9.59 After the East Asian crisis, there has been an extensive debate on the issue of capital account liberalisation and imposition of controls. The volatility in capital flows driven by the information technology revolution immediately transfers the valuation of risks associated with uncertainty across the globe which leads to contagion (Mohan, 2003). The emerging consensus in the developing countries is that capital account should be gradually liberalised and not undertaken before strengthening the financial systems and supported by a consistent macroeconomic framework, stable exchange rate policies and strong institutional framework in the financial markets (Reddy, 2000d). There is also a consensus that controls, when necessary, should be temporary; they should be imposed on inflows rather than outflows and should be market based rather than direct and, as far as possible, they should be focussed on short-term volatile flows (see Chapter VIII).

Corporate Governance

9.60 Poor corporate governance was identified as one of the root causes of the East Asian financial crisis. The absence of effective discipline on corporate managers, coupled with complicated and opaque relationships between corporations, their owners and their finance providers severely affected investors' confidence in the region's corporate bodies. It has been observed that economies that took early steps to improve corporate governance recovered from the crisis more quickly than those which have not addressed this issue. The East Asian crisis showed that good corporate governance is important not only for individual corporations to raise capital but also for an economy to achieve sustainable growth.

9.61 Since banks and financial institutions are highly leveraged entities, the quality of corporate governance practices followed by them has systemic implications. Given the deregulation, global integration and sweeping changes taking place in the environment in which the financial system operates, corporate governance has become particularly important. High ethical standards, adoption of high quality accounting principles, appropriate checks and balances through external and internal audits, clear division of responsibility, disclosure and transparency relate not merely to the individual firms or banks, but to the stability of the entire financial structure. In particular, it has become vital to set up firewalls against what has come to be termed as aggressive accounting practices that ultimately compromise the stake of shareholders in the corporate entity (Box IX.3).

9.62 In response to a mandate given to the OECD in 1998, a set of standards and guidelines on good corporate governance known as OECD Principles of Corporate Governance was developed and subsequently endorsed.[20] The principles focused on the following five areas: (i) rights of shareholders; (ii) equitable treatment of shareholders; (iii) role of stakeholders in corporate governance; (iv) disclosure and transparency; and (v) responsibilities of the board.

9.63 The issue of corporate governance has assumed prominence in recent times, particularly in view of the inter-locked accounting irregularities in the US which had systemic implications. The role of auditors, investment analysts and chief executives in the irregularities highlighted the need for more stringent regulation over the functioning of these entities. Enactment of Sarbanes-Oxley Act 2002 in the US is a major step in prevention of such irregularities in future (Box IX.4).

Strengthening the Financial System

9.64 With globalisation, concerns about the increased vulnerability of international banks and complaints regarding absence of level playing field came to the fore. Capital of banks is considered as the last line of defence against the vulnerability of banks to crises. After mooting various proposals to set capital standards for international banks, the Basel Committee on Banking Supervision (BCBS) was able to achieve an agreement in July 1988, which was phased in by January 1993. Known as the 1988 Capital Accord, the agreement focused on credit risk only. It required international banks to hold a minimum total capital equal to 8 per cent of risk-adjusted assets, with at least half of this met by Tier I capital.[21]

9.65 The Capital Accord may be termed as a first major step in rebuilding the banking segment of the new international financial architecture. The capital ratios suggested by the 1988 Capital Accord was criticised on the grounds that they appeared to lack economic foundation; the risk weights did not reflect accurately the risk of the obligor and it did not account for any

[20] These were endorsed by ministers at the OECD Council meeting at ministerial level during 26-27 May, 1999.

[21] Tier I capital comprises of equity capital and disclosed reserves. Risk adjusted assets were defined as the sum of the risk-adjusted assets on and off balance sheet. On-balance sheet assets were assigned to one of four risk buckets (0 per cent, 20 per cent, 50 per cent and 100 per cent). Off-balance sheet contingent contracts, such as letters of credit, loan commitments and derivative instruments, which are traded over the counter, needed to be first converted to a credit equivalent and then multiplied by the appropriate risk weight.

Box IX.3

Changes in International Accounting Practices

Accounting irregularities have deeply shaken public confidence in the reliability of financial reporting. The International Accounting Standards Board (IASB), based in London, began its operations in 2001 with a primary objective of "developing a single set of high quality, understandable and enforceable global accounting standards." A strong thrust towards this objective was provided by the European Union's decision to require publicly-traded companies to use International Financial Reporting Standards (IFRSs) from 2005. More than 90 countries will be using or permitting IFRSs by 2005. The IASB aims at developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the Board cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world.

Upon its inception the IASB adopted the body of International Accounting Standards (IASs) issued by its predecessor, the International Accounting Standards Committee. Fifteen standards that have been revised under the IAS improvements project are:

IAS 1 : *Presentation of Financial Statements*
IAS 2 : *Inventories*
IAS 8 : *Accounting Policies, Changes in Accounting Estimates and Errors*
IAS 10 : *Events after the Balance Sheet Date*
IAS 16 : *Property, Plant and Equipment*
IAS 17 : *Leases*
IAS 21 : *The Effects of Changes in Foreign Exchange Rates*
IAS 24 : *Related Party Disclosures*
IAS 27 : *Consolidated and Separate Financial Statements*
IAS 28 : *Investments in Associates*
IAS 31 : *Interests in Joint Ventures*
IAS 32 : *Financial Instruments: Disclosure and Presentation*
IAS 33 : *Earnings per Share*
IAS 39 : *Financial Instruments: Recognition and Measurement*
IAS 40 : *Investment Property*

Some of the salient changes, especially those relating to disclosure and transparency are as follows:

