BIS WORKING PAPERS

No 92 – October 2000

RECENT INITIATIVES TO IMPROVE THE REGULATION AND SUPERVISION OF PRIVATE CAPITAL FLOWS

by

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Copies of publications are available from:

Bank for International Settlements
Information, Press & Library Services
CH-4002 Basel, Switzerland

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This publication is available on the BIS website (www.bis.org).

ISSN 1020-0959

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Abstract

In this paper, an attempt is made to put the changing attitudes of policymakers towards international capital flows into a broader economic and historical context. The paper then goes on to suggest that policymakers today wish, on the one hand, to achieve the benefits of freer capital flows while trying to minimise the risks they pose on the other. Various suggestions for achieving the second objective are then critically evaluated. While most seem to have merit, no single suggestion would seem sufficient in itself to avoid all problems. As in many areas having to do with crisis prevention, incremental progress across a broad front would seem warranted.

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* This paper was first presented at the conference "Crisis prevention and response: where do we stand with the debate on reform of the international financial architecture?", organised by the Forum on Debt and Development and held in The Hague, 26-27 June 2000. The views stated herein are those of the author and are not necessarily the views of the Bank for International Settlements.

Contents

1. Changing attitudes to international capital flows

Before turning to how official attitudes to private capital flows have changed over time, it is useful just to look at the facts.[1] Prior to World War I net capital flows were proportionally as large as today although the complexity and volume of the interactions (gross) was then much less. Most of the flows in the earlier period were in the form of long-term bonds, with governments, railways, mining and other commodity extraction enterprises being the primary beneficiaries. Since in large part governments were building infrastructure at the time, it could be contended that most of these loans were in some way linked to exports and the means to service debt. Nevertheless, there were many crises even if crises post-1972 have been both more frequent and more severe.

Following on the events of the 1930s, there was a collapse in international capital flows (as well as trade) and only a very gradual recovery after World War II. Beginning in the 1960s, and constantly accelerating subsequently, there has been a sharp revival of international capital flows although their composition now differs markedly from that seen prior to World War I. As to maturity, loans tend to be of rather shorter duration. Moreover, the reliance on bond financing is less today, with both purchases of equity and foreign direct investment playing a much more important role. Bordo (2000) ascribes this change in large part to modern communications, which allow more direct oversight and therefore raise the comfort zone insofar as risk-taking (at a distance) is concerned. Recurrent foreign exchange and banking crises have been experienced in emerging markets over the last two decades, with new concerns about maturity mismatches (as in Korea in 1997) adding to traditional credit and market risk as catalysts for crises.

Official attitudes to international capital flows have also changed greatly over the years. However, what has not changed is the underlying reality of the so-called “impossible trinity”. A country cannot have unhampered international capital flows, a fixed exchange rate system and its own independent monetary policy all at the same time.[2] Different and changing views as to which of the three should be given up have been at the heart of the century-long debate over the merits of international capital flows.

Under the gold standard, the desirability of open capital flows was never called into question. Nor, generally speaking, was the desirability of a fixed, global exchange rate system debated. While it was recognised that this regime meant the absence of a domestically orientated monetary policy, many looked upon this as a favourable attribute since politicians were commonly regarded as less disciplined

[1] For a useful survey of both the facts pertaining to the globalisation of international financial markets and related policy issues, in particular international rescues, see Bordo (2000).

[2] This is one of the principal insights for which Robert Mundell recently received the Nobel prize. See Mundell (1963).

with respect to the public purse than they ought to be. Under the Bretton Woods system, fixed exchange rates were considered essential to avoid the competitive devaluations and the drying-up of trade which had characterised the 1930s. The retention of a domestic policy capability was also seen as important even if the Great Depression had called into question the efficacy of monetary policy in such extreme circumstances. In light of these exigencies, capital flows were generally discouraged by the official community and various forms of exchange controls were maintained in many developed countries well into the 1980s.

However, with time, capital flows gradually increased as euromarkets, offshore centres and advancing technology allowed old restraints to be circumvented. By 1972 the Bretton Woods system had collapsed and the main industrial countries reverted to a floating exchange rate regime. While it took another 25 years, a similar outturn has been observed in many emerging markets, most recently in Asia and in Latin America. Interestingly, these latest developments took place against the backdrop of a debate as to whether the Articles of the Charter of the IMF should be altered to allow the Fund to actively encourage capital account liberalisation. While it is not clear that the motivation for this was linked to the impossible trinity problem, the reality of freer capital flows certainly had implications for this issue.

