IX INTERNATIONAL FINANCIAL ARCHITECTURE

Introduction

9.1 The design of international financial architecture that is appropriate for promoting economic growth while ensuring financial stability has been a subject of intense debate worldwide. Despite frequent modifications to adapt to the changing needs of national economies and emerging complexities of the globalisation process, the international financial architecture has, arguably, had only a limited success in ensuring global monetary and financial stability. While weaknesses of international financial architecture had been exposed in various economic crises occurring in the world economy from time to time, it was perhaps the widespread East Asian crisis in 1997 that triggered a renewed debate on the need to revamp the architecture for the international monetary and financial system.

9.2 With the contagion spreading across several countries, the East Asian crisis revealed serious shortcomings of the international financial architecture in respect of both crisis prevention and crisis management. Some of the major shortcomings observed included: (i) untimely and inadequate availability of financial assistance for the countries under stress; (ii) absence of an effective debt resolution mechanism; (iii) lack of a comprehensive and reliable early warning system; and (iv) absence of effective means to involve the private sector in resolving crises.

9.3 Inadequacies in the international financial architecture have, time and again, underscored the need for a new framework. Consequently, several measures were initiated by the international financial community and national authorities to address the weaknesses of international financial architecture. The perceived role of a new architecture, it was felt, would be to reduce the probability of a crisis; contain the severity of crises when they occur; and as far as possible, insulate the global economy from contagion, while providing desirable level of confidence to the national authorities to sustain the process of globalisation.

9.4 In the debate on international financial infrastructure, increased recognition has been given to three pre-requisites for the efficient functioning of the financial sector, *viz.*, a well designed infrastructure, effective market discipline, and a strong regulatory and supervisory framework. A well designed infrastructure includes a proper legal and judicial framework, good corporate governance, comprehensive accounting standards, a system of independent audits and an efficient payment and settlement system. Effective market discipline also requires a good credit culture and well developed equity and debt markets with a wide variety of instruments for risk diversification. A sound regulatory and supervisory system contributes to the development of financial infrastructure and in enforcing market discipline.

9.5 Against this backdrop, this Chapter analyses, in detail, the international financial architecture that has been evolving after the East Asian crisis. The chapter is organised into five sections. Section I deals with the international financial architecture in historical perspective. Section II critically analyses the evolution of the new international financial architecture in the aftermath of the East Asian crisis. Section III presents the Indian perspective of the new international financial architecture. Section IV delineates some of the issues for further reform in the international financial architecture. The Chapter ends with concluding observations.

I. HISTORICAL PERSPECTIVE OF INTERNATIONAL FINANCIAL ARCHITECTURE

9.6 The importance of economic cooperation among nations has always been recognised. In the recent period, however, it has emerged as a pre-requisite for overall growth and stability worldwide. The international financial architecture whose genesis can be traced back to the days of gold standard has come a long way in terms of international economic cooperation.

9.7 During the period of the gold standard that prevailed from 1875 to 1914, gold played the role of a medium of exchange along with a store of value. Under the gold standard, the standard unit of currency was a fixed weight of gold or the value of a fixed rate of gold with paper money convertible on demand into gold. The gold standard came under severe constraint after the World War I. War ravaged economies chose

to revive their economies independently given the then lack of cooperation among nations. Various countries engaged in competitive devaluations to get an edge over others in the prevailing unrestricted trade environment. Such 'beggar thy neighbour' policies devastated the international economy. World trade declined sharply. Unemployment surged and the standard of living declined in many countries. Unable to serve the needs of nations, the gold standard in which gold played the role of a medium of exchange, was abandoned in 1931.

9.8 A series of efforts were made towards the end of World War II to restore some order to the international monetary system. Three main decisions emerged in a conference held at Bretton Woods, New Hampshire (USA) in 1944 to negotiate the institutional set-up for the post-War world economic order: (i) all national currencies were to be tied to the US dollar which, in turn, was pegged to gold (at $35 an ounce); (ii) capital controls introduced during the wartime were to remain in place; and (iii) international institutions like the International Monetary Fund (IMF) and the World Bank were to be founded.

9.9 Countries that joined the IMF agreed to keep their exchange rates pegged to the US dollar and in the case of the United States, the value of the dollar was fixed in terms of gold. The peg could be adjusted but only to correct a 'fundamental disequilibrium' in the balance of payments and that too with the concurrence of the IMF (the Articles of Agreement). The system worked well as long as the US had enough gold to back its currency. With the then large current account surplus, the US had both ability and willingness to continue the gold/dollar standard to command international acceptability. However, the situation soon reversed on account of over-financing of exports by the US and the picking-up of economic activity in war-torn countries. Both these factors led to a dollar glut, which strengthened the role of dollar as an international currency but at the cost of loosened grip of the Federal Reserve on money supply and consequent inflation. Also, the potential dollar claims against the US gold supply became seven times larger than what could be honoured by the United States. Recognising this precarious situation, the US severed the link between the dollar and gold on August 15, 1971. The US Government suspended the convertibility of the US dollar and the dollar reserves held by other countries into gold. Gold became another commodity whose price was left to the market forces of demand and supply. Since then the IMF members have been free to choose any form of exchange arrangement except pegging their currency to gold.[1]

9.10 The Smithsonian Agreement among the Group of Ten countries, entered into in December 1971 with the objective of re-instituting a system of stable exchange rates at new par values, lasted only 14 months. The UK government decided to allow the Sterling to float in June 1972. In early 1973, the Swiss Franc and then the Japanese Yen were allowed to float against the US dollar. The international financial system was now left to the vicissitudes of the market forces of demand and supply. With this, the gold standard became history and by 1973, the dollar firmly assumed the role of the world's key international currency.

9.11 The decade of 1970s was marked by a sharp rise in syndicated bank lending, especially to Latin American countries. The first oil shock[2] that occurred in 1973 had serious implications for the US economy as also for developing economies. With the US importing half of its oil from the OPEC, an inflationary shock struck the US economy coupled with a massive transfer of wealth to OPEC nations in the form of petrodollars. On the other hand, oil-importing developing countries, suffering a deteriorating balance of payments situation, required funds for financing their oil and other crucial imports. As funds from the IMF for such purposes were available on a limited scale and that too on some restrictive conditions, rescue came from the recycling of the petrodollars. Flushed with petrodollars along with limited absorptive capacity, OPEC nations started parking their petrodollars with European and American banks, which, in turn, given the general recessionary trend, used such petrodollars and eurodollars to provide loans to developing countries.[3] The spurt in petrodollar funds, in turn, increased developing countries' debt heavily. The second round of OPEC price increase in 1979 made this high level of debt unsustainable. The US economy suffered a three-year period of stagflation (1979-81) along with further worsening of trade and current accounts. The requirements of developing countries for funds received another demand impetus, and the American banks were more than ready to provide loans to them. Loans to developing countries, mainly Latin

[1] This was formalised in terms of the Second Amendment to the Articles of Agreement of the IMF which became effective on April 1, 1978.

