PRELIMINARY

An Evaluation of Proposals to Reform the International Financial Architecture*

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I. Introduction

The 1960s were the heyday of would-be reformers of the international monetary system, as widening cracks in the dollar exchange standard brought forth a host of reform proposals -- eventually culminating in the early 1970s in the floating of major-currency exchange rates and in the first allocation of the new international reserve asset, the SDR. After a long lull, Phase II of that reform effort has taken place over the past six or seven years under the banner of "strengthening the international financial architecture" (hereafter, IFA).[1] In this latter case, the motivation for reform was supplied by the Mexican peso crisis of 1994-95 and even more so, by the Asian financial crisis of 1997-98. As in the 1960s, the list of reform proposals has been long and varied.

In this paper, I provide a preliminary assessment of some of the leading reform proposals. Because the IFA covers such a wide subject area, it is necessary to be selective in a short paper.[2] Here, I have used the lending policies and practices of the IMF as a convenient organizing device to discuss selected key issues in the reform debate.[3] More specifically, Section II looks at proposals to increase the interest rate and/or reduce the maturity of IMF loans. Section III focuses on proposals to restrict the size of IMF rescue packages. Section IV, which covers the most ground, examines various dimensions of IMF conditionality, including proposals to replace ex post macroeconomic policy conditionality with pre-qualification based on structural policies, proposals to reduce the scope and detail of IMF conditionality, proposals to narrow

[1] By the IFA, I mean the institutions, policies, and practices associated with the prevention and resolution of banking, currency, and debt crises, primarily (but not exclusively) in emerging economies.
[2] For a detailed list of ongoing reform activities in the IFA, see IMF [2000a]. An integrated analysis of IFA reform issues can be found in Eichengreen [1999] and Council on Foreign Relations [1999]. Williamson [2000] presents an analysis of reform proposals, including several made by groups not covered in this paper.

currency-regime choices and/or increase private-creditor burden-sharing, and proposals to condition Fund assistance on the implementation of international financial standards. Finally, in Section V, I offer some concluding remarks on priorities for IFA reform over the next year or two.

I have not attempted to provide a comprehensive review of the burgeoning literature on the IFA. Rather, I have selected a subset of leading reform proposals by drawing on a group of recent appraisals of the IFA, including: the Report of an Independent Task Force Sponsored by the Council on Foreign Relations (hereafter, the CFR Report [1999] and CFR Task Force); the Report of the International Financial Institution Advisory Commission (hereafter, the Meltzer Report [2000] and Meltzer Commission); the U.S. (Clinton Administration) Treasury Department Response to the IFI Advisory Commission (hereafter, U.S. Treasury [2000]); the Report from G-7 Finance Ministers to the Heads of State and Government at Fukuoka, Japan on July 8, 2000 (hereafter, G-7 Finance Ministers [2000]); the Statement of G-7 Finance Ministers and Central Bank Governors at Palermo, Italy on February 17, 2001 (hereafter, G-7 Communique [2001]; speeches on the IMF by former U.S. Treasury Secretary Summers at the London Business School in December 1999 (hereafter Summers [1999]) and before the Congress' International Monetary and Finance Committee in April 2000 (hereafter Summers [2000]); and speeches on the Need for an International Lender of Last Resort, on the IMF, and on the IMF's Contingency Credit Line by IMF First Deputy Managing Director Stanley Fischer in New York in January 1999 (hereafter, Fischer [1999]), in Washington

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[3] I have also used this format in Goldstein [2000b]. The present paper updates and expands upon the analysis in the earlier one.

DC in February 2000 (hereafter, Fischer [2000a]), and in Mexico City in November 2000 (hereafter, Fischer [2000b]), respectively.

II. Interest Rates and Maturity of IMF Loans

Part of Bagehot's [1873] famous counsel for an official lender of last resort is that it should lend at a penalty rate. If the interest rate is too low, borrowers that are in trouble may not face a sufficient incentive to be more careful next time; they will also see the official lender as their first, not last resort. In addition, borrowers that are not currently in trouble may take excessive risks because they know that there is a cheap source of credit available if things turn out badly.

With these considerations in mind, it has often been suggested that the Fund increase the interest rate it charges borrowers. Countries that enter into standby and Extended Financing Facility (EFF) arrangements with the Fund pay an interest rate (called the rate of charge) that is a weighted average of short-term interest rates in the G-5 countries (United States, France, Germany, Japan, and the United Kingdom) plus a small surcharge. The rate of charge averaged 4.7 percent in 1997, 4.4 percent in 1998, 3.9 percent in 1999, and 5.1 percent last year. Developing countries, particularly when they are encountering difficulties and/or crisis conditions, have to pay much more than that to access private international capital markets. For example, emerging-market bond spreads (relative to U.S. Treasuries) have fluctuated from 375 to 1700 basis points since the outbreak of the Thai crisis in mid-1997. This large difference between Fund and private borrowing costs is characterized by some as an unwarranted subsidy that promotes both excessive borrowing from the Fund and borrower "moral hazard."

In late 1997, the Fund seemingly took some account of this criticism by endowing its newly created Supplemental Reserve Facility (SRF) with an interest rate of 300-500 basis points above the rate of charge on regular IMF loans (with the rate higher for longer repayments than for shorter ones). This higher interest rate, however, need not apply to the whole loan. For example, in the recent (December 2000) program with Argentina, only one-fifth of the Fund's $13.7 billion commitment was made available under the SRF; the other 80 percent was provided under normal stand-by terms.

Former U.S. Treasury Secretary Summers [2000] concluded in April of last year that "...a strong case could be made for an overall increase in the basic rate of charge" (p. 5). It has been reported that late last summer the G-7 countries pushed in the Fund's Executive Board for a modest increase in the rate of charge but that opposition from developing countries and some others blocked that proposal; in the end, the compromise was to impose an interest rate premium only for "large" Fund loans; see Section III.

The Meltzer Commission [2000] concluded that IMF interest rates (presumingly, including SRF rates) are not high enough; specifically, they propose that Fund borrowing cost be set at a premium over the sovereign yield paid by the borrowing country one week prior to applying for an IMF loan. The U.S. Treasury [2000] concluded that such a (Meltzer Commission) penalty rate would be too high -- so high as to worsen the underlying financial position of the borrowing country. The Fund's First Deputy Managing Director, Stanley Fischer [1999], has also argued that the penalty rate charged by the lender of last resort should be defined relative to the interest rate during "normal" times (not one week prior to the crisis), since the objective of the rescue is to achieve the

good -- non-panic -- equilibrium. This would imply penalty rates closer to SRF terms than to “Meltzer” terms.

I suspect that if SRF interest rate terms were extended to all non-concessional IMF lending, the impact would be greater on the speed with which countries repay their Fund borrowings than on the frequency of Fund borrowing. I say that for two reasons.

First, when countries finally decide to ask the Fund for emergency financial assistance, it is usually in dire circumstances when financing from the private capital markets is unavailable in large amounts. As argued by Eichengreen [2000], politicians who are fighting for survival are not likely to be deterred from going to the Fund by a higher interest rate. In this connection, it is relevant to note that neither Turkey nor Argentina -- both of which recently secured IMF financing packages in excess of 500 percent of their Fund quotas -- were apparently dissuaded by either SRF interest rate terms or by the new interest rate premium for large loans. All of this suggests that the decision to go to the Fund is apt to be less price elastic than the decision of how rapidly to repay the Fund loan-- especially if the interest rate rises (as with the SRF) the longer the loan is outstanding. Crisis countries have more room for maneuver at the time of repayment than they do at the outbreak of the crisis.

