many of the poorest countries and of representatives of civil society was criticised. The poorest countries have not been as adversely affected by the recent international financial crisis as some of the emerging market economies, but nonetheless many of the recommendations made in the reports affect these countries. It was suggested that a more decentralised policy-making process, that makes greater use of regional fora, could facilitate wider participation. In addition, there were calls for the establishment of an ongoing mechanism for inclusive dialogue between industrial countries, emerging market economies and developing countries.[3] Second, while the publication of the reports was welcomed, it was noted that many people do not have access to the Internet and do not understand English.[4]

REPORT OF THE WORKING GROUP ON TRANSPARENCY AND ACCOUNTABILITY

There was broad agreement that transparency and accountability can help to prevent crises and to resolve the crises that do occur. Recommendations for

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[2] In April 1999, the IMF published several documents summarising progress in strengthening the architecture of the international financial system. See the Managing Director's Statement to the IMF Executive Board and his Report to the Interim Committee, which are available on the IMF website.

[3] Since the publication of the reports, two seminars on the international financial architecture have been held, one in Bonn in March 1999 and the other in Washington, DC in April 1999. Participation in these seminars was broadened to include not only the countries that participated in the working groups that prepared the reports but also Chile, Côte d'Ivoire, Egypt, Morocco, Saudi Arabia, Spain, Switzerland and Turkey.

[4] The preface and executive summary for each of the reports have been translated into Spanish.

strengthening the transparency and accountability of the private sector, national authorities and the international financial institutions (IFIs) were strongly welcomed, but many interested parties felt that further steps were needed. Calls for greater transparency at the IMF were especially prominent. Some also cautioned against attaching too much importance to transparency; a more fundamental question was whether and how investors and creditors use available information. Furthermore, it was stressed that transparency is broader than the provision of information and refers to the openness and clarity of the decision-making process as well.

Interested parties noted the significant improvements that the IFIs have made in the transparency of their views and operations in recent years, and welcomed the report's recommendation that the IFIs adopt a presumption in favour of the release of information. Concerns were expressed by some about the report's support for using 'confidentiality' as an excuse to maintain secrecy, but others contended that confidentiality was essential to ensure candid discussions between the IFIs and their member countries.

Numerous proposals were made by interested parties for enhancing the transparency of the IFIs. There were calls for the agendas and minutes of Executive Board meetings at the IMF and the World Bank to be made public so that citizens have an opportunity to hear what is said on their behalf, and for a Transparency Report to be prepared on the IMF itself. There was significant support for allowing countries to elect to publish their Article IV consultations.[5] And interested parties suggested various ways in which the process by which IMF adjustment programmes are designed could be made more transparent. These include: permitting other government ministers and parlementarians to participate in programme discussions alongside finance ministry officials and central bankers; making programme documents and policy papers available to the public before they are discussed by the Executive Board, so that the Executive Board has an opportunity to hear a wide range of views; and disseminating IMF reports, such as Letters of Intent, more widely in programme countries. Implementation of these proposals would represent important steps toward designing programmes that are more equitable, that better incorporate the needs of the poor and of the environment, and that have wider support in the programme country.

The report's call for the IFIs to strengthen their evaluation processes was echoed by many interested parties. The IMF's current external evaluation mechanism was viewed by some as inefficient and lacking in independence. It was suggested that the IMF create an independent evaluation unit that is adequately funded, whose staff have their careers protected, that reports directly to the Executive Board rather than to

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[5] In March 1999, the IMF Executive Board initiated a pilot project for the voluntary release of Article IV reports and shortened the time limits for access to the IMF's archives. See the IMF's Public Information Notice No. 99/36 of 16 April 1999.

management, and whose reports are made public.[6] The transparency of the World Bank's Operations Evaluation Department could also be enhanced, for example by making its Performance Audit Reports and other evaluations publicly available. Another suggestion was to create an independent ombudsman at the IMF and the World Bank.