[2] Outraged by the US support of Israel during the Yom Kippur War, the OPEC put an embargo which dramatically raised the price of oil (from $1.30 a barrel in 1970 to $10.72 per barrel by 1975).

[3] Large accumulated US dollars with oil exporting countries are known as Petrodollars. Eurodollars are US dollar deposits in commercial banks outside the United States.

American countries, were made at variable interest rates. Funds raised were utilised mainly to pay for oil imports, the development of import substitution industries and financing large infrastructure projects. However, restrictive monetary policies, needed to deal with the inflationary impact of the rise in oil prices, pushed up the cost of servicing the existing debt as well as the cost of new borrowings. Global demand also slowed down as a result of which investment projects undertaken turned out to be unsustainable. The build-up of developing countries' debt coupled with increasing liabilities of debt servicing on account of rising interest rates led to a debt crisis that surfaced with Mexico in 1982. The debt crisis, which engulfed countries like Argentina, Brazil, Chile, Venezuela, Peru, Nigeria, Philippines, Turkey, Poland, Romania, and many other countries, exacerbated the problem as the western economies were themselves suffering from stagnation.

9.12 Almost all the debt crisis affected countries of Latin America went in for IMF's Stabilisation programmes and World Bank's Structural Adjustment Programmes (SAP).[4] In view of the fact that the existing financing mechanisms were inadequate and that some of the low income countries needed highly concessional financial support on a longer term-basis, the IMF set up the Structural Adjustment Facility (SAF) in March 1986 besides its regular funding scheme, which was subsequently renamed as Enhanced Structural Adjustment Facility (ESAF) in December 1987, for providing assistance on concessional terms to low income member countries (such as Bolivia, Guyana, Honduras, and Nicaragua from Latin America and the Caribbean region) facing a persistent balance of payment problem.

9.13 Given the formidable magnitude of the debt (approximately US $ 300 billion), the funding from the IMF and the World Bank was insufficient to resolve the debt crisis and the need was felt for restructuring the debt by involving the private sector (Bulow and Rogoff,1990). A plan, known as Brady Plan (formulated by Nicholas Brady, Secretary, US Treasury), was evolved in 1989, which involved a permanent reduction in principal and the existing debt servicing obligations. Substantial funds were raised from the IMF, the World Bank and other sources by debtor nations to facilitate such a debt reduction by issuing instruments such as debt-equity swaps, buy-backs and exit bonds.

9.14 Gross capital flows at global level rose significantly since the 1980s (See Chapter VIII). Capital flows to developing countries quadrupled between the early 1980s and early 1990s. Total net private capital inflows to emerging market economies finally peaked at US $ 226.5 billion in 1996 (Bulow and Rogoff, 1990). The increase in capital flows was also marked by a change in composition. Unlike the capital flows of the 1980s, most of which were in the form of syndicated bank lendings, capital flows in the 1990s comprised largely foreign direct investment (FDI), bonds (including short-term debt), and portfolio flows (See Chapter VI). The sharp increase in international capital flows in the 1990s to developing countries was facilitated by two factors. First, developing countries liberalised their domestic financial sector and external sector. The proportion of emerging stock markets allowing free entry to foreign investors roughly doubled to nearly 60 per cent between 1991 and 1994 (World Bank, 1997). Developing countries created investment opportunities for institutional investors by privatising public sector enterprises and deepening their financial markets. Second, advances in information and communication technology made it much easier to evaluate and monitor investment prospects around the globe.

9.15 The 1990s also exhibited a series of crises, beginning with the fall of the exchange rate mechanism (ERM) of the European Monetary System in 1992-93, the Mexican crisis in 1994, the East Asian crisis in 1997, the Russian and Brazilian crises in 1998, and later Argentine and Turkish crises in 2001.

9.16 The ERM crisis brought into focus the ability of speculators to precipitate a crisis and the limited ability of available foreign exchange reserves to stem the run on a currency in a world of volatile capital flows. The ERM crisis also highlighted the trade-off between monetary and exchange rate management policies under a convertible currency. Mexico again suffered a currency crisis, which deteriorated into a debt crisis in 1994 mainly due to volatile capital flows. This time, however, being a partner of the US in North American Free Trade Area (NAFTA), Mexico received a large bail out package of unprecedented magnitude amounting to around US $ 50 billion of official financing. The enormity of the crisis alarmed the world community. Accordingly, the G-7 meeting at Halifax

[4] The stabilisation programme of the IMF seeks to achieve fiscal consolidation and current account stabilisation, while the World Bank's Structural Adjustment Program (SAP) is a long-term programme aiming at raising the GDP and facilitating the integration of borrowing country with the world economy.

in July 1995 called for a number of measures to improve the stability of the global economy.

9.17 The most severe shock to the then existing international financial architecture was witnessed during the East Asian crisis, which unfolded in 1997. The East Asian crisis began with the collapse of the Thai Baht in July 1997 and then engulfed other Asian countries like South Korea, Indonesia, Philippines and Malaysia. The East Asian crisis could not be explained along traditional lines as some of the countries that were affected exhibited strong macroeconomic fundamentals. The crisis reflected a typical case of structural imbalance and some major deficiencies in the affected economies. Uncontrolled capital account liberalisation on the back of weak financial systems that were characterised by poor monitoring and surveillance, inappropriate policy stances such as pegged exchange rates and unlimited access to foreign currency loans for the private sector led to the crisis. Lack of timely and adequate financial assistance from the multilateral institutions, at least initially, seems to have exacerbated the crisis.

9.18 The post East Asian crisis period was to be marked by a series of country-specific financial crises. Faced with significantly large capital outflows in the face of inadequate reserves, Russia defaulted on its domestic and external debt in August 1998. It subsequently devalued its currency, thereby disrupting the international economy to a certain extent. This event reinvigorated the debate on evolving an appropriate mechanism to sovereign debt restructuring. In February 1999, following months of speculative pressure and in spite of a large IMF rescue package, the Brazilian Real was devalued. Although Brazil was a victim of the unsettled international capital markets, it did have fundamental problems. Its innovative *Real Plan,* adopted in 1994, to control hyper-inflation (more than 2,700 per cent per year at that time) and acceleration in GDP growth led to a dramatic decline in inflation, an overvalued currency and a widening current account deficit. Moreover, inadequate fiscal consolidation led to fears of default, high interest rates, and a consequent debt spiral.

9.19 In September 2001, Argentina defaulted on almost US $ 3 billion debt owed by it to the IMF (the largest non-payment of a loan in IMF history). Argentina, with foreign exchange reserves of over US $ 13 billion, chose to keep its kitty closed until the IMF agreed to a three-year aid deal. Interactions between an unsustainable fiscal regime and the existing currency board arrangement in the face of unfavourable external developments were the most crucial elements in the Argentine crisis. The inability to mount an effective and timely policy response under the assumption that the short boom experienced by the economy during the mid-1990s would be sustained further compounded the problem.