Second, we should not forget that a big difference between (upper credit tranche) IMF loans and loans from the private sector is that the former come with strong policy conditionality. Whatever its economic merits, such policy conditionality may be viewed as politically costly by the borrowing country since domestic political opponents can argue that the authorities have surrendered the steering wheel to “foreigners.” In other words, when comparing IMF loans to private-sector loans, we have to look at the

"conditionality-equivalent" interest rate, not just the nominal interest rate. A strong hint that conditionality matters for perceived borrowing cost is that, despite the large difference in nominal borrowing costs as between the Fund and private markets, we don't observe emerging economies tripping over themselves in a rush to come to the IMF at the first sign of balance-of-payments trouble. Instead, as argued above, countries come to the Fund late in the game. Conditionality (along with the Fund's senior creditor status) also gives Fund loans a higher probability of repayment than loans made by private creditors, implying that the market-clearing nominal interest rate for Fund loans is lower than that for private-sector ones. Again, the implication is that an increase in the rate of charge may not have a huge impact on the frequency of Fund borrowing (so long as Fund conditionality remains intrusive in both scope and detail).

Next, consider the maturity of IMF loans. Standby arrangements cover a one to three year period and drawings are phased on a quarterly basis. Repayments on standby arrangements used to be mandated within 3.25 to 5 years of each drawing; under the so-called "facilities initiative' agreed last September, repayment maturities were shortened to 2.25 to 4 years. EFF arrangements, which are meant to address adjustment problems which require bold structural transformation of the economy, normally run for three years (and can be extended for a fourth) and have phasing comparable to standby arrangements. The same facilities initiative also shorted repayment maturities for EFFs -- from 4.5 to 10 years of the drawing to 4.5 to 7 years. Since the SRF was meant to deal with "... exceptional balance of payments difficulties due to a large, short-term financing need resulting from the sudden disruptive loss of market confidence ...," it was created with shorter than normal repayment terms, namely 1 to 1.5 years after each disbursement.

The Meltzer Commission [2000] has proposed that the maturity of IMF loans be cut back more drastically -- to a maximum of 120 days with only one allowable rollover (leading to a maximum maturity of 240 days). The underlying rationale is that the Fund ought to be lending solely to counter liquidity crises (not insolvency crises) and that liquidity crises are typically very short-lived. The Meltzer Commission notes that prolonged use of IMF resources has been a serious shortcoming of IMF lending, with 24 of the Fund's member countries in debt to the Fund in 30 or more of the past 50 years, and 46 more countries in debt for at least 20 of those years.

The U.S. Treasury [2000] called the Meltzer repayment period "unrealistically short," noting that even in recent success cases, countries needed much longer than four months to be in a position to repay IMF loans. Fischer [1999] has rejected the notion that is straightforward to distinguish cases of illiquidity from insolvency. He argues that this distinction is often indeterminate in a crisis since it depends on how well the crisis is managed.

The G-7 Finance Ministers [2000], along with former U.S. Treasury Secretary Summers [2000], have acknowledged that prolonged use of Fund resources needs to be more strongly discouraged, albeit without suggesting a specific maturity cap. Instead, they would rely on an SRF-like price incentive to encourage prompt repayment. The G-7 Finance Ministers Report [2000] argued that for all non-concessional IMF facilities, "... the interest rate should increase on a graduated basis the longer countries have IMF resources outstanding." Presumably, they were aiming for something closer to SRF maturities (1-2 years) than to Meltzer maturities (4-8 months). In addition, there is a definite suggestion to make more selective and less frequent resort to the longer-maturity

EFF window (in favor of shorter-maturity standby arrangements). Summers [2000] argued that the countries that are likely to fit the EFF's (new) requirements are lower-income transition countries that are undertaking far-reaching structural reforms to secure stabilization, and countries with incomes just above the threshold for concessional IMF financing under the Poverty Reduction and Growth Facillilty (PRGF).

Given the contrast between the Fund's stated purpose (Article I of the Fund's Articles of Agreement speaks of making the Fund's general resources "temporarily available" to members dealing with balance of payments problems) and the track record of frequent prolonged use of Fund resources, moving to reduce the maturity and repayment periods for IMF loans makes sense. Charging higher interest rates for longer repayment periods should help to promote that objective. Likewise, making resort to the EFF less frequent should keep the Fund from getting too involved in those longer-term structural aspects of development that are best handled by the World Bank (see discussion in Section IV on the scope of Fund conditionality). It seems neither necessary nor desirable, however, to insist on repayment within a few months' time a la the Meltzer Commission recommendations. The recoveries from both the Asian crisis and the Mexican crisis have been rapid -- indeed, much quicker than is normally the case for countries experiencing "twin crises" (i.e., the simultaneous occurrence of currency and banking crises).[4] Policy should not be set solely in terms of the best performers. Moreover, in many cases, the relatively rapid resumption of market access was accelerated by large-scale bail-outs and "blanket guarantees" (including large, uninsured creditors of banks) -- bail-outs that we should seek to avoid or reduce in the future. And in cases where the illiquidity/insolvency distinction is more blurred (e.g., a crisis where the holes in the

balance sheets of banks and/or corporations are hard to gauge quickly), it will be helpful to have longer than eight months for countries to repay.

It is also relevant to contrast the current mood on repayment maturities with that prevailing at the time the longer-maturity Fund lending windows (the EFF, the Structural Adjustment Facility, and the Enhanced Structural Adjustment Facility) were created . At that time, the maturity of Fund loans was also under attack -- but from the opposite direction.[5] Then, the criticism was that Fund lending programs were too short-sighted, too focused on correcting balance-of-payments disequilibria, and not focused enough at promoting sustainable economic growth. Demand-management alone could not do the job; supply measures were needed and these would take time. The recommended prescription was greater financial support for structural reforms, along with longer program periods and repayment maturities to allow those structural reforms to take hold and bear fruit. Now that many more developing countries have access to private capital markets, that private capital flows have become extremely large relative to official finance, and that prolonged use of Fund resources has become a widespread problem, the pendulum is swinging back the other way.

III. Size of Fund Loans

Another important dimension of Fund lending is the size of rescue packages. The Fund's normal access limits for its loans are expressed in terms of a country's quota in the Fund. More specifically, the normal access limits are 100 percent of quota annually and 300 percent on a cumulative basis. By this metric, the amounts committed under

[4] See Goldstein et al [2000]

[5] See, for example, Helleiner [1987], Camdessus [1987], and Conable [1987].

rescue packages for Mexico (1995), Thailand (1997), Indonesia (1997), Brazil (1998), Argentina (2000), and Turkey (2000) were exceptionally large since they fell in range of 500-830 percent of quota. The rescue package for South Korea (1997) was much larger still --1900 percent of quota.[6]

The amounts actually disbursed under the Asian rescue packages were however considerably smaller than the amounts committed. More fundamentally, the IMF has maintained that other metrics should be used to evaluate the size of packages instead of quotas (or absolute dollar figures). Fischer [1999] and Mussa [1999] have noted that Fund quotas have not kept pace with the growth of GDP, trade, or capital mobility, and therefore that quotas constitute a poor benchmark for evaluating the size of Fund loans. Fischer [1999] notes that if the IMF quotas were today the same size relative to output of IMF member countries as they were in 1945, quotas would be three times larger; adjusting quotas for the growth of world trade over the same period would leave them nine times larger. In a related vein, Mussa [1999] contends that official financing in the Asian crisis was not large relative to the decline in gross private capital flows during that period, or to the crisis countries' current-account adjustments, or to the huge output losses borne by the crisis countries.

Much of the recent concern about the size of Fund emergency financing has been that large rescue packages may contribute to moral hazard on the part of private creditors to emerging economies. If these private creditors come to expect that Fund loans to emerging-economy governments will make these governments more capable and more likely to bail them out in cases of adverse circumstances, then private creditors will act

[6] One of the reasons the rescue package for Korea was so large relative to its quota is that Korea's quota is so small for its economic size.

less prudently in monitoring the performance of borrowers. Put in other words, if private creditors are shielded unduly from the consequences of poor lending and investment decisions, market discipline will suffer and future crises will become more likely.