Regarding transparency standards for the private sector and national authorities, four avenues for improvement were identified. First, environmental, social and labour issues could be incorporated into international standards. Investors and creditors are increasingly recognising that such issues can have a material impact on a firm's financial position, and indeed in some countries, including Canada and the United States, environmental issues have been integrated into generally accepted accounting principles. Likewise, natural resources and environmental liabilities can significantly affect a country's long-term outlook and consequently should be measured and disclosed as part of the Special Data Dissemination Standard (SDDS). Some interested parties also proposed that the Code of Good Practices on Fiscal Transparency encourage governments to disclose information about their spending on the environment.

Second, recommendations pertaining to the dissemination of external debt statistics could be improved. It was stressed that countries should disseminate comprehensive data on the amortisation schedule of external liabilities, including the repayment schedule of outstanding IMF loans.[7] Also, the IMF was urged to consider further improvements in the timeliness and coverage of the reserves (a frequency of one week with a lag of one week was suggested), external debt (by residency, maturity and currency) and capital flows categories of the SDDS.[8]

Third, the transparency of hedge funds, investment banks, investment funds and other asset holders could be enhanced.[9] Interested parties supported the report's recommendation that the modalities of compiling and publishing data on the international exposures of such asset holders be examined, and many private sector representatives expressed a willingness to co-operate with the official sector in this endeavour. Some felt that onerous reporting requirements would result in hedge funds and other asset holders moving offshore and thus recommended that the focus be on

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[6] An external evaluation of the IMF's Enhanced Structural Adjustment Facility (ESAF) was completed in June 1998 and released to the public for comment. External evaluations of the IMF's surveillance and economic research activities will be completed before the end of 1999. The IMF plans to review its experience with external evaluations towards the end of 1999 with a view to establishing a mechanism for more systematic and independent evaluations.

[7] The IMF has begun to provide information about its level of resources and liquidity position and is considering releasing data on programme countries' forthcoming obligations to the IMF.

[8] In December 1998, the IMF strengthened the SDDS in the areas of international reserves and external debt. See the IMF's Public Information Notice No. 99/25 of 26 March 1999.

[9] In May 1999, the Financial Stability Forum established an ad hoc working group to recommend actions to reduce the destabilising potential of hedge funds and other highly leveraged institutions (HLIs). The working group will present its final report to the Forum by spring 2000. In February 1999, the International Organisation of Securities Commissions (IOSCO) established a task force on HLIs.

enhancing the transparency of banks' and other counterparties' transactions with such asset holders.[10] [11]

Finally, incentives for the private sector and national authorities to comply with international standards could be strengthened. There was strong support for the report's recommendation that compliance be monitored through Transparency Reports, and it was suggested that the focus of Transparency Reports be expanded to include standards for financial supervision and regulation, corporate governance and insolvency procedures, in addition to the disclosure standards mentioned in the report.[12] Some believed that Transparency Reports alone do not provide adequate incentives for compliance and should therefore be complemented with other sanctioning mechanisms, such as conditioning financial assistance from the IMF on compliance with international standards.

REPORT OF THE WORKING GROUP ON STRENGTHENING FINANCIAL SYSTEMS

Interested parties endorsed the report's focus on the contribution that international standards in the areas of corporate governance, internal controls, liquidity management, insolvency procedures and banking supervision can make to the development of a robust, efficient financial system. Many suggested, however, that the report inadequately addressed the impact of capital account liberalisation on financial stability and incentives to comply with international standards.

The report was criticised for not considering the contribution that capital controls could make to the stability of underdeveloped financial systems.[13] It was argued that there is a need to develop principles to guide capital account liberalisation, with a particular focus on the sequencing of capital account liberalisation with measures to strengthen the financial system. In industrial countries, financial institutions' own risk-management practices, strong prudential supervision and effective regulation generally prevent excessive risk taking by financial institutions. In emerging market economies, these lines of defence are often underdeveloped, and thus there may be a case for buttressing financial stability through quantitative limits or Chilean-type taxes on foreign borrowing.