9.20 The immediate cause of crisis in Turkey in 2001 was a combination of portfolio losses and liquidity problems in a few banks, which triggered a loss of confidence in the entire banking system leading to a reversal of capital flows. The overnight interest rates soared, culminating into a failure of the banking system. The Turkish Lira was devalued by 30 per cent in February 2001 and the Government adopted a floating exchange rate regime to keep most of its reserves intact.

9.21 Some stylised facts emerging from a series of crises in the 1990s and the beginning of the present decade can now be put in perspective. The crises of the 1990s could be characterised as capital account crises as in almost all the cases they were caused by sharp and quick reversal of capital flows. Thus, while debt crises of the 1980s were caused by inability of the indebted countries to service the debts which were largely in the form of syndicated bank loans, the crises of 1990s were caused by reversal of capital flows, which were largely in the form of short-term bonds and portfolio flows. The approach towards the management of such flows failed to take into account associated risks. Inappropriate exchange rate policy was the other most common feature in all the crisis hit countries. Domestic financial systems in most of these countries were fragile due to inadequate supervision of the banking system. Corporate governance practices followed by the corporate sector also left much to be desired. Most of these countries were also found to be lacking in transparency.

9.22 The Asian crisis in 1997 and subsequent crises in Russia, Brazil, Argentina and Turkey exposed several weaknesses of the international financial architecture relating to preventive requirements, surveillance system and crisis resolution measures. Inappropriateness of exchange rate policies, haphazard and unplanned capital account liberalisation leading to exposure of the economy to risky foreign capital, mainly short-term debt, and inadequate domestic institutional framework were some of the major weaknesses. Besides, absence of strict and reliable monitoring and surveillance of financial system, lack of comprehensive and reliable early warning systems, and deficiencies in the international rating system adopted by the rating agencies turned out to be grossly inadequate. Finally, inadequate international liquidity to meet different

needs and to build confidence, lack of timely and appropriate financial assistance from multilateral institutions, especially the IMF, lack of effective debt resolution mechanisms and involvement of private sector in resolving crises, and application of 'one-size-fits-all' policy recommendations and the accompanying conditionalities by multilateral lending institutions were also responsible, *albeit* indirectly.

9.23 Although inadequacies in the international financial architecture were exposed during the debt crisis in Latin American economies in the 1980s and some measures were initiated to reform the architecture, regrettably, it did not become a rallying point for the overhaul of the then existing architecture. As a result, the vulnerabilities of the existing structure resurfaced with the East Asian crisis, which brought with it the "contagion effect" for the first time spreading across several countries even with sound economic policies and macroeconomic fundamentals. This proved to be a turning point for the debate on the reform of the international financial architecture.

9.24 The Asian crisis brought to the fore several broad issues, which have since become the focus of the current debate on international financial architecture:

(i) The decades of 1980s and 1990s witnessed a sharp increase in trade and finance. However, there has not been a commensurate increase in the lending resources of international financial institutions (IFIs). In view of the growing size of capital flows and the speed with which they could be reversed, it is argued that international financial institutions will not be able to deal effectively with the crises. It is, therefore, being felt in many quarters that resources of international financial institutions need to be augmented suitably to enable them to cope with the crises should they occur. The crises of the 1990s have also raised several concerns about governance of international financial institutions.

(ii) Capital flows have been observed to cause overshooting of exchange rates as market participants act in concert. It is their expectations and reactions to news, which drive capital flows and exchange rates out of alignment with fundamentals (Mohan, 2003). The crises reflected the tendency of financial markets to experience sharp boom-bust cycles. During financial booms, lenders and borrowers underestimate the risks involved in high levels of indebtedness. Such risks only become apparent, with particular severity, during the ensuing downswings and panics. This volatility reflects not only imperfections in the flow of information, but also radical changes in its interpretation and sharp revisions in expectations as new information arrives.

(iii) In the light of the volatility induced by capital flows and self-fulfilling expectations that this can generate, there is now a growing consensus that emerging market countries should, as a matter of policy, maintain "adequate reserves" (Jalan, 2003; Reddy, 2003b). Large reserves are deemed to be necessary as they provide 'self insurance' which can be potentially more effective to deal with crises than provided by the existing international financial architecture.

(iv) The East Asian crisis has demonstrated that financial crises are contagious and foreign exchange markets are prone to bandwagon effects (Mohan, 2003). Markets do not adequately discriminate between countries with strong and weak economic fundamentals under panic conditions. In many cases, financial crises spread because highly leveraged international investors, faced with losses in one market and ensuing margin calls, sell good assets in other countries to recoup the losses leading to sharp swings in asset prices. Investment banks and mutual funds may also engage in a similar behaviour in order to raise liquidity in expectation of withdrawals by clients (IMF, 2001).

(v) Any form of financial crisis imposes substantial social costs for an economy, particularly in respect of a debt crisis or banking sector crisis. As it happens, poor sections of society bear a substantial share of the costs of adjustment to debt crisis, whereas they benefit only marginally from financial booms. The experience of many developing countries in several regions of the world also indicates that the social effects of debt crisis continue to afflict countries even after several years of successful economic restructuring and recovery. The Latin American experience since the early 1980s is particularly relevant in this regard.

(vi) The recent crises have also brought into sharp focus a fundamental anomaly in the process of development of the global economy in the last decade. The speed of adjustment of the global regulatory and institutional regimes to the increasingly sophisticated and dynamic international financial world, with rapid globalisation of financial portfolios, has been inadequate. In brief,

existing institutions are sometimes found deficient to deal with financial globalisation. This is true for institutions at the international level as well as for domestic institutions.

(vii) The East Asian crisis showed that financial system problems could influence the effectiveness of monetary policy, set off capital flight, create large fiscal costs related to rescuing of troubled financial institutions, and deepen economic recessions. Moreover, financial weaknesses can have contagion effect. Thus, growing financial liberalisation and increasing mobility of international capital at an unprecedented rate have underlined the need for appropriate domestic macroeconomic and financial policies (World Bank, 2000).

(viii) Recent global developments have transformed the environment in which a country's economic and financial policies operate, throwing up opportunities as well as challenges. Globalisation has greatly expanded economic interdependence and interaction of countries. This has created the need for greater coordination in terms of the design of appropriate institutional architecture as well as standardisation reflected in increasing internationalisation of policy environment, *i.e.*, adoption of similar economic and financial policy approaches (Mohan, 2003).

9.25 Against the backdrop of various deficiencies of the international financial system, several initiatives have been undertaken by the international community to reform the present architecture.

II. NEW INTERNATIONAL FINANCIAL ARCHITECTURE: THE EVOLVING STRUCTURE

9.26 The process of reform in the international monetary and financial system, although steady, is marked by certain points of inflexion. While the basic objectives of the international financial structure continue to remain same, *viz.*, of fostering global trade in goods and assets, promoting prosperity and growth, achieving an equitable distribution of wealth and ensuring global monetary and financial stability, the instruments and policies envisaged to deal with the new challenges of unstable global capital flows in an era of crises and contagion are quite different from those applied in the earlier period of crises.

