

THE IMF AND THE WORLD BANK IN THE NEW FINANCIAL ARCHITECTURE

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Abstract

The frequency of crises in recent years has drawn attention to the weaknesses in the international financial system and rekindled interest in its reform. At first, the crisis in East Asia, followed by the collapse in the Russian Federation, with spillover effects on Wall Street, created a widespread perception that the existing system was hopelessly inadequate and a radical reform was needed. This was the spirit of Prime Minister Blair's impassioned call for "building a Bretton Woods for the new millennium", which raised expectations of a major institutional restructuring. More recently, as financial markets have stabilized, the initial enthusiasm for radical reform has subsided and the ongoing discussions on the new financial architecture have a more limited scope. They focus on ways of improving surveillance in international financial markets, strengthening the financial system in developing countries, and increasing transparency and the flow of information to private markets to allow them to function better. Talk of restructuring the Bretton Woods institutions for the new millennium has given way to a more modest objective of strengthening cooperation between the International Monetary Fund and the World Bank to increase their effectiveness in crisis prevention and crisis management.

The Fund and the Bank have a long history of cooperation, and one can certainly build on this tradition to improve their capacity to meet future challenges. However, the nature of cooperation in the future need not be a simple extrapolation of the past. The challenges facing the international financial system today are quite different from those of the past, and it is precisely because of these differences that there is a need for a new financial architecture. The purpose of this paper is to evaluate the impact of developments on the relative roles of the Fund and the Bank in the future. The paper is divided into four sections. Section I provides a brief overview of the changing roles of the Fund and the Bank in the past which led to a considerable overlap in their activities in the 1980s. Section II summarizes why the crises of the 1990s are fundamentally different from earlier episodes of balance-of-payments difficulties and therefore call for very different responses. Section III discusses some of the main elements which have been proposed as part of the new financial architecture and examines their implications for the roles of the Fund and the Bank. Section IV presents a summary assessment of various proposals for improving coordination between the Fund and the Bank currently under consideration and evaluates their relevance in the light of the larger reforms needed in the system.

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I. Evolution of the overlap between the Fund and the Bank

The Fund and the Bank were originally established as part of the international financial architecture created at Bretton Woods, based on the system of “fixed but adjustable par values”. Under this system countries undertook two critical commitments: (i) to maintain their exchange rates within a very narrow range of the declared par values, to be changed only with the prior approval of the Fund; and (ii) to eschew restrictions on current payments. These commitments reflected the determination of participating countries at the time to avoid the debilitating experience of the inter-war years when competitive devaluations and exchange restrictions produced a downward spiral in world trade. Restrictions on current payments were seen to be antithetical to the expansion of trade and were therefore to be avoided, but the system did not seek to eliminate or even regulate restrictions on capital account transactions which were in place in most countries and were expected to continue.

A. *The first phase: distinct identities*

The Bretton Woods architecture envisaged very different roles for the International Monetary Fund and the World Bank. The Fund was established to be the guardian of the par value system and was expected to oversee its operation, ensuring that countries complied with the commitments undertaken by them. It also stood ready to provide short-term finance, subject to appropriate macroeconomic conditionality, to help countries deal with temporary balance-of-payments problems in a manner which would not be “destructive of national and international prosperity”. As supervisor of the system as well as a financier, the Fund dealt with both industrialized and developing countries and its approach to managing balance-of-payments problems was very similar in both cases.

The World Bank’s original function was the financing of reconstruction in war-torn countries and development in developing countries. The former was quickly taken over by Marshall Aid and the Bank settled down at a very early stage to the task of financing projects in developing countries. It was expected to finance projects which were economically viable but which otherwise might not be financed because of the scarcity of domestic resources and the difficulty in obtaining external

finance since international capital markets were relatively undeveloped at the time. Bank financing was generally accompanied by project-level conditionality which occasionally also extended to sector-level policies, but it did not involve macroeconomic conditionality. The Bank did make regular assessments of development policies and prospects of individual borrowing countries, but this was primarily to establish the creditworthiness of the borrower and not with a view to specifying conditionalities for its lending.¹ Unlike in the case of the Fund, the Bank’s membership was asymmetric, distinguishing between borrowing and non-borrowing members, with the Bank lending only to the former.

The two institutions functioned with very little overlap for the first 25 years of their existence, as each provided finance which was for different purposes and was linked to very different types of policy conditionality. However, development finance can never be completely divorced from macroeconomic policy and there were some jurisdictional overlaps in the early years.² Recognition of the possibility of overlapping activities led to the issuance in 1966 of formal guidelines for Fund-Bank collaboration, demarcating areas of primary responsibility for each institution. The Fund was assigned primary responsibility for “exchange rates and restrictive systems, for adjustment of temporary balance-of-payments disequilibria, and for evaluating and assisting members to work out stabilization programmes as a sound basis for economic advance”. The Bank was assigned primary responsibility for “the composition and appropriateness of development programmes and project evaluation including development priorities”.

The 1966 guidelines recognized that between these two “clear cut areas of responsibility” there were other areas of interest to both institutions, e.g. the structure and functioning of financial institutions, the adequacy of money and capital markets, the capacity to generate domestic savings, external financing and external debt, and that in these areas each institution would form its own view and differences were implicitly accepted. However, in the event of a conflict of views in an area within the primary responsibility of one institution, the view of that institution would prevail over that of the other. These issues could be discussed between the two institutions, but the guidelines explicitly ruled out any critical review by one institution with a member country on issues within the primary responsibility of the other institution, except with the latter’s prior consent.

B. The overlap in the 1980s

Changes in the world economy in the 1970s forced both the Fund and the Bank to reorient their activities in a manner which considerably increased the overlap between the two institutions in the 1980s. The role of the Fund changed dramatically after the collapse of the par value system in 1973. The shift by major currencies to floating rates, combined with the growth of capital markets, made the Fund irrelevant as a source of finance for industrialized countries. No major industrialized country borrowed from the Fund after 1976 and its financing role thereafter focused only on developing countries, with countries in transition being added in due course. The Fund responded to the needs of its exclusively developing country clientele by introducing several new facilities tailored to their special requirements, which had the effect of moving Fund financing closer to development financing of the type provided by the Bank.

The critical factor driving the change was the recognition that the balance-of-payments problems of many developing countries were of a structural nature and therefore very different from the traditional Fund conception in which balance-of-payments deficits were seen as a reflection of excess aggregate demand. Deficits caused by excess demand were obviously best handled by demand restraint, supplemented by exchange rate changes whenever it was felt necessary to stimulate the production of tradeables relative to non-tradeables. Adjustment was expected to be accomplished in a relatively short period of time, which is why IMF standby arrangements typically provided finance for a period of between one year and 18 months, to be repaid between three to five years after each drawing. This approach was inappropriate for developing countries suffering from structural constraints which limited their capacity to expand the production of tradeable goods. Reducing aggregate demand to reduce the current account deficit in this situation often led to underutilization of capacity and unemployment, which could not be countered by depreciating the exchange rate to stimulate the production of tradeables. Expanded production of tradeable goods could be achieved only by removing structural bottlenecks, which often required a period of increased investment, a process which would take time. This meant that current account deficits had to be financed over a longer period and the period of repayment also had to be extended. These considerations led to the establishment of the Extended Fund Facility (EFF) in 1974, which enabled developing countries to receive assistance over a three-year period (and therefore also

in a larger total amount) and extended the repayment period to between four and eight years, which was later extended to between four and 10 years.

Fund financing also moved closer to Bank financing because of the introduction of concessionality for low-income countries. In 1976 the Trust Fund was established, financed by profits on the sale of a part of the Fund's gold, to make medium-term loans (repayable over a period of between five and 10 years) to low-income countries at near zero interest rates and with weak conditionality.³ Ten years later another concessional facility was introduced responding to the problems of low-income countries in Africa suffering from persistent economic stagnation after the oil shocks of the 1970s. It was recognized that revival of growth in these countries was possible only if larger balance-of-payments deficits could be financed, and that the financing had to be on concessional terms because their debt-servicing capacity was severely constrained. In 1986 the Fund established the Structural Adjustment Facility (SAF) to make loans to IDA-eligible countries at 0.5 per cent interest repayable between the fifth and tenth year after each drawing. This was followed a year later by the Enhanced Structural Adjustment Facility (ESAF), designed to provide a larger volume of resources on the same terms, but with more stringent conditions.⁴

The Bank also moved closer to Fund-type activity by shifting from its earlier exclusive focus on project financing to providing balance-of-payments support. Most developing countries experienced a mounting burden of debt following the oil crisis which created serious macroeconomic imbalances and led to a slowdown in growth by the end of the 1970s. The Bank's management came to the conclusion that it could make little impact on development in this situation if it continued to focus only on project lending. Weaknesses in macroeconomic and sectoral policies in the developing countries were seen to be at the root of their poor performance and unless these policy weaknesses were corrected it was felt that continued project lending could make little difference.⁵ The Bank therefore introduced Structural Adjustment Loans (SALs) in 1980 to provide non-project tied assistance in support of wide-ranging policy reforms aimed at increasing the efficiency of resource use. The package of reforms typically covered tax policy, price decontrol, trade policy, privatization of public enterprises and reforms in the financial sector. In 1982 Sector Adjustment Loans (SECALs) were introduced with policy conditionality being more narrowly focused on a particular sector.

Since adjustment lending resembled balance-of-payments financing it created an obvious overlap with the Fund, with the possibility of conflict between the two institutions. To avoid conflict, it was clarified that SALs would deal with policy issues other than fiscal policy and exchange rates, which were the core areas of the Fund. Since fiscal and exchange rate issues could not be entirely avoided in formulating SALs, the Bank undertook to coordinate with the Fund on these issues in order to ensure that adjustment lending did not become a means of sustaining an unviable macroeconomic position. In fact, the expectation was that in practice SALs would generally be used in cases where a Fund programme was already in place.

For its part, the Fund recognized that its ESAF programmes for low income countries had to be firmly grounded in appropriate structural policies which could bring about sustainable growth. ESAF programmes were therefore preceded by consideration by the Board of a Policy Framework Paper (PFP), prepared jointly by country authorities and the staffs of the Bank and the Fund, which was expected to lay out the medium-term policy agenda to be followed by the country. Joint preparation of the PFP was intended to ensure full coordination with the Bank and also to ensure “ownership” by the country. In practice, it did achieve coordination between the two institutions, but for a variety of reasons, including the lack of capacity in many low-income countries, the success achieved as regards ownership is questionable.