Today, the conventional wisdom would be that there should in principle be no further reimposition of direct controls over capital flows. However, the removal of existing controls should be done carefully and at a pace consistent with the evolving capacity of the domestic financial system to withstand associated shocks. Countries should also follow one or other of two possible exchange rate regimes. They should either float "freely" and conduct an independent monetary policy, or they should try to link their currency "irrevocably" to some other currency and eschew domestically oriented monetary policy altogether. Of course, both of these choices are somewhat of a caricature. No currency floats entirely freely, since the domestic monetary authority must always have some views as to the implications of exchange rate movements.[3] Moreover, no fix is irrevocable since the domestic pain implied by currency board arrangements may prove unbearable.[4] Indeed, even currency unions (and variants on "dollarisation") can be abrogated.

Over the postwar period there has been a considerable evolution in thinking with respect to exchange rate regimes and international capital flows. This has perhaps made the inevitability of more mobile capital flows a trifle more palatable. A first point is that the Bretton Woods system assumed that fixed exchange rates were needed to ensure an open trading system. Clearly the explosive growth of trade in

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3 For a recent discussion of this, see White (1999).

4 Neither the Hong Kong Monetary Authority nor its Argentine counterpart act as pure currency boards. In both cases the authorities take measures to ensure some cushioning of the interest rate effects of reserve changes due to exogenous capital flows and the trade account.

recent decades, spurred as well by the development of financial markets to hedge foreign exchange exposure, has reduced the force of this argument. A second point is that it has become increasingly obvious that direct capital controls invite evasion and become porous with time, and that new technological advances are constantly compressing the period for which controls remain effective. In contrast, the positive implications for resource allocation of international capital flows are becoming increasingly appreciated. As for the capacity of such international capital flows to incite domestic crises, it is also being increasingly accepted that such flows have sometimes been more catalyst than cause.[5] In many recent crises, the underlying problems were essentially linked to domestic credit expansion: in Mexico in 1994 due to excessive consumption, and in Asia due to excessive (ie unproductive) investment. Nevertheless, for many, the temptation to shoot the messenger has proved irresistible.

It must of course be readily admitted that international capital flows also have significant downsides. They can exacerbate domestic excesses, in effect allowing postponement of needed policies and thereby demanding still larger policy adjustments later. Moreover, the suddenness of the reversal of these flows may make it all but impossible to avoid the policy adjustment becoming disorderly. Internationally integrated financial markets also mean that financial markets in emerging market countries are vulnerable to interest rate increases in industrial countries. As well, there is growing evidence that equity markets in developing countries are more correlated with those of industrial countries than would seem consistent with the underlying fundamentals.[6] While the adoption of floating exchange rate regimes significantly mitigates these dangers, it by no means wholly eliminates them.

In the light of these insights, recent policy initiatives to regulate and supervise private capital flows have focused on means to curb possible “excesses” while essentially maintaining or moving carefully towards a regime of free capital flows. While a whole host of bodies have been involved in formulating such recommendations over the last few years, particular emphasis will be placed here on evaluating recommendations made recently in various papers published by the Financial Stability Forum.[7] In the various sections that follow, four sets of such initiatives are considered. The first of these has to do with transparency: the need for better data, disclosure and indicators of vulnerability. The second and third sets of recommendations have to do with the behaviour of creditors and debtors respectively. The fourth part of the paper deals with how these recommendations might be implemented in practice. As always, actions speak louder than words. However, actions also demand considerably greater efforts on the part of all the parties concerned.

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[5] See White (1998).

[6] See BIS (2000b), Chapter V.

[7] See FSF (2000a, b, c, d, e). These papers were, of course, drafted in full knowledge of earlier proposals.

2. Measures to improve data, disclosure and indicators of vulnerability

A presumption underlying recent recommendations in this area is that "excessive" capital flows will be less likely if the disclosure of information of various kinds is improved. An underlying but not always clearly specified question is whose welfare is best promoted by such transparency. On the one hand, we might have the recipient country, and more specifically the particular borrowers, who are receiving the money. On the other hand, we have the lenders providing international capital. With respect to the former, "excessive" generally means inflows with the potential to do macroeconomic damage, whether on the way in (say rapid credit expansion, inflation and asset price bubbles), or on the way out (banking and foreign exchange rate crises and associated recession). This was the principal source of concern during the recent Mexican and Asian crises. With respect to creditors, "excessive" would mean flows of such a magnitude as to call into question the solvency of the lending institution or, ultimately, a whole set of financial institutions. This was the principal concern in the debt crisis of the early 1980s, at least viewed from the perspective of the creditors.