Initiatives Undertaken by the International Community

9.27 The international financial architecture in recent years has been evolving rapidly with frequent episodes of financial crisis in emerging market economies. The Mexican crises of 1995 resulted in the largest support of official financing to avoid a debt default. The US Treasury and the IMF garnered US $ 50 billion of official financing to redeem the whole stock of *tesebonos.*[5] In exchange, Mexico adopted a set of policy changes aimed at cutting its current account deficit and reducing inflation. However, the Mexican 'bailout' brought into focus the moral hazard problem associated with such a package and the limitations of IMF's resources (Kenen, 2001). The Rey Report (G-10 Working Party chaired by Jean Jacques Rey), which was preceded by the Halifax Summit of 1995, supported large scale financial assistance, as was done in Mexico, only under exceptional circumstances and recognised the inherent problems of moral hazard and inequitable distribution of burden of adjustment in cases of such financing.[6] While praising the effectiveness of the Paris Club[7] and the London Club[8] in restructuring sovereign debt, it rejected the proposal for radical innovations such as the establishment of an International Bankruptcy Court to meet the need of sovereign debtors. However, it recognised the difficulties associated with the restructuring of sovereign bonds.

9.28 In response to the Halifax recommendations, the IMF also initiated some measures, which, *inter alia* included: (i) an Emergency Financing Mechanism (EFM) to foster prompt and continuing consultations between the Fund's Management and its Executive Board; (ii) a Special Data Dissemination Standard (SDDS) and a General Data Dissemination System (GDDS) to improve transparency; and (iii) the New Agreement to Borrow (NAB) to augment the Fund's resources.

9.29 Notwithstanding the reforms initiated by the IMF in line with the Halifax recommendations, the East

[5] Short-term debt instruments which were repayable in Pesos but indexed to the US dollar were issued by the Mexican Government. This was issued to limit the loss of foreign exchange reserves of Mexico.

[6] The Halifax Summit recommended for (i) Development of an Early Warning System for crises prevention; (ii) Development of an 'Emergency Financing Mechanism' at the IMF for crisis resolution; (iii) Enhancement of Fund resources by doubling the entitlement under General Agreement to Borrow (GAB); (iv) Safegaurd the financial system through strengthening international co-operation in supervising financial instruments and markets (v) Reform the legal system involving restructuring of sovereign debt (vi) Examination of 'other procedures' such as the establishment of an International Bankruptcy Court.

[7] Paris Club is a forum of official creditors for restructuring sovereign debt.

[8] The London Club provides for a forum for restructuring sovereign debt to commercial banks.

Asian crisis of 1997 took the international economy by surprise. In response to this crisis, the IMF adopted new instruments in the form of the Supplementary Reserve Facility (SRF) in 1997 and the Contingent Credit Line (CCL) in 1999. However, the use of such facilities was tagged to the compliance with stricter Fund conditionality. The severity of the crisis in East Asia and its contagion effect as experienced in Russia, Brazil, and Argentina brought into sharp focus the limitations of the content and sequencing of the IMF's programmes and the corresponding role of the international financial institutions in ensuring global stability.

9.30 A meeting of Finance Ministers and Central Bank Governors from a number of systemically significant economies (G-22) was held in Washington, D.C. in April 1998 to examine issues related to the stability of the international financial system and the effective functioning of global capital markets.[9] This meeting stressed the need for action in three key areas, *viz.*, enhancing transparency and accountability; strengthening domestic financial systems; and managing international financial crises. In 1999, the G-7 established the Financial Stability Forum (FSF) to promote international co-operation and exchange of information among national and international bodies involved in supervising and regulating the financial sectors. The FSF established three working groups to address the issues of international capital flows, activities of hedged funds and other highly leveraged institutions and the problems posed by the offshore financial centres. Another major development was the creation of a new international forum in 1999, the G-20 comprising the G-7 countries and other systemically important countries, including emerging market economies (EMEs). The G-20 was established to involve the EMEs in an effort to reform the international financial architecture. On the other hand, the issue of Fund conditionality, which was discussed in the Meltzer's Report,[10] commissioned by the US Congress described conditionality to be both intrusive and ineffective (Kenen, 2001). The crises in Russia, Brazil and Argentina which brought to the fore the difficulties involved in restructuring sovereign bonds resulted in the IMF's initiative for establishing a Sovereign Debt Restructuring Mechanism (SDRM) in 2001 and the whole set of issues involving Fund lending into arrears.

9.31 The evolving international financial architecture is broadly centred around six main issues: (i) ensuring a transparent and stable global financial system so as to minimise the risks of crises; (ii) the involvement of the private sector in crisis prevention and resolution to evolve a mechanism so as to ensure an equitable sharing of burden between the sovereign debtors and the lenders in the event of crises; (iii) strengthening the IMF surveillance system with greater disclosures and transparency; (iv) encouraging sound principles of corporate governance; (v) prudent management of the external sector; and (vi) strengthening the financial sector. Some of the major initiatives undertaken to reform the international financial architecture are dealt with in greater detail in the following sections.

International Core Principles, Standards and Codes

9.32 Development and implementation of standards and codes is one of the cornerstones of the recent initiatives to strengthen the international architecture. Adherence to international standards and codes of good practices has been found desirable, especially for those countries, which access international capital markets. International standards and codes of good practices provide benchmarks for policymakers at the domestic level and investors at the global level to judge the level of stability of the domestic systems, which is a pre-requisite for a well-functioning open financial system. Various standard-setting bodies constituted by central banks, international financial institutions, national authorities and international supervisory and regulatory bodies were drawn together by the Financial Stability Forum (FSF) and a set of 12 standards have been highlighted as a common reference for various standards. These include: (i) monetary and financial policy transparency (IMF); (ii) fiscal policy transparency (IMF); (iii) data dissemination (IMF); (iv) insolvency (World Bank); (v) corporate governance (OECD); (vi) accounting (International Accounting Standards Committee, IASC); (vii) auditing (International Federation of Accountants, IFAC); (viii) payment and settlement (Committee on Payment and Settlement System, CPSS); (ix) money laundering (Financial Action Task Force, FATF); (x) banking supervision (Basel Committee on Banking Supervision, BCBS); (xi) securities regulation (International Organisation of Securities Commissions, IOSCO); and (xii) insurance (International Association of Insurance Supervisors, IAIS) (Box IX.1).

[9] The April meeting was attended by Finance Ministers and Central Bank Governors from Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, the United Kingdom and the United States. The heads of the BIS, IMF, OECD and the World Bank, as well as the Chair of the Interim Committee, attended as observers (The Willard Group).

[10] International Financial Institution Advisory Commission, 2000.