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[10] In May 1999, the Financial Stability Forum established an ad hoc working group to evaluate the uses made by market participants of offshore centres and to assess progress by offshore centres in meeting international financial standards. The working group will present its final report to the Forum by spring 2000.

[11] In January 1999, the Basel Committee on Banking Supervision issued a report analysing banks' interactions with highly leveraged institutions (HLIs), together with guidance on sound practices in such dealings.

[12] The IMF has published two experimental studies similar to Transparency Reports. Australia's Task Force on International Financial Reform issued a report assessing the implementation of international standards and other international reforms in Australia.

[13] In May 1999, the Financial Stability Forum established an ad hoc working group to evaluate measures to reduce the volatility of capital flows and the risks to the financial system of excessive short-term external indebtedness. The working group will present its final report to the Forum by spring 2000.

Many interested parties underscored the report's recommendations for correcting structural distortions that discriminate in favour of short-term debt. Among those distortions highlighted were: obstacles to long-term borrowing and to foreign direct investment, regulatory practices in industrial countries that treat short-term bank claims more favourably than long-term claims, and weak enforcement of prudential limits on domestic banks' uncovered foreign exchange exposure.[14] Greater exchange rate flexibility was also seen by some as a means of discouraging a large build-up of short-term external debt.

It was stressed that strengthening the supervision of financial systems was not only an issue for emerging market economies. Improvements were also needed in the supervision of financial institutions in industrial countries, including oversight of hedge funds, currency traders and other firms undertaking large cross-border transactions.[15]

There was strong agreement on the need to enhance international co-operation and collaboration on financial sector issues. Some interested parties supported the report's call to define more clearly the roles and responsibilities of the IMF and the World Bank in this area.[16] Others favoured a more radical option: the creation of a single global financial authority to oversee the activities of institutions participating in the international financial system.[17]

It was suggested that the report could have placed greater emphasis on the role of the private sector in developing international standards and in monitoring compliance. The report recommends that standards be developed through a broad international consultative process, as this helps to ensure their wide adoption. Generally, only representatives of the official sector are formally included in the consultative process; no consideration is given to whether and how the private sector could take a more significant or even leading role in the process of standard setting.

Several interested parties made proposals for strengthening incentives to implement international standards. In addition to the actions identified in the report, IMF assistance could be conditioned on progress towards compliance with international standards, interest rates on IMF loans could be made a function of compliance, or

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[14] In June 1999, the Basel Committee on Banking Supervision issued a proposal for a new capital adequacy framework, including changes in the risk weighting on short-term loans.

[15] In May 1999, the Financial Stability Forum established an ad hoc working group to recommend actions to reduce the destabilising potential of hedge funds and other highly leveraged institutions. The working group will present its final report to the Forum by spring 2000.

[16] The IMF and the World Bank have established a Financial Sector Liaison Committee to facilitate collaboration in the provision of advice on financial sector issues.

[17] At their meeting in February 1999, finance ministers and central bank governors from the Group of Seven established a Financial Stability Forum to promote information exchange and co-ordination among national authorities, the IFIs and international regulatory or experts' groupings with responsibilities for questions of international financial stability.

eligibility for a pre-approved IMF credit line could be based on compliance.[18] Others noted that implementation of international standards should be voluntary and that countries at different stages of development will necessarily proceed at different speeds. The shortage in emerging market economies of experts trained to implement international standards was also highlighted as a significant obstacle to implementation.

REPORT OF THE WORKING GROUP ON INTERNATIONAL FINANCIAL CRISES

There was broad support for the report's approach to the prevention and management of international financial crises, notably its emphasis on strengthening insolvency and debtor-creditor regimes, developing innovative debt contracts, promoting creditor co-ordination and enhancing mechanisms to facilitate orderly debt workouts. Yet, there was less consensus about how to implement this approach. Moreover, many interested parties felt that the report gave inadequate consideration to the challenges posed by capital account liberalisation and to the social impact of financial crises.