Most analysts that call for smaller IMF rescue packages on grounds of lender moral hazard acknowledge that moral hazard is a problem with all insurance arrangements. The solution is not to have no insurance but rather to limit the amount of payment (e.g., coinsurance or deductibles) and/or to price the insurance appropriately (i.e., higher insurance rates for more risky policyholders). They also concede that a lender of last resort, by providing emergency assistance to an illiquid (but not insolvent) borrower and thereby preventing a costly default and its spillover to other borrowers, serves a useful function for the economy as a whole. Moreover, it is recognized that equity holders and bond holders suffered large losses in the Asian crisis, and that banks took a sizeable hit during the Russian crisis. Still, most of the critics conclude that smaller IMF rescue packages would reduce lender moral hazard, improve market discipline and crisis prevention, and prevent IMF money from financing sustained capital flight. In addition, smaller packages would provide a practical mechanism for introducing private-sector involvement (since any shortfall between debt payments and liquid assets inclusive of IMF loans would need to be covered -- one way or another -- by the private sector).

On the other side of the fence, even those who regard the (lender) moral hazard criticism as greatly exaggerated acknowledge that Fund rescue packages in the run-up to the Russian crisis of 1998 were too large and were a key reason why investors continued to pour money into Russian government securities (GKOs) despite weak economic fundamentals. They argue however that there is no empirical evidence suggesting that

moral hazard was driving private capital flows to Mexico and/or to Asia in the run-up to their crises, or that the composition of capital flows has since then switched in favor of the lenders (banks) usually singled-out as the main beneficiaries of lender moral hazard. [7] On conceptual grounds, they also emphasize that since Fund rescue packages are loans (not grants) with reasonable interest rates and with a history of very low default; since there are no losses on these loans, Fund lending cannot be considered a "direct" source of moral hazard.[8] Moreover, they maintain that moral hazard is small relative to the real hazards facing developing countries in today's capital markets.

Although the Meltzer Report [2000] concluded that Fund loans generated serious moral hazard problems ("the importance of the moral hazard problem cannot be overstated," p. 33), the Commission did not recommend smaller IMF rescue packages as an antidote for that problem. Following the Bagehot [1873] guideline that a lender of last resort should "lend freely" (albeit at a penalty rate and on good collateral), they propose that the Fund lend on a substantial scale -- indeed, up to one year's tax revenue --to countries that have met certain pre-qualification criteria. This could result in massive rescue packages -- far larger than any loans the Fund has extended heretofore. For example, as noted by the U.S. Treasury [2000], such a lending guideline, if say, applied to Brazil in 1997 would have resulted in a $139 billion rescue package -- 3088 percent of Brazil's quota in the Fund and almost ten times as large as the Fund rescue package extended to Brazil in early 1999. The Meltzer Commission proposes instead that moral

[7] See Zhang [1999] and Eichengreen and Hausman [2000].
[8] See Mussa [1999]. He refers to "indirect" moral hazard as a situation where international financial support facilitates moral hazard by national governments. The Meltzer Report [2000] has this in mind when it charges that the IMF "... did little (in Asia) to end the use of the banking and financial systems to finance government-favored projects, eliminate so-called "crony capitalism" and corruption, or promote safer and sounder banking and financial systems." (p. 33).

hazard problems be tackled by encouraging financial institutions in the borrowing countries to adopt higher standards of safety and soundness and by discouraging reliance on short-term borrowing.

The strongest call for a return to smaller Fund loans has come from the CFR Task Force. The CFR Report [1999] argues that the Fund should distinguish "country crises" (crises that do not threaten the functioning of the international financial system) from "systemic crises," and should treat the two differently. For country crises, the Fund should return to normal access limits (100-300 percent of quota). For systemic crises, the Fund should turn to systemic lending windows -- the existing New Arrangement to Borrow (NAB) if the crisis is mainly the result of the borrowing country's policy inadequacies and a Fund program is needed to correct those policy shortcomings, and a newly created "contagion facility" if the country is mainly a victim of contagion. A super-majority of creditor countries would have to reach the judgement that the crisis was "systemic" to activate either the NAB or the contagion facility. Once activated however, the systemic facilities could provide large access and the contagion facility would be funded by a special allocation of IMF Special Drawing Rights (SDRs).

The CFR Report [1999] maintains that smaller Fund loans for country crises would still permit some cushioning of the recession, some smoothing operations in foreign exchange markets, and a modest contribution toward the cost of bank restructuring and recapitalization. These loans would not however -- desirably in the report's view -- be large enough to support the defense of overvalued fixed exchange rates or to bail-out large uninsured private creditors. The CFR Task Force also rejects the view that there is certain unique size of a Fund rescue package that is needed to restore "confidence" in the

crisis country. It notes that some empirical studies have found that asset prices typically fail to stabilize right after the signing of a Fund program;[9] instead, stability comes later, when there is stronger evidence of political leadership and when there are concrete policy actions to deal with policy shortcomings. Yes, the CFR Task Force acknowledges that smaller Fund rescue packages would probably increase the cost of market borrowing for developing countries and perhaps reduce somewhat the flow of private capital to them. But it argues that since net private capital flows to emerging economies in 1990-96 period were too large and the interest rate spread on that borrowing too low, some moderate move in the opposite direction would be no bad thing.

By going to smaller Fund loans for country crises, by making IMF loans to countries with unsustainable debt profiles conditional on greater private-creditor burden sharing, by encouraging all countries to include "collective action clauses" in their sovereign bond contracts, and by allowing the Fund to approve standstills declared by the debtors with unsustainable debt profiles, the CFR Report [1999] believes it would be possible to reduce significantly indirect (lender) moral hazard stemming from Fund rescue packages. [10]

The U.S. Treasury [2000] has rejected the very large Fund loans implicit in the Meltzer Commission recommendations as "... unrealistic and undesirable" and as surpassing the financial capacity of the Fund and increasing moral hazard.

It was only relatively recently that the U.S. Treasury and G-7 Finance Ministers came out in favor of an incentive to reduce the scale of IMF loans. Last September as part of the facilities initiative, the IMF Executive Board agreed to impose an interest rate

[9] See Brealey and Kaplanis [1999].
[10] On the importance of collection action clauses and creditor steering committees, see Eichengreen [1999].

surcharge for “large” IMF loans: 100 basis points for IMF for IMF loans equal to 200 percent of quota, rising to 300 basis points for loans above 300 percent of quota.

There appear to be three main differences between the CFR view and the U.S. Treasury view on the scale of Fund financing.

First, as regards constraints/disincentives on large rescue packages, the Clinton Treasury preferred a price (interest rate) mechanism while the CFR Task Force preferred a quantity cum governance constraint (i.e., loans above 300 percent of quota would have to be deemed “systemic” by a super-majority of creditors, and those official creditors -- not the Fund -- would bear the credit risk). A disadvantage of the interest rate approach (and of leaving the decision to be made by the borrower) is that countries in crisis may be willing to pay a large premium to get enough Fund resources to defend overvalued exchange rates or to bail-out uninsured private creditors -- even if there is no a systemic risk involved. If such a demand for large rescue packages is relatively price-inelastic -- as I believe it is -- then lender moral hazard will not be much deterred by such a (moderate) size-related premium.

One aim of requiring super-majorities for “large” packages is to counteract the bias for creditor countries to regard crises in their own neighborhood as systemic (even if they are not). Another aim is to counteract the bias toward discounting unduly the effect of a bail-out today on the probability of future crises. The disadvantage of the quantity cum governance approach is the risk of ineffectiveness or inaction in the face of a genuine systemic threat, i.e., a super-majority of official creditors may allow the crisis to spread by refusing to extend the larger loan.

A second difference is that the Treasury's approach gives more "discretion" to IMF management and to U.S. authorities in deciding when to activate very large rescue packages. This is because the definition of "exceptional circumstances" which activates abnormally large access under standby and EFF arrangements, and the definition of "systemic" which activates very large access under the SRF and CCL, are in the eye of the beholder and don't require super-majority consent. In contrast, the CFR approach makes the decision to activate very large access one is that is shared more equally among a wider group of creditor countries.