Without wishing to diminish the importance of transparency, its limitations must also be clearly recognised. Insofar as transparency about the economic circumstances of recipient countries is concerned, how lenders use such information is also crucial. For example, as far back as 1996, the BIS international banking statistics[8] clearly indicated a dangerous build-up of foreign short-term liabilities by many Asian countries. This was not sufficient to stop the boom in international lending. As for transparency contributing to the improved health of institutions undertaking international lending, the problem is that there are no clear criteria for determining when such lending threatens to undermine their health, either individually or collectively. When things are going well, all loans look creditworthy, and vice versa. Moreover, at the micro level, the exposure of one financial institution to a sector/country might seem appropriate. However, if all financial institutions in a country were exposed to the same degree to that same sector/country, the overall exposure of the creditors' financial system could become dangerous. Problems of this sort will be a recurring theme in considering the merits of the various recommendations being assessed in this paper.

This having been said, a number of sensible suggestions for increasing transparency, and in turn market functioning, have been made recently. A first set, with clear implications for the work of the BIS, has to do with providing better data on international debt exposure. The second set of suggestions has to do with enhanced disclosure about short-term position-taking with respect to the currencies of emerging market economies. And the third set of recommendations concerns the provision of better indicators of potential vulnerability in emerging market economies to crises of various kinds.

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8 See BIS (1996).

2.1 Improving the international financial statistics

Those concerned with the exposure of emerging market economies to potential capital outflows and liquidity problems would welcome comprehensive statistics indicating the external liabilities and assets of individual countries. The FSF Capital Flows Report recommends certain enhancements in this regard.

In principle, it would be best to collect comprehensive debt statistics from the debtor countries themselves, but such statistics are generally unavailable and then only with long lags. The IMF is pursuing improvements in this area (to be incorporated into the SDDS) but, for the moment, the much more timely creditor-based statistics remain at the heart of the external debt statistics. Data collected from banks active in international lending are reported to the BIS and are aggregated to gain an indication of the exposure of borrowers resident in individual countries. These data are then supplemented with statistics indicating funds raised through securities issues in international markets (also collected by the BIS), statistics on official trade credit (OECD) and debtor-side data concerning such issues as Brady bonds (IMF and World Bank). Recently, these statistics have been re-evaluated and improved and they are now available on a regularly updated basis on the internet.[9]

In the case of some countries there do exist quite comprehensive debtor-side statistics, and it is not uncommon that they differ from the creditor-side statistics just referred to. A study is now under way at the BIS, consistent with another recommendation from the FSF Capital Flows Report, to establish why these differences occur. Indeed, some explanations are already available. It is clear that the creditor-side data, as currently constructed, fail to incorporate domestically issued debt securities purchased by foreigners as well as the effects of internationally issued debt securities purchased by domestic buyers. The FSF has in fact recommended that efforts be undertaken to collect such numbers with a view to improving the current creditor-side statistics.

In assessing the external vulnerability of individual countries, information about assets is a useful complement to information about liabilities. In view of the misperceptions about official reserve levels generated by “unorthodox” operations carried out by the Bank of Thailand and the Bank of Korea in the recent Asian crisis,[10] the Committee on the Global Financial System (CGFS), in cooperation with the IMF, devised a template for proper disclosure in this area. Subsequently the IMF adopted these standards, which are now also part of the SDDS. The G10 countries agreed to apply the template to themselves (“pour encourager les autres”) and are now in the process of doing so. Progress on the part of the emerging market economies remains very mixed to date.

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9 See www.bis.org for "Joint BIS-IMF-OECD-World Bank statistics on external debt” (BIS-IMF-OECD-World Bank (2000)).

A second set of concerns relates to the health of the financial institutions which have lent money to emerging markets. In this case, creditor-side data can be collected on a consolidated basis (ie the worldwide exposure of an individual institution) and then aggregated to determine the exposure of a set of institutions (say Canadian banks) to individual countries. This has been done since the early 1980s, though recently a number of improvements have been implemented through the efforts of the CGFS and the BIS. First, the consolidated statistics will shortly be available on a quarterly rather than a semiannual basis. Second, the reporting lag before publication will be significantly reduced. Third, banks resident in 17 additional countries will begin reporting to the BIS. Fourth, and probably the most important improvement, data will shortly be available on an ultimate risk basis. That is to say, loans made to (say) Japanese banks in Hong Kong will now be classified as an exposure to the former rather than the latter. These new attributes will also be helpful in improving estimates of debtors' exposure based on the use of these creditor statistics.