Box IX.1
International Standards: Institutions Involved

Standard	Institution
Macroeconomic Policy and Data Transparency	
Code of Good Practices on Fiscal Transparency	IMF
General Data Dissemination System (GDDS)	IMF
Special Data Dissemination Standard (SDDS)	IMF
Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Institutional and Market Infrastructure	
Principles of Corporate Governance	OECD
International Accounting Standards	IASC
International Standards on Auditing	IFAC
Core Principles for Systemically Important Payment Systems	CPSS
Real Time Gross Settlement Systems	CPSS
Settlement Risk in Foreign Exchange Transactions	CPSS
Report of the Committee on Inter-bank Netting Schemes of the Central Banks of the Group of Ten Countries (The 'Lamfalussy Report')	CPSS
OTC Derivatives: Settlement Procedures and Counterparty Risk Management	CPSS
Clearing Arrangements for Exchange-Traded Derivatives	CPSS
Delivery Versus Payment in Securities Settlement Systems	CPSS
Ten Key Principles for the Improvement of International Co-operation Regarding Financial Crimes and Regulatory Abuse	G-7
The Forty Recommendations of the Financial Action Task Force on Money Laundering	FATF
How Should We Design Deep and Liquid Markets	CGFS
Financial Regulation and Supervision	
Core Principles Methodology	BCBS
Sound Practices for Banks' Interactions with Highly Leveraged Institutions	BCBS
Core Principles for Effective Banking Supervision	BCBS
International Convergence of Capital Measurement and Capital Standards	BCBS
Amendment to the Capital Accord to Incorporate Market Risks	BCBS
Supervisory Framework for the use of 'Backtesting' in Conjunction with the Internal Models Approach to Market Risk Capital Requirements	BCBS
The Supervision of Cross-Border Banking	BCBS
Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments	BCBS
Principles for the Supervision of Banks' Foreign Establishments (the Concordat)	BCBS
Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms	BCBS
Sound Practices for Loan Accounting, Credit Risk Disclosure and Related Matters	BCBS
Enhancing Bank Transparency	BCBS
Principles for the Management of Credit Risk	BCBS
Framework for Internal Control Systems in Banking Organisations	BCBS
Operational Risk Management	BCBS
Risk Management for Electronic Banking and Electronic Money Activities	BCBS
Principles on the Management of Interest Rate Risk	BCBS
Risk Management Guidelines for Derivatives	BCBS
Objectives and Principles of Securities Regulation	IOSCO
IOSCO Resolution: Principles for Record Keeping, Collection of Information, Enforcement of Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws	IOSCO
Methodologies for Determining Minimum Capital Standards for Internationally Active Securities Firms which Permit the Use of Models under Prescribed Conditions	IOSCO
Guidance on Information Sharing	IOSCO
Report on Co-operation Between Market Authorities and Default Procedures	IOSCO
Principles of Memoranda of Understanding	IOSCO
Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms	IOSCO
International Disclosure Standards for Cross-border Offerings and Initial Listings by Foreign Issuers	IOSCO
Risk Management and Control Guidance for Securities Firms and their Supervisors	IOSCO
Client Asset Protection	IOSCO
Operational and Financial Risk Management Control Mechanisms for Over-the Counter Derivatives Activities of Regulated Securities Firms	IOSCO
Securities Activity on the Internet	IOSCO
The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts	IOSCO
Principles for the Supervision of Operators of Collective Investment Schemes	IOSCO
Report on Investment Management Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum	IOSCO
Co-ordination between Cash and Derivative Markets: Contract Design of Derivative Products on Stock Indices	IOSCO
Insurance Core Principles	IAIS
Principles on the Supervision of Insurance Activities on the Internet	IAIS
Supervisory Standard on Group Co-ordination	IAIS
Insurance Core Principles Methodology	IAIS
Principles for the Conduct of Insurance Business	IAIS
Supervisory Standard on On-Site Inspections	IAIS
Supervisory Standard on Licensing	IAIS
Guidance on Insurance Regulation and Supervision for Emerging Market Economies	IAIS
Model Memorandum of Understanding	IAIS
Principles Applicable to the Supervision of International Insurers and Insurance Groups and their Cross-Border Operations	IAIS
Supervisory Standard on Asset Management by Insurance Companies	IAIS
Supervisory Standard on Derivatives	IAIS
Supervision of Financial Conglomerates	JF
Intra-Group Transactions and Exposure Principles	JF
Risk Concentration Principles	JF

Source: Clark, A. (2001). JF : Joint Forum

9.33 Notwithstanding the benefits of adopting standards and codes, it is argued that such an adoption cannot guarantee financial stability. Further, the extent and depth of integration of domestic economies with international capital markets could vary from country to country. As such, all codes may not be equally relevant for a country, thereby, warranting country specific prioritisation in the extent and pace of compliance. In fact, international standards themselves keep evolving. Besides, the implementation of these standards and codes, which have multiplied in recent times, could impose severe strain on the manpower and financial resources of the implementing countries and could involve micro management of sovereign national economies and, therefore, may be overtly intrusive. An 'inclusive process' in the implementation of standards and codes, therefore, would be crucial. Under such circumstances, it is felt that each country should have the necessary flexibility to move towards broad consistency with freedom to deviate depending on its unique circumstances. Apart from reduction in cost, this will also help in strengthening ownership of standards and codes (Reddy, 2001).

9.34 An important development in the context of standards and codes has been the initiation of experimental case studies or Reports on the Observance of Standards and Codes (ROSCs) by the IMF, in collaboration with the national authorities and the World Bank. The ROSCs consist of a description of country practices and an independent assessment by the Fund of the extent to which the country meets the standard(s). The purpose of such assessments is to help identify weaknesses that may lead to economic and financial vulnerability, help countries determine reform and development priorities and provide further impetus for improved transparency and disclosure and help create incentives to adhere to standards. Keeping in view the resource requirements as well as coordination problems, the IMF has adopted a modular approach in which each standard would be assessed separately and the entire range of standards would be assessed over time. While the IMF produces reports on data dissemination and fiscal transparency as part of its usual surveillance process, reports on financial sector standards, particularly the one on banking supervision is prepared as part of the joint Bank-Fund Financial Stability Assessment Programme (FSAP). Participation in ROSCs and FSAP is, however, voluntary. The IMF feels that in future ROSCs will help national authorities develop their own reform plans, assess compliance with international standards and codes, and serve, if published, as a signal of their policies' enhanced transparency. They will also provide inputs for IMF surveillance and technical assistance.

Role of the Private Sector in Crisis Prevention and Resolution

9.35 One of the most contentious issues in the recent debate has been about achieving "private sector involvement" in crisis prevention and resolution. This issue is raised in the context of sovereign debt restructuring. Some of the key aspects involved in the restructuring of sovereign debt include: (i) estimating the size of the financing requirements; (ii) the prospects for a spontaneous return to capital market access; (iii) the availability of tools for securing appropriate private sector involvement; (iv) the impact on the country's future cost of borrowing; and (v) the possible impact of spillover effects on other countries.