Adjustment lending proved to be a useful innovation partly because it responded to developing country demands for more flexible conditionality than that usually associated with Fund programmes. Fund conditionality was typically limited to a few (at most 10) key macroeconomic policy variables and focused heavily on fiscal discipline and restraint on domestic credit expansion. Targets for each performance variable were precisely quantified by specifying particular levels of domestic credit, credit to the government, or reserves to be met at the end of each quarter, and failure to meet any one target could lead to drawings being interrupted. SAL conditionality was much broader, often covering as many as 30-50 policy actions in different areas!⁶ Instead of fixing specific compliance dates for policy action, SALs were tranching so that disbursement under each tranche could be effected once the agreed set of policy actions relating to that tranche had been taken. The Bank was generally also more flexible in determining compliance, relying on a broad assessment of

whether the programme was on track. SECALs added a new dimension of flexibility since developing countries were able to obtain financing based on reforms in only one sector, where they might be more easily acceptable for domestic reasons. Adjustment lending increased rapidly, reaching about 25 per cent of Bank lending in the second half of the 1980s; and this is a measure of the extent of overlap between the two institutions.

A by-product of the overlap was the emergence of the so-called Washington Consensus, which sought to integrate the approaches of the Fund and the Bank. Sound development policy was sought to be defined as a combination of (i) macroeconomic balance (basically a low fiscal deficit), which was the traditional concern of the Fund, and was viewed as an essential precondition for growth, and (ii) efficiency-enhancing reforms (e.g. decontrolling private sector activity, opening the economy to trade and foreign investment, and privatizing the public sector as much as possible), which was the focus of the structural reform effort spearheaded by the Bank. The consensus was modified over time in response to criticism on some important points, e.g. the possibly negative effect of fiscal discipline, and sometimes also market-oriented reforms, on the poor. This led to a redefinition of the consensus to recognize that structural reforms must be supplemented by direct efforts at poverty alleviation by protecting certain types of government expenditure, e.g. in the social sectors, which were especially important for the poor and also by increasing expenditure on poverty alleviation programmes.

Developing countries were particularly concerned that a consensus on broad directions of policy should not degenerate into a “one size fits all” approach, and they consistently emphasized the need to tailor programmes to suit the circumstances and constraints of individual countries. Differences across countries could arise on issues of pace and sequencing, and also on the strategic importance of concentrating on particular areas. The Fund and the Bank also differed on these issues. The Fund typically placed much greater emphasis on fiscal balance, calling for relatively quick reductions in the fiscal deficit irrespective of how they were achieved, while the Bank focused much more on efficiency-enhancing reforms some of which could involve trade-offs with deficit reduction. The emphasis to be placed on tariff reduction as a structural reform measure at a time of fiscal stringency is an obvious example where the Bank was often in favour of a faster reduction in tariffs to reduce trade distortions even at the cost of a higher fiscal deficit, while the Fund tended to be

much more concerned about the impact of such reductions on fiscal balance.

Conflict over Argentina and the Concordat of 1989

Despite the overlap there was no overt conflict between the Fund and the Bank until the celebrated case of Argentina in 1988, when the Bank decided to go ahead with adjustment lending even though negotiations with the IMF for an Extended Fund Facility had recently collapsed. In the Bank's view, the Fund was insisting on too strong a fiscal correction because of its traditional focus on aggregate demand, whereas the Bank, being more concerned about structural reforms, was willing to accept a less ambitious fiscal target. It is well known that the Bank's management was under pressure from the United States Treasury to go ahead with the loan.⁷ In the event, the Fund's judgement was vindicated when it became clear, shortly after the approval of the adjustment loans by the Bank's Board, that Argentina would not be able to meet the expected criteria of fiscal performance and disbursements had to be interrupted.

The Argentina fiasco, as it has been described by Polak (1997), generated concern in several quarters. It was the first case where the Bank proceeded with adjustment lending despite a clear finding of macroeconomic unsustainability by the Fund staff. The Fund was understandably concerned that it might create a precedent which would encourage countries in difficulty to postpone or avoid taking necessary corrective steps, and seek support from the Bank as an easier alternative. This would undermine the credibility of the Fund as the established arbiter of what was needed to achieve macroeconomic stabilization and devalue its good housekeeping seal of approval. Also, the G-10 deputies were concerned about lack of coordination between the two institutions leading to the possibility of conflicting policy advice to the country concerned.

Intensive consultations ensued between the two institutions to resolve these problems and culminated in the so-called Bank-Fund Concordat of 1989, which superseded the earlier guidelines on Bank-Fund collaboration. The main features of the Concordat are summarized in box 1. It is significant that the Concordat did not seek to eliminate, or even reduce, the overlap between the Bank and the Fund. On the contrary, the overlap was accepted as a natural development given the changed circumstances of the world economy and the difficulties being experienced

by so many developing countries. The Concordat focused instead on the limited objective of improving coordination between the Bank and the Fund and avoiding conflicting advice if possible, while preserving the independence of action of each institution.

In the event of a disagreement, the Concordat prescribed an extensive process of consultation but the final decision was left to be taken by the Executive Board of the institution concerned after hearing the view of the other institution. What this meant was that the management of one institution could not be vetoed by the management of the other, even if it differed on issues within the primary responsibility of the other institution. In such cases the Executive Board of the lending institution would have the right, after having heard the view of the other institution, to act independently.

II. The crises of the 1990s: new sources of fragility

Issues of coordination between the Fund and the Bank surfaced again at the time of the East Asian crisis as both institutions worked together to help crisis-hit countries. Each institution also introduced innovations in its lending policies to respond to the new situation. At first glance this can be viewed as a logical continuation of the overlap which had developed over the 1980s. However, there are significant differences between the crises of the 1990s and earlier payments problems suffered by developing countries, and these differences have important implications for the role of the two institutions in the future. A brief digression on the distinctive features of the new type of crisis is therefore appropriate.

A. Crises of confidence

Each of the major crises in the 1990s – Mexico in 1994, East Asia in 1997, the Russian Federation in 1998 and Brazil in 1999 – had features peculiar to itself, but they all shared an important common characteristic. They were crises of confidence originating in the capital account and therefore very different from earlier episodes of payments problems in developing countries which typically arose in the current account.⁸ The vulnerability of developing countries to such crises has increased in the 1990s because many countries have liberalized restrictions on capital

Box 1**THE CONCORDAT OF 1989**

The Concordat of 1989 defined each institution's area of "primary responsibility" more elaborately than in the 1966 guidelines.

- The Fund's areas of primary responsibility were "the aggregate aspects of macroeconomic policies and their related instruments – including public sector spending and revenues, aggregate wage and price policies, money and credit, interest rates and the exchange rate".
- The Bank's areas of primary responsibility were development strategies, sector and project investments, structural adjustment problems, policies dealing with the efficient allocation of resources, priorities in government expenditure, reforms of the administrative system, the production trade and financial sectors, the restructuring of state enterprises and issues related to creditworthiness. The mandate of the Bank specifically excluded the aggregate aspects of economic policies, which were the exclusive preserve of the Fund.
- It was recognized that both the Fund and the Bank had legitimate concerns with regard to macroeconomic and structural issues, and that each institution would need to undertake independent analysis of these issues and take the results into account in their policy advice and lending operations.
- Elaborate procedures were laid down to enhance coordination between the Bank and the Fund through periodic meetings at various official levels, including sharing of information between the two institutions. These procedures were designed to keep each institution aware of the views of the other on a more continuous basis. The Bank was expected to ascertain the view of the Fund on the adequacy of macroeconomic policies, before formulating its own opinion, even in cases where there was no Fund programme. Similar obligations were imposed on the Fund vis-à-vis the Bank with regard to developmental and structural policies.
- In the event of irreconcilable differences on a matter within the primary responsibility of one institution, the Concordat stipulated that "the institution which does not have primary responsibility would, except in 'exceptional circumstances', yield to the judgement of the other institution". Polak (1997) reports that the original draft prepared by the Fund had made it mandatory to yield in such cases but this was not acceptable to the Bank, and the present version with the exception clause was finally agreed. Exceptional circumstances were "expected to be rare", but when they did arise the managements were expected to consult their respective executive boards before proceeding.
- Each institution was also allowed to lend to a member in arrears to the other institution subject to appropriate consultation. The key consideration was that each institution would consider whether the arrears to the other were an indication that its own resources would not be safeguarded.

movements in order to integrate more fully into global financial markets and improve their access to international capital flows. While access has definitely improved, this has been achieved at the risk of greater volatility and instability. Financial markets have long been known to suffer from euphoria and panics which can create boom-bust cycles, and

this applies to the international capital market also. Inflows can exceed the level warranted by underlying fundamentals when perceptions are favourable, as was clearly the case in East Asia before the crisis, but outflows can also be disproportionately large when perceptions change and there is a loss of confidence.

It is important to appreciate that the risks faced by developing countries integrating with global financial markets are substantially greater than for industrialized countries. One reason for this is that developing countries are objectively more vulnerable to changes in external economic circumstances and this is bound to be reflected in greater instability in investor perceptions. However, this “objectively justifiable” instability is magnified by information deficiencies. Investors, especially portfolio investors, typically have much less information about conditions in developing countries than in industrialized countries and this can exaggerate the response to negative developments, leading to greater volatility. Lack of information also increases the likelihood of herd behaviour and the risk of contagion, both of which intensify volatility. Developing countries not only face greater volatility, but they are also more vulnerable to any given level of volatility because of the thinness of their markets compared with the size of resources that can be moved by global investors. The same degree of volatility in capital flows therefore has a much greater impact on prices in developing country markets (both forex and equities) than in industrialized countries.

Instability is heightened by the fact that it is not easy to predict what can cause a crisis of confidence in a particular situation. One can be fairly sure that economies that are fundamentally strong on all counts are unlikely to become victims of panic behaviour. At the opposite end of the spectrum, economies that are visibly weak will invariably have problems, though such economies are more likely to suffer from chronic external payments difficulties rather than the danger of a sudden crisis. Between these extremes, however, there will be many countries where an otherwise strong economic performance may be suddenly clouded by the emergence of some weaknesses. If investor perceptions always changed as a continuous response to changes in economic fundamentals, inflows would dry up gradually as weaknesses emerged, giving clear warning signals and ample time to take corrective action. However, investor perceptions often change in a discontinuous fashion. A build-up of negative factors may be ignored for some time by investors in the belief that it is either temporary or will be corrected by appropriate policies, but if this does not happen perceptions can change suddenly, triggering a sudden reversal of capital flows. This can easily turn into a self-fulfilling panic in which the financial markets may fail to play a stabilizing role. Instead, the system is pushed from an initial equilibrium to another equilibrium which is

much less favourable and from which recovery is not easy.⁹

What triggers a panic will vary from situation to situation. In Mexico, for example, vulnerability had built up over time with a steady deterioration in the current account, reaching 8 per cent of GDP in 1994, and a substantial real appreciation in the peso in the years preceding the crisis. The large current account deficit was not seen to be a problem at the time because it was financed by strong private inflows.¹⁰ Perceptions changed in the course of the year because of a series of negative developments including a shift to a more expansionary macroeconomic policy, the assassination of a presidential candidate and the rebellion in the Chiappas region. Lack of transparency in disclosing the extent of reserve use in the course of the year intensified the strength of the negative investor reaction, which led to a large withdrawal of funds towards the end of the year.