Yet a third difference relates to the financing of very large rescue packages. Under existing Fund policy, the large access afforded under the SRF and CCL are financed out of the Fund's existing quota pool of resources. This runs the risk that if there are many serious financial crises occurring simultaneously and if it has been some time since the Fund has had a quota increase (as in 1998), then the Fund may not have enough resources to put out such a large and contagious fire. In contrast, the CFR approach provides new money for systemic contagion cases by financing large access with a special SDR allocation.

Those favoring large IMF rescue packages sometimes argue that they are the financial analogue to the (Colin) "Powell Doctrine" on military intervention: be selective in choosing where to intervene; but once the decision is made to go in, employ "overwhelming force" to guarantee a successful outcome. In my view, that analogy is flawed in at least three respects.

To begin with, the IMF's de facto capacity to mobilize overwhelming financial force (along the lines recommended in the Meltzer Report) is limited. Unlike national central

banks, the IMF cannot create money. Even in periods when the IMF's liquidity situation is relatively comfortable, I doubt that the IMF's main shareholders would be comfortable approving loans that run potentially to thousands of percent of the borrowing country's quota (in the absence of an extraordinary systemic threat). Where sovereign entities are involved, willingness to pay needs to be assessed along with ability to repay, and actual and perceived inequities in burden-sharing linked to the repayment of Fund loans -- both across groups within the borrowing country (e.g., taxpayers versus large domestic creditors of banks) and across countries (e.g., workers in the borrowing country versus private creditors in the lending countries) -- means that willingness to pay is not a sure thing. Unlike national central banks, the Fund does ask for collateral on its loans. Although arrears to the Fund have been relatively infrequent in the past, they are hardly unknown. In fact, the way the Fund currently calculates its rate of charge has been influenced by a brief but unhappy upsurge in arrears in the 1980s. This does not deny that the essence of a good official crisis lender is that it is willing to supply loans in a crisis to solvent borrowers in amounts not available from private lenders. But it does underline that there are non-trivial repayment risks associated with very large Fund loans. My reading is that large Fund rescue packages are already unpopular in the legislatures of some large creditor countries. They would surely be much more so if there were a large default to the Fund and to creditor governments. The reality is that the Fund will not be given the same lender-of-last-resort capability as a national central bank even if the penalties for defaulting on an IMF loan were much larger than they are today.

Second, the effectiveness of large financial force in restoring stability to countries is less assured than in the military example. With country rescues, winning the confidence

game requires good crisis management and, in particular, good macroeconomic and supporting policies. If crisis management is poor, then the "financing gap" will get much larger (via capital flight) than originally assumed and even a very large Fund loan is likely to be inadequate to the task at hand. The recent spat between Prime Minister Ecevit and President Sezer (just before two important Turkish Treasury Bill auctions) is illustrative of how quickly a large Fund program can lose market confidence when prospects for policy implementation deteriorate unexpectedly. In contrast, if the accompanying policies are good, it may be possible to restore stability and confidence with Fund loans within normal access limits. The fact that asset prices don't seem to stabilize immediately after the announcement of a Fund program supports the view that the amount of Fund money is not all that matters -- and maybe not even the main thing that matters.[11]

Third, even large Fund loans that are repaid on time and that are effective in restoring stability carry a moral hazard risk that private lenders will be even less careful in the future in assessing the creditworthiness of borrowers. Such moral hazard seems more important in the financial sphere than in the military one. Some observers have dismissed the practical significance of lender moral hazard by noting that several empirical studies have failed to find a link between earlier large rescue packages (e.g. Mexico in 1994-95 or Asian crisis countries in 1997) and the post-crisis behavior of interest rate spreads for emerging-market borrowers.

A new study by Dell'Ariccia et al [2000] suggests that most of the previous work on the empirical significance of lender moral hazard cum IMF rescue packages is

[11] See, for example, Haldane [1999].

methodologically flawed.[12] They argue persuasively that a good event study has to satisfy three conditions: (i) it has to change the public perception of the extent and/or the character of future international crisis lending; (ii) it has to be unexpected (otherwise the reaction to the event could show up before the event rather than after it); and (iii) it must not lead to a reassessment of risks other than through the expectations of future international rescues.[13] The events following the Russian default in August 1998 come closest to meeting these requirements for a valid experiment. They also show that it is inappropriate to look only at impact of the event on the average level of spreads for a single country; instead, the test should look to changes in the level of spreads in a wide range of countries, to changes in the sensitivity with which spreads react to fundamentals, and to changes in the cross-country variance of spreads (also controlling for fundamentals). In the end, their results find strong evidence consistent with the existence of (lender) moral hazard. At the very least, the findings of Dell'Ariccia et al [2000] should give pause to those who dismiss lender moral hazard in the 1990s as peanuts.

If large IMF rescue packages are to be discouraged, there remains the question of how best to do so. Not surprisingly (given my role as project director and author of the CFR Report), I regard the CFR approach to discouraging large rescues as preferable to the interest-rate-premium approach recently adopted by the IMF's Executive Board.

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[12] This criticism would apply, for example, to Zhang [1999] and Lane and Phillips [2000].

[13] Because rescue funds are fungible, there is also the complication that the indirect, moral-hazard impact of international rescues may extend to a variety of domestic institutions and domestic creditors, and some of these may not issue publicly-traded debt.

IV. IMF Policy Conditionality

Returning once again to the Bagehot [1873] guideline for a (national) lender of last resort, it specifies that lending should be done on "good collateral." In this context, good collateral serves several purposes. It provides a test of whether the borrower is just illiquid rather than insolvent (i.e., a solvent borrower has good collateral to pledge; an insolvent one does not). Because the good collateral has market value, it safeguards the solvency of the lender. It also avoids the potentially time-consuming process of negotiating and monitoring conditions on the borrower that would maximize the likelihood of repayment. And it reduces (borrower) moral hazard by discouraging the borrower from holding risky assets that would not be accepted as good collateral.

As noted above, the IMF does not lend to countries against collateral. Instead, it lends to countries that have a balance of payment need under "adequate safeguards." What are these safeguards? The main one is the policy action(s) -- so-called "conditionality" -- that the borrowing country agrees to undertake to qualify for the loans. These policy conditions are meant to correct the underlying balance-of-payments problem and to restore the borrower's ability to repay the Fund. Policy conditions are negotiated and agreed between the borrowing country and the Fund. These conditions typically cover macroeconomic policies (i.e., monetary and fiscal policies), exchange rate policy, and a range of structural policies (e.g., financial-sector policies, trade policy, reform of public enterprises, etc). As a further safeguard, Fund disbursements are made in phases or "tranches" (rather than all at once), with the ability to draw that tranche dependent on the

borrower meeting certain pre-agreed performance criteria.[14] Because some other lenders (both official and private) condition their lending to the borrowing country on either the existence and/or successful implementation of a Fund program, the amount of funding that the borrowing country can lose by not meeting the performance criteria is usually larger than the loss of Fund support. If the borrower does not repay the Fund on time, it faces loss of access to future Fund lending and ultimately even expulsion. And since member countries regard their creditor position in the Fund as part of their international reserves, the Fund has consistently maintained the view that it cannot reschedule its loans to countries with debt-servicing difficulties. Some observers submit that the explicit and implicit costs that would be associated with not repaying Fund loans give the Fund a de facto if not de jure status as a preferred (senior) creditor.

Even the most ardent supporters of the Fund would admit that the above description of Fund conditionality does not do justice to the problems often encountered in its implementation. In some cases, negotiations over policy conditions can be long and contentious, and the borrowing country may never take "ownership" of the program. Drawings may be interrupted because of non-observance of the performance criteria. Sometimes, funding may continue despite non-observance of performance criteria because of political pressures from a variety of sources (including the Fund's major shareholder countries). In still other cases, the economic analysis and advice embodied in the policy conditions may be inappropriate for the unfolding economic conditions on the ground (e.g., the recession may be deeper than anticipated when the program was formulated) and revisions to program design may be too slow in coming. And borrowing

[14] These performance criteria are meant to be within the control of the borrower. If unexpected developments intrude that prevent the borrower from meeting the performance criteria, the borrower may

countries that do not repay on time may either get de facto rescheduling (extension of new IMF loans to repay earlier ones) or may get many chances to repay before their eligibility for new loans is cut-off or before they get expelled. Still, when all is said and done, supporters argue that the existing system of conditionality works reasonably well most of the time, and that, just as importantly, it works better than the leading alternatives.