9.36 The problems of sovereign debt restructuring are associated with different perceptions of the participating agents in the process. While the official sector views the sovereign debt restructuring process as disorderly and too costly to the debtor, the private creditors tend to foresee a constant risk that a sovereign's external creditors will be treated less favourably than other creditor groups (Roubini, 2002). They worry that any further steps to protect the sovereign from litigation would weaken the sovereign's incentive to pay. On the other hand, some sovereign debtors perceive that the official sector's interest in developing a bankruptcy regime is primarily motivated by a desire to reduce the level of official support provided to debtor countries. The basic problems of the debt restructuring process need to be examined in the context of such varied perceptions about the present mechanism. Several problems need to be addressed in this context. There is tendency for a rush to exit from the sovereign's debt at times of liquidity problems even when the sovereign is solvent and a rush for litigation in case there is a suspension of payments. Besides, there is a problem of having free riders or holdout litigation when the restructuring plan is not approved by a super majority of bond holders. The absence of an enforceable priority structure for the sovereign's own debt, which raises issues of equity and the relative treatment of different creditor groups, is another malaise to the system (Roubini and Setser, 2003). Moreover, the requirement of policy conditionality for enhancing the capacity of the debtor to honour its obligations and the role of the IMF in this context, as well as 'moral hazard' problems associated with 'rush to default' make the debt restructuring process problematic (Mussa, 2002).

9.37 The role of the private sector in forestalling a debt crisis is assuming importance especially in the context of limiting moral hazard problems associated with IMF bail-outs and to ensure a more equitable

sharing of the burden of adjustment between the creditors and debtors and strengthening market discipline. The whole idea is to ensure an orderly debt restructuring process and restore early access to international capital markets for the crisis affected countries.

9.38 While there is widespread acceptance of the need for an involvement of the private sector in crisis resolution, a consensus regarding the "mode" of burden sharing is yet to emerge. It is argued that a public sector imposition of default losses on the private sector would impair future private capital flows by sending the wrong signal that countries can default painlessly, thereby, destroying the quasi-collateral nature of sovereign debt. On the other hand, a too generous approach risks a moral hazard problem.

9.39 Before examining the various suggestions for "involving the private sector" it is imperative to have an overview of the nature of private sector response and its participation in crisis resolution, particularly debt restructuring, as experienced by the international community. This would bring to light the extent of voluntary participation of the private sector in recent episodes (Box IX.2).

Box IX.2

Debt Restructuring: International Experience

The international community has witnessed a number of episodes of financial crises in the recent years including debt default by both sovereign and private borrowers. The ensuing debt restructuring process involved varying degrees of voluntary initiatives by the private creditors. This is evidenced by the country experiences of debt restructuring as illustrated below:

- *Brady bond*[11] *debt reduction* - Restructuring under the Brady plan included at least two basic options for debt holders including the exchange of loans for either par bonds or discount bonds. The principal payments and a portion of the interest payable on both par bonds and discount bonds were collateralised by U.S. Treasury zero coupon bonds and other high grade instruments. Mexico was the first nation to begin negotiating with its commercial bank creditors in 1982 and succeeded in restructuring under the Brady Plan during 1989-90. This was followed by a number of countries including Argentina, Brazil, Ecuador, and Uruguay among others. Though this form of an arrangement for restructuring of bank claims initially proved to be quite successful, the dominance of Brady bonds in the emerging markets' debt markets gradually eroded during the 1990s. The default of Ecuador on its Brady bond claims in 2000 has lowered the credibility of this vehicle as a superior claim.
- *London-club rescheduling* - The classic case of private sector involvement (PSI) in the early phase of the 1980s debt crisis was the rescheduling of bank claims (including medium-term to longer maturities) at par and with interest rates above LIBOR. The reduced role of such rescheduling in the 1990s was mainly on account of a smaller share of syndicated bank claims (and larger share of bond claims), and perhaps as well because of the lesser dominance of book-value accounting and greater incidence of mark-to-market valuation even among major banks (Cline, 2002).
- *Spontaneous lending* remains the most voluntary form of private sector involvement as was experienced by Mexico in 1994-95.
- When an economy is in crisis, the uninterrupted inflow of direct investment can be a key source of stability, comprising an important source of voluntary PSI .
- Maintenance of short term inter-bank and trade credit by international banks as was done in the case of Brazil in the second quarter of 1999 mitigating liquidity/refinancing risks.
- A more formal elongation of short-term international bank claims into 1 to 3 year notes, as was done in Korea in early 1998 represents a relatively voluntary mode but one involving greater exertion of moral suasion and concentration among lenders.
- *Bond exchange maintaining value* - The cases of Pakistan in 1999, Ukraine in 2000, and especially Argentina's mega-swap in June, 2001, are in this category. In these exchanges, the sovereign sets forth an offer that involves an exchange of existing bonds for new ones bearing longer maturities, and at interest rates that are not lower than the original interest rates. The offers involve lesser or greater degrees of voluntarity. Whereas the Argentine swap involved more consultation with bondholders, the Pakistan and Ukraine offers were less voluntary. In principle, these exchanges do not involve debt forgiveness (Cline, 2002).
- *Bond exchange and forgiveness* - Such restructuring involving some amount of forgiveness is represented by the restructuring of Russian GKOs (treasury bills) and former Soviet debt to banks (1998), and Ecuador's Brady and other sovereign bonds, defaulted on in September 1999. After protracted London Club negotiations, some US $ 32 billion debt of the former Soviet Union was exchanged for US $ 20 billion in long-term bonds in an agreement in February 2000. In Ecuador, a unilateral exchange offer resulted in an exchange of approximately US $ 6 billion in Brady and Euro-bonds at an effective loss of about 40 per cent in January, 2000. In both of these cases "exit consent" clauses largely vitiating the claims of any holders not accepting the exchange were employed to help achieve high participation (Cline, 2002).

[11] Brady bonds were created in the wake of the Latin American debt crisis in the 1980s in an effort to restructure outstanding sovereign loans and interest arrears into liquid debt instruments.

9.40 As evident from these experiences, some degree of voluntary private sector involvement has always been an integral part of debt restructuring. Thus, suggestions to reform the present architecture through "binding in" the private sector need to be considered after maintaining a judicious balance between the objective of maintaining some degree of voluntarity in such participation as against the risk of "moral hazard" associated under the statutory process. The recent suggestions to involve the private sector in the debt restructuring process are based on three broad proposals: (i) the introduction of contractual provisions into new external debt issuance, particularly "Collective Action Clauses" (CACs);[12] (ii) creation of a new statutory regime to provide bankruptcy-style protection for a sovereign as has been proposed by the IMF in the form of the Sovereign Debt Restructuring Mechanism (SDRM); and (iii) the development of a Code of Conduct for a sovereign to follow during debt restructuring.

9.41 Contractual proposals seek to change the restructuring process by changing the provisions found in sovereign debt contracts, which are expected to reduce the problems associated with the free rider and holdout litigation. Introduction of CACs in international bond issues can take place in the following four ways:

- Using current New York law documentation in some jurisdictions;[13]
- Using current English law documentation in other jurisdictions;[14]
- Adoption of the new clauses as proposed by G-10 group of countries, which recommends following the English law convention and allows a bond's financial terms to be amended with a 75 per cent vote. Moreover, the G-10 also sought to broaden the use of trustees.
- Adoption of the Group of Six clauses as proposed by the private creditors, where the provisions for amending financial terms would be tighter than the provisions now found in English law bonds, and provisions for amending non-financial terms would be tighter than the provisions now found in the New York law bonds.