- Disclosure is required of critical judgements made by management in applying accounting policies. Disclosure is required of those assumptions made by management that are important in determining accounting estimates and could cause material adjustment to the carrying amounts of assets and liabilities (IAS 1).
- The definition of related parties and the disclosure requirement for related parties have both been expanded by adding parties (*e.g.,* joint ventures and post-employment benefit plans) and by requiring disclosure of transactions, balances, terms and conditions, and details of guarantees (IAS 24).
- Consolidation, if required, is regardless of the nature of the parent entity. Thus the requirement to consolidate controlled subsidiaries applies to parent entities that are venture capital organisations, mutual funds and unit trusts (IAS 27).
- Entities are required to disclose the compensation of key management personnel (IAS 24).
- Investments in subsidiaries, jointly controlled entities and associates, when an entity elects to present separate financial statements, are to be accounted for at cost or in accordance with IAS 39 (IAS 27).
- IAS 32 requires disclosure of information to increase users' understanding of why financial instruments are used by businesses and the associated risks. This includes information on (i) the risks associated with the entity's financial instruments; (ii) management's policies for controlling those risks; (iii) the accounting policies applied to the instruments; (iv) the nature and extent of an entity's use of financial instruments; and (v) the business purposes they serve. Improvements effected by IASB focused on reduction of complexity by clarifying and adding guidance, elimination of internal inconsistencies, and incorporation into the standards key elements.
- IAS 39 requires derivatives to be reported at their 'fair' or market value, rather than at cost. This overcomes the problem that the cost of a derivative is often nil or immaterial and hence if, derivatives are measured at cost, they are often not included in the balance sheet at all and their success (or otherwise) in reducing risk is not visible. In contrast, measuring derivatives at fair value ensures that their leveraged nature and their success (or otherwise) in reducing risk are reported. As in the case of IAS 32, improvements focused on reduction of complexity by clarifying and adding guidance, elimination of internal inconsistencies, and incorporation into the standards key elements

Improvements of standards are an ongoing process. Changes in future would depend upon future experience and evolution of new instruments, markets and institutions. The revision of standards also aims to make them universally applicable. Given the diversity in financial and corporate developments in various countries, achievement of convergence of standards across countries would be a challenge that would be faced by IASB.

Source: International Accounting Standards Committee (2003).

Box IX.4

Sarbanes-Oxley Act

The Sarbanes-Oxley (SOX) Act, in the US, represents a response to the series of accounting irregularities in the US. The SOX Act of 2002, enacted on January 23, 2002 aims to protect investors by improving the accuracy and reliability of corporate disclosures. It recognises the importance of sound information for improving the allocative efficiency of markets. The Act emphasises timely and reliable public disclosure of financial statements and changes in ownership of shares due to trading activity, independence of audit committees and obligations, strengthening of criminal penalties and addressing of conflict of interest by security analysts. These elements are expected to make far reaching changes in the management of corporate entities.

The SOX Act provides for setting up of Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public companies that are subject to the securities laws. The PCAOB would register public accounting firms that prepare audit reports; establish or adopt auditing quality control, ethics, independence and other standards relating to the preparation of audit reports; conduct inspection, investigations and disciplining of audit firms; and impose sanctions, wherever justified, on audit firms or associated persons. Same set of standards would apply to foreign accounting firms that prepare an audit report for domestic companies.

In order to ensure auditor independence, the following provisions are made: (i) rendering of certain type of services to the same audit client by an audit firm are prohibited and PCAOB is empowered to provide exemption on a case by case basis; (ii) lead audit partner has to be rotated every 5 years; (iii) auditor is to report to the auditing committee on critical accounting policies, discussions with management officials and other material information; and (iv) an audit firm whose employee during the last one year was CEO/CFO/Controller/Chief Accounting Officer can not act as an auditor of the Company.

To promote corporate responsibility principal Executive/ Financial Officers would certify that the signing officer has reviewed the report, the report does not contain any untrue statement or omits a material fact, *etc.* Any improper influence on conduct of audits would be treated as unlawful.

The Act enhances the ambit of financial disclosures by disclosure of all material off-balance sheet transactions and other material disclosures in annual and quarterly financial reports. At least one member of the audit committee should be a financial expert. There will be enhanced review of disclosures made by certain companies and their financial statements. The Act provides for formulation of rules to eliminate conflicts of interest among analysts.

Source: Sarbanes-Oxley Act of 2002.

benefits from diversification. It was also realised that through financial innovation it was possible to make “cosmetic” adjustments to boost reported capital ratios without enhancing their soundness. The Accord treated all banks alike, and thus did not give safer banks the incentive to distinguish themselves from riskier ones in order to save on capital. The Accord, therefore, has been fine-tuned over time to account for financial innovation and some of the risks it did not consider initially.

9.66 A major lesson learnt from the East Asian crisis was that the concept and measurement of country risk had changed, going beyond the traditional concept of sovereign and transfer risk to include the risks posed by private sector counterparties. The importance of measuring the interrelationship between different types of risks during times of crisis also came to the fore. The experience underscored the need to place greater emphasis on stress testing and scenario analysis. Rating agencies also needed to take steps to refine their methodologies in the light of the crisis.

9.67 To develop supervisory cooperation and to strengthen prudential supervision in the emerging markets, the Basel Committee put forth a comprehensive set of principles for effective banking supervision (the Core Principles for Effective Banking Supervision) in 1997. A package of the existing Basel Committee recommendations, guidelines and standards in a reasonably compact form is also provided to the emerging economies.

9.68 The BCBS has been actively expanding its links with supervisors in non-member countries with a view to strengthen prudential supervisory standards in all the major markets. These efforts have taken a number of different forms, including:

- The development and dissemination throughout the world of policy papers on a wide range of supervisory matters;
- The creation of a close network of worldwide supervisory authorities, who meet in an international conference every two years;
- The pursuit of supervisory cooperation at local level through the creation of regional supervisory committees and active support for their activities;
- The increasing provision of supervisory training both in Basel and at regional or local level.

9.69 With greater international coordination, the pronouncements of the Basel Committee have become more and more influential as standards to which supervisory authorities, both in developed countries and in the emerging markets, aspire. Their credibility has been supported by the principle that all the material proposals are subject to a consultative process, in which the private sector and supervisory authorities, including those from the non-G10 countries, have an opportunity to provide input.

The New Basel Accord

9.70 In June 1999, the Basel Committee released for comment its proposal for a new capital adequacy framework. The Basel II framework has been constructed over the following three pillars:

a) Pillar I - Minimum Capital Requirements: the minimum capital requirement is the sum total of the capital charges for credit risks, operational risks and market risks. Guidelines and methodologies to be followed in estimation of risks have been provided.

b) Pillar II - Supervisory Review Process: notwithstanding improvements in risk sensitivity of capital and market discipline, the New Accord underscores the crucial role of supervisory oversight. Supervisors may, if required, call for maintenance of higher capital than the minimum requirement by an institution.

c) Pillar III - Market Discipline: improvement in transparency by increasing disclosure requirements is expected to ensure the credibility for banks internal ratings used under Pillar I.

9.71 The rationale for moving towards Basel II arises from the need for flexibility and better risk sensitivity (Table 9.1).

