Bandid Nijathaworn: Some thoughts on IMF reform on crisis prevention and crisis resolution

Speech by Mr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, presented to the G-20 Workshop on Reform of Bretton Woods Institutions, Tokyo, 28 February 2006.

*   *   *

Thank you Chairman,

First, let me thank the Ministry of Finance of Japan for inviting me to this workshop on the reform of the Bretton Woods Institutions. This workshop is another reminder that the work on IMF reform is still ongoing.

Next year will be a full ten years since the height of the Asian financial crisis. Over the past decade, many important ideas on the reform of the IMF have been advanced, but still there is no consensus on how the reform should move forward.

I see today's workshop as another opportunity to contribute to this ongoing debate. And whatever the outcome may be, the reform will certainly mark a critical turning point for the global economy, as the Bretton Woods Institutions attempt to adapt their roles and responsibilities to the forces of globalization.

Today, I have been asked to speak on IMF crisis prevention and crisis resolution.

Given the limitation of time, and the fact that the recommendations on these two issues have been many and are well-known, I thought the best way for me to add value to today's discussion is to share with you our thoughts on the subject, as well as to make three specific points.

The <u>first point</u> is how the Fund can improve its surveillance by focusing on how best to reduce the likelihood of crises in emerging markets, in particular, how to help emerging markets better cope with the challenge of the next crisis.

The <u>second</u> is our view that the Fund's surveillance and its works on crisis resolution should recognize the usefulness of national and regional self-insurance efforts that are being pursued by a growing number of countries.

And the <u>third</u> is our suggestion that the Fund's works on crisis prevention and crisis resolution can benefit from a clear separation of these two functions in terms of duties, responsibilities, and decision-making, so as to achieve greater effectiveness and accountability.

To begin, the consensus seems to be that the Fund has not been doing a good-enough job on crisis prevention and crisis resolution. This is evidenced by a string of financial crises in emerging markets that had happened, which does not reflect well on the Fund's surveillance mechanism. In addition, dissatisfactions were expressed in the Fund's perceived lack of consistency and coherence in its approach to crisis resolution, in the shortcomings of its program design and conditionality, and most importantly, in the way political pressure from the major economies were allowed to influence the program content and decisions.

In the Thai case, our own experience with IMF involvement was not dissimilar. Dissatisfactions were recorded in the program design that exacerbated the liquidity problem into a near-systemic problem, in the overly tight stabilization policies based on too optimistic assumptions that led to serious economic dislocations, and also in the Fund's approach to financial sector restructuring and privatization which were flawed and alleged to benefit foreign interest.

Of course, different problems of different economies require different solutions, and it may not be fair to compare one program directly with another. But, for the most part, criticism of the Fund on crisis prevention and crisis resolution centers mainly on four issues: (1) the quality and the effectiveness of its surveillance mechanism in preventing the crisis; (2) the independence of its assessments and decisions on program design; (3) the conditionality that it imposes; and (4) the lack of a clear and predictable process in crisis resolution.

As I noted earlier, many good solutions have been put forward. The Fund has also responded positively to the criticisms by implementing many new and important initiatives. Importantly, its work on crisis-prevention has become more pro-active. The Article IV process has been strengthened with increased focus on debt sustainability. The Fund's works on standards and codes, FSAP, and the inclusion of collective action clauses in bond contracts, are all important innovations and provide the global economy with new benchmarks.

So far, I would say that improvements in Fund surveillance, its policy advice, as well as the transparency it encourages have led to sound policies, better institutions, and overall greater flexibility in emerging markets. A big pay-off was evident last year when the improved economic resilience enabled emerging markets to cope better with the impact of the high oil price. But, definitely, more can be done.

And the **first point** I want to make is that IMF surveillance would be most useful for emerging markets if it strengthens its focus on helping members to better prepare for coping with the challenge of the next crisis.

My view is that, with the improvements in economic fundamentals and policies that we are now seeing within emerging markets, there is now less likelihood than before that the next crisis, if it were to occur, will originate from imbalances within emerging market economies.

On the contrary, imbalances now seem to be more of a challenge for the major economies with the financing now becoming a major component of the global capital flows. An unwinding of the imbalances could lead to economic slowdown and sudden changes in the financial conditions of the major economies, which, as the past episode of capital account crises shows, can create difficulties for emerging markets in terms of growth implications, abrupt reversals of capital flows and sudden stops. It is in this context that Fund surveillance could help members to be more informed of the implications of such risks, and to assist members, through Fund policy advice, on how best to prepare.

In this respect, I have a view that the Fund could do more in three areas.

First, it should step up its surveillance of the major economies by providing frank and independent assessments. Also, the briefings, papers, and analyses that the Fund prepares on G7 economies and meetings could be shared more widely with other Fund members.

Second, in the area of financial markets surveillance, a few things could also be done. The Fund could produce and circulate monthly report on global financial markets to members focusing on the key financial flows to keep members informed of what the Fund sees as the current trends and risks in financial markets. Important in this context is the monitoring of activities or position-takings of large institutional players and hedge funds. Also, it would be useful for members if the Fund could develop its own in-house view of a benchmark risk scenario which then can be used, or shared with members, in stress-testing the vulnerabilities of economies to capital flow reversals.

And third, in addition to the debt sustainability framework, the central focus of the Fund's surveillance in emerging markets should be the analyses of capital flows and capital account sustainability. In fact, a definitive framework for analyzing capital account sustainability would be most helpful for emerging market members in their own assessments of their vulnerabilities to capital flow reversals. I think this capital account sustainability framework is important, given the Fund's mandate on the balance of payments and the recent episode of capital account crises in emerging markets.

The **second point** I want to raise is that the Fund should look more positively at the progressing efforts by members to increase their own immunity against the risks of financial crisis and contagion by engaging in various self-insurance activities.