9.42 Recently, some countries such as Brazil, Korea, Thailand and Mexico, among others, with IMF supported programmes, have issued sovereign bonds with CACs. This will facilitate the rescheduling of existing bonds (as opposed to exchange) by a super-majority vote of holders. Theoretically, this can be done in bonds issued in the United Kingdom, which typically contain such clauses, but not in bonds issued in New York, which typically have been interpreted to require 100 per cent bondholder's approval for restructuring. However, in the two cases where this could have been done, *i.e.,* those of Pakistan and Ukraine (with bonds issued under U.K. law), it was not used. Efforts in this area continue on a case-by-case basis in IMF supported programmes.

Statutory Proposals

9.43 The statutory proposals[15] primarily aim at addressing the holdout/free rider problem through the creation of a statutory regime. Statutory proposals are, however, different from contractual proposals in two respects. First, a statutory regime would create the capacity to override the existing sovereign debt contracts, and, thus, immediately allow majority voting. Secondly, a statutory regime would replace a process that requires amending the financial terms of each and every bond separately. Under a statutory regime, a single aggregated vote by all bond holders on the debtor's restructuring proposal would replace such diverse efforts. The proposed Sovereign Debt Restructuring Mechanism

[12] CACs are certain contractual provisions (which govern debt contracts) between the debtor and creditors for resolving the debt related issues by fostering consultations and dialogue between the two parties. Such clauses are consensual and reduce the incentive for, or ability of, a small number of dissident creditors to disrupt, delay or prevent arrangements to support a credible adjustment programme agreeable to a majority of the concerned parties.

[13] A standard New York law contract requires the unanimous consent of all creditors to change "key financial terms", which are defined narrowly as payment dates and amounts. All other terms typically can be amended with the support of half or two-thirds of the outstanding bondholders (Roubini and Setser, 2003).

[14] A standard English law contract allows a super-majority of bondholders (typically 75 per cent) present at a meeting that meets quorum requirements to amend all the bond's terms, including the bond's payment dates and amounts. English law bonds usually make it more difficult for an individual bondholder to initiate litigation (Roubini and Setser, 2003).

[15] Also termed as the Anne Krueger approach, as she first highlighted the issue in a speech in November 2001.

(SDRM)[16] by the IMF reflects such an effort to introduce a statutory framework for smooth bond restructuring.

9.44 The statutory approach (i) allows for cessation of claims against the country in crisis; (ii) imposes a stay on litigation following the debt suspension; (iii) oversees voting process to determine the restructuring framework that is binding on all creditors ('majority restructuring') - thereby eliminating the 'free riding' or 'rogue creditor' problem; (iv) provides for interim financing from the IMF and ensure seniority of credit to new private financing; (v) prevents 'rush to default' by the debtor country - by linking activation of SDRM to Fund's assessment of country's debt sustainability; and (vi) ensures that the debtor country adopts appropriate policy measures so as to preserve asset values. A number of countries have expressed their reservations about the adoption of a SDRM suggested by the IMF. Resolving the conflict between the two dominant statutory and contractual approaches (in view of the revealed preference for the statutory approach by the IMF and for the contractual approach by the US) was crucial for ensuring further progress on the SDRM. By early April 2002, it became evident that both the IMF and the market based approach could be complimentary. The IMF, therefore, came out with an updated version of the statutory approach which was closer to the contractual approach. Under this synthetic approach, while the private sector can be encouraged to incorporate CACs into new sovereign debt contracts, the IMF can refine statutory approach by incorporating whatever the private sector proposes which may be necessary to tackle outstanding issues of inter-creditor equity, particularly, the aggregation problem across creditors. The revised approach of the IMF emphasised that the Fund will only aim at catalysing early and effective dialogue between the sovereign debtor and the creditors to ensure that the mechanism does not interfere with the sovereignty of debtor – only the sovereign debtor can request for activating SDRM. The mechanism would be used to restructure debt that is judged to be unsustainable. The integrity of the decision making process under the mechanism should be safeguarded by an efficient and impartial dispute resolution process.

9.45 The statutory proposal involved a number of technical issues, which need to be resolved. The issue of how the claims of official bilateral creditors would be treated under the SDRM is still a contentious one. Similarly, there are certain claims (because of their nature), which cannot be aggregated and would need to be restructured outside the framework of SDRM. In view of this and other difficulties, the IMF members seem unwilling to establish the SDRM through an amendment of the Fund's Articles. In the April 2003 communique of the IMF, it was indicated that it is not feasible at present to move forward to establish the SDRM and hence there is considerable merit in exploring the potential scope for aggregation under a contractual framework.

A Code of Conduct

9.46 The arguments for developing a code of conduct are based on the need for addressing the coordination problems that arise in a restructuring exercise. A code may help in laying out a roadmap describing how a debtor and its creditors should try to coordinate the restructuring of individual debt instruments so as to ensure sustainability of the restructuring exercise. In principle, a code could lay out a set of general principles, or it could introduce detailed procedural requirements that a debtor would need to meet to qualify for IMF lending (Roubini and Setsar, 2003). The existing proposals for the introduction of a code include the following:

- The Banque de France proposed a code that would set out both general principles and best practices for meeting these general principles.[17]
- The Institute of International Finance (IIF) has proposed an extensive code of debtor conduct to be enforced by IMF conditionality (Roubini and Setsar, 2003).

9.47 To sum up, there has been some progress in the direction of crisis resolution initiatives. Efforts are also underway to develop CACs to augment a market-led process for restructuring of sovereign bonds. It is heartening to note that rapid progress has been made in promoting the inclusion of CACs in international sovereign bond issuances. Positive developments

[16] The IMF has put forward three different proposals: (i) In November 2001, the IMF proposed to provide a debtor with temporary legal protection; (ii) The March 2002 IMF proposal suggested allowing a super- majority of creditors to vote to determine whether or not to give the debtor legal protection; (iii) In January 2003, the IMF proposed dropping a stay altogether, and relying instead on the deterrent value of the ability to bind in hold-outs and perhaps other litigation retardants.

[17] Toward a Code of Good Conduct on Sovereign Debt Re-Negotiation, paper prepared by the Banque de France, January 2003.

relating to the development of a voluntary Code of Conduct to deal with debt restructuring is also a promising departure from the earlier era.

IMF Surveillance and Initiatives in Ensuring Financial Stability

9.48 In the wake of a series of recent crises, the IMF has taken several steps towards strengthening its surveillance mechanism, both at multilateral and bilateral levels. Traditionally, the objective of the multilateral surveillance has been to serve as "early warning systems", while the bilateral surveillance process largely involves exchange of views through Article-IV negotiations in the field of money, credit, and public finances so as to identify the impact on the balance of payments position. Occasionally, it also served as a channel for influencing the policies of national governments. Recognising the role of capital account in triggering a crisis, the surveillance process has started emphasising issues relating to capital account, financial and banking sectors and financial sector stability as well as issues relating to income distribution, governance, environment, labour market and social policies.