9.72 The first pillar, the new capital requirements, aims at making capital charges more correlated with the credit risk of the banks' assets. The Committee also proposes to develop capital charges for risks not considered in the current Accord, such as interest rate risk in the banking book and operational risk. Regarding credit risk, the Committee proposes a new standardised approach and alternative approaches based on banks' internal ratings frameworks. The new standardised approach retains some parts of the 1988 Accord, such as, the definition of regulatory capital. Its major novelty is the replacement of the existing risk weighting scheme by a system where the risk weights are determined by the rating of the borrower, as defined, for example, by a rating agency. According to the proposed system, for each given class of borrowers, those with high ratings have a risk weight smaller than 100 per cent but those with the lowest rating have a risk weight larger than 100 per cent.

Table 9.1: Basel Accord: Rationale for Change

The Existing Accord	The Proposed New Accord
1	2
Focus on a Single Risk	More emphasis on banks' own measure, internal methodologies, supervisory review and market discipline.
One Size Fits All	Flexibility, menu of approaches, incentives for better risk management.
Broad Brush Structure	More risk sensitivity.

Source: Bank for International Settlements (2001).

9.73 The second pillar, the supervisory review process, is intended to ensure that a bank's capital position is consistent with its overall risk profile. According to the Committee, the review process should include the principles that: (i) banks need to operate with capital above the regulatory minimum and supervisor should be able to require them to hold capital in excess of that minimum; and (ii) the supervisors should seek to intervene at an early stage to prevent capital from falling below prudent levels.

9.74 The last pillar is intended to encourage banks to disclose information in order to enhance the role of market participants in monitoring banks. This would also compel banks to be more vigilant as far as various disclosures are concerned. To that end, the Committee has proposed that banks disclose information, *inter alia*, on their components of regulatory capital, risk exposures and risk-based capital ratios computed in accordance with the Accord's methodology.

9.75 BCBS has adopted a consultative approach so as to make the new capital adequacy framework as widely acceptable as possible. After receiving a significant response to the Second Consultative Document, the Third Consultative Document was issued in 2003 and the comments received on them are being considered.

9.76 The literature on the optimal regulation in the presence of asymmetry of information shows that incentive compatibility calls for a menu approach instead of a 'one size fits all' rule. The Committee's approach appears to indicate a move in that direction. In addition to the standardised approach, it also allows for internal ratings based (IRB) approach, which recognises that banks are better informed about their risks than regulators and can make use of that informational advantage. For measurement of operational risk also, a menu approach has been adopted. Though the details of the Accord are yet to be finalised, it would be at this stage apposite to discuss some implications of the broad framework (Box IX.5).

Box IX.5
What does Basel II Hold for the future?

The New Accord is expected to be implemented within G-10 countries from end 2006 and is expected to encompass internationally active banks, and other significant banks as national supervisors deem appropriate. Outside the G-10 countries, the national supervisors have been provided the flexibility to develop their own timetable and approach depending on their perception of benefits of the new framework for the domestic banking system. Basel II is expected to make the capital allocation more risk-sensitive. Use of supervisory oversight with market discipline would broad base and reinforce the supervisory framework and financial stability. While the Accord aims at leaving the total capital requirement for an average risk portfolio broadly unchanged, banks with a greater risk appetite will find the capital requirements increasing, and *vice versa*.

The New Accord provides a flexible structure in which banks, will adopt subject to supervisory review approaches which best fit their level of sophistication and their risk profile. Depending on their risk management capabilities, the banks would have the flexibility to upgrade from the standardised approach to internal ratings based (IRB) approach for measurement of credit risk. Under the standardised approach, the risk buckets have been aligned more closely to the underlying risk, and banks and corporates can now receive a more favourable risk weight than their sovereign. Two options under IRB approach - foundation and advanced - have been provided so that the IRB approach is now capable of being used by many more banks. A menu of approaches has also been provided for measurement of operational risk. The New Accord allows banks to use ratings provided by external credit rating agencies.

Although the initial focus of Basel II is primarily on internationally active banks, its underlying principles are intended to be suitable for application to banks of varying levels of complexity and sophistication. Basel II will be applied on a consolidated basis to internationally active banks to preserve the integrity of capital in banks with subsidiaries by eliminating double gearing. The scope of application of the Accord will be extended to include, on a fully consolidated basis, any holding company that is the parent entity within a banking group to ensure that it captures the risk of the whole banking group. A three-year transitional period for applying full sub-consolidation will be provided for those countries where this is not currently a requirement. The New Accord would require increased co-operation between supervisors, especially for the cross-border supervision of complex international banking groups. The Accord Implementation Group, set up by the BCBS, is developing a set of principles to facilitate closer practical co-operation and information exchange among supervisors. Moreover, supervisors would have to test that individual banks are adequately capitalised on a stand-alone basis to ensure that capital recognised in capital adequacy measures is readily available for their depositors.

The complexity and sophistication of the proposals, however, may restrict universal application of the New Accord in the emerging markets, where the banks continue to be the major segment of financial intermediation. The New Accord would involve shift in direct supervisory focus away to the implementation issues. Moreover, banks and the supervisors would be required to invest large resources in upgrading their technology and human resources to meet the minimum standards. The increasing reliance on external rating agencies in the regulatory process may undermine the initiatives of banks in enhancing their risk management policies and practices and internal control systems. The supervisors would find it difficult to verify the accuracy of a bank's internal rating system.

The Reserve Bank has pointed out that the minimum standards set even for the internal rating based foundation are complex and beyond the reach of many banks. Besides, the line of demarcation between the six broad classes of exposures (*viz.,* corporate, sovereigns, banks, retail, project finance and equity) could often be thin. As such, without recognising the institutional framework and geographical spreads such segregation could pose serious implementation problems. The New Accord could also enhance the minimum regulatory capital, especially for banks in developing economies, due to reasons, such as (i) withdrawal of uniform risk weight of 0 per cent on all sovereign claims (OECD and non-OECD); (ii) explicit capital charge; or (iii) imposition of higher risk weights on claims on certain high risk exposures like venture capital or private equity (RBI, 2001).

Another adverse impact of the New Accord would be reduction in lending by internationally active banks in developing countries due to relative predominance of borrowers with sub-BBB ratings as compared to the industrialised countries. Procyclicality of capital requirements and ratings would lead to higher capital requirement and consequently, lower credit supply during recessions and *vice versa* during booms, resulting in larger amplitude of business cycles as a country progressively adopts the New Accord (Ray, 2002). Moreover, with increasing financial and economic integration, the vulnerabilities and cycle swings could become more synchronised and more pronounced. Basel II has recognised the existence of procyclicality in its capital requirements and has tried to take care of it partly through flattening of risk-weight curve, introduction of stress tests and provision for buffer capital over the minimum requirement under Pillar I.