East Asia's vulnerability arose from what we now know was a pervasive weakness in the financial sector, though this was completely missed by Fund surveillance and also by the World Bank, which had an extensive involvement in Indonesia and some involvement in Thailand. It was also missed by the international credit rating agencies which are an important source of information for financial markets. The only warning signals spotted by Fund surveillance in 1996 were the size of the current account deficit in Thailand and the real appreciation of the baht, and these were discussed by the Fund with the Thai authorities.¹¹ However, the depth of the crisis in Thailand and its spread to other countries as investors concluded that similar weaknesses were endemic, was certainly not anticipated.

The major factors which contributed to fragility in East Asia varied across countries and are summarized in box 2. They are clearly linked to weaknesses in the financial sector in the sense that a stronger financial system would have avoided many of the problems. Banks would not have lent so extensively to highly leveraged corporations, especially those with large volumes of unhedged foreign debt. They would also have avoided large unhedged exposure to foreign borrowing on their own account. This would have moderated foreign inflows in the earlier years by creating a more realistic perception of the returns on investment and the risks involved. It would also have avoided the very large build-up of short-term loans from international commercial banks which was an important source of vulnerability in all the affected countries.

Box 2**FACTORS UNDERLYING EAST ASIAN CRISIS**

Many of the factors which contributed to the currency crisis in East Asia reflect weaknesses in the financial sectors of the countries of the region. There were variations from country to country, but the following factors were relevant over most of the region.

- Large private inflows, attracted by favourable investor perceptions, were channelled into unproductive domestic investments by banks and other financial intermediaries which were either too weak to undertake proper credit appraisal or were knowingly engaged in cronyism, or both.
- The financial system tolerated high debt-equity ratios which made corporations, and also the banks lending to them, highly vulnerable in the event of a downturn.
- Exchange risk was underestimated by both banks and corporations, possibly because of the experience of nominal exchange rate stability. This encouraged an excessive unhedged exposure to foreign borrowing, often short term.
- Total external debt was not high (except perhaps in Indonesia) but the ratio of short-term debt to foreign exchange reserves increased sharply in the years preceding the crisis. Banks in the Republic of Korea were actually encouraged to borrow short term as this segment was liberalized, while longer-term borrowing remained restricted. The offshore banking facilities in Thailand had the same effect. The build up of short-term debt added to vulnerability in the event of non-renewal of such loans.
- Lack of transparency also made surveillance ineffective and may have delayed adjustment. Thailand's intervention in forward exchange markets pre-committed much of Thailand's available reserves without this being known to the market. Similarly, the Republic of Korea's foreign exchange reserves were not effectively available because they had been lent to branches of the country's banks abroad to meet their short-term obligations. Earlier public disclosure of these actions would have led markets to change perception earlier, in which case the change may have been more gradual.
- Foreign banks lent excessively to East Asian banks possibly because of the perception that governments would ultimately guarantee these loans. Critics have argued that the Fund's Mexico bailout contributed to the perception that such loans were effectively government-guaranteed.

B. Managing the new type of crises

Managing the new type of crisis poses special problems. A loss of confidence, whatever its cause, can be highly destabilizing because of the possibility of a large reversal of capital flows. Net positive inflows on which a country depended in order to finance the current account deficit may cease altogether, as new lending is held back. It may also become negative as short-term loans are not rolled over. The open capital account also makes it easier for domestic capital to flow out in anticipation of exchange rate depreciation.¹² Unlike the traditional

balance-of-payments crises originating in the current account, in which pressure typically built up gradually, crises originating in the capital account can explode quite suddenly, creating a sudden need for financing with very little time to negotiate a programme. The volume of finance needed is much larger than earlier, and most of the financing is also generally needed up front if confidence is to be restored. If credible corrective policies are quickly put in place and enough financing is made available to calm markets, it may be possible to restore confidence relatively quickly, in which case capital flows may return relatively quickly to normal levels. In such

Table 1

FISCAL BALANCE TARGETS IN FUND PROGRAMMES					
	<i>Actual 1997</i>	<i>Initial package</i>	<i>First revision</i>	<i>Second revision</i>	<i>Third revision</i>
Indonesia	0.2	1.0	-1.0	-3.0	-8.5
Malaysia	2.6	2.5	0.5	-3.5	--
Philippines	-0.9	0.0	-1.0	-3.0	--
Republic of Korea	0.3	0-0.3	--	-0.8	-1.8
Thailand	-0.9	1.0	1.0	-1.6	-2.4

Source: World Bank (1999).

situations it may not be necessary for the financing package mobilized to be fully disbursed and, even if it is, repayments can be made very rapidly from the restoration of normal capital flows. Unlike in the case of structural balance-of-payments problems, the financing needed for a crisis of confidence does not have to be long term and, in any case, certainly not concessional.

Restoration of confidence must obviously be the prime objective of policy in such crises, but it is often not clear what is needed to achieve this objective. In Mexico in 1994 the crisis was quickly contained and Mexico made a relatively quick recovery. East Asia, on the other hand, was very different. The Fund was able to put together rescue packages for Thailand, Indonesia and the Republic of Korea in a commendably short time, and it received full cooperation from the World Bank and the Asian Development Bank, both of which contributed to the rescue packages in the form of structural adjustment loans to supplement Fund financing. However, unlike in the case in Mexico, the Fund's East Asia programmes did not succeed in stabilizing the situation; in fact, the currency collapse actually intensified after the programmes were put in place and all three countries suffered an exceptionally sharp economic contraction. Growth forecasts for the programme countries were revised downwards on several occasions in quick succession, giving rise to criticism in some quarters that the Fund's programmes were not only inadequate but also may have actually worsened the situation. These developments clearly eroded the credibility of the Fund as a crisis manager.¹³

The East Asian experience illustrates the ineffectiveness of traditional stabilization programmes,

with their reliance on fiscal restraint and interest rate policy in the face of crises originating in the capital account. The Fund has been widely criticized for insisting on a traditional dose of fiscal restraint in East Asia even though none of the East Asian countries suffered from fiscal imbalances at the time of the crisis. It has argued that even if a fiscal imbalance was not the cause of the problem, some fiscal restraint had to be part of the solution because an increase in government savings was necessary in order to bring about the improvement needed in the current account to ensure external balance. However, this argument ignores the special nature of the East Asian situation where capital outflows had precipitated excessive currency depreciation, which had strongly negative balance-sheet effects on banks and corporations, which in turn depressed domestic demand. Fiscal tightening is normally part of a traditional Fund adjustment package, especially one involving depreciation of the exchange rate, because depreciation is normally expected to have a stimulating effect on the demand for tradeables and aggregate demand restraint is needed to maintain macroeconomic balance while allowing the current account to improve. In East Asia, however, any demand-stimulating effects of currency depreciation, working through the relative price of tradeables, were completely swamped by the negative balance-sheet effects of the large currency depreciation. This negative effect was not taken into account in the Fund's programmes, perhaps because the extent of the depreciation was not anticipated. The initially tight fiscal targets were of course loosened very considerably when it became evident that the economies were undergoing an exceptionally sharp economic contraction (see table 1). Nevertheless, the initial tightness calls into question the appropriateness of the macroeconomic policy design.

The Fund also relied heavily on interest rate policy in its East Asian programmes, and again in Brazil, but this policy failed to prevent an exchange rate collapse in all these cases while imposing severe economic costs in the short run. The World Bank (1999) has implicitly criticized the Fund's approach by arguing that the empirical evidence that high interest rates help restrain currency depreciation is inconclusive, whereas there is strong evidence that they damage economic growth. The limitations of interest rate policy in handling a currency crisis originating from the capital account certainly need to be studied carefully, especially because the financial community tends to regard high interest rates as an essential element in any stabilization package.

One can be reasonably certain that high interest rates will succeed in reducing pressure on the currency when this pressure arises from a widening of the current account deficit in a situation of excess aggregate demand. In such a situation high interest rates help to reduce aggregate demand, which automatically moderates the pressure on the exchange rate. However, where exchange rate depreciation is being driven by capital outflows, higher interest rates are presumably expected to help by increasing the return on domestic assets and encouraging an inflow of capital. This relationship may not work quite as expected. The interest rate level needed to offset the perception of an imminent depreciation is very high and such high rates, if maintained for any length of time, can depress the real economy. Stiglitz and Furman (1998) point out that if the disruptive effect of raising interest rates on the real economy leads to a sufficient increase in the default risk it could theoretically counter the incentive effect of high interest rates on capital flows and thus actually worsen the situation. East Asia was particularly vulnerable to the negative effects of high interest rates because corporations were highly leveraged and commercial banks were also extensively exposed to the property sector against collateral of real estate, the value of which is highly sensitive to interest rates.

Critics of the Fund have argued that lower interest rates would have avoided some financial distress without necessarily worsening the extent of exchange rate depreciation, and might even have helped achieve an earlier recovery because the real economy would have performed better, encouraging an earlier return of confidence. Fund spokesmen point to the gradual recovery in exchange rates which has since taken place in the Republic of Korea and Thailand, with a parallel decline in interest rates in those countries, as evidence that the policy was basically sound

though painful in the short run.¹⁴ This is clearly an area where further research is necessary.

III. The new financial architecture: some key elements

The new type of crisis witnessed in the 1990s has important implications for the functioning of the Fund and the Bank in the future. These institutions had evolved mechanisms for cooperating in handling the older types of payments problems, but the crises of the 1990s pose new challenges and possibly also call for somewhat different policy responses. In this section we focus on some of the key elements currently being discussed in the context of the new international financial architecture to help deal with these problems. These are:

- Strengthening the financial sector in developing countries;
- Improving bilateral and multilateral surveillance;
- Making the Fund a genuine lender of last resort;
- Introducing mechanisms for orderly negotiations with private creditors;
- Managing the social consequences of crisis;
- Creating an internationally agreed regime for restrictions on the capital account.

The future role of the IMF and the World Bank should be defined in the light of decisions made on these issues.

A. *Strengthening the financial sector*

The most commonly discussed lesson from East Asia is that it is necessary to strengthen the financial sector in developing countries, especially for countries integrating with international financial markets. This is ultimately a process of institutional development which can be achieved only over several years, but the first step is to improve the regulatory framework governing various parts of the financial sector. The discussions on the new financial architecture have outlined the action needed on several fronts. Reforms in the banking system must obviously have top priority, given the special importance of banks in the financial system. This calls for improvement in the prudential norms and standards applied to com-

mercial banks and also in the supervisory system for monitoring and enforcing them. Regulatory reform is also needed in the operation of securities markets and the functioning of the insurance sector. These reforms need to be underpinned by reform of the substructure. Accounting practices and standards need to be upgraded in most developing countries as an essential precondition for improving the allocative efficiency of both the banking system and the capital market. Also, experience in East Asia has shown that domestic bankruptcy laws are often inadequate for private creditors and domestic banks wishing to take legal action to recover loans. Finally, improvements in corporate governance are also needed.