9.49 Newer methods of surveillance have been devised which include: (i) precautionary arrangements under which members agree to a Fund arrangement without intending to use IMF resources - which can help in boosting market confidence; (ii) informal staff monitoring under which the Fund regularly monitors members' policies without formally endorsing them; and (iii) enhanced surveillance under which close and formal monitoring of the policies is undertaken without necessary Fund endorsement; these are generally seen as useful for facilitating debt rescheduling.

9.50 Besides the usual Article IV process, as mentioned before, the Fund conducts, on a voluntary basis, a Financial System Stability Assessment (FSSA), which draws on country specific joint Fund-Bank Financial Sector Assessment Programme (FSAP) reports (IMF, 2000b). These assessments essentially aim at: (i) identifying strengths, vulnerabilities and risks; (ii) ascertaining the financial sector's development and technical assistance needs; (iii) evaluating observance and implementation of relevant international standards and codes including an assessment of the ability of this observance in addressing the problems; and (iv) helping in the formulation and implementation of appropriate policy responses (IMF and World Bank, 2003).

9.51 The experience based on a pilot programme that started in 1999-2000 involving 12 countries, including India, showed that FSAP typically focuses on: (i) the macroeconomic environment; (ii) financial institutions' structure and soundness; (iii) financial market structure and market liquidity; (iv) review and assessment of systemic risks in payment systems and risk management procedures; (v) the legal framework and the system of official oversight, prudential regulations and supervision, including observance of standards, core principles and good practices; (vi) the institutional and legal arrangements for crisis management, financial safety nets, financial institution and corporate intervention and workout mechanisms; and (vii) key reforms and measures at the disposal of the authorities to reduce vulnerabilities and to minimise systemic risks. Besides the proposed 24 annual assessments, the Fund has developed a list of Macro-Prudential Indicators[18] (MPIs) that would enable the national authorities to better monitor their own financial system.

9.52 With regard to multilateral surveillance, the World Economic Outlook (WEO) assessments have already been supplemented by the International Capital Markets Surveys which offer a comprehensive review of developments in the global financial markets and their possible implications for the world economy. With a view to improving arrangements for the surveillance of global vulnerabilities, the Group of Seven (G-7) has also taken the initiative in the form of a Financial Stability Forum (FSF), as mentioned before, which meets regularly to assess risks to global financial system and to identify and oversee actions that are needed to overcome any crisis.

Enhanced Disclosures and Transparency

9.53 The East Asian crisis brought to the light deficiencies in disclosures relating to the international reserves, foreign currency liquidity and off-balance sheet activities in foreign currency of central banks and other public sector entities (IMF, 1998). It was strongly felt that wrong and misrepresented information is potentially more dangerous than lack of information and that deficiencies in such information have made it difficult to anticipate and respond to crises. Transparency with regard to certain external transactions, particularly foreign exchange reserves and short-term liabilities are critical to prevent the severity and suddenness of crises. Both the complexity and the importance of such information have increased as a result of the ongoing globalisation of financial markets and financial innovations.

[18] MPIs are broadly defined as indicators of the health and stability of financial systems. The IMF interim committee held its Consultative Meeting on MPI and Data Dissemination in September 1999 and gave its various recommendations on the identification, analysis and use of MPIs.

9.54 The case for transparency of monetary and financial policies is based on two premises (IMF, 2000b). First, the effectiveness of monetary and financial policies can be improved if the public is aware of the objectives of policy and if the authorities can make a credible commitment to meeting them. Second, to the extent that monetary and financial authorities are given a high degree of operational autonomy within the governmental apparatus, good governance calls for holding them accountable to the public and the government.

9.55 Timeliness of disclosure is another crucial issue in this respect. Timely disclosure of information can strengthen the accountability of the authorities by better apprising the public of the authorities' policy actions and risk exposure, particularly in foreign currency. It can spur a more timely correction of unsustainable policies and possibly limit the adverse effects of contagion in times of financial turbulence. It can allow the market participants to form a more accurate view of the financial health of individual countries and vulnerability of regions, thereby limiting uncertainty and the associated volatility in financial markets. Thus, timely and reliable information about economic and financial policies, practices and decisions can play an important role in crisis prevention and management strategy. The need for greater information disclosure and transparency was one of the basic recommendations of one of the three Working Groups formed by the Financial Stability Forum (FSF).[19]

9.56 The IMF has taken a number of initiatives to enhance the transparency of information of member countries. It encourages members to release Public Information Notices (PINs), which describe the IMF Executive Board's assessment of the country's economy and policies. Disclosure of information, which is consistent with the international standards and principles, helps in ensuring transparency and comparability among the national economies. In this regard, IMF's Special Data Dissemination Standard (SDDS) has made considerable progress with a focus on four key dimensions, *i.e.*, the coverage, periodicity and timeliness of the data; access by the public to those data; integrity of the data; and quality of the data. The data template provides information on a number of parameters including currency composition, deployment of foreign exchange reserves and forward position. The template for reporting reserves is now being used by over 50 countries subscribing to the SDDS of the IMF. The IMF Executive Board has plans to further strengthen the SDDS.

9.57 The establishment of an Independent Evaluation Office (IEO) in July 2001 by the IMF marks an important step towards enhancing the transparency of its activities and economic policy formulations. IEO has produced insightful reports on the IMF's role in the recent capital account crises and fiscal adjustment in Fund supported programs, providing objective assessments of arguably some of the most controversial and contentious issues related to the functioning of the Fund.

Exchange Rate Management and Capital Account Convertibility

9.58 A series of recent crises has brought to the fore the issue of the choice of an appropriate exchange rate regime. There is a fair degree of agreement that stability in the exchange rate is well served by the stability in the conduct of monetary policy (Jalan, 1999). In most countries, the weight of experience seems to be clearly in favour of intermediate regimes with country-specific features, no targets for the level of the exchange rate, exchange market interventions to ensure orderly rate movements, and a combination of interest rates and exchange rate interventions to fight extreme market turbulence (Mohan, 2003). Moreover, there is no single exchange rate regime that is best for all countries, at all times, in all circumstances (Mussa *et al,* 2000). Thus, the choice of an appropriate exchange rate system and maintenance of orderliness in the foreign exchange markets would continue to be issues of debate in the context of international financial architecture (see Chapter VII).

[19] The Working Group on Transparency and Accountability considered the contributions that transparency and accountability can make to improvements in economic performance, as well as the nature of information needed for effective transparency and accountability. Members attached particular importance to enhancing the relevance, reliability, comparability and understandability of information disclosed by the private sector. They recommended that priority be given to compliance with and enforcement of high-quality accounting standards. There was consensus on the need to improve the coverage, frequency and timeliness with which data on foreign exchange reserves, external debt and financial sector soundness are published. Furthermore, members recommended that consideration be given to compiling and publishing data on the international exposures of investment banks, hedge funds and other institutional investors. With a view to enhance transparency members recommended that international financial institutions adopt a presumption in favour of the release of information, except where release might compromise a well-defined need for confidentiality. Members also recommended that the IMF prepare a Transparency Report summarising the extent to which an economy meets internationally recognised disclosure standards.