Perceptions about the applicability of the New Accord vary among the developed countries as well. European regulators see Basel II, like Basel I, as a global standard to be applied to all banks. On the other hand, American regulators, reportedly, intend to apply the new rules to fewer than a dozen of their banks. Thus, most of the American banks may enjoy the advantage of theoretically lower cost of making loans.

Securities Market

9.77 Securities markets are a major component of the financial sector and as such play a central role in the stability of the financial sector. They offer an alternative source of intermediation, enhancing efficiency through competition and also reducing the pressure on the banking sector. Sound regulation and effective supervision is essential for maintenance of investor confidence and maintenance of macroeconomic stability. Development of standards and codes for the securities market under FSAP has been done by the International Organisation of Securities Commission (IOSCO). IOSCO is an association of securities regulatory agencies, self-regulatory organisations and international institutions, with the IMF and the World Bank as affiliate members. Endorsed in 1998, the IOSCO Principles cover such areas as the regulator, enforcement, issuers, market intermediaries, collective investment schemes and secondary markets.

9.78 The IOSCO Objectives and Principles of Securities Regulation set a standard against which a country's practice of regulation and supervision of securities market is assessed. Individual countries are themselves taking steps to develop markets, review their ongoing regulatory and supervisory procedures and adopt international best practices. Countries are also making efforts to strengthen the legal environment in which the financial systems are operating. Appreciable steps have also been taken to improve bankruptcy procedures.

III. INDIA'S PERSPECTIVE ON INTERNATIONAL FINANCIAL ARCHITECTURE

9.79 The orderly functioning of the global markets is crucial both for short-term stability and sustainable growth of emerging markets. The crises of the 1990s have amply demonstrated that deficiencies in international financial architecture may have several ramifications for other countries even if they themselves continue to pursue sound macroeconomic and financial policies. Therefore, an appropriate international financial infrastructure that can ensure global financial stability is of particular relevance to an emerging market like India.

9.80 As a member of various international groups – the International Monetary and Financial Committee (IMFC) at the IMF, Development Committee of the World Bank, the Bank for International Settlements (BIS), the Group of 20 and the Working Groups set up by the Financial Stability Forum and various other organisations, India has been playing an active role in the discussions on the international financial architecture and related issues.

9.81 India is one of the founding members of G-20, which was created in September 1999 to establish an informal mechanism for dialogue among systemically important countries within the framework of Bretton-Woods institutional system. The G-20 aims at promoting international financial stability. India became the first developing country to assume the leadership of G-20 in March 2002. The G-20 Deputies and Ministerial Meetings held in July 2002 and November 2002, respectively, in New Delhi deliberated on a range of issues concerning international financial architecture. India has also been actively involved with the Group on Joint Task Force on Securities Settlement Systems constituted by CPSS, the International Organisation of Securities Commissions (IOSCO), Core principles Liaison Group (CPLG) constituted by the BCBS, and the joint IMF-World Bank FSAP.

9.82 India has been closely monitoring the developments on all aspects of the new international financial architecture and has been fine-tuning and strengthening the internal crisis prevention and management frameworks. India is also one of the first members to subscribe to the Special Data Dissemination Standards (SDDS) through which information, relevant for assessment of macro-economic stability is being disseminated regularly. India voluntarily agreed for an FSAP. After the completion of the programme in 2001, India's internal frameworks for assessing financial system stability have been validated.

9.83 In addition to being closely associated with several international standards setting bodies, India was a part of the Task Force on the Implementation of Standards and participated in the Joint Committee Group meeting of the FSF. The Task Force was set up to explore key issues relating to standards, codes and core principles and consider the strategy for fostering implementation of international standards relevant for a sound financial system. The Reserve Bank was also represented at the Follow Up Group on Incentives for Implementation of Standards instituted by the FSF following submission of the Task Force Report to ascertain how various elements of market and official incentives could best reinforce one another within the framework of the overall strategy to foster implementation of standards.

9.84 In the context of increasing uncertainty associated with capital flows as evident from several crises in emerging and transition economies, the major issues pertaining to international financial infrastructure including the choice of exchange regime, foreign exchange reserves, management of capital flows, strengthening of financial systems with appropriate institutions, and appropriate supervisory and regulatory framework, international transparency codes and standards have assumed considerable significance for developing economies, in general, and India, in particular (Jalan, 1999).

9.85 Keeping in view the deficiencies of international financial architecture and risks associated with globalisation and financial integration, India has been following a gradual and cautious approach towards liberalisation of the financial and external sectors. Conceptually, the Indian approach to financial sector reforms is based on five principles, *viz*., cautious and proper sequencing; mutually reinforcing measures; complementarity between reforms in the banking sector and changes in fiscal, external and monetary policies; developing financial infrastructure; and developing financial markets (Reddy, 2000c and 2000d). While this approach is at variance with the 'big-bang' approach pursued in several countries, the gradualist approach is credited with the advantage of enhancing macro stability, whilst at the same time, fostering the microeconomic linkages.

9.86 In pursuing financial and external sector reforms, India has emphasised on the process of institution building. The broad strategy of institution building process, especially in the financial sector, encompasses strengthening of existing institutions including banks and financial institutions to adapt to market conditions and enable such institutions to operate in tune with market pressures. Institutions in the private sector are encouraged to foster competition while ensuring adequate safeguards in terms of appropriate regulatory and legal framework and monitoring mechanism. Prudential regulations and supervisory standards have been put in place in line with international standards to ensure safety and soundness of institutions and markets. Transparency and accountability in operations were introduced to enhance the credibility of the banking system (RBI, 2003a).