Consistent with recommendations made by the FSF Capital Flows group, further improvements have recently been suggested by a Working Group of the CGFS.[11] In particular, the statistics should include exposure in the form of such off-balance sheet items as derivatives, guarantees (given by the banks as well as those given to the banks) and also undrawn contingent credit facilities. Mindful of the reporting burden this puts on banks, the Working Group (as well as the FSF Capital Flows group) recommended that these changes be phased in by 2004 and that they rely as much as possible on reporting systems developed for the banks' own internal risk management processes. In this sense, the recommendations parallel the market-compatible and market-friendly approach increasingly being followed by the Basel Committee on Banking Supervision (BCBS).

2.2 Improving disclosure with respect to position and risk-taking

At the height of the Asian crisis, there were repeated allegations that highly leveraged institutions (HLIs), in particular hedge funds, were speculating against certain currencies. More broadly, concerns were raised that portfolio shifts and associated capital flows were exacerbating currency volatility.[12] In response to these events, the CGFS examined whether firm-level information about position-taking in foreign exchange markets could be collected, aggregated to ensure anonymity, and then published

[10] In the former case, forward exchange rate intervention had been heavily used. In the latter case, some of the reserves had been invested with Korean banks, which had used them to pay down liabilities of Korean companies which had borrowed abroad. In both cases, the true level of available reserves was lower than official estimates.

[11] See BIS: CGFS (2000).

[12] In the case of Hong Kong and South Africa, it was alleged that HLIs were conducting twin operations that bordered on the unethical. In the Hong Kong case, funds were said to have sold the Hong Kong dollar short while at the same time shorting the equity market. If the Hong Kong Monetary Authority (HKMA) were to raise rates to support the currency, profits would be made as equity prices fell. Were interest rates not to be raised, profits would be made as the currency fell. In the event, the HKMA defended itself by intervening vigorously in the equity market, making very significant profits in the process.

on a regular basis. Preliminary investigations soon indicated that such information would not be provided on a voluntary basis. Many of the firms contacted felt that they had better insights than others about market positioning, and that this proprietary information could be used by them to generate profits. As for the possibility of making mandatory the provision of such information, several authorities felt it would be politically impossible to ensure the needed legislation and the project had thus to be considered impractical.[13]

While not specifically directed to international capital flows and position-taking with respect to currencies, a number of other initiatives are under way aimed at improving disclosure with respect to risk-taking more generally. The broadest of these is the Multidisciplinary Working Group on Enhanced Disclosure,[14] which is currently organising a pilot study into the feasibility and the usefulness of enhanced disclosure with respect to risk and exposure data. A panel of firms representing a broad cross section of financial market participants and activities are participating and a pilot study disclosure template has been extensively discussed and revised. The first set of results (some quantitative and some qualitative) will be submitted to national regulators and then analysed as to their usefulness (relative to collection costs) by the Working Group itself.

It should also be noted that the BCBS, in the light of the events surrounding the difficulties of Long-Term Capital Management in autumn 1998, has suggested that banks pay much closer attention to the investment practices (especially the use of leverage) of those to whom they lend.[15] More recently, the FSF Working Group on Highly Leveraged Institutions suggested that higher capital charges might be imposed when required information of this sort was not forthcoming. Finally, legislation is pending in the United States that will require compulsory disclosure by HLIs above a certain size. At the most recent meeting of the FSF, there was widespread support for this initiative and a suggestion that it might usefully be imitated elsewhere.

Just as better data provide no panacea, greater transparency may also have shortcomings alongside its obvious benefits. One possibility is that greater openness will lead to more emulation and herd-like behaviour, exacerbating sudden shifts in capital flows and market prices. A second complication is that all this information will be collected only periodically. Given the ease with which positions can be

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[13] The degree of disappointment generated in the official community varied sharply across countries. Most disappointed were those who felt industry disclosure was a quid pro quo for the decision of the official community to publish regularly a full account of their foreign exchange reserves and associated intervention.