The severity of the crisis in Asia was attributed by some to, at least in part, imprudent capital account liberalisation. Capital controls were seen by many as helpful to prevent the build-up of financial imbalances, particularly when weaknesses exist in the domestic financial system, and to limit contagion. It was noted that even among many industrial countries, full liberalisation of the capital account is a relatively recent development.

It was recognised that capital account liberalisation can be beneficial for growth and efficiency, but many felt that policymakers should differentiate between different types of capital flows. Few argued against the liberalisation of equity investment, but there was support for prudential controls on short-term flows. Some also saw merit in more ambitious proposals for reducing the volatility of international capital flows, such as a Tobin-type tax on financial transactions or George Soros' proposed insurance against default on external debt up to a predefined limit.

More generally, a number of interested parties thought that the report could have given greater consideration to the possible trade-offs arising from capital account liberalisation. International capital mobility constrains the policy choices of national authorities and may lead to 'competitive deregulation'. This in turn may constrain the ability of national authorities to provide public goods, including a cleaner environment and improved labour standards. Against these potentially deleterious effects of capital account liberalisation are the benefits that come from increased foreign investment, especially increased foreign direct investment.

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[18] In April 1999, the IMF established a new financing facility, the Contingent Credit Line (CCL). One criterion for access to the CCL is a country's progress in adhering to relevant international standards. See the IMF's Press Release No. 99/14 of 25 April 1999.

A few interested parties suggested that the report should have expressed greater support for exchange rate flexibility. By making currency risk explicit, flexible exchange rates may encourage banks and firms to hedge their foreign exchange exposures and can help to deter excessive capital inflows. Others thought that there is no one exchange rate regime that is appropriate for all countries, and instead emphasised the importance of maintaining consistent exchange rate, monetary and fiscal policies.

There was concern that insufficient attention was given to systemic risks arising from excessive leverage, concentration of positions and market manipulation by hedge funds and other HLIs. According to some interested parties, recent experience in Asia demonstrated the potentially destabilising impact that the activities of hedge funds can have on the financial systems of small- and medium-sized open economies. It was suggested that the IMF study on *Hedge Funds and Financial Market Dynamics* be updated to take account of events since its publication in May 1998.

Regarding the best framework for resolving financial crises, the report attempts to take a balanced approach, recommending that the assistance and support of the IMF and the other IFIs remain the key response to crises, yet also recommending that the contribution of the private sector to the resolution of crises be enhanced. There was considerable support for this approach, although a few suggested that further consideration be given to the development of a global lender of last resort. Moreover, some expressed concern about the lead role that the report appeared to assign to the IMF. It was suggested that some of the other IFIs could play an equally important role in resolving financial crises, and might indeed be in a better position than the IMF. In this context, it was suggested that regional financing mechanisms, such as the proposed Asian Monetary Fund, could help to limit contagion. In addition, questions were raised about the appropriate role for an international institution and its technical staff in dealing with sovereign countries that seek its assistance. A balance needed to be established between IMF conditionality and the outcomes of a country's political process.

Notwithstanding support for the report's general approach to crisis resolution, views differed about how best to implement this approach. Some interested parties suggested that the official sector should be more proactive than the report envisioned in strengthening incentives for creditors to co-operate with each other and to participate in debt restructuring negotiations. For example, IMF lending rates and disbursements could be conditioned on governments' willingness to modify their international bond contracts to allow qualified majority voting, collective representation and the sharing of litigation proceeds, and access to major financial centres could be conditioned on the inclusion of these so-called collective action clauses in international bond issues. Negotiations could also be facilitated, and information asymmetries reduced, through the creation of a standing committee of creditors, but this too would require leadership by the official sector.