9.87 Recognising the importance of self assessment, the Reserve Bank appointed a Standing Committee on International Financial Standards and Codes (Chairman: Y.V.Reddy) in December 1999, in consultation with the Government in order to: (i) identify and monitor developments in global standards and codes being evolved in the context of international developments; (ii) consider the applicability of these standards and codes to the Indian financial system; and (iii) chalk out a road map for aligning India's standards and practices to the evolving international standards. In 2000, the Standing Committee constituted ten Advisory Groups comprising non-official experts in the area of banking supervision, bankruptcy laws, corporate governance, data dissemination, fiscal transparency, insurance regulation, accounting and auditing, monetary and financial transparency, payment and settlement system and securities market regulation to examine the feasibility and time frame of compliance with international best practices. An internal Group on Market Integrity subsequently covered issues relating to money laundering. Reports of the Advisory Groups were placed in public domain for wider discussion. The approach followed by India was based on the internationally acclaimed systematic three-step process of identification of standard and codes, in-depth assessment and mapping a comprehensive course of possible actions for achieving the best practices. A synthesis report was prepared to encompass the major observations and recommendations of the Advisory Groups, to identify the inter-linkages amongst different standards, and to provide an overarching view while listing the required specific legal reforms and to identify the follow-up action required by the concerned regulatory agencies and other authorities. The spirit of the Indian approach could be summarised as follows: "The process in India is an exercise that aims at understanding and comprehending various standards and codes in terms of rationale, technical complexities, institutional and legal requirements and the immediacy and relevance at the present stage of development and institutional structure. Second, it is intended to result in getting a fair view of the country's status with reference to standards. Third, this would enable getting an idea about the necessary steps required to move closer to the adherence of standards and codes. Fourth, it would sensitise the regulatory authorities, agencies and institutions about the priority areas of action" (Reddy, 2001).

9.88 In respect of standards and codes, India has been stressing the importance of ensuring that the manner in which these standards are developed and monitored does not degenerate into categorising countries as performers and non-performers. Such categorisation could entail adverse market implications for these countries. The IMF (along with other international bodies) should continue to work towards developing the best practices but only rely on market based incentives to encourage voluntary compliance. Given the low base, from which the developing countries have to start for complying with these norms, only a gradual approach could work.

9.89 In the area of transparency, the Reserve Bank has been at the forefront among national monetary authorities in terms of disclosure practices. The Reserve Bank publishes daily data on a number of variables such as exchange rates, forward premia, foreign exchange turnover and weekly data on movements in foreign exchange reserves in the Weekly Statistical Supplement (WSS) of its Bulletin with a time lag of one week. Moreover, data on the Reserve Bank's purchases and sales in the foreign exchange market along with outstanding forward liabilities on reserves *etc*., are published in the Reserve Bank of India Bulletin with a time lag of one month. The Reserve Bank is also disclosing the details of its contingent liabilities, income earned, balances in foreign exchange fluctuation reserves account and the exchange equalisation accounts. India is among the 50 countries, which have adopted the SDDS template for publication of detailed data on foreign exchange reserves.

9.90 In the area of financial sector, wide ranging reforms have been initiated. In the first phase of reform, initiated under the recommendations of the Committee on the Financial System (Chairman: M. Narasimham) in 1992, regulations and laws which were coming in the way of development of a sound and competitive banking system were removed. This included, progressive reduction of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR), interest rate deregulation, introduction of capital to risk weighted asset system in line with international standards, introduction of objective criterion of income recognition, asset classification and provisioning, enhancing transparency in financial statements and autonomy measures for public sector banks. The second phase of reforms, based on the recommendations of the Committee on Banking Sector Reforms (Chairman: M. Narasimham) in 1998, which is currently underway, relates to introduction of sophisticated financial instruments and facilitating consolidation and rationalisation of banking system. The main reforms undertaken include increasing the CRAR from 8 per cent to 9 per cent, enhancing the provisioning requirement, bringing the norm for asset classification at par with the international practice and compliance with international accounting standards.

9.91 The central plank in strengthening the financial sector and improving the functioning of financial markets is a set of prudential norms aimed at imparting strength to banks and financial institutions as well as greater accountability and market discipline. These norms include not only capital adequacy, asset classification and provisioning but also accounting standards, exposure and disclosure norms, investment, risk management and asset-liability management guidelines. There has been considerable progress in the implementation of risk management systems although there is a need for substantial upgradation of management information systems, preparation of contingency plans and stress testing. Internal systems need to be developed further for quantifying and monitoring operational risk. Efforts are on strengthening of the regulatory and supervisory framework and achieving international best practices in banking supervision. In recent years, there has been a shift in emphasis from micro-regulation to macro-management, supported by a tightening of prudential norms and improvements in the functioning of the financial markets (Jalan, 2002). Banks are being encouraged to improve the reliability and robustness of their risk management, management information and supervisory reporting systems. A scheme of prompt corrective action based on early warning triggers is being developed as a supervisory tool. The Reserve Bank and the Government have initiated a wide range of legal reforms to enable the regulatory and supervisory regime to keep pace with advancements in information and communication technology. The envisaged reforms relate to electronic cheques, cheque truncation, securitisation and reconstruction of financial assets, the payment system and money laundering. In respect of the financial institutions, the Reserve Bank has been in favour of divesting all or part of its holdings to mitigate the conflict of interest that could potentially arise in regulating the entities (Jalan, 2002).

9.92 The Reserve Bank of India has generally welcomed the proposed Basel II norms. Since Basel II would be implemented initially on internationally active banks and other significant banks as the national supervisors may deem fit, a precise definition of an internationally active bank is imperative for ensuring competitive equality and consistency of application of various requirements. The Reserve bank has suggested to BCBS that all banks with cross-border business exceeding 20 to 25 per cent of their total business may be defined as internationally active banks. Second, in view of greater probability of contagion and systemic risk inherent in cross holding of capital, a material limit (up to 10 per cent of the total capital) on cross-holdings of capital and other regulatory investments may be prescribed and any excess investments over and above the limit would be deducted from total capital. Third, risk weighting of banks should be de-linked from the credit rating of sovereigns in which they are incorporated. Fourth, supervisors are neither equipped nor competent to identify whether the External Credit Assessment Institutions (ECAIs) are using unsolicited ratings to put pressure on entities to obtain solicited ratings and hence cannot decide on their suitability for capital adequacy purpose. Fifth, while internationally active banks in emerging economies may initially be required to follow the Standardised Approach, they may be allowed to use the internal ratings for assigning preferential risk weights on certain types of exposures, after validation of the internal rating systems by national supervisors. Sixth, there is a strong case for revisiting the risk weights assigned to sovereign exposures when the exposures are aggregated as a portfolio which enjoy the benefits of diversification similar to the approach adopted for retail procedures. Lastly, the capital charge for specific risk in the banking and trading books should be consistent to avoid regulatory arbitrages (RBI, 2003b).

9.93 A set of "Core Principles for Systemically Important Systems" to promote safe and efficient payment systems worldwide was developed under the aegis of the BIS in 2001. The Reserve Bank has been taking steps towards achieving these international best practices as part of the overall reform in the financial system.