These activities include (1) strengthening domestic policies, institutions, and data transparency which have led to greater flexibilities in dealing with shocks, (2) improving external positions by running current account surpluses, reducing external debt, and holding larger international reserves, (3) being more careful with capital account liberalization with greater willingness to use prudential and capital account measures to check excesses and to deter speculative short-term capital flows; and (4) engaging in regional cooperative efforts, such as the Chiang Mai Initiative in East Asia, to undertake collective regional surveillance and set up liquidity facilities that can be drawn in the case of emergency.

To me, these developments reflect the genuine desire by regional policymakers to work together towards a common goal of reducing the likelihood of the next crisis. The Fund can look more positively at these developments as they contribute to raising global capabilities in preventing and dealing with financial crises. In particular, regional arrangements, such as the Chiang Mai Initiative, if correctly designed and disciplined, can be an important supplement to the existing IMF facilities.

For those of you not familiar with East Asia, the Chiang Mai Initiative, or CMI, was set up in the aftermath of the Asian financial crisis in the year 2000 as a regional arrangement of the ten ASEAN member countries plus Japan, China and Korea. The Initiative comprises a process of economic and financial surveillance at governmental level and a voluntary financing arrangement in terms of a network of bilateral swaps, which now amounts to US $ 55.5 billion. Twenty percent of the agreed bilateral swaps can be drawn to meet emergency liquidity needs unrelated to an IMF program. The CMI is now under review, with a view of making it more useful and more relevant to the needs of the region in the longer-term.

I see regional arrangements, such as CMI, as an important regional financial architecture that complements and supports the Fund's works on crisis prevention and resolution.

First, in addition to IMF surveillance, the surveillance undertaken under CMI provides a new dimension of peer review that draws on regional knowledge and expertise in the surveillance process.

Second, the drawdown of the bilateral swaps under the first tranche provides an important liquidity support facility. This is a feature which is now missing in all of the Fund's current lending facilities, and

Third, since the remaining drawdown of the swaps is linked to a formal package of assistance that requires exceptional financing, Governments in the region, in a way, have pre-committed substantial amount of fund to be made available to support crisis resolution. In this regard, the IMF will only stand to benefit because part of the financing requirement will have already been shouldered by Governments in the region, thereby equipping the Fund with greater financial leverage to deal with other issues elsewhere.

Let me now turn to other aspects of self-protection against future crises. On self protection through reserves accumulation, I think it is only proper that differentiation is made of the reasons for reserve buildup on a country-by-country basis. This is to say that one needs to assess whether the buildup is excessive with respect to that country's overall level of exposure to the global financial markets, to its structure of exports and imports, and to the country's overall level of external liabilities.

On self-protection through the use of capital account measures, I welcome the fact that the Fund's thinking on this subject has become more liberal. On occasions, it is appropriate to use capital account measures for crisis prevention. And on capital account liberalization, I agree with my ASEAN colleagues that it would be more useful for the Fund to concentrate on managing the process of capital account liberalization of its members instead of discussing whether to make capital account liberalization an explicit purpose or mandate of the Fund.

Finally, the **third point** I want to make today is that I see strong merits in separating lending and surveillance. At present, crisis resolution is done as an extension of surveillance by the area departments using the approach they see fit. Separating these two functions in terms of duties, responsibilities, and decision-making would provide clear accountability within the IMF on role and responsibilities over these two issues.

Moreover, since crisis prevention and crisis resolution require different sets of skills and expertise, separating the two would allow the Fund to pool resources and the special skills on a Fund-wide basis, thereby strengthening the overall institution's capabilities to deal with crisis resolution.

Finally, with the work on crisis resolution becoming more centralized, the Fund's program design could be more uniformly structured to reflect a common set of guiding principles in relation to absolute limits of access to IMF financing, the use of standstills on debt repayment, the role of the Fund in debt restructuring, and the extent of the involvement of the private sector.

We have given some thoughts to this issue, and to execute the idea, one solution would be for the Fund to set up a new department that will handle only crisis cases involving exceptional financings. This new department will take over the responsibilities of crisis management and resolution from the area departments and will have the responsibility for designing the rescue package and acting as coordinator between creditor Governments contributing to the rescue package, other creditors in the private sector, IMF management, and the country concerned, to push through the rescue program. In this model, a separate Resolution Board will also be set up to approve, monitor, and supervise the implementation of the rescue package, of which membership will come directly from representatives of Governments contributing to the rescue package, key IMF members, and IMF management. The IMF Executive Board will vote to provide IMF's contributions to the package but would have no other involvement. This is to separate the decisions on surveillance and lending.

This simple model of separation illustrates three benefits that can add to the current process. First, there will be clearer accountability within the Fund in terms of duties, responsibilities, and decision-making for its works on surveillance and crisis resolution. Second, there are benefits of resource pooling which will allow the Fund to handle crisis cases with all available resources and with the program design structured under a common set of guiding principles. And the third, the program design will have greater likelihood to be adopted since it has utilized the best expertise available and has the highest degree of perceived legitimacy, since the governance of the Resolution Board better reflects the interest of all stakeholders, be they borrowers, creditors and private markets.

The challenge to IMF reform on crisis prevention and crisis resolution has many dimensions, and recommendations that have been made to address this challenge are wide-ranging. Given the limited time that we have, I hope my contributions today have been useful.

In closing, I would like to stress that the IMF has responded well to the needs for reform with new important initiatives and measures that are now showing positive results. I am confident that, going forward, the IMF will be able to come up with a credible reform agenda that will lead to greater improvements in our capabilities to maintain the stable economic and financial environment which is essential for the well-being of the global economy.

Thank you.