It is also recognized that the need for reforms is not limited to developing countries and that improvements are needed as well in financial markets in industrialized countries. The international operations of institutions such as hedge funds and other investment institutions operating from offshore banking systems are inadequately regulated at present. Leveraged trading in particular needs better regulation, at least in terms of disclosure, so that lending institutions can be better informed about the risks involved.¹⁵ Some features of bank regulation in industrialized countries actually encourage short-term flows to developing countries by ascribing lower risk weights to short-term loans, thus creating a regulatory incentive for short-run lending which increases the potential volatility of flows to developing countries.

The broad coverage of the reforms needed for the new financial architecture reflects the fact that financial markets are highly interconnected and regulation of one segment of the market will not serve the purpose. It is necessary to take an integrated view of the functioning of the international financial system and all its sub-sectors instead of the present segmented approach in which regulatory issues relating to individual sectors are discussed in separate organizations, e.g. banking issues are discussed in the Basle Committee while issues related to the functioning of the securities markets are discussed in the International Organization of Securities Commissions (IOSCO).

The United Nations Committee on Development Planning suggested the creation of a World Financial Organization as a sort of supranational body exercising supervisory powers over the financial sector as a whole.¹⁶ The G-7 countries have opted for a more modest alternative of bringing together national authorities of the G-7 countries and the major inter-

national institutions and other concerned international bodies in a Financial Stability Forum which will act as a consultative group rather than a supranational supervisor. The forum consists of two representatives from the IMF, the World Bank, the Basle Committee, the Bank for International Settlements (BIS), IOSCO and the International Association of Insurance Supervisors (IAIS) respectively, and three representatives from each of the G-7 countries. The 33-member forum will be chaired by the General Manager of the BIS for a three-year period and will be serviced by a small secretariat based in the BIS. No developing countries are included in the forum at present, although it has been reported that it may be expanded to include some emerging market countries "at a later stage". Inclusion of major developing countries in this forum is surely essential to ensure even a minimal degree of participation and representation.

It is important to recognize that there are practical problems in establishing international regulatory standards for various parts of the financial sector. It is necessary to distinguish between those areas where standards already exist, which have gained wide acceptability among industrialized countries, and other areas where this has yet to be achieved. Examples of the former are the standards relating to prudential norms and supervision of banks evolved by the Basle Committee, the standards relating to the operation of securities markets evolved by IOSCO and standards for regulating insurance evolved by IAIS. Considerable homogenization of standards has taken place across industrialized countries, but there are important differences. Prudential standards applied in the Japanese banking system, for example, did not fully meet international expectations.

A practical problem in applying international standards of financial regulation to developing countries is that these standards may require some modifications to take account of developing country characteristics. For example, the Basle Committee standards for prudential norms and supervision of commercial banks were designed for banks operating in industrialized countries with fully developed financial markets and very efficient legal systems, and could pose problems if applied in countries which do not have similar well-developed financial markets. For example, mark-to-market practices for valuing securities can present problems when securities markets are illiquid. Similar problems will arise in other areas where standards already exist, such as in the operation of securities markets and in insurance. The existing standard-setting bodies are

dominated by industrialized countries and are not likely to identify modifications of international standards for developing countries. There is an area where the Fund and the Bank could play a useful role by defining modifications appropriate for developing countries and also by determining phased transition paths for achieving full compliance with international standards. Transition paths defined by the Fund and the Bank are more likely to acquire international respectability and will provide developing countries with operational guidance in moving to higher standards. Progress by individual countries could be monitored by the Fund in the course of bilateral surveillance. In addition, the Fund and the Bank could offer technical assistance to countries needing such assistance to achieve compliance in individual areas.

Establishing common standards in some of the other areas will be much more difficult. Accountancy standards, for example, are much stricter in the United States than in Europe and although the International Accounting Standards Committee is working to evolve common standards, it is not clear whether the United States would accept any dilution of the Generally Accepted Accounting Principles. Corporate governance is a relatively new concern even in industrialized countries and there are considerable differences in corporate governance practices, depending on whether the country follows the Anglo-Saxon model, the German model or the Japanese model. The OECD is currently working on an international standard for corporate governance, but it is unlikely to go much beyond stating some very broad principles, the practical application of which would be very different in different countries. Common standards for bankruptcy laws are perhaps furthest in the future. Here again, practice varies considerably across industrialized countries, with the balance between debtor and creditor interest being struck differently from country to country.

To summarize, the effort to upgrade regulatory and supervisory systems in different parts of the financial system in developing countries will certainly increase the transparency of, and flow of information from, emerging country markets, and this should help financial markets to function more effectively vis-à-vis these countries. However, some caveats are important. First, the introduction of regulatory structures is no guarantee against a financial crisis – there are numerous examples of crises occurring in regulated financial markets in developed countries. The effectiveness of regulation depends on how the system is implemented in practice, and this depends heavily on the quality of supervision. It will take sev-

eral years for supervisory institutions in developing countries to build the supervisory skills needed. Another caveat relates to the nature of regulation itself. There is a growing body of opinion that the focus of supervision in banking should move away from enforcement of standard norms relating to capital adequacy, asset classification by risk category, provisioning etc. to a comprehensive assessment of the risk management system in each bank. Supervision would then focus on assessing the adequacy of the risk management system in each bank and checking whether the system is actually being followed. It is obviously impossible to define common international standards in this type of approach. Nor would it be appropriate for developing countries to be judged by adherence to traditional mechanical norms while industrialized country institutions switch to more sophisticated systems of risk assessment, which give their financial institutions much greater flexibility.

All this underscores the fact that conventional wisdom on financial regulation is itself evolving and it is important for the developing country constraints and perspectives to be taken into account in evolving standards in future. The expansion of the Financial Stability Forum to include developing countries and the role of the Fund and the Bank as spokesmen for the developing countries are particularly important in this context.

B. Improved surveillance

Surveillance is a core activity of the Fund, which conducts bilateral surveillance of individual countries through its annual Article IV consultations and multilateral surveillance through periodic reviews of the international economic situation in the form of the *World Economic Outlook*. Both types of surveillance need to be strengthened so that vulnerabilities are identified at an earlier stage in future.

Bilateral surveillance needs to be strengthened to address the various information deficiencies which contribute to instability in financial markets facing developing countries. Timely availability of information and transparency are critical in this context. The establishment of the IMF's Special Data Dissemination Standard in 1996 is an important advance. For its part, the Fund has published a Code of Good Practices on Fiscal Transparency and is currently working on a Code of Conduct on Monetary and Financial Policy. Implementation of these codes will help present a much more reliable picture of the fis-

cal and monetary conditions in member countries on a comparable basis.

Particular attention will have to be paid to financial sector weaknesses, especially in developing countries which are more integrated with global financial markets. Since both the Fund and the Bank are actively involved in work on the financial sector there is scope for greater cooperation between the two, and we will return to this subject in section IV. However, effective surveillance requires the Fund to cooperate not only with the World Bank but also with other important players, including in particular BIS and IOSCO. The recently established Financial Stability Forum will help the Fund in this context.

In the past, surveillance was designed primarily to keep the Fund and member governments informed of developments in individual countries. In future it must play a much larger role in feeding information to financial markets to improve market efficiency. This raises problems because of the constraints of confidentiality associated with Article IV consultations. The Fund has recently introduced the practice of releasing Public Information Notices (PINs) summarizing the outcome of Board discussions of Article IV consultation reports, where the country under review requests such release. This is clearly a step in the right direction. However, out of 138 Article IV consultations concluded in 1997/98 countries chose to have PINs released in only 77 cases, a fact which indicates that many countries wish to retain confidentiality. This may be partly because countries which do not have and are not seeking substantial access to international financial markets do not see any advantage in releasing PINs. However, countries seeking access to financial markets are likely to take a different stand and in any case will be pushed towards greater disclosure by market pressure.

If surveillance is expected to improve the functioning of financial markets it must also pay greater attention to market perceptions than is done at present. It is not easy for the Fund to incorporate market perceptions in formal surveillance activity since governments can always downplay such assessments as being subjective. But greater use of market sources can often add useful information. For example, the build-up of non-performing assets in some of the East Asian banking systems was not documented in official circles but was definitely suspected by market circles, which routinely discounted the low officially reported figures (Khatkhate and Dalla, 1995).

Multilateral surveillance also needs to be improved. It must focus more sharply on developments which could add to instability in the external environment facing developing countries. The impact of industrialized countries' policies on developing countries through their impact on world trade has been the focus of attention for some time. Their impact on capital flows to developing countries is equally important. For example, low interest rates in industrialized countries created conditions which favoured a heavy flow of capital to developing countries and also made them vulnerable to a reversal, but this vulnerability was not sufficiently highlighted in multilateral surveillance. These linkages need more attention in future. Multilateral surveillance does not of course imply an ability to achieve policy correction. The Fund has not played a significant role in policy coordination among the G-7 countries in the past and this situation is unlikely to change.¹⁷ However, it could try to become a more vocal spokesman for developing countries, which are not represented in G-7 deliberations at all, and yet are highly vulnerable to G-7 policy decisions.

The Bank can play an independent supplementary role in multilateral surveillance by highlighting longer-term problems of particular interest to developing countries. The recent practice of issuing an annual publication on global economic prospects for developing countries is a useful step in this direction; it is not necessary to achieve close coordination between this publication and the *World Economic Outlook*. Differences in perspective between the Fund and the Bank can legitimately exist in view of the Bank's special focus on development issues, and transparency requires that these differences be fully aired.

C. *The Fund as lender of last resort*

A major issue in the discussions on the new financial architecture is whether there should be an international lender of last resort to deal with situations where otherwise well-managed economies are hit by panic outflows of capital. The analogy is drawn with the domestic banking system, where the central bank acts as a lender of last resort to prevent a solvent bank from falling victim to a run on deposits. Since countries with open capital accounts are potentially vulnerable in the same way to a loss of confidence which may not reflect any weakness in fundamentals, it is argued that the new financial architecture should include an international lender of

last resort to help countries deal with such situations. There are several practical problems which have to be resolved before this idea can be put into practice.

One set of problems relates to the availability of resources on the scale required. The Supplemental Reserve Facility (SRF) introduced by the Fund in December 1997, is an important new instrument which allows the Fund to provide short-term finance without limit in the event of exceptional balance-of-payments difficulties attributable to a sudden and disruptive loss of market confidence.¹⁸ However, the Fund's total resources are not sufficient, even after the implementation of the last quota increase and the activation of the New Arrangements to Borrow (NAB), to enable it to meet all the financing needs that could arise in this context. Keynes' original vision of a Fund empowered to create its own liquidity without limit is too radical to be accepted. A less radical but feasible alternative would be to amend the Articles to allow the Fund to issue SDRs to itself for use in lender-of-last-resort operations, subject to a cumulative limit on the total volume of SDRs that could be created by the Fund for this purpose. The limit could be determined by an 85 per cent majority, as is the case for a general allocation of SDRs. Within this limit the Fund should be empowered to issue SDRs to itself to finance lender-of-last-resort operations approved by the Board. SDRs created for this purpose should be extinguished on repurchase by the borrowing country, to be reactivated again only in similar circumstances. This arrangement has several advantages. It would not amount to a permanent increase in unconditional liquidity as in the case of a general allocation of SDRs. The additional liquidity would be activated only in the context of lender-of-last-resort programmes and would be linked with appropriate conditionality and subject to majority support in the Board, which in practice requires substantial support from the G-7 countries. The liquidity created would be only for the duration of the crisis since the SDRs would be extinguished on repurchase.