Much of the recent debate about the need for IMF reform revolves various dimensions of policy conditionality. Here, I take up in turn four such dimensions, namely: (i) ex post policy conditionality versus ex ante conditionality (i.e., pre-qualification based on structural-policy pre-conditions); (ii) the scope of conditionality; (iii) currency regime and private-sector burden-sharing aspects of conditionality; and (iv) implementation of international financial standards.[15]

(i) <u>ex post policy conditionality versus pre-conditions</u> (i.e., ex ante conditionality) -- The Meltzer Report [2000] was extremely critical of the existing (ex post) approach to Fund conditionality. The majority in the Meltzer Commission concluded [2000, p.7] that detailed Fund policy conditionality has "... burdened IMF programs in recent years and made such programs unwieldy, highly conflictive, time consuming to negotiate, and often ineffectual." They go on to argue that there is no evidence of systematic, predictable effects from most of the IMF's policy conditionality. Later on, they maintain (not entirely consistently) both that if the IMF did not exist, the market would force a country in crisis to follow similar policies and that IMF policy conditionality in the Asian crisis actually made the crisis countries worse off than they would have been without IMF

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be granted a "waiver" to draw anyway.

assistance. Put in other words, when the bottom-line results in IMF program countries look good, the outcome would have happened anyway (without the IMF); and when the results look bad, they reflect the negative influence of IMF policy conditionality and advice.

Interesting enough, the Meltzer Report [2000] did not recommend that the Fund insist on "good collateral" as a substitute for its policy conditionality (despite the fact that the Commission's Chairman favored this prescription in his recent writings on how to redesign the Fund[16]). Some have argued that if countries in crises were able to satisfy a stringent collateral requirement, then they wouldn't need the Fund (i.e., they would be able to use this collateral to borrow from private creditors); hence, little "additional" financial stability would be obtained by such a reform. While one can point to episodes where even borrowers with good collateral could not get credit in a panic, perhaps the Commission gave this "additionality" argument some weight. Or perhaps the Commission became convinced that giving the Fund a more established de jure status as a preferred creditor -- cum lending only to countries that met certain pre-qualification requirements (see discussion below) -- would provide sufficient protection for the Fund against credit risk. Or perhaps the collateral idea just wasn't deemed attractive enough to elicit majority support either within the Commission or outside more generally. In any case, the collateral idea (as a substitute for ex post policy conditionality) went by the wayside.

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[15] There is also an issue of whether Fund conditionality should supercede any conditionality that would be linked to crisis lending from "regional" official crisis lenders (such as an Asian Monetary Fund).
[16] See, for example, Meltzer [1999].

Nevertheless, the Meltzer Report [2000] did recommend that the Fund eliminate most of the macroeconomic and structural policy conditions that have characterized (upper credit tranche) Fund programs in the past. It proposed instead that countries qualifying for short-term Fund liquidity assistance would need to meet the following pre-conditions: (a) freedom of entry and operation for foreign financial institutions; (b) regular and timely publication of the maturity structure of outstanding sovereign and guaranteed debt and off-balance sheet liabilities; (c) adequate capitalization of commercial banks -- either by a significant equity position a la international standards, or by subordinated debt held by non-governmental and unaffiliated entities; and (d) a proper fiscal requirement. These new rules would be phased in over a period of five years.

Developing countries that met these pre-conditions would be eligible immediately for short-term liquidity assistance; those developing countries that didn't meet these pre-conditions would not be eligible (unless there is an unusual situation where the "... crisis poses a threat the global economy"). Larger industrial countries would not be eligible for IMF liquidity assistance; their central banks would assume this task.

To establish the seniority of IMF claims on borrowing countries, members would exempt the IMF from negative pledge clauses and would give the IMF specific legal priority with respect to all other creditors (secured and unsecured). Countries that defaulted on IMF debts would not be eligible for loans or grants from other multilateral agencies or other member countries.

Under the Meltzer Commission plan, the IMF would continue to offer advice on a wider range of economic policies (including the currency regime) in its Article IV consultations with developing countries, and these reports would be published promptly.

Industrial countries could opt out of these IMF consultations if they wished. But the IMF could not make its advice on economic policy a condition for its loans. Nor could the IMF make other types of loans for whatever purpose. Longer-term institutional assistance to foster economic development would be the responsibility of a reconstructed World Bank or regional development banks. The IMF's Poverty Reduction and Growth Facility (PRGF) would be closed.

Criticisms of the structural policy pre-conditions in the Meltzer Report have been offered mainly on four grounds.

First, there is the charge that the (majority in the) Meltzer Commission misread history. This criticism is evident within the Meltzer Commission itself from the dissent penned by four of commission members appointed by the Congressional Democrats (namely, C. Fred Bergsten, Richard Huber, Jerome Levinson, and Esteban Torres).[17] In looking at the fifty year tenure of the IMF and the World Bank (hereafter, the IFIs), the dissenters concluded that "... the bottom line of the 'era of the IFIs,' despite obvious shortcomings, has been an unambiguous success of historic proportions in both economic and social terms." (p. 119). They note, in addition: that almost all the crisis countries of the past few years, ranging from Mexico, to the countries of East Asia, to Brazil, have experienced rapid "V-shaped" recoveries; that never in human history have so many people advanced so rapidly out of abject poverty; and that more than half of the world's

[17] The Meltzer Commission had 11 members. Six of those (Allan Meltzer, Chairman; Charles Calomiris, Tom Campbell, Edwin Feulner, Lee Hoskins, and Manuel Johnson) were appointed by the Congressional Repurblicans; the other five members (Fred Bergsten, Richard Huber, Jerome Levinson, Jeffrey Sachs, and Esteban Torres) were appointed by the Congressional Democrats. In the end, eight members (all six Repubican appointees, Jeff Sachs, and Richard Huber) voted for the Report, and four members were opposed (including Richard Huber who supported both the majority and minority reports).

population now lives under democratic governments. In short, "... the allegations of the report simply fail to square with history." (p. 121).

The CFR Report [1999], while stressing the need for IMF reform, painted a more favorable picture of IMF involvement. For example, in evaluating the Fund's role during the Asian crisis, the Report concluded: "...As costly as the Asian crisis has been, no doubt we would have seen even deeper recessions, more competitive devaluations, more defaults, and more resort to trade restrictions if no financial support had been provided by the IMF to the crisis countries.... there can be legitimate differences of view about IMF advice on fiscal and monetary policy in the crisis countries.... But we had a look in the 1930s at how serious global instability is handled without an IMF, and few would want to return to that world." (p. 88).

The IMF has challenged the Meltzer Report's reading of the empirical studies on the effects of IMF programs. Fischer [2000], for example, summed-up the recent studies as follows: "The consensus view now seems to be that in a typical [IMF] program, economic activity will be depressed in the short term as macroeconomic policies are tightened, but that growth subsequently revives as structural reforms take root. Meanwhile, the balance of payments improves, removing the need for further Fund financing. The impact on inflation is usually favorable (although in general not large enough to be statistically significant" (p. 8).

A second line of criticism of the Meltzer pre-conditions approach is that these pre-conditions would suffice neither to prevent financial crises nor to achieve the balance -of-payments adjustment necessary to restore countries' ability to repay the Fund; some

critics would go farther and argue that reliance of these pre-conditions alone would promote financial instability.