[14] This Group is chaired by Peter Fisher of the Federal Reserve Bank of New York and includes representatives of the BCBS, CGFS, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and a number of hedge funds and other financial institutions. This initiative is sometimes referred to as Fisher II since Fisher was also the Chairman of an earlier working group, sponsored by the predecessor of the CGFS, encouraging better disclosure by financial institutions of their activities in derivative markets.

[15] See BIS: BCBS (1999b) and the follow-up document (BIS: BCBS (2000)).

altered in modern financial markets, anything short of real-time disclosure may give a very misleading indication of what is really going on.

2.3 Improving indicators of vulnerability in emerging market economies

The FSF Working Group on Capital Flows also recommended that greater efforts be made to collect data and construct indicators of the potential vulnerability of emerging market economies to exchange rate crises and banking crises. There is now a vast literature on such issues[16] which, broadly put, concludes that indicators of potential exchange rate crises seem more reliable than those used to predict banking crises. While this might just be the nature of the beast, data shortcomings in the case of bank exposure may also be an important explanatory factor.[17] It should also be noted that these indicators often fail to predict actual crises. Perhaps worse, they often predict crises which fail to happen. Public disclosure of such predictions might then conceivably cause crises which might otherwise never have happened. As with the other measures recommended above to improve transparency and enhance rational decision-making, there can be a downside to these efforts.

For the last two years, the CGFS has been regularly reviewing crisis indicators for emerging market economies which have been constructed by the staff of the BIS. In association with other statistics germane to assessing the future prospects of individual countries, qualitative assessments are made of where problems with systematic implications might arise. This exercise is conducted within the framework of a broader assessment of changing risks and vulnerabilities in the international financial system. The results of the Committee’s deliberations are subsequently transmitted orally to the G10 Governors by the Chairman of the CGFS and are an important input to similar discussions which take place regularly (with a broader group of participants) at the FSF.

3. Policy responses directed to creditors

Various kinds of lenders are responsible for international capital flows: banks, securities firms, insurance companies, funds of various sorts, and investors who purchase directly market instruments (bonds, equities, notes, etc) issued by borrowers in emerging market economies. The question then arises as to how each might be induced to behave more prudently, so as to avoid “excessively” large or

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[16] The forthcoming *BIS Working Paper* (Hawkins and Klau (2000)) provides a useful overview of the current state of knowledge.

[17] The IMF has recently embarked upon a major exercise to improve data and contribute to the construction of better vulnerability indicators. See IMF (2000b).

volatile swings in international capital flows. Three sets of incentives can be suggested: better internal governance by lenders, more market discipline and better external regulation and supervision.[18]

Contrary to popular opinion, and in spite of the continuing existence of various safety nets, many lenders have lost money in recent financial crises in emerging markets. This should make lenders more cautious in the future. Moreover, the on-going discussions about "Private Sector Involvement" in the management and resolution of crises make it clear that creditors may suffer in future crises even more than in the recent past. There is a growing consensus that official funding of the size observed in the Mexican (1994) and East Asian crises, which helped limit private sector losses, should not be the norm in the future. As suggested in the G7 Communiqué issued in Cologne (20 June 1999) and translated into practice in the context of a number of sovereign debt restructurings since, bonded debt will no longer enjoy the effective seniority which it had during the 1980s.[19]

Nevertheless, there remain significant reasons to fear that internal governance constraints may prove inadequate to prevent future capital flows from discomforting emerging market economies. The financial industry is becoming increasingly competitive. At the same time, shareholders are increasingly demanding greater shareholder value. This combination may bias investment in the direction of those classes of assets which provide higher rates of return, which include investments in emerging market economies, even though they are inherently riskier. Moreover, even if the exposure of any single investor to a single country remains rather small (relative to capital), the cumulative effect on the country's capital account could well prove hazardous to the recipients.

Given that the financial viability of the lenders has not been significantly affected by recent losses in emerging markets, effective market discipline of the traditional type might also seem unlikely. Indeed, markets collectively are as likely to be as influenced by excessive "animal spirits" as are individual institutions. Nevertheless, some moderation of the collective movement into particular countries might be achieved through ongoing consultations between committees of lenders and representatives of borrowers. The sharing of views in such a forum about potential vulnerabilities might well prove useful. This suggestion has been made repeatedly[20] in the context of discussions as to how the private sector might become more directly involved in both crisis prevention and crisis management. A further force for collective moderation would be for lenders and rating agencies to pay greater attention to whether individual countries meet agreed international standards with respect to financial

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18 For a fuller discussion of the analytical framework within which to discuss crisis prevention measures in the international financial system, see BIS (2000b), 148-9. Reference is made there to the "three Ps", namely: three problems (short-term volatility, medium-term misalignments and contagion), three pillars (sectors, markets and infrastructure) and three prescriptions (internal governance, market discipline and supervision).