In the absence of such an arrangement, the only alternative is the one proposed by Fischer (1999), who argues that while an international lender of last resort is definitely needed it is not necessary that it must be able to create its own liquidity. That function could be just as effectively performed by the Fund "arranging" finance from different sources. The credibility of this alternative obviously depends on the ability of the Fund to mobilize resources on a sufficient scale when needed. The East Asian experience is not encouraging in this context. The Fund was able to mobilize a total of \$117 billion for Indo-

nesia, the Republic of Korea and Thailand, consisting of its own resources and contributions from the World Bank and the Asian Development Bank and from bilateral sources (see table 2). However, the bilateral contributions for Indonesia and the Republic of Korea, which were almost half of the total package for these countries, were only a "second stage back-up" with considerable uncertainty about the circumstances under which they would become available.¹⁹ The programmes of Indonesia and the Republic of Korea were clearly inferior to the Mexican programme in 1995, in which there was a large bilateral United States contribution (\$21 billion). If the bilateral contributions for Indonesia and the Republic of Korea are excluded, the total volume of resources mobilized for East Asia was only \$76 billion compared with \$49 billion for Mexico, whereas a comparable figure for the three East Asian countries, using GDP as the scaling factor, would be close to \$200 billion! The inadequacy of the financing provided in East Asia has been identified by the World Bank (1999) as one of the reasons why the Fund programmes did not succeed in stabilizing the situation in the initial stages.²⁰

We also need to consider whether it is desirable to draw on the resources of the World Bank and the relevant regional development bank to meet the needs of crisis financing. This may have been unavoidable in the East Asian case because there was no other source from which resources could have been mobilized, but the discussions on the new financial architecture should consider whether this is an ideal arrangement. As pointed out earlier, the financing needed to deal with crises of confidence is quite different from that normally provided by multilateral development banks, and this would suggest that the appropriate longer-term response is to strengthen the capacity of the Fund to meet all the requirements. Direct involvement of the World Bank and the relevant regional development bank in crisis lending operations only distracts these organizations from their primary function, which is to provide long-term development finance, a distraction which is particularly undesirable in an environment where the flow of such lending has been declining in real terms over the past decade. The Bank should of course be free to negotiate adjustment lending separately for crisis-hit countries, and such lending may well be needed as part of structural reforms in the post-crisis phase, but this should be a separate activity with no compulsion to complete the process in time to include resources as part of the total financing package. Structural adjustment lending requires time in order to design an appropriate policy framework, and this

Table 2

COMPOSITION OF RECENT RESCUE PACKAGES ^a					
(\$ billion)					
	IMF	World Bank	Regional dev. bank	Bilateral	Total
Brazil, 1998	18.1	4.5	4.5	14.5 ^b	41.6
Indonesia, 1997	11.2	5.5	4.5	21.1	42.3
Mexico, 1995	17.7	--	--	31.1 ^c	48.8
Republic of Korea, 1997	21.1	10.0	4.2	23.1	58.4
Russian Federation, 1998 ^d	15.1	6.0	--	1.5	22.6
Thailand, 1997	4.0	1.5	1.2	10.5	17.2

Source:

- a* The rescue packages for each country represent resources available over different periods for each case.
b From industrial countries, including direct assistance from Japan and from others through BIS.
c Comprises \$20 billion from the United States, \$1.1 billion from Canada and a \$10 billion credit line from the BIS.
d Conditional commitments to the end of 1999. Of these, \$1.5 billion shown under "bilateral" consists of Japanese support co-financing the World Bank.

process should not be hurried to fit within the time-frame in which a crisis management package has to be finalized.

These considerations suggest that there is a need to strengthen the Fund's ability to provide finance in crisis situations. One way of doing this is through a greater expansion of quotas. Industrialized countries have been reluctant to agree to large quota increases in the past on the ground that such increases are not necessary because creditworthy countries have ample access to liquidity under normal conditions in global capital markets. However, crises originating in the capital account exemplify cases of market failure and since these cases can multiply rapidly because of contagion, there may be a need for Fund financing on a large scale in such situations. It can still be argued that a large increase in Fund quotas is not the best way of empowering the Fund to deal with crisis situations since quotas increase the general financing capability of the Fund. This concern can be met by giving the Fund access to special borrowing facilities available only for lender-of-last-resort programmes. The General Arrangements to Borrow (GAB) and the NAB provide such backup, but the availability of these resources is subject to the specific consent of the contributing countries for each call, in effect giving each contributing country a veto on the use of its resources for each particular pur-

pose. What is needed are pre-arranged lines of credit from the major central banks, which could be coordinated through the BIS and be available automatically for use by the Fund in lender-of-last-resort programmes approved by the Fund's Board. The major developing countries, which are members of the BIS, could join in contributing to these lines of credit on an appropriate-burden sharing basis. If becomes necessary to access resources from the World Bank or the relevant regional development bank, this should be in the form of bridge finance to the Fund, which can be repaid by the Fund in a short time.

The conditionality to be attached to last-resort financing also poses formidable problems. One view is that such a facility must be very different from the present arrangement whereby countries negotiate programmes with the Fund after a crisis has arisen and access to resources therefore depends on the outcome of negotiations undertaken in situations where the country is in a weak position and can be pressured into accepting unnecessarily tough conditionality.²¹ Since central banks acting as lenders of last resort lend freely (i.e. in large amounts) to solvent banks facing liquidity problems, with no conditions except a penal interest rate, it is sometimes argued that countries facing panic outflows should have similar access to large volumes of finance to calm markets without having to negotiate on conditionality at that

time (see, for example, Griffith-Jones, 1999). This ignores the fact that central banks provide last-resort financing only to banks which face liquidity problems but are otherwise solvent and that central banks are particularly well placed to judge the solvency of banks in distress because of intensive supervision. The existence of supervision reduces the moral hazard that could otherwise arise with last-resort financing. Since similar intrusive supervision does not exist for countries, automatic extension of low-conditionality financing would attract the charge of moral hazard. Conditionality in this situation becomes the only basis for ensuring solvency.

One way out of the dilemma would be establish a precautionary or contingency financing arrangement under which a country could pre-qualify for future assistance by complying with performance conditions agreed with the Fund before there is any crisis, in exchange for which it would obtain assured access to short-term financing on a large scale in the event of a crisis. The knowledge that such an arrangement is in place can be expected to calm markets and reduce the likelihood of a panic-induced crisis. A proposal of this type was considered by the IMF at the time of the Mexican crisis but was not found practical. It is being considered again in the wake of the East Asian crisis. There is considerable support for such an arrangement, but designing a precautionary facility poses several problems.

The major difficulty with a contingency financing facility is that performance criteria thought to be appropriate prior to a crisis cannot continue to be the only performance requirements if a crisis does occur. This is because crises rarely take the form of a purely irrational panic arising in an otherwise completely normal situation. What is much more likely is that countries face a crisis because they are suddenly perceived to have become vulnerable because of some adverse external or internal development, or because of belated recognition of a weakness which existed earlier but was not known to the market. In such situations there is a need for some adjustment in policy to reflect the new development.²² A partial solution lies in treating pre-qualification as a basis for releasing at least a first tranche of the crisis package, with relatively minimal conditionality, while simultaneously initiating negotiations to determine appropriate conditionality for additional support. Such an arrangement could help to stabilize markets if pre-qualification is seen to increase the probability that Fund resources will be made available in the event of a crisis.²³

Pre-qualification could also pose some difficult problems in the pre-crisis period. Any departure from agreed performance criteria would either require prompt corrective action or withdrawal of cover. Since the effectiveness of the pre-qualification safety net depends upon its availability being publicly known, any withdrawal of cover would also have to be made public, and this could generate controversy because the withdrawal of cover could itself precipitate a loss of confidence. Performance requirements in the pre-crisis period could also change as a result of a change in external circumstances which in the view of the Fund might warrant intensification of policy parameters for continued eligibility for cover. If the required change in those parameters is not accepted by the country, the Fund may have to withdraw cover, which again is bound to attract controversy.

D. Orderly debt restructuring

A lacuna in the existing system, which makes it difficult to handle crises of confidence, is that creditors have an incentive to exit at the first sign of trouble in the hope of escaping before the crisis gets out of hand, which in turn intensifies the crisis. It is argued that the system would be more stable if countries facing panic outflows could have recourse to an internationally sanctioned mechanism for invoking a temporary standstill during which the government could initiate discussions with major private creditors, inform them of measures being taken to deal with the crisis and, where relevant, of the extent of Fund support available, and negotiate a restructuring of payment obligations so that the country could meet them without a disruptive depreciation of the currency.²⁴ Such an arrangement would ensure that the burden of adjustment is shared more fairly between lenders and the debtor country and would avoid the moral hazard in the present system whereby Fund resources are used to repay private creditors who get away scot free.²⁵ It could also be used to encourage new private sector lending if new flows could be given seniority over pre-crisis debt, thus creating incentives to “bail in” the private sector.

Debt negotiations with private creditors have taken place in the past, but they have had no formal legal sanction and creditors have been technically free to treat suspensions of payment as a default. In practice, the outcome has depended upon the degree of support a country can mobilize from official quarters. In the 1980s the Managing Director of the Fund took the initiative to persuade the New York banks

to provide a fresh infusion of funds as a condition for Fund financing of debt-burdened Latin American countries. More recently in the Republic of Korea, the United States Treasury Secretary is reported to have intervened personally to encourage the New York banks to cooperate in restructuring the short-term obligations of banks from the Republic of Korea. However, these cases involve a high degree of non-transparency and it is doubtful whether similar support would be extended to other countries, especially those which do not pose systemic risk. Establishing an internationally agreed procedure whereby countries could introduce a temporary standstill with IMF approval, and perhaps also involve the IMF in the restructuring negotiations, would make the process more transparent and even-handed.²⁶

Several practical problems have to be resolved before debt restructuring can be implemented. First, there is the problem of determining which debts should be covered by the standstill and the subsequent restructuring negotiations. Clearly, trade credit should be completely excluded to avoid disruption in current payments. Other debts can be categorized into (a) sovereign debt owed to government or other official sources; (b) sovereign or semi-sovereign debt owed to private creditors, i.e. banks or bondholders; (c) commercial bank debt owed to other banks or bondholders; and (d) private sector debt. Attempting to restructure debt in all these categories is impractical and it is therefore necessary to focus on some important categories. Sovereign debt owed to governments is covered by the Paris Club. Private sector debt is best left to normal market forces and bankruptcy procedures. Debts in (a) and (c) above are perhaps the most suitable for negotiated restructuring. Since the context in which the restructuring may be considered is a crisis of confidence, the focus of the negotiation must be on short-term debt in these categories. This could be defined as debt with original or residual maturity of one year to 18 months, leaving other debts in these categories outside the restructuring. Even if debt restructuring is limited to some categories, it is relevant to consider whether the standstill provisions should be applied to all categories pending the outcome of negotiations.