Again, the dissenting group within the Meltzer Commission reached very different conclusions than the majority. Specifically, they argued that the majority would have the IMF totally ignore the macroeconomic policy stance of the crisis country, thereby sanctioning Fund support for countries with runaway budget deficits and profligate monetary policies. They go on to conclude that: "... this would virtually eliminate any prospect of overcoming the crisis; it would instead enable the country to perpetuate the very policies that triggered the crisis in the first place and thus greatly increase the risk of global instability." (p. 121). They also note that the "proper fiscal requirement" included in the pre-conditions is left undefined in the Report, and if left open to content, would require Fund conditionality of the same type that the majority rejects.[18]

The U.S. Treasury [2000] reached a similar verdict on the effectiveness of the proposed Meltzer pre-conditions: "... the proposed eligibility criteria are too narrow. Even where they are met, they would be unlikely to protect economies from the broad range of potential causes of crises. The criteria focus on the financial sector, and yet even problems that surface in the financial sector often have their roots in deeper economic and structural weaknesses." (p. 17). The Treasury worries further that combining large Fund disbursements with ineffective eligibility requirements could actually increase the amount of moral hazard in the system.

[18] My IIE colleague, C. Fred Bergsten, who was a member of both the Meltzer Commission and the CFR Task Force, maintains that both the undefined "proper fiscal requirement" and the systemic override (that allows assistance to countries that don't meet the pre-qualification criteria if there is a threat to the global economy) were added to the Meltzer Report at the last minute in an attempt to reduce the impact of the joint dissent.

Yet a third criticism is that it would prove neither feasible nor desirable to exclude completely from IMF financing countries that didn't meet the structural pre-conditions. Fischer [1999] offers the following assessment on that point: "... It is doubtful that the international community would be indifferent to the fate of countries that do not meet the pre-qualification requirements, or to the instability that might be generated when they get into trouble and are denied help. In practice, in such circumstances the large industrial countries would probably find another, less transparent, way to help the country in crisis." (p. 10). I suppose the retort of the Meltzer Commission would be that other ways of assisting countries that don't meet the pre-qualification requirement are to be preferred to IMF assistance since they would be more (not less) transparent and wouldn't risk turning the IMF into a "political slush fund."

The CFR report [1999] rejected the all-or-nothing approach to eligibility for IMF assistance. In its recommendations, countries that follow a set of "good housekeeping" crisis-prevention policies qualify for a lower interest rate from the Fund than do countries that do not follow these policies. But the latter group is not excluded from IMF assistance.

In its evaluation of the Meltzer Commission's pre-qualification criteria, the U.S. Treasury [2000] argued: "... this recommendation would preclude the IMF from being able to respond to financial emergencies and support recovery in the vast majority of its members, possibly including all of the emerging market countries affected by the financial crises of 1997 and 1998.[19] The exclusive focus on relatively strong emerging

[19] Bergsten [2000] made essentially the same point in earlier testimony on the Meltzer Report before the Senate Committee on Banking, Housing, and Urban Affars.

economies would leave out most of the Fund's membership, notably all low income countries and many transition economies." (p. 17).

The fourth set of criticisms of the Meltzer pre-conditions is that their implementation would involve more serious operational problems and raise more questions than the authors imply. For one thing, as argued in the CFR Report [1999], it is far from clear that pre-qualification would deter speculative attacks. Hong Kong, for example, had $60-100 billion of reserves in 1997-98 and pledges of financial support from Beijing; yet it faced strong attacks on its currency during that period. For another, it is probably naive to assume that the decision to declare countries that originally met the pre-conditions as ineligible (because of subsequent backtracking on compliance) would not be subject to strong political pressures. Also, the Report does not discuss who would monitor compliance with the pre-conditions; if the answer is that national regulatory authorities would do it (see discussion below on international financial standards), then there is a serious question of whether those judgements would be objective. Last but not least, there are questions about whether some of the pre-conditions would have their intended effects. For example, Garber [2000] has argued that a subordinated debt requirement for banks (similar to the proposal advanced by the Meltzer Commission) could likely be manipulated and evaded, thereby weakening its attraction as a mechanism for stronger market discipline.

At present, the notion of pre-qualifying for IMF liquidity assistance applies only to drawings under the Fund's recently-established (April 1999) Contingency Credit Line (CCL). Countries can qualify for the CCL if they have good macro policies, are complying with international financial standards, and have constructive relations with

their private creditors. As originally formulated, eligibility to draw was far from automatic, however; specifically, pre-qualified countries could not draw until the IMF's Executive Board conducted an activation review to determine if the country was severely affected by contagion and if it intended to adjust its policies as needed. In addition, countries were to pay a commitment fee and an interest rate that was the same as under the SRF. So far, all of this has been academic as (somewhat embarrassingly) no country has yet applied for the CCL. According to the IMF (Fischer [2000b]), the unpopularity of the CCL probably owed to its pricing structure: because the interest rate on the CCL was the same as that on the SRF, there was no incentive to pre-qualify; in addition, access to the credit line was not seen as automatic enough (if a crisis broke out). An alternative hypothesis is that the unpopularity derives from the ambiguous signal that applying for the CCL sends, i.e., it could be interpreted as suggesting the country is expecting trouble; in addition, because the IMF has recently speeded-up its decision-making for disbursement from other Fund facilities in a crisis, pre-qualification may not confer as much of an advantage as previously supposed.

Last September as part of the "facilities initiative," the IMF's Executive Board agreed to make the CCL more attractive by reducing the interest rate surcharge (from the previous 300 basis points to 150 basis points), by reducing slightly the commitment fee, and by both making monitoring arrangements less intensive and the activation review less demanding. We'll see if those sweeteners attract any more bees.

In the end, I do not find the Meltzer structural-policy pre-conditions attractive as an alternative way of qualifying countries for IMF financial assistance. While meeting those criteria would, ceteris paribus, reduce the risk of getting into a crisis, they're not

sufficient by themselves to deter a crisis; just as important, they are not very useful for getting out of a crisis once it hits.

Recent cross-country empirical research on financial development and on vulnerability to a banking crisis does indeed suggest that easing restrictions on foreign bank entry impacts positively on the efficiency of the domestic banking system and reduces banking fragility, particularly in emerging economies with small financial systems.[20] Also, many of the concerns about foreign-bank entry -- for example, that foreign banks will destabilize the flow of credit during a crisis, or that foreign banks will drive domestic banks out of business, or that foreign banks will lower the effectiveness of banking supervision -- have not found empirical support.[21] Likewise, I believe that better public disclosure and more timely publication of data on the currency and maturity composition of debt would be helpful in discouraging the build-up of large currency and maturity mismatches (see Section V).

But helpful is not the same thing as adequate to the task at hand. The same empirical research that shows that vulnerability to emerging-market banking crises is reduced by easier entry of foreign banks also shows that it would be reduced by lower state ownership of banking systems, by less generous deposit insurance and official safety nets, and by other factors (including wider banking powers) -- and the Meltzer pre-conditions say nothing about those determinants of fragility. More generally, freedom of entry in banking plus a subordinated debt requirement are not likely to be adequate substitutes for the wider range of factors outlined (e.g., "fit and proper" requirements for getting a banking license) in the Basle Core Principles of Banking Supervision and in the

[20] See Barth et al [2000] and Caprio and Honohan [2000].
[21] See Goldberg et al [2000] and Claessens and Jansen [2000].

recent empirical literature. In addition, while empirical research suggests that many currency crises are preceded by banking crises, many others are not.[22] Giving huge credit lines to countries without any monetary policy conditionality seems counter-intuitive. The fiscal policy pre-condition is not discussed in a serious way in the Meltzer Report; it reads like an after-thought.

More troubling still, freedom of entry for foreign banks and timely reporting of debt maturities will not get you out of a balance-of-payments crisis. Without measures to reduce absorption and to switch expenditure from foreign to domestic goods, the crisis country's ability to repay is not likely to improve. While I share the Meltzer Commission's desire to reduce the scope and intrusiveness of present Fund structural policy conditionality, this does not look like the best way to do it.

By the same token, I am not a big fan of the CCL. I believe the design flaws there extend beyond pricing and that it is possible to create a superior lending window to deal with the systemic cases of cross-country contagion along the lines outlined in the CFR Report [1999].