9.94 One of the guiding principles behind the reforms in the payment and settlement systems of the country has been the need to provide for safe, secure and efficient systems. The Reserve Bank has strived to provide systems which are compliant with the Core Principles for Deferred Net Settlement Systems. As a first step, the Reserve Bank had identified the Systemically Important Payment Systems, which have the propensity for systemic risks. These include, among others, inter-bank clearing, high value clearing, government securities clearing and settlement and foreign exchange clearing apart from the Main/MICR clearing. The introduction of screen based trading in Government securities following the delivery versus payment (D*v*P) II model in the form of the Negotiated Dealing System (NDS), was a milestone in this regard. The commencement of foreign exchange clearing by the Clearing Corporation of India Ltd. aimed at net settlement of the foreign exchange transactions. This is a major step forward, which has brought about more efficiency and safety. The Reserve Bank has also embarked upon the introduction of a Real Time Gross Settlement (RTGS) System for settlement of inter-bank and customer related funds transfers on a real time mode. The Reserve Bank is also in active deliberation with the CPSS-IOSCO Task Force for laying down sound practices for central counterparties. These initiatives would result in payment and settlement systems being at par with international standards.

9.95 There has been considerable thinking on corporate governance issues recently in India. A number of committees and Advisory groups including, among others, the Kumaramangalam Birla Committee, the Advisory Group on Corporate Governance (Chairman: R. H. Patil) and the Committee on Audit and Corporate Governance (Chairman: Naresh Chandra) framed codes for corporates. The Advisory Group on Banking Supervision (Chairman: M. S. Verma), the Advisory Group on Corporate Governance (Chairman: R. H. Patil) and the Consultative Group of Directors of Banks/ FIs (Chairman: A. S. Ganguly) have made wide ranging recommendations relating to corporate governance both in respect of corporate firms and financial institutions in India. While several recommendations of these Committees/ Groups have already been implemented, others are under consideration of the authorities.

9.96 Opening up of the economy has also necessitated reforms in the debt markets in India. The Reserve Bank took on the responsibility of developing the Government securities market. The strategy adopted by the Reserve Bank was to set up institutions and then divest its holdings as the market matured to avoid the problems of moral hazard of the lender of last resort and the conflict between ownership and regulation and supervision. The system of Primary Dealers (PDs) was adopted from advanced countries that used it to widen and deepen markets. To widen the market and infuse foreign funds, foreign institutional investors were allowed to invest in Government dated securities. Recently, the Government securities market was thrown open to retail investors through the introduction of screen-based trading. The Reserve Bank is also giving unstinted support to development of the technological infrastructure in the financial markets for ensuring greater efficiency and transparency in operations as well as risk free settlement.

9.97 In the capital market, reform measures have focused on regulatory effectiveness, boosting competitive conditions, reducing information asymmetries, mitigating transaction costs and controlling of speculation in the securities market. Capital Issues (Control) Act, 1947 was repealed in 1992 paving the way for market forces to play its role in the determination of price of issue and allocation of resources for competing uses. The Indian capital market was opened to foreign institutional investors (FIIs) in 1992. In order to provide greater transparency, anonymity, and lower transaction costs, the 'open outcry' system prevalent earlier, was replaced with 'screen-based trading'. The Securities and Exchange Board of India (SEBI) has been entrusted with considerable regulatory powers to ensure fair play. The National Stock Exchange (NSE) was incorporated in 1992. In order to ensure free and speedy transferability of securities, the Depositories Act, 1996 was enacted enabling electronic settlement of securities. Over the last few years, several measures have been taken to deepen and widen the foreign exchange market so as to provide the market participants to undertake foreign exchange transactions with reduced uncertainty (see Chapter VII).

IV. INTERNATIONAL FINANCIAL ARCHITECTURE: AREA OF FURTHER REFORMS

9.98 As has been discussed in the foregoing sections, the underpinnings of the evolving international architecture hinge on various issues such as adherence to globally accepted standards and codes, equitable sharing of burden between the private creditors and the sovereign debtors, effective surveillance, adequate transparency, and effective disclosure practices. However, it should be recognised that the changes in the international financial order is reflective of the underlying changes in the global financial system. Here, an important issue arises relating to the speed of adjustment of the global order to independent changes in the global financial system and the recognition that such changes represent a continuous process. Thus, there cannot be any "straight-jacketed" approach towards reforming the existing financial architecture. Moreover, the adoption of the new initiatives by the sovereigns for debt restructuring, both in terms of content and timing should be guided by the fundamental premise of voluntarity as reflected in specific country situations. In recognition of such basic principles, there are some areas where further reforms are called for. They could be broadly divided into two categories, *viz.,* (i) reform of the multilateral financial institutions, especially the IMF; and (ii) other reforms.

Reform of the Multilateral Financial Institutions

9.99 The role of financial assistance for countries facing exogenous shocks can hardly be overemphasised, given the fact that these shocks can have negative impact on developing countries' growth, macroeconomic stability, debt sustainability and poverty ratios. The impressive gains made by developing countries in recent years can be eroded considerably when they face such exogenous shocks. The IMF has taken steps to include a systematic focus on surveillance and fund assistance programmes towards tackling the adverse effects of exogenous shocks, with a view to reducing response delays. The recent initiatives to strengthen the existing instruments with the Fund [*e.g.*, Emergency Natural Disaster Assistance, Compensatory Financing Facility (CFF), Stand by credit tranches, and augmentation of Poverty Reduction and Growth Facility (PRGF) programmes] are welcome. However, there is a clear need to establish a broad menu of instruments, and apply the appropriate instrument depending on the nature of the shock, based on country-specific requirements. Sufficient flexibility is needed on the part of the multilateral agencies to meet the financing and adjustment needs of low income countries affected by exogenous shocks. Enhanced financing may be warranted depending on the intensity of shocks (Reddy, 2003b).

9.100 The evolving debate for reform in the international financial architecture has sharply brought into focus the need for reform in the structure of the international financial institutions, particularly the IMF. The debate on the need for reform of the IMF is basically centered around the issues of (i) surveillance and governance of the IMF, involving the need for change in the present quota formula so as to adequately represent the interests of the emerging market economies and adequacy of Fund resources; (ii) the role of the IMF in the context of a Lender of Last Resort as was suggested in the Meltzer's Report (2000); (iii) the role of IMF conditionality; and (iv) the policy with respect to Fund lending in arrears and its implications for enforcing a more orderly debt restructuring mechanism.