More generally, it is necessary to consider whether the standstill should extend beyond debt-related payments to cover other capital outflows as well. It is difficult to justify unilaterally freezing payments due to foreign creditors while an open capital account allows domestic capital to exit freely and intensify the crisis, which could lead to demands for more drastic debt restructuring to ensure viability.

Special problems arise where foreign residents hold bonds denominated in domestic currency. It is not practical to seek to restructure repayment obligations to foreign holders of domestic bonds but not to others. If payments are allowed in domestic currency but it is sought to block repatriation, this becomes a restriction on repatriation of capital. Should such repatriation be restricted while other repatriation (e.g. by direct foreign investors) is not? There is no consensus as yet on these issues.

Another set of issues relates to the practical problem of conducting negotiations with a large number of creditors. In the Latin American debt crisis of the 1980s, most of the debt was sovereign debt owed to a handful of commercial banks and it was easy to identify and negotiate with few major creditors. Today, commercial bank debt is much less concentrated than it was earlier, and so the number of commercial banks involved is much larger. This creates a possible free-rider problem in which smaller banks have an incentive to act as free-riders, refusing to accept restructuring. It is not clear how this can be eliminated. The proportion of debt in the form of bonds has also increased substantially, and it is impossible to negotiate with large numbers of bondholders in the absence of legal provisions in bond contracts providing for collective representation and specifying the extent of majority consent needed to apply the restructuring terms to all bondholders.

Perhaps the most difficult issue is the extent to which the IMF should be directly involved in providing some sort of official sanction to the standstill and possibly also assisting the country concerned in debt negotiations. Involvement of the IMF has advantages because it would help to evolve uniform practices which can be followed in all cases. It could also link the availability of additional Fund support to an agreement on restructuring, incentivizing both the debtor and the creditor to come to a reasonable agreement, and also ensuring effective burden-sharing. However, there is resistance to getting the IMF directly involved in sanctioning departures from debt contracts and in determining the terms of renegotiation.

The current state of the consensus on debt restructuring in official circles is perhaps best reflected in the report of the G-22 Working Group on Financial Crises. The report emphasizes the high cost of even a temporary suspension of payments and therefore urges the need "to make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time". It recognizes that a

temporary suspension may become unavoidable in certain circumstances, but it stipulates that this option should be considered only when it is clear, from consultations with the Fund and other international financial institutions, that even with appropriately strong policy adjustments the country will experience an exceptionally severe financial and balance-of-payments crisis. The report specifically warns against “disruptive unilateral action” – an implicit criticism of the Russian unilateral repudiation in 1998 – and recommends trying to achieve a cooperative solution. The report goes on to recommend facilitative measures which would make it legally possible to renegotiate with creditors should this become necessary, such as the inclusion of various types of collective representation clauses in bond contracts.

To summarize, the G-22 Working Group stops short of endorsing an internationally approved process for invoking a standstill with IMF approval. The requirement of prior consultation with the Fund and examination of alternative policy options implies that debt restructuring is not a “first resort” instrument in crisis containment and that countries must first try to stabilize the situation through conventional methods. In practice, this means that there could be a period during which the system will be under pressure and outflows could continue to occur. In the absence of financing of the lender-of-last-resort type, efforts to contain these outflows may not be very successful and may force resort to restrictive high interest rate policies which may have very high short-term economic costs. This illustrates the basic dilemma with debt restructuring proposals. There are strong moral hazard grounds for discouraging debt restructuring except as a last-resort option. However, if debt restructuring can be resorted to only after conventional means have been exhausted, there is a danger that it will be used only after most of the damage has been done, and not to forestall damage as its proponents would like.

E. Managing the social consequences of crises

An important feature of recent crises is that the impact on the poor can be very severe. Estimates provided for Indonesia, Mexico, the Republic of Korea and Thailand by the World Bank (1999) show a sharp decline in real wages and an increase in unemployment rates between the pre-crisis year and the post-crisis year in all these cases. Estimates of changes in poverty in East Asia are more tentative

because they depend on the change in income distribution, which is not easy to predict, but large increases in poverty are expected in all the crisis-affected countries.

Crisis management strategies must therefore try to ensure that the negative impact on the poor is minimized. Although fiscal discipline may require a reduction in total real government expenditure, this should be achieved while protecting those expenditures which are of particular importance for the poor. For example, a reduction in total subsidies may be unavoidable but the focus should be on cutting subsidies which are not effectively targeted, of which there are usually many, while preserving those subsidies which are effectively targeted at the poor. There may even be a case for increasing targeted subsidies in certain circumstances. Similarly, it is necessary to protect expenditure on social services, especially health and education, which are crucial inputs into the welfare and human capital of the poor. These expenditures often suffer during periods of fiscal tightening and this is typically at the expense of the poor. The effort to preserve or perhaps even increase pro-poor expenditures while reducing total expenditure can succeed only if other expenditures can be subjected to even deeper cuts. This is not easy, but that only reveals the nature of the difficult choices involved in achieving adjustment with a human face.

Special efforts can also be made to provide social safety nets which would help to maintain income levels of the poor and those affected by unemployment. Special public works programmes for providing wage employment could be introduced, or expanded where they already exist. The cost-effectiveness of these programmes, however, depends critically on the extent of leakage to non-target groups and also on the productivity of the resulting assets created. International experience suggests that leakages to non-target groups can be very large unless programmes are very carefully designed and monitored. Efforts to achieve quick results will lead only to projects which have high public visibility but low efficiency.

This is clearly an important area for Fund-Bank collaboration. The Bank can help in formulating appropriate performance criteria for Fund programmes which would ensure that the pro-poor components of expenditures in the government budget are not reduced. The Bank can also directly finance social safety net programmes which can be very useful in the post-crisis phase, provided that they are designed in a manner which maximizes effectiveness. How-

ever, as pointed out earlier, these programmes should be separate from financing provided in the context of crisis management which should ideally be sourced from the Fund.

F. Capital account liberalization

Prior to the East Asian crisis, industrialized countries were pressing for broadening the mandate of the Fund to include liberalization of capital movements, and this was reflected in the Interim Committee's statement in Hong Kong (China) in October 1997 calling for consideration of an amendment to the Fund's Articles to make liberalization of capital movements one of the purposes of the Fund. Although many developing countries have liberalized the capital account to varying degrees, most still retain substantial capital controls and many developing countries have reservations about giving the Fund an expanded mandate in this area for fear that it might create pressure to liberalize capital account transactions at a faster pace. The crises in East Asia and Brazil have highlighted the problems which can arise if the capital account is liberalized prematurely and the pressure for rapid movement in this area has therefore diminished, but the issue remains on the agenda of the Fund's Board and will have to be addressed as part of the new architecture for the global financial system.

Given the increased importance of capital flows in the global economy, and the fact that many developing countries are progressively integrating with the global financial market, it is somewhat incongruous that the Fund has no mandate at all in this area. If the Fund is to function effectively as the principal international overseer of the international financial system, it can be argued that it must have some mandate for monitoring, and perhaps even regulating, restrictions on capital account transactions. It is important that this should not become an instrument for pushing developing countries prematurely into liberalization of the capital account, denying them the flexibility to impose controls on capital flows if they feel these are needed for macroeconomic management. One way of giving the Fund a limited mandate would be to abandon the approach of including the liberalization of capital movements as one of the purposes of the Fund and focus instead on the limited objective of enabling the Fund to supervise capital restrictions with a view to creating more orderly conditions in international capital markets.

The only obligation on members should be to inform the Fund of the restrictions they impose on capital account transactions and also any changes made therein. Countries would then be free to adopt any regime they liked, and also change it at will, but the subject would become a legitimate issue for discussion by the Fund, and countries would be under some pressure to justify their actions in the course of surveillance.²⁷

A regime of this sort could also evolve into one whereby developing countries may, of their own volition, accept binding obligations to avoid imposing restrictions on certain types of capital transactions except in consultation with the Fund. Restrictions imposed in emergency conditions could be made subject to review, with a presumption of return to normal conditions within a predetermined period. This would give the Fund a role in supervising obligations accepted by developing countries of their own volition and help to increase transparency and investor confidence in emerging markets. The incentive for developing countries to accept obligations voluntarily would depend on whether financial markets viewed such discipline with favour as reflected in credit ratings and yield spreads.

From the perspective of developing countries there will be the lurking suspicion that even a limited mandate is likely to generate pressure on them to liberalize their capital account at a faster pace and could also be reflected in Fund conditionalities at times when Fund financing is needed. This is a legitimate concern which cannot be lightly dismissed. To some extent it can be addressed by suitable drafting of the mandate. More substantively, developing countries could insist that such arrangements should only be considered as part of a package where the Fund's ability to act as a lender of last resort is strengthened, and it is also given some authority to provide legal sanction to restrictions on capital payments which may have to be imposed in an emergency. Industrialized countries have so far shown little inclination to support proposals which increase the financing available to the Fund or put the Fund in a position where it may legitimize new restrictions imposed on capital movements by a developing country. However, a one-sided use of the Fund to push for liberalization of capital markets, without also strengthening it in ways that would help contain volatility and instability is clearly unbalanced. Progress in this aspect of the new financial architecture may require balanced movement on both fronts.

IV. The Fund and the Bank in the new architecture

In this section we examine various proposals relating to the future role of the IMF and the World Bank which are being considered as part of the discussions on the new financial architecture. These proposals reflect the state of the current consensus on architecture issues, which emphasizes the need to make financial markets work more effectively rather than supplant them. The role envisaged for the Fund and the Bank in this framework is one of improving surveillance and contributing to strengthening the financial sector in developing countries to prevent crises from occurring. It also envisages strengthening the capacity of these institutions to deal with crises if they occur, and this is to be achieved not by radical restructuring but by improvements in their existing capacities and better cooperation.

The existing arrangements for cooperation between the two institutions have been reviewed on the basis of the experience in handling the East Asian crisis. Both institutions have concluded that the Concordat of 1989 continues to provide an acceptable framework for Fund-Bank cooperation, but additional arrangements for cooperation are needed in some areas.