(ii) <u>scope and detail of conditionalilty</u> -- Among the charges leveled at the IMF during the Asian crisis, none was probably more widespread than the criticism that the Fund has allowed the scope and detail of its conditionality to become over-extended, particularly in the area of structural policies.[23] The most visible manifestation of the "reach" of Fund programs was the vast array of structural conditions (more than a 100) in the Fund's 1997 program with Indonesia.[24] These included, inter alia: measures dealing with reforestation programs; phasing-out of local content programs for motor vehicles;

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[22] See Goldstein et al [2000a].
[23] See Feldstein [1998].

discontinuation of support for a particular aircraft project and for special privileges granted to the National Car; abolition of the compulsory 2 percent after-tax contribution to charity foundations; development of rules for the Jakarta Clearinghouse; the end of restrictive marketing agreements for cement, paper, and plywood; the elimination of the Clove Marketing Board; the termination of requirements on farmers for the forced planing of sugar cane; the introduction of a micro credit scheme to assist small businesses; and 18 specific follow-up actions to the findings of the audit of Bank Indonesia.

I have recently completed a comprehensive review of IMF structural policy conditionality (Goldstein [2000a]). Among the main findings were the following: (i) structural policy conditionality is a now a common and important element of Fund conditionality; (ii) combining prior actions, performance criteria, structural benchmarks, and program reviews, it has been typical over the past 3 or 4 years for a one-year stand-by arrangement to have about a dozen structural conditions and for a three-year EFF (Extended Fund Facility program) to have on the order of 50 such conditions; (iii) about two-thirds of those conditions fell in the areas of fiscal policy, financial-sector reform, and privitization, with the rest scattered across a fairly wide field; (iv) structural conditions in the Fund's recent programs with Indonesia, South Korea, and Thailand were much more numerous and detailed than is usually the case; (v) there has been a pronounced upward trend in structural policy conditionality over the past fifteen years, and this trend has become steeper in the 1990s; (vi) there has been a shift over time in the instruments used by the Fund to monitor structural conditionality, with resort to structural benchmarks, conditions for program reviews, and prior actions having risen faster than

[24] See Goldstein [2000a].

formal performance criteria; (vii) obtaining compliance with Fund conditionality has been a serious problem (including the Fund's structural policy conditionality), with the compliance rate hovering about 50 percent and falling over time; (viii) for the most part, the Fund's structural policy recommendations reflect the economics profession's consensus of what constitutes sensible policy reform, although some serious mistakes on sequencing have sometimes taken place; and (ix) looking at the Fund's recent experience with structural conditionality as a whole, the Fund has bitten off more --in both scope and detail -- than either it or its member countries can chew. There are limits-- no matter how numerous and detailed the Fund's monitoring techniques -- to how far the Fund can push a country to undertake structural reforms that it is not committed to.

This upward trend in Fund structural policy conditionality owes to many influences. Here, let me just mention seven of the factors discussed more fully in Goldstein [2000a].

(i) In the 1970s and early 1980s, Fund programs came under sharp criticism from many developing countries as being too demand-oriented and too short run, and as not paying enough attention to economic growth, to supply-side reforms, and to income distribution. Since it was developing countries that increasingly constituted the "demand" for Fund resources, neither the Fund nor creditor governments could easily dismiss that criticism. New lending windows with higher structural policy content and with lending terms more favorable to low-income countries were created, and monitoring techniques for gauging compliance with structural policy conditions evolved.

(ii) The huge transformation task faced by the transition economies -- especially in the first half of the 1990s -- made structural policies and the building of a market infrastructure the name of the game in that region. And the IMF (along with the EBRD)

was at the center of the technical assistance and policy lending to those transition economies. Again, structural benchmarks came to be relied upon as a way of monitoring structural policy conditionality across a wide front. When structural problems arose in later crises (Asia), the same monitoring techniques were applied.

(iii) All the while, the Fund was more and more interpreting its mandate as broader than just promoting macroeconomic and financial stability and helping countries to manage financial crises. From the mid-1980s on, economic growth and later, high-quality growth, were given increased prominence. And after the Mexican peso crisis of 1994-95, crisis prevention -- with particular attention to strengthening financial systems at the national level and developing international standards and codes of good practice -- too moved up on the agenda.

(iv) Crises that involve severe balance-sheet problems of banks and private corporations lead to more structural policy intensive Fund programs than do those that stem from traditional monetary and fiscal policy excesses -- and the Asian crises of 1997-98 had those balance-sheet problems in spades.

(v) The long-standing and growing problem of obtaining good compliance with Fund programs led over time to greater reliance on prior actions and to more wide-ranging and detailed structural policy conditions -- presumably in an effort to penalize poor earlier track records, to thwart evasion, and to detect slippage at an earlier stage. The Fund's 1979 Guidelines for Conditionality in stand-by arrangements -- which might have reined-in excessive structural policy conditionality --came to be viewed by the Fund's Executive

Board as broad principles of intention -- not as something to be monitored carefully and enforced.[25]

(vi) In the meantime, a wide array of legislative groups, NGOs, and even other international financial organizations, came to the see an IMF letter of intent as the preferred instrument of "leverage" for their own agendas in emerging economies. Yes, the ILO might be the logical place to push core labor standards but it doesn't have the teeth of an IMF program. Simultaneously, various G-7 governments -- and particularly the Fund's largest shareholder -- were finding it increasingly difficult to get congressional support for "clean" IMF funding bills. Reflecting this congressional pressure from both major parties, the U.S. Executive Director at the Fund has been obliged to support with voice and vote a long list of structural policies (ranging from protection of the environment, to promoting economic deregulation and privatizing industry), and the U.S. Treasury is required to report annually to the Congress on its compliance with relevant sections of the Foreign Operations, Export Financing, and Related Programs Appropriation Act of 1999. Likewise, in countries where there was prolonged use of Fund resources, IMF letters of intent sometimes became an instrument of leverage which the Finance Ministry could use to push structural reforms on other departments in the government that were opposed. In short, everybody has gotten in on the act.

(vii) Unlike other IFIs, the Fund and the World Bank have sufficient "ground troops" to do on-site visits to all countries. In addition, at least in official circles, the Fund has

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[25] Guideline 9 of the 1979 Guidelines states: "....Performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives. Performance criteria will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles.... Performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macroeconomic impact."

developed a reputation as able to act quickly and efficiently. When new structural challenges have arisen, there has therefore been a tendency to say, "give it to the Fund; they go there anyway; have them just add a few specialists on problem x to the mission." And the management of the Fund has apparently not said "no" very often to those demands.

Feldstein [1998] has argued that when the Fund contemplates including a particular policy reform in its programs with emerging economies, it should ask itself two questions: is this reform necessary to restore the country's access to international capital markets; and would the Fund ask the same measures of a major industrial country if it were the subject of a Fund program. If the answer to either question is "no," then that policy should not be part of the Fund program.

The CFR Report [1999] concluded that the traditional separation of responsibilities between the Fund and the World Bank had become blurred in recent years-- to the disadvantage of both institutions and their clients. It recommended that the Fund confine the scope of its conditionality to monetary, fiscal, exchange rate, and financial-sector policies. This is the same "core competence" outlined for the Fund in a recent external review of Fund surveillance by a group of outside experts led by former Bank of Canada Governor John Crow (see Crow et al [1999]). Financial-sector policies (and surveillance) were included in the Fund's mandate under the rationale that banking and financial-sector problems were much more connected than other structural policy areas to the prevention, management, and resolution of financial crises. The CFR Task Force also recommended that the World Bank should concentrate on the longer-term structural and social aspects of economic development and should expand its work on social safety nets. The Bank

should not be involved in crisis management, or in emergency lending, or in macroeconomic policy advice.

As noted earlier, the Meltzer Report [2000] recommended that the IMF cease lending to countries for long-term structural transformation (as in the transition economies) and for long-term development assistance (as in sub-Saharian Africa). It would eliminate the Fund's concessional lending window for poor countries, the Poverty Reduction and Growth Facility (PRGF). Long-term structural assistance to support institutional reform and sound economic policies would be the responsibility of the World Bank and the regional development banks (i.e., the Asian Development Bank, the African Development Bank, and the Inter-American Development Bank).