9.101 In this context, Reddy (2003b) aptly pointed out: "As regards strengthening of surveillance, we have come to a stage when we have all the tools available, but there are still doubts about their effectiveness for a variety of reasons. We should recognise that origins of crises in the past were also in the industrial countries and advanced financial centres leading to sudden capital flow reversals. While markets have started to learn to discriminate among countries, there is still a long way to go". Recognising that in surveillance, the Fund has a significant role in building confidence of both borrowers and lenders, which is important for an orderly market behaviour, several issues, including suggestions to improve the efficacy of the surveillance mechanism, have been raised. These include: (i) the vulnerability assessment exercise for the emerging market economies needs to be improved; (ii) early warning system models today are far from perfect and suffer from high false-to-signal ratios; (iii) noting that the IMF management has proposed an even handed approach to the Fund's surveillance, the fundamental question relates to what purpose it serves and whom it is meant for; (iv) given that the objective is no doubt to identify vulnerabilities and pre-empt crises from occurring or minimizing severity of such crises, when they occur, some clarity and transparency about the target of surveillance would be in order. It has also been emphasised that the Fund has to take a view on whether the Fund's assessment is meant for national governments in its role as a confidential advisor, or for the market players who in any case rely on alternative avenues for assessing publicly available information (Reddy, 2003b).

9.102 In recent years, there has been a growing realisation that the finances available from the IMF would not be sufficient to meet the requirement if most of the member countries need them at the same time. The IMF gets ordinary resources from its members quota subscriptions, which could be supplemented occasionally by borrowed resources when in need. Several suggestions have been put forward to improve the resources of the IMF. The main proposals include:

(i) Enlarge the total quotas commensurate with the growth of world output and the growth in the volume of world trade with some emphasis on the redistribution of these quotas with adequate weightage to developing countries;

(ii) Fund could issue SDR to itself for use in Lender of Last Resort (LOLR) operations subject to pre-determined cumulative limit and other appropriate safeguards under Article XVIII of the Articles of Agreement; and

(iii) Mobilise significant bilateral/multilateral resources to supplement its own during crisis.

9.103 The decision of the Twelfth General Review of quota in January 2003 not to increase the Fund quotas has brought into focus the issue of Fund governance. Over the years, the prevailing system of quota and voting power have created distortions, which, in turn, have raised issues of equity. Presently, a group of 24 industrial countries control 62 per cent of the voting power, while more than 85 per cent of the members (159 out of the 183 members) together hold the remaining 38 per cent of the votes. In the present milieu, the existing imbalance is viewed as evidence of the lop-sidedness of the governance of the IMF. Effective governance of the IMF demands that the institutional benefits and burdens are equitably shared among the members and that the checks and balances operate efficiently in the decision-making process. Improving IMF governance and thus reducing the 'democratic deficit' in its functioning needs to be approached through structural reforms aimed at redistribution of the voting power amongst member countries (Reddy, 2003a).

9.104 Closely related to the issue of enhancing the Fund resources through revision of quotas is the evolving role of the Fund as the supplier of international liquidity. In the late 1990s, several economists including Giannini (1999) and Fischer (1999) favoured an international institution serving as an international lender of last resort. Fischer (1999) and Giannini (1999) argue that the main function of the lender of last resort in most modern industrialised economies is that of "crisis manager", a role that does not necessarily require vast amounts of capital. The management of international liquidity has a special role in preventing and avoiding contagion from financial crises and lessening their adverse economic effects. The arguments for a 'lender of last resort' (LOLR) are centered on the requirements for providing adequate international liquidity in times of crises. The role of IMF should not be viewed as a LOLR as it is not in a position to supply unlimited liquidity. However, much can be done to improve the way IMF operates so that, in effect, it moves in that direction. Thus, IMF resources need to be sufficiently enlarged in order to enable it to enhance the stability of the international financial system (Reddy, 2003a).

9.105 For the IMF to take over the International Lender of Last Resort (ILOLR) function, sufficient augmentation of its general resources appear critical. It is felt that the "the liquidity creation ability of the IMF should be in situations when (i) countries in financial crisis require support; and (ii) when the IMF has run out of its own resources as well as the available funds under the arrangements to borrow" (Reddy, 2003a). Even though the aggregate quota of all members amount to about SDR 212 billion, usable resources at the disposal of the Fund at any point of time are about 30 to 40 per cent less since a large part of the quota based resources are not usable. New Arrangements to Borrow (NAB) and General Arrangements to Borrow (GAB) can supplement the Fund resources to a maximum of SDR 34 billion. The IMF has the option of assuming the ILOLR function as under Article XVIII it can allocate SDRs "to meet the long-term global need, as and when it arises, to supplement existing reserve assets". In other words, "IMF can remain as a quasi lender of the last resort" (Reddy, 2003a) or it could be said as "IMF is lender of some sort" (Jalan, 1999).

9.106 India has also raised this issue on several occasions that IMF could issue SDRs to itself to augment its resources at the time of need and relinquish the additional liquidity so created as and when the member countries effect the repurchases (Jalan, 1999). If this arrangement can be implemented, the IMF can effectively create unlimited liquidity and support the national initiatives in bridging any liquidity shortfall. The role of the IMF as an "lender of some sort" would further improve its standing among EMEs, "….IMF's effectiveness would be enhanced even as a conditional limited liquidity creator irrespective of whether this facility is actually operated or not. The fact of availability itself could enhance the IMF's capacity to influence markets. Coupled with the ongoing work on the SDRM as well as progress in Collective Action Clause, this initiative would strengthen the IMF's effort towards crisis resolution" (Reddy, 2003a).

9.107 In the context of the financing framework of the IMF, four main concerns have been expressed (Reddy, 2003a). These concerns relate to (i) the burden of additional expenditures borne almost entirely by the borrowers in the General Resources Account (GRA) and not shared by other members of the IMF despite the fact that the financial support to borrowing countries account for only 35 per cent of the total budget of the IMF, while 65 per cent is spent on activities which benefit almost all members; (ii) complexity of the income generating structure and the accounting procedure inhibits reduction in the rate of charge applicable to the GRA borrowing countries; (iii) the entire burden of the increasing the reserves of the IMF is placed on the GRA borrowing countries through charges and surcharges levied on them; and (iv) neutral members who are neither creditor or debtor do not bear any part of the expenditure burden of the IMF. Again, certain dilemmas from the point of view of the countries approaching the IMF in view of undesirable domestic political message attached, compliance with Fund conditionality and necessary adjustments have been highlighted (Reddy, 2003a). These dilemmas relate to the stage at which the country approaches the Fund for support, level of adjustment the country is prepared to undertake, minimum amount needed from IMF for managing the crisis, how much support IMF would provide and how does one assess both upside and downside risks of alternative paths of adjustments.