While supporting greater participation by the private sector in the resolution of crises, a number of interested parties criticised mechanisms that bind in creditors during a crisis, preferring instead a continuous process of dialogue between creditors and debtors. It was argued that lending into arrears and the mandatory inclusion of collective action clauses in bond contracts would make it more difficult for debtors to access global capital markets and would thus be counterproductive. In contrast to the report's support for the decision by the IMF Executive Board to widen the IMF's 1989 policy on lending into arrears to encompass bonds and other non-bank credits, some interested parties contended that IMF lending into arrears should be avoided, apart from exceptional circumstances where private creditors supported such lending. Collective action clauses were seen as a potentially prudent form of liability management, but it was felt that their incorporation into bond contracts should be voluntary.

Still others suggested that a voluntary, market-based approach to crisis resolution was inefficient, and that instead it was necessary to institutionalise procedures to sanction sovereign defaults and to facilitate sovereign debt reschedulings. Defaults and reschedulings could be important steps in recovering from a financial crisis, and the development of an international insolvency regime could make these options more palatable to debtors.[19] It was also argued that insolvency was a fundamental problem in many developing and emerging market economies, and that the cancellation of external debt was a pre-requisite for growth and development in these economies.[20]

A few interested parties cautioned against the rigorous application of insolvency regimes during crises. Any disposal of assets during a crisis would likely be at firesale prices and, owing to liquidity problems among domestic creditors and investors, to foreigners. One suggestion was for insolvency regimes to permit discrimination in favour of residents in the event of an economy-wide crisis.

Notwithstanding strong support for limiting the range of activities covered by government guarantees and ensuring that those guarantees that are offered are explicit and appropriately priced, it was suggested that it was unrealistic to expect governments to adhere rigidly to such guidelines, especially during a crisis. Debtor and creditor governments were likely to come under heavy pressure from powerful commercial or other interests to compensate for losses, and might not be willing to accept the economic, political and social consequences of financial failures. Limits on the range of activities covered by explicit guarantees might de facto result in more liabilities being covered by implicit guarantees.

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[19] The IMF Executive Board is considering the amendment of Article VIII, Section 2b of the IMF's Articles of Agreement to allow for the imposition of temporary stays on creditor litigation.

[20] The IMF and the World Bank are currently developing proposals to strengthen the present framework for debt relief, including through the Heavily Indebted Poor Countries (HIPC) initiative.

Finally, the report was criticised for not addressing the social impact of financial crises. The report made no mention of social safety nets for the poor and other members of society who are the most adversely affected by financial crises. It was strongly felt that minimising the human cost of crises and helping economies strengthen their social policy responses and institutions to deal with crises should be prominent in discussions about the international financial architecture.[21]

[21] Minimising the human cost of crises and encouraging the adoption of policies that better protect the most vulnerable in society was one of the topics on the agenda of the second seminar on the international financial architecture, held in Washington, DC in April 1999. The World Bank is developing principles of good practice in social policy.

LIST OF CONTRIBUTORS

This synopsis is based on comments received directly or indirectly from the following institutions, organisations and individuals. Written comments not readily available from other sources are available upon request from the secretariat (email. gavin.bingham@bis.org; tel. +41-61 280 8080; fax. +41-61 280 9100).

Asia-Pacific Economic Co-operation
    Sixth Finance Ministers' meeting
Bretton Woods Project (London, UK)
    on behalf of Action Aid, Catholic Fund for Overseas Development, Catholic Institute for International Relations, Christian Aid, and Save the Children
Centre of Concern / Rethinking the Bretton Woods Project (Washington, DC)
Andrew Crabtree (Roskilde University, Denmark)
Barry Eichengreen (University of California, Berkeley)
European Network on Debt and Development (Brussels, Belgium)
Focus on the Global South (Bangkok, Thailand)
Friends of the Earth (Washington, DC)
Institute for International Finance (Washington, DC)
    Working Group on Financial Crises in Emerging Markets, comprising twenty-five leading international financial firms
    Working Group on Transparency in Emerging Markets Finance, comprising nineteen leading international financial firms
Intergovernmental Group of Twenty-four on International Monetary Affairs
    Sixtieth and sixty-first Ministers' meetings
Michael Lloyd (European Parliament, Brussels)