19 In the 1980s' emerging market crisis, debt bonds were a very small part of total debt and their restructuring was judged to be more trouble than it was worth. Partly in consequence, bond issues subsequently became much more common and the outstanding stock of such debt can no longer be ignored.

20 For a recent example, see EFC (2000).

stability.[21] However, a recent survey of market participants by a working group of the Financial Stability Forum indicated wide-spread ignorance of the existence of such standards.[22] Clearly, a significant marketing effort will be required before countries are made to pay an appropriate market price for non-conformance in this area.

This brings us to the third set of incentives to more prudent behaviour, that provided by the supervisors. The first issue to be addressed is whether the detailed provisions of the Basel Capital Accord encouraged an excessive inflow of capital into emerging market economies in the form of short-term, and particularly interbank, liabilities. Prima facie, the 20% risk weighting for sub-one-year interbank lending to banks[23] in non-OECD countries might have been expected to have such undesirable systemic effects. This is the case even if, at the level of an individual firm, it makes good sense to treat a short-term loan as less risky than one that is locked in for a longer period.[24]

This question of risk weights was raised in the context of the recent review of the Basel Capital Accord. A working group concluded that "Lack of data and observations meant that the working group could not establish firm evidence one way or the other on the question of distortions induced by the risk weights, but some of the tests offered the possibility of the maturity of lending being affected".[25] A similar investigation by the CGFS also concluded that the risk weights might have had some influence, but that other factors were likely to be more important in explaining both the volume and maturity of lending by internationally active banks. The perceived safety net, which banks seemed to feel alleviated credit risk, market risk and liquidity risk, were noted in particular.

Although the new Basel Capital Accord has yet to be finalised, it seems clear that major banks and many others will use the internal ratings-based approach and thus will be categorising more carefully the individual credit risk of counterparties. To this extent, some of the criticisms of bias implicit in the old Accord may no longer apply. However, under the proposed standardised approach, likely to be used by many less sophisticated banks, similar issues of bias could arise depending on the final design of the system. However, at the moment, it seems very likely that the risk weighting applied to lower-quality borrowers will be higher using the new system than the old one.

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21 There are currently around 50 sets of such standards on the website of the Financial Stability Forum (www.fsforum.org).

22 See FSF (2000e).

23 The risk weight for maturities of one year or more is 100%, five times as high.

24 Fallacies of composition of this sort are receiving increased attention. For example, were all banks to find themselves hitting against minimum capital provisions at the same time, their collective efforts to cut loans to strengthen their capital base might induce an economic slowdown that actually made their capital position worse (given higher loan losses) rather than better. The best known example of such a fallacy of composition in the macroeconomic literature is the "fallacy of savings" pointed out by Keynes.

25 See BIS: BCBS (1999a), p 28.

A second issue having to do with the supervisory regime relates to the possible procyclicality of capital requirements. One example of this in the old Capital Accord was the possibility for Japanese banks to factor in 45% of unrealised capital gains on investments into their measured Tier 2 capital. Since international capital flows also tend to respond to shifts in the level of available capital, such procyclical tendencies could have effects on these flows as well.

Under the proposed new Capital Accord, there is a risk that the increased reliance on internal credit ratings by lending banks might have the effect of exacerbating any such tendencies. This could happen if internal ratings were themselves inherently subject to waves of rising and falling confidence, and if market discipline fails because it too is subject to the same tendencies. In this situation, the reliance on the supervisors (Pillar II of the new Accord) to moderate such tendencies will be all the more important. However, when it comes to efforts specifically directed towards moderating international capital flows, supervisory oversight will generally suffer from the same problem as reliance on internal governance and market discipline. Viewed from the perspective of an individual creditor, the sums involved may not be large enough to merit great concern on the part of the supervisors.

4. Policy responses directed to debtors

In the absence of other viable alternatives, the onus would fall back on the recipients of international capital flows to protect themselves as best they could. The FSF Capital Flows Report first recommends that emerging market countries should identify any biases towards shorter-term capital flows that may exist within their own jurisdictions and should try to remove them. The Report falls short, however, of recommending Chilean-style capital controls to actively induce longer-term lending by penalising flows which remain in the recipient country for less than a specified time period.[26] Nor does the Report note the widespread practice of forbidding domestic banks to have open positions in foreign currency, at different maturity positions and in aggregate. This might help remove at least one source of potential difficulties.