9.108 The fact remains that the Fund programmes represent a delicate balance between uniformity of treatment of members and flexibility that accounts for country specific situations. The scope of conditionality was expanded significantly in the aftermath of a series of financial crises that gripped a number of systemically important emerging market economies in the 1990s. Some conditionality is legitimate for drawings that are made when a country is experiencing balance of payment problems originating in inappropriate macroeconomic policies, or for the use of funds which is greater than the automatic low-conditionality facilities. However, there is some evidence that such conditionalities are attached without due regard for the borrower countries' circumstances. Moreover, the prescriptive recommendations by the IMF also fail to resolve the economic problems within the countries. A number of criticisms have arisen on IMF conditionality in the East Asia. It has been argued that conditionality should not include issues related to economic and social development strategies and institutions, which, by their very nature, should be decided by the national authorities, based on broad social consensus. Nor should conditionality cover areas within the purview of other international institutions and agreements, such as the World Trade Organisation (Fischer, 2002). Thus, the ongoing debate underlines the need to review the effectiveness of the present framework of Fund conditionalities.

Other Reforms

9.109 Apart from reforms in the international financial institutions, some other reforms are also needed which would have significant ramifications on the design of the future financial architecture.

9.110 First, there is immediate need to improve the consistency of macroeconomic policies at the global level (UN, 1999). The past economic crises have highlighted the need to enhance the coherence of macroeconomic policies at the global level. Global coherence should aim at adoption of a set of interrelated national policies, rather than the adoption of identical decisions, since economic conditions would be varying in different economies at a given time. For achieving this objective, there should be some mechanism to ensure co-ordination of national policies.

9.111 Second, it is important to ensure that the manner in which the standards/codes/transparency norms/Macro Prudential Indicators (MPIs) are developed and monitored does not degenerate into categorising countries into performers and non-performers. Furthermore, the type of transparency/ disclosure norms that could be prescribed for matured financial systems, could at best serve only as guiding reference points for not so matured financial systems, requiring implementation of such norms only in a flexible and gradual manner. Given the enormous prevalent divergences in institutional development, systems, and the nature of relations amongst various arms of national governments, the implementation of standards and codes should continue to be voluntary in nature and keeping in view the country specific conditions.

9.112 Third, the regulation of the credit rating agencies is emerging as an important issue. Capital flows to a large number of emerging and developing countries are to a large extent affected by the assessments and the ratings assigned by the international credit rating agencies (such as, Moody's, or Standard and Poor's) to them. The shortcomings of the ratings assigned by these agencies was clearly exposed during the East Asian crisis in 1997 when they failed to warn these countries of the impending crisis (Reddy, 2000a). *Ipso facto* these agencies had focused too narrowly on the conventional indicators of country risk such as fiscal balance, banking sector health, national trade and current account balances, and overlooked more dangerous imbalances building up in capital accounts, particularly in short-term money market flows, and the huge pre-crisis build-up of Asian corporate debt. In view of this, there is a need for an international framework having a equitable representation of the borrowers and lenders for monitoring the credit rating agencies. Furthermore, a more continuous scale may be devised for the credit ratings of countries so that changes in these are gradual and not dramatic. This will allow the affected countries to take corrective measures before the situation gets out of control (see Chapter VI).

9.113 Fourth, the need for transparency in an integrated world can hardly be over emphasised. However, at the same time it is important to assess whether the market interprets the available information appropriately. Prior to all the crises in the emerging markets in the 1990s, information on a whole range of important indicators was already available. Post-crises analyses have prominently prompted measures to enlarge the list of indicators. The speed at which most financial firms alter their both on-balance sheet and off-balance sheet positions makes even the most recently reported information obsolete. It is also not clear whether these position shifts are triggered by any assessment of new information or by noise driven panic. Accordingly, there is need for a careful assessment of various issues involved (See Chapter VII).

V. CONCLUDING OBSERVATIONS

9.114 The issue of an appropriate international financial architecture, which has been debated from time to time, resurfaced with a renewed thrust after the East Asian crisis. The surge in global capital flows in the late 1980s and the early 1990s coincided with the opening up and financial liberalisation in several developing economies. Accordingly, capital flows to the emerging market economies rose significantly until the East Asian crisis. However, the experience from the East Asian and subsequent crises elsewhere in the 1990s highlighted the serious downside risks associated with capital flows. Recurrent incidents of crisis and contagion resulting largely from the reversal of capital flows seriously exposed the weaknesses of the existing international financial architecture both in terms of crisis prevention and resolution. In particular, episodes of the 1990s highlighted the inadequacy of the resources available with the international financial institutions (IFIs) to help the countries in distress.

9.115 The need to reform the existing international financial architecture, thus, emanated from the compulsion of developing the necessary safeguards to ensure global financial stability in the wake of volatile capital flows. The focus of the new evolving international financial architecture, accordingly, has been on the development of a transparent and stable global financial system so as to minimise the risks of crisis and contagion. However, in order to pursue the objective of growth with stability effectively, it is important to take into account several factors. First, the inter-relations amongst the various components of the emerging architecture should be clearly recognised. Reliance on any one or even a few of the different proposals for reform, without a clear understanding about the implicit inter-dependence among the various components may weaken the process of globalisation. Second, the need for restructuring the existing international financial architecture should necessarily be complemented by the adoption of appropriate domestic policies based on sound macroeconomic management and an efficient financial system supported by comprehensive prudential regulation and supervision of financial institutions. A strong and resilient domestic system can withstand shocks and reduce the probability of crises or contagion. Third, in view of the fact that the resources available with the IFIs have been grossly inadequate to support countries facing rapid capital outflows, there is an urgent need to augment such resources. Along with this, concerns regarding governance of IFIs would also need to be addressed. Finally, in the present era of transition of the existing international financial architecture, the need to maintain adequate international reserves can hardly be over-emphasised. Accumulation of international reserves can act not only as a 'safety valve' against capital flight, but more importantly, can serve as an effective market signal about the strength of an economy.

9.116 Keeping in view the weaknesses of international financial architecture, India has followed a gradual and cautious approach towards globalisation, in general, and financial integration, in particular. The pace and sequencing of integration have been carefully calibrated. Along with the increased integration, emphasis has also been laid on building domestic financial institutions and financial infrastructure, development of an appropriate regulatory framework, adherence to international standards and codes and strengthening of corporate governance. These policies have held India in good stead.

9.117 Developing an appropriate international financial architecture is a continuous and evolving process. India has been playing an important role in the new international financial architecture in various international fora. Future deliberations on the issue of international architecture should be consultative, providing an adequate and just representation to various economic groups in general, and to developing and emerging economies in particular.