A. Cooperation in financial sector work

There is general agreement that Fund-Bank cooperation needs to be greatly enhanced in work related to the financial sector. Strengthening the financial sector in developing countries is necessary both from the point of view of macroeconomic stability and from the point of view of allocative efficiency. Both institutions therefore have a strong interest in this area with somewhat different emphases. The Fund is concerned with financial sector issues which affect macroeconomic balance, are relevant for the effectiveness of macroeconomic policy instruments, or concern problems which can generate systemic risk. The Bank is concerned with developing and implementing strategies for the medium-term development of the financial sector, including restructuring of banks and financial institutions, improving systems of prudential regulations and supervision, and related capacity-building. This broad division of responsibilities necessarily leaves a substantial area of overlap.

The United Kingdom recommended the establishment of a common department for financial sector issues to service both institutions. This has not found favour and instead each institution plans to strengthen its own capability with elaborate arrangements for consultations at various levels, including field-level coordination in financial sector work, participation in each other's missions and even joint missions. A Financial Sector Liaison Committee has been established comprising senior staff of the Monetary Affairs and Exchange and the Policy Development and Review Departments of the Fund and of the Financial Sector Board and the Poverty Reduction and Economic Management Network of the Bank. The committee will help coordinate the work of the two institutions in this area and delineate respective roles for the two institutions reflecting their mandates and comparative strengths.

The effectiveness of these arrangements can only be judged on the basis of actual experience in the future. However, it is important to emphasize that while mechanisms for consultation aimed at eliminating disagreements to the extent possible are desirable, the achievement of a common Bank Fund position on all financial sector policy issues should not be viewed as an overriding objective. Financial sector development in developing countries in an environment of global financial integration is a complex process in which perceptions of best practice are still evolving. There may be room for different views on many points and it is more important for the Fund and the Bank to remain open to ideas from outside in this area, including the views of market participants and national regulators, than to reach common positions on all issues.

An important area where the Fund and the Bank can cooperate is in ensuring that the concerns of developing countries are appropriately taken into account in the development of international regulatory standards for the financial sector. As participants in the G-7 Financial Stability Forum, they can help shape the evolution of an international consensus on the application of standards in different areas to developing country situations. Once standards are agreed in the relevant international forum they can help to evolve guidelines for applying these standards in developing countries, including the determination of appropriate transition paths which take account of country-specific constraints. They can also provide technical assistance to developing countries seeking assistance in attempting to comply with agreed standards. Finally, the two institutions can cooperate to enhance the effectiveness of Fund sur-

veillance in monitoring implementation of these standards in individual developing countries.

B. Coordination in crisis management operations

While existing mechanisms for coordination between the two institutions for their normal lending operations are broadly acceptable, they are not adequate in crisis situations, as the East Asian experience shows. The suddenness with which the crisis broke in East Asia left very little time for consultation and, as it happened, the Bank differed from the Fund on many aspects of crisis management. Some of these differences relate to differences on structural policies which are within the domain of the Bank. For example, the Fund programme involved closure of 16 insolvent banks. Because of the severe time constraints within which the Indonesian programme was formulated, the Bank was not adequately consulted. We now know that the Bank had reservations about the Fund's approach. The closure of the banks was announced in a manner which created uncertainty about the security of deposits in the other banks, leading to a run on deposits and a flight of capital which worsened the currency collapse. The Bank also appears to have had a different view on the extent of fiscal restraint and the interest rate policies advocated by the Fund, both of which are within the Fund's area of primary responsibility. However, this division of responsibility should not make the Bank's views irrelevant. Since short-term stabilization measures can disrupt the development process, or conflict with longer-term structural policy objectives, it is necessary for the Bank's views to be adequately reflected in formulating crisis management programmes.

Recognizing these difficulties, the two institutions have reached agreement on new procedures to ensure effective coordination between them in future crisis management operations. The responsibility for the overall stabilization programme, including the adoption of urgent structural measures which may have to be taken in the initial stage of stabilization, rests squarely with the Fund. However, in future the Bank will be fully involved in programme formulation in the early stages through participation by Bank staff in Fund missions or through parallel missions. The Bank's involvement is obviously especially necessary in order to deal with structural issues where it has primary responsibility, and where it may later even engage in direct lending. The proposed proce-

cedure will also allow the Bank to contribute to the formulation of other parts of the programme as well. If the Bank was not in a position to make firm recommendations on structural issues within the time-frame in which the crisis management package has to be finalized, the Fund would take the necessary decisions, on the basis of preliminary understandings with Bank staff, to be modified later on the basis of more in-depth work. The introduction of *ex post* flexibility in this way is a definite improvement. Follow-up activity on the structural side would be undertaken by the Bank, with Fund staff participating in Bank-led missions.

The Bank's contribution to programme formulation would obviously be most useful in situations where it has an ongoing involvement in the crisis-hit country, but this cannot be taken for granted. The Fund and the Bank therefore propose to identify a group of key emerging countries where significant financial sector reforms are under way, or are likely to be required, and to assist the authorities in evolving appropriately sequenced plans for financial sector reform. By focusing Fund surveillance and Bank sector work on structural issues in the financial sector in these countries in this way, both institutions expect to develop an improved understanding of the financial system and to identify possible problems for corrective action, which will help in formulating crisis management programmes should this become necessary.

The current consensus on Fund-Bank cooperation also appears to favour direct financing by the Bank to supplement Fund financing at times of crisis. The Emergency Structural Adjustment Lending (ESAL) procedure recently approved by the Bank is designed to enable the Bank to play this role.²⁸ The approach adopted in this paper is different. We have argued that Bank financing should not be part of the crisis management package, although the Bank may well involve itself in adjustment lending as part of post-crisis restructuring.

In addition, the Bank could play an even more important role in the post-crisis recovery phase by helping countries regain access to international capital markets. Given the information asymmetries from which developing countries suffer, and the market failures associated with contagion, it is quite possible that crisis-hit developing countries may find it difficult to access commercial markets even though policy correctives have been put in place which justify fresh access. The World Bank could play a market-compatible role, bringing developing coun-

try borrowers back to the market earlier rather than later through the use of its guarantee facility. Since market access is likely to be needed by the private sector, the Bank's insistence upon a government counter-guarantee is not an ideal arrangement. Diluting this requirement will require legal changes in the Bank's Articles, but it is time that the Bank considered such changes to allow it to use suitably priced guarantees to help private sector borrowers to re-enter international capital markets in the post-crisis phase.

C. Should the Fund be merged with the Bank?

An issue which needs to be addressed is whether, in view of the perceived need for cooperation and coordination between the Fund and the Bank in so many areas, there is a case for merging the two institutions. Proposals for merger have surfaced in the past because the overlap between the two institutions made it difficult to distinguish the Fund's activities from those of the Bank and merger was seen as a logical way of avoiding duplication of work and possible conflicting advice (see Crook, 1991). The suggestion for a merger has been advanced again – in the aftermath of East Asia – by former Secretary of the Treasury, George Schultz.²⁹

A merger would be logical only if one were to conclude that there is no distinctive role for the Fund in the new financial architecture which cannot be performed just as efficiently by the Bank. This is clearly not the case. On the contrary, the distinctive features of latter-day crises imply that the Fund's role, both in surveillance and as a financing institution, has become more distinct from that of the Bank. Surveillance in future must focus much more on market perceptions and short-term factors which could affect confidence, and these areas are outside the special expertise of the Bank. Surveillance by the Fund in future must therefore involve more extensive consultation between the Fund and many other participants in the international financial system in addition to the Bank. The financing requirements for handling latter-day crises are also very different from what they used to be. The Fund has to be able to provide large volumes of finance to support programmes aimed at restoring confidence, but unlike in 1980s such financing does not have to be long-term and certainly not concessional.

These developments suggest that instead of a merger of the two institutions the role of the Fund in

the future should actually become more distinct from that of the Bank. The Fund should focus more sharply on sources of instability in the international financial system and on handling balance-of-payments problems which are either short-term or systemic in nature. It could even be argued that financing operations related to chronic balance-of-payments problems of low-income countries, e.g. the ESAF and the Heavily Indebted Poor Countries (HIPC) Initiative, are much closer to structural adjustment lending where corrective policies focus heavily on extensive structural reform, and should perhaps be shifted to the Bank, with cooperation from the Fund being made available on technical matters. The problem of transferring the resources involved, which are currently located in the Fund, will present legal difficulties, but this problem could be overcome provided that the principle is accepted.

D. Reform of the Interim and Development Committees

A common complaint about the present system is the lack of a high-level political forum which takes a unified look at interrelated issues such as the functioning of the international financial system, macroeconomic stability and policy coordination in the major industrialized countries, special problems of vulnerability of emerging market economies, and the impact of international trends on the development process. The Fund-Bank annual meeting of Governors is largely ceremonial, and given its size it cannot be anything else.

The Interim Committee and the Development Committee are more compact political-level bodies which meet twice a year. Though they have a substantially overlapping membership, they function as separate committees with Fund-related issues being dealt with in the Interim Committee and Bank issues in the Development Committee. Their functioning leaves a great deal to be desired. Until recently, both committees operated with procedures in which most of the time was devoted to prepared speeches with little opportunity for substantive interaction between Ministers. The procedure has been greatly improved in this respect in recent years, but the objective of creating a forum capable of taking an integrated view of the interrelated issues of international finance, trade and development, with substantive discussions at a high political level, has yet to be achieved.

The principal reason why the two committees have not served as forums for substantive discussions

is simply that the industrialized countries have not found it necessary to use them for this purpose. They engage in fairly extensive interaction among themselves in the G-7, based on detailed preparatory work at the official level by deputies from capitals, and positions arrived at through this process are often presented in the meetings of the two committees more or less as *faits accomplis*. Industrialized countries do not perceive the need for a substantive discussion with developing countries at a political level before formulating their own position, because the consent of the developing countries is not actually needed in order to push policy in the Fund and the Bank in the direction they want. On rare occasions developing countries have used their voting power to block an initiative by industrialized countries, as happened in Madrid in 1994, when the industrialized countries had a strong interest in pushing through a special allocation of SDRs in favour of transition countries but were unwilling to concede a significant general increase. Since the decision required an 85 per cent majority, the developing countries were in a position to block the proposal, which they did, but they did not succeed in extracting agreement on a general increase.

The need to consult developing countries was seen to be more compelling in the wake of the East Asian crisis in order to secure agreement on the broad outline of the new financial architecture. However, the United States, which took the initiative on this issue, bypassed the Interim Committee and invited an ad hoc collection of 22 countries (the G-22, which has since been expanded to G-33) to discuss the issue. The group included a number of emerging market economies which were judged to be “systemically” important, many of which would not have been included if the discussions had taken place in the Interim Committee, which reflects the constituency structure of the IMF Board. It is more representative of the diversity of developing countries, but it does not include all the economically significant emerging market economies, and involvement of significant “stakeholders” was obviously felt to be necessary.

Various proposals for reform of the Interim and Development Committees have been made in the recent past. A long-standing proposal to convert the Interim Committee into a council with decision making powers, which was provided for in the Second Amendment, was recently considered by the IMF Board but did not meet with approval. Two proposals for restructuring the Interim and Development Committees are currently under consideration.