The FSF Capital Flows Report emphasises the need for countries to monitor and assess their vulnerability to a sudden withdrawal of foreign currency funding. Further, the Report suggests that the sovereign should be concerned not only about the government's own vulnerability, but also about that of the nation as a whole since, in a crisis, the foreign currency requirement of others (banks in particular) could well fall back onto the sovereign. As a further practical step in this direction, the Report concludes that the IMF and World Bank should be asked to draw up "guidelines" of best

[26] For a fuller discussion of such controls and many related issues, see BIS (2000a).

practice in the area of national/sovereign external debt management.[27] In effect, governments should try to maintain higher levels of foreign exchange reserves depending on the level of shorter-term liabilities that might suddenly be withdrawn.[28]

While governments must clearly try to monitor their vulnerability to international capital flows, the concept of focusing on the national balance sheet has a number of shortcomings.[29] First, in assessing the national external position, data will be required on corporate foreign exchange exposure. This was a major source of trouble in both the Mexican and the East Asian crises. Unfortunately, in most countries such data are not available even for on-balance sheet items, much less off-balance sheet exposure. Second, for governments to focus on, and implicitly take responsibility for, the potential vulnerabilities of private sector entities could risk engendering a significant degree of moral hazard. This tendency could of course be offset by a determined effort on the part of governments to force the private sector to protect itself against prospective movements in the exchange rate.

A third problem is that it is not at all clear that measures of short-term liabilities to foreigners accurately measure the extent of the potential foreign exchange problem. Domestic residents can also sell domestic assets and purchase foreign ones, and indeed it is very common to find domestic asset holders leading the rush for the exits. Moreover, the longer-term assets of foreigners, including foreign direct investment, can still be a source of exchange rate pressure if they can be covered in other markets.[30] Put succinctly, the more developed the financial markets of the emerging market economy, the less likely to be useful are simple guidelines for prudent portfolio behaviour. This having been said, regulations, such as those prohibiting the lending of domestic currency assets to foreigners who might wish to sell them, might still be useful under some circumstances.

A final suggestion arising from the FSF Capital Flows Report is that emerging market economies might wish to develop domestic bond markets for issues in domestic currency. This would in principle allow investors to tap domestic savings rather than have recourse to foreign bond markets, and would help avoid a dangerous degree of foreign exchange exposure. Indeed, if foreigners were to buy such

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[27] In fact, the Fund and the World Bank are already well advanced in such an endeavour. This parallels other work the Fund is carrying out on best practice for internal debt management as well as the management of foreign exchange reserves. See footnote 34 below.

[28] This might be thought a variation on the so-called "Guidotti rule", which recommended that countries' foreign exchange reserves (including contingent credit lines) should cover debt service and repayments due within the next year. This approach has shortcomings in that it implicitly assumes a balanced trade account and no other capital flows. Given the tendency for capital flight on the part of domestic as well as foreign residents in crisis situations, these shortcomings must be thought serious.

[29] These issues were actively discussed at a meeting of senior central bankers from emerging market economies which took place last November at the BIS. See BIS (2000a).

[30] A number of commentators on recent capital inflows into emerging markets have expressed satisfaction that the inflows are increasingly in the form of foreign direct investment. One might be reminded of the once fashionable "Lawson doctrine", which said that current account deficits were not a problem if they were the by-product of private sector decisions and not government excess.

bonds denominated in domestic currency, then access to foreign savings would also be maintained but with foreigners taking on the exchange rate exposure. Clearly, there is merit in this suggestion, particularly since well developed local bond markets would provide more diversified sources of finance in good times as well as bad.

Nevertheless, some outstanding questions still need to be answered. First, if there were to be less net borrowing abroad, this would imply a smaller current account deficit and some process of internal macroeconomic adjustment (higher savings or lower investment). Depending on how it occurred, this might be more or less welcome.[31] Second, the infrastructure required to set up a properly functioning bond market is not cheap. This raises the question of the minimum size required for a country to have its own domestic financial markets. It could be that a more effective alternative would be the issue of bonds denominated in domestic currency in some well developed overseas markets; perhaps of a regional nature, as recently suggested by the Hong Kong authorities. Third, and this applies to issues in both domestic and foreign markets, there is the broader question of how to generate demand for longer-term bond issues denominated in currencies with a sometimes dreadful track record. This issue of "original sin"[32] may be the most difficult one to deal with.

5. Implementing policy recommendations in practice

The FSF has sent out to each of the international financial institutions a list of all the policy recommendations, generated by its Task Forces, which apply specifically to that institution. Most of the recommendations noted in Sections 2 and 3 above fall into this category. Presumably these institutions will respond appropriately and the FSF will monitor their compliance. As for recommendations which apply to the national authorities in the industrial world, it is envisaged that the national representatives in the FSF would do the monitoring and follow up in the first instance. How compliance might be enforced, were problems of non-compliance to emerge, remains moot. In the final analysis, none of these recommendations have the force of international law.[33]

However, even greater problems with implementation seem likely to arise at the level of the emerging market economies themselves. This would pertain to the recommendations made in Section 4 above, and indeed to the much broader range of suggestions that have been made as regards crisis prevention in the financial markets of emerging market economies. Even when it is clear what needs to be done, mustering the political will to do it in the face of entrenched interests will prove difficult. Shortages of

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[31] A higher savings rate would have been most welcome in Mexico in the early 1990s. Conversely, a lower investment ratio would have been the preferred outcome in East Asia in the second half of the 1990s.

[32] This term was originally coined by Ricardo Hausmann. See Hausmann (2000).

[33] For an interesting and comprehensive overview of such issues, see Giovanoli (2000).

required resources, not least of skilled and motivated government employees, pose further challenges. Support from the international community will be necessary, but not necessarily sufficient.

Providing the proper incentives for action will be essential. One aspect of this could be ongoing assessment of compliance by the IMF and World Bank. The Financial Sector Assessment programme, currently being undertaken on a test basis in the context of Article IV surveillance, is an example of the genre. The problem with this approach is that there is simply too much for the IFIs to do. The web site of the FSF currently lists over 50 sets of international standards of best practice. Twelve of these are designated as being of particularly high priority. Moreover, as universal institutions, the IFIs should in principle treat each of their 180 member countries equally with respect to whatever programmes of ongoing assessment are put in place. Subject to this latter stipulation, the need to set priorities with respect to subject matter becomes all the more important.[34]

Even supposing a proper assessment of compliance could be made in the area of international capital flows, how might enforcement be assured? One possibility is the withdrawal of funding for non-complying countries, but this presumes they were receiving money from the IFIs in the first place. Another possibility which might be envisaged is that non-compliance might be brought to the attention of the FSF or some other international body or grouping. In this case, some variant on the "name and shame" approach seemingly favoured by the Financial Action Task Force might or might not be deemed appropriate.[35] Another possibility is that the FSF might bring these results to the attention of the G7 or the G20. Ministers and Governors who are members of these groups might then try to apply peer pressure to improve behaviour. Ultimately, these groups might even apply collective sanctions to non-performers, though the track record in this regard is not very promising.

Indeed, collective action would seem all the less probable given that the individual country receiving the capital inflows would be the most likely to be directly hurt by such flows. If the country itself did not care enough to properly protect itself, why should other countries collectively wish to force it to do so? In practice then, peer pressure might most effectively be applied by drawing attention to what

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34 The Fund has recently begun to draft some standards of best practice with respect to domestic debt management and the proper management of foreign exchange rate reserves. See IMF (2000a) and IMF (2000c). However, a number of commentators have expressed the view that these items should not be high on the list of the Fund's priorities given other urgent measures required to support crisis prevention.

35 The Financial Action Task Force is concerned with international money laundering. It has recently published a list of jurisdictions (mainly offshore financial centres) graded according to their degree of willingness to cooperate with international authorities concerned about money laundering. Similar initiatives have also been taken by the OECD with respect to the somewhat different issue of jurisdictions considered to be tax havens. The FSF Working Group on Offshore Financial Centres recently classified all such centres into three categories based on assessments (by other banking supervisors) of the quality of their banking supervision. This assessment included the willingness of the OFC supervisors to share information with banking supervisors in other jurisdictions. The FSF Working Group was at pains to note that their classification was not based on some idea of unacceptable behaviour. Rather, it was a simple recording of above average, average, and below average assessments. It is expected that future IMF assessments (on site) will not only refine the work done to date but also lead to more clarity as to what should be done with the results.

seems to be in the recipient countries' own best interests. Recognition of this self-interest seems likely to be the best spur to effective action.

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ISSN 1020-0959