- (i) The first is to retain the present two-committee structure but make the committees more symmetric by making the Bank a full partner in the Interim Committee and enforcing a clear delineation of responsibilities between the two committees to avoid overlaps. In this case, global economic issues, including their implications for development, would be discussed only in the Interim Committee while the Development Committee would focus on specific development-related initiatives, including those in which the Fund is involved such as ESAF and HIPC.
- (ii) The second alternative involves the creation of a single overarching group at Ministerial level to address global economic issues, with the Interim Committee and the Development Committee continuing to address specific Fund and Bank issues as at present. The Fund and the Bank would be full partners in the new group, while other institutions such as the WTO, UNCTAD, BIS and IOSCO could be permanent observers and could be involved in the preparatory work for agenda items in these areas. The group could meet twice a year as the Interim and Development Committees do at present, with a plenary session in the morning for the overarching group followed by separate Interim and Development Committee meetings as at present. The new group could also meet on other occasions if circumstances warranted without being linked to meetings of the two committees.

The first alternative clearly reflects a minimalist approach and is unlikely to achieve any significant improvement on present practice other than giving the Bank a more elevated position in the Interim Committee in the event that the committee is not converted into a council. The second alternative is clearly more ambitious and involves a substantive change in the present arrangements. Its main advantage is that it would create a new international forum at which major industrialized countries and developing countries, including all the emerging market countries, could interact with each other and also with the major players in the global financial system, such as the BIS, UNCTAD, IOSCO and WTO, in order to evolve a consensus on critical issues facing the global economy from the perspective of both industrialized and developing countries.

The country composition of the new forum could be made wider than that of the Interim Com-

mittee by including the top 10 industrialized countries by size of quota in the Fund, plus the top 10 among the other members, which include oil-exporting countries, transition countries and developing countries, plus all those countries not already covered by this criterion but which represent their constituencies on the IMF Board.³⁰ This formula is likely to produce a group of around 30 countries which would include all the major “stakeholders” defined in terms of economic potential, and would ensure a degree of representativeness based on objective selection criteria.

This would create a credible international forum which could take an integrated view of the functioning of the global economic system in which operational issues related to the Fund and the Bank would be only part of the agenda. The forum would include some of the major non-government participants in the international financial system, which is necessary given the enormously increased role of private markets. The proposal also has the advantage of continuing the Interim and Development Committees in more or less their present forms, which is useful for providing operational guidance for the Fund and the Bank respectively. A potential problem in this proposal will be the pressure to expand the new international forum to include various international agencies connected with one or other aspect of development. Too broad a definition of development will widen the net too much and dilute the effectiveness of the forum if it is ever established. This should obviously be avoided.

Notes

- 1 Both the quality of its project portfolio and the credit-worthiness of its borrowers were important considerations for an organization dependent on the markets for its funds.
- 2 In the 1960s, for example, the Bank adopted a “programme of projects” approach in some Latin American countries, linking disbursements for a group of projects to the pursuit of macroeconomic policies to control inflation. In the mid-1960s the Bank also engaged in non-project lending for India to provide much needed balance-of-payments support (see Kapur et al., 1997).
- 3 The Trust Fund was included in the package at the time of the Second Amendment to the Articles in 1976 in order to obtain the consent of the developing countries to the amendment. These countries had participated in the discussions on international monetary reforms in the Committee of Twenty in the hope of securing some link between the provision of liquidity through SDRs and the expansion of development assistance. No such link was accepted, however, and the Trust Fund was offered instead as a sop.
- 4 ESAF interest rates were subsidized by grants from the aid budgets of some aid donors. This introduced an overlap

(admittedly very small) on the resources side between the Fund and the Bank/IDA, since interest subsidies came from the same pool of resources from which IDA contributions were made.

- 5 Fiscal problems in borrowing countries also made it difficult for many developing countries to maintain a pipeline of new projects, because they could not always find the counterpart domestic resources needed to add to the projects already under way.
- 6 Many of these policy initiatives involved regulatory, legal and institutional changes which could not be reduced to precise quantitative targeting. Some of the multitude of actions were in the nature of consequential action within the same areas to bring about institutional reform.
- 7 It is relevant to note that the Bank’s Vice President for Development Policy at the time, Stanley Fischer, who is now First Deputy Managing Director of the Fund, had expressed reservations on proceeding with the Argentine loan in view of the fiscal problems identified by the Fund (see Kapur et al., 1997).
- 8 Balance-of-payments problems in the past typically arose from a deterioration in the current account caused either by domestic policy misalignments or a change in external circumstances or, in the case of developing countries, by structural constraints on the supply side. The structural nature of balance-of-payments problems in developing countries has long been recognized and it calls for a longer period of adjustment, and therefore a larger cumulative amount of financing, but the annual financing need in such cases is still defined by the degree of pressure on the current account.
- 9 The theoretical literature on panics and bank runs treats such cases as examples of multiple equilibria (see, for example, Diamond and Dybvig, 1983).
- 10 The conventional wisdom at the time was that if a current account deficit was not a reflection of public sector deficits, and was being financed by private flows, the market had clearly judged it to be sustainable and there was no cause to worry. This obviously ignored the potential instability in private flows, a lesson which has been learned since then.
- 11 The Thai current account deficit had reached 8 per cent of GDP, the same level as in Mexico before the crisis, and there was also a real appreciation of the baht, though not as much as in the case of the peso. Fund surveillance clearly picked up signals which had preceded the crisis in Mexico, but it did not pick up financial sector weakness which had not been identified as a cause of crises earlier.
- 12 This is not to deny that capital flight can take place even without capital account liberalization. However, while a regulated system has leakages, the speed at which outflows can take place in the face of restrictions is obviously much lower.
- 13 See, for example, Radelet and Sachs (1998). The failure of the Fund’s programmes in the Russian Federation and Brazil was less damaging to the Fund’s credibility, because in those cases the failure was due to non-performance of the requirements under the programme. This is most glaring in the case of the Russian Federation, but it was also true in Brazil, where fiscal commitments under the programme were called into question in the legislature, thus creating doubts about the government’s ability to implement the programme.
- 14 A Fund Staff study (Lane et al., 1999) has defended the high interest rate policy followed in East Asia by arguing that it was not associated with an excessive contraction in money supply. Real growth in money supply and domestic

- credit in all three countries was adequate to accommodate growth, and it was particularly accommodative in Indonesia. A lower interest rate policy would have meant an even faster growth in money supply, with the risk of intensifying the inflation-depreciation cycle.
- 15 Disclosure alone may not be much help because the complexity of many derivative instruments makes it very difficult to determine the net exposure to risk of institutions extensively involved in derivatives trading. The whole issue of the management of risks associated with derivatives is one which needs greater attention from regulators not only in developing countries but also in industrialized countries.
- 16 The relationship between such a body and the national regulators was never clarified, although it is clearly an important issue which cannot be avoided.
- 17 The marginalization of the Fund in substantive policy coordination among G-7 countries was most evident at the time of the Plaza Accord and the Loure Accord.
- 18 SRF resources are made available over a period of one year and carry an interest rate 300 basis points above the normal Fund charges. They are expected to be repaid between one and one and a half years after withdrawal, but the repayment period can be extended by a year. In the latter case the interest spread increases to 500 basis points.
- 19 It was relatively clear that the bilateral package for Thailand was to be disbursed *pari passu* with Fund financing. No part of the bilateral package for Indonesia or the Republic of Korea was disbursed.
- 20 The Fund staff study of the East Asian experience (Lane et al., 1999) admits that the resources made available under the programmes were deemed to be sufficient only on the assumption that the programmes would lead to a quick restoration of confidence reversing the capital outflow. This did not happen, however.
- 21 The recent Brazilian package is an example of a Fund arrangement negotiated in anticipation of a crisis, but even that negotiation was carried out at a stage when the crisis was looming and conditionality was therefore fairly stiff.
- 22 If all possible types of adverse developments could be fully anticipated, the appropriate policy response in each hypothetical case could also be defined and agreed in advance, and financing could be extended automatically in the event of a crisis, subject to the pre-agreed policy corrections being adopted. However, it is clearly impossible to anticipate all the circumstances in which a crisis would be triggered and agreement, reached in advance on the corrective action needed. In the absence of such agreement, some negotiation of suitable conditionality after the crisis occurs appears unavoidable.
- 23 Since pre-qualification implies a substantial convergence of perceptions between the government and the Fund before the crisis, it could be argued that it increases the probability that a mutually acceptable adjustment programme to deal with the crisis will be negotiated.
- 24 This process is mutually beneficial for both debtors and creditors just as domestic bankruptcy laws are designed to prevent creditors from engaging in a "grab race" for assets, which would only push the debtor into liquidating. Since the value of the firm as a going concern is generally greater than the value of its assets in liquidation, bankruptcy laws provide opportunities for firms to bring in fresh capital and restructure their debts in a mutually beneficial manner for both debtors and creditors.
- 25 Exiting creditors would not be seen to benefit if Fund programmes actually succeeded in stabilizing exchange rates. However, when these fail to do so, as in East Asia, the Russian Federation and Brazil, creditors able to exit because of Fund financing do benefit. The benefit is evident where the debt is denominated in domestic currency and the exit enables them to avoid the loss of confidence, but it is also present where the debt is denominated in foreign currency, since exiting creditors avoid the increase in default risk associated with an exchange crisis.
- 26 This is not to suggest that it would ensure identical terms of debt restructuring. That would necessarily depend on the circumstances of each case.
- 27 This is effectively the formula that was used for exchange rate regimes in the Second Amendment after the collapse of the Bretton Woods system. Members can choose whatever regime they wish, but they must inform the Fund of their choice.
- 28 SALs are specifically designed to allow the Bank to lend in conjunction with a Fund programme to countries facing a crisis where there is a presumption that the country will need structural adjustment lending in the post-crisis phase. ESALs have a much shorter repayment period (between three and five years) and carry an interest rate at least 400 basis points higher than the Bank's normal lending rate.
- 29 Schultz, writing jointly with William Simon and Walter Wriston (Schultz et al., 1998), first criticized the Fund for imprudent lending and adding to moral hazard in East Asia, and argued that it should be abolished. Subsequently, he suggested the alternative of merging it with the World Bank (Schultz, 1998).
- 30 The 20 countries that would qualify on this basis in the first two categories are the United States, Germany, Japan, France, the United Kingdom, Italy, Canada, Belgium, the Netherlands and Switzerland among the industrialized countries, and Saudi Arabia, the Russian Federation, China, India, Brazil, Venezuela, Mexico, Argentina, Indonesia and South Africa among the others. All the G-22 participants would be included except Australia, Hong Kong (China), the Republic of Korea, Malaysia, Poland and Thailand. Some of these, e.g. Australia, would be likely to be included as constituency representatives.

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