The U.S. Treasury [2000] opposed the Meltzer Commission's recommendations that the PRGF be closed and that long-term assistance to foster development and sound economic policies be handled exclusively by the World Bank and the regional development banks. It emphasized that poverty reduction in poor developing countries will not occur without economic growth, and that good growth performance in these countries will not take place without sound macroeconomic policies. Since the Treasury saw the Fund's particular expertise in helping countries to set up appropriate macroeconomic frameworks as not being shared by the multilateral development banks (MDBs), it was opposed to transferring this responsibility from the Fund to the MDBs. Moreover, it did not feel that the Fund advice on macroeconomic policy would be influential in poor countries unless it was supported by some Fund lending arrangement. It also hinted that bilateral contributions funding the IMF's concessional lending activities might be cut back to some extent if the IMF were no longer involved in lending

to poor countries. All this being said, the U.S. Treasury [2000] did acknowledge that the IMF's role in concessional lending "... needs to change significantly." (p. 22) Specifically, it called within the PRGF for a clearer division of labor between the Fund and the Bank, with the Fund focusing on macroeconomic policy and structural reform in related areas (tax policy and fiscal management) and with the Bank taking the lead on national poverty-reduction strategies and [other] structural reforms.

For its part, the Fund defends its lending activities to its poor country members. Fischer [2000a] argues that poor countries also have macroeconomic problems and that they have a right like every other member to access the facilities of the Fund. He also maintains the new PRGF will improve lending to the poor countries because it forces the Fund, in cooperation with the Bank, "... to make sure that the macroeconomic framework is fully consistent with what needs to be done for social reasons." (p. 4).

In their report of last summer (July 2000), G-7 Finance Ministers [2000] expressed support for the Fund's role in the PRGF. The Report also noted that the issues dealt with by the Fund and the Bank are increasingly interrelated. It acknowledged that a "... clearer definition of their respective responsibilities and activities" would be desirable but didn't provide any specific suggestions on what this definition should be. Indeed, it pretty much ducked the issue. At their most recent meeting in February 2001 (and the first one to include new U.S. Treasury Secretary O'Neill), G-7 Finance Ministers and Central Bank Governors issued a short communique (G-7 [2001]); under the heading of strengthening the international financial architecture, they looked forward to "further progress on prioritization of IMF conditionality." (p. 2).

Given the long-standing pressures emanating from both industrial and developing economies to use the IMF to pursue wide-ranging goals, the practical difficulties of getting the Fund to focus on a leaner agenda should not be underestimated. Still, there are early signs from both new IMF Managing Director Horst Kohler [2000] and from new U.S. Treasury Secretary Paul O'Neill that they want to get the Fund "back to basics" and to streamline IMF conditionality. If they can sustain that shift in direction, they will deserve our applause.[26] For reasons laid out in both the CFR Report [1999] and the Crow Report [1999], I think the most sensible definition of Fund core competence is monetary, fiscal, exchange rate, and financial-sector policies; the rest should be the comparative advantage and primary responsibility of other IFIs.

I find unpersuasive the argument that if the PRGF were transferred to the World Bank, the Fund would be unable to have a significant influence on the macroeconomic framework in its poorer member countries. If the focus of the PRGF is really on long-term poverty reduction strategies, the Bank should take the lead role (including supplying the financing). To ensure that the Fund's voice on macroeconomic policies is heard loud and clear, the Fund should have a strong "sign off" mechanism. Giving the Bank its own PRGF-type lending window hardly seems a good solution; why does the world need two windows to do nearly the same thing? The institutional specifics of IFI lending facilities need to give way to a sensible and consistent division of labor -- not the other way around.

[26] Also commendable was the decision of the Fund last year to eliminate several lending facilities that were no longer needed (namely, the Buffer Stock Financing Facility, the Currency Stabilization Fund, and the Debt and Debt Service Reduction Facility).

(iii) <u>currency-regime and burden-sharing aspects of Fund conditionality</u> -- Given the crisis events of the past several years, no discussion of Fund conditionality would be complete without addressing currency regime and private-creditor burden-sharing issues.

Among larger emerging economies with relatively open capital markets, the list of those that have been able to maintain a fixed exchange rate for five years or longer is now very short: Argentina and Hong Kong. During the past six years, Mexico, most of the Asian crisis countries, Russia, Brazil, and Turkey (among others) have all been forced to abandon publicly-declared exchange rate targets of one kind or another. The main lesson that has been taken away from this experience is that emerging economies should choose either a regime of managed floating or a "hard peg" (i.e., a currency board or dollarization). Adjustable peg regimes (so-called "soft pegs") are now widely regarded as too fragile for a world of high capital mobility -- both because they offer no workable "exit mechanism" once the fixed rate becomes overvalued, and because there are strict limits to how long emerging economies can keep interest sky high in a currency defense (especially when the country has a weak banking system, or the corporate sector has a high debt-to-equity ratio, or the economy is in recession, or the government has a large fiscal deficit with a lot of floating rate debt). Despite these vulnerabilities, history suggests that some emerging economies will be tempted to try to maintain overvalued soft pegs if they think they can get large-scale IMF or G-7 financial support in a crisis; the Brazilian crisis in early 1999 was a leading case in point.

The Meltzer Commission [2000] recommended that countries avoid pegged or adjustable exchange rates and suggested that the IMF should use its Article IV consultations to make countries aware of the costs and risks associated with pegged or

adjustable rates. The Report states that fluctuating exchange rates or hard pegs would be a better regime choice. It is noteworthy however that the Meltzer Report [2000] did not recommend that the IMF include the currency regime as one of the structural pre-conditions for IMF liquidity assistance, arguing that stabilizing budget and credit policies are far more important than the choice of exchange rate regime.

The CFR Report [1999] concluded that managed floating should be the Fund's main-line currency regime recommendation for emerging economies, with hard pegs also advocated in particular circumstances.[27] It went farther however than the Meltzer Commission. Specifically, the CFR Task Force recommended that the IMF not provide large-scale financial assistance to countries that are intent on defending arguably overvalued fixed exchange rates.[28] In this sense, the CFR Task Force would make exchange rate policy an integral part of Fund conditionality.

The IMF also seems to share this consensus on currency regime choices for emerging economies. Fischer [2000a] noted that all the countries that recently had major international crises had relied on a pegged or fixed exchange rate system before the crisis. He also projected that "... we are likely to see emerging market countries moving towards the two extremes, of either a flexible rate or a very hard peg -- and in the long run, the trend is most likely to be towards fewer currencies." (p. 10).

The U.S. (Clinton) Treasury likewise endorsed the "corners" view of currency regimes for emerging economies. Summers [1999] has stated that countries maintaining a fixed

[27] Under the Fund's existing Articles of Agreement, countries can choose any currency regime (with the exception of linking the currency to gold). But this does not mean that the Fund cannot ask countries to follow a particular exchange rate policy as a condition for Fund financial assistance.

[28] A sizeable minority (11 of 29 members) of the CFR Task Force also took the view that there could no stability for emerging-economy currency regimes and no international financial stability more broadly until there was greater stability in G-3 currency relationships. Toward that end, they proposed a "target zone" plan for the G-3 currencies. The majority of the task force, however, rejected this approach.

rate should be expected to make explicit the extent to which monetary policy is being subordinated to the exchange rate objective, and (if using fixed rates as a tool of disinflation) to disclose the nature of their exit strategy. He concludes that "... countries that are involved with the world capital market should increasingly avoid the 'middle ground' of pegged rates with discretionary monetary policies, in favor of either more firmly institutionalized fixed rate regimes or floating." (p. 4).

In my view, the "corners school" consensus on currency regimes for emerging economies is soundly based on the lessons of experience. The key question is whether the G-7 and the IMF are prepared to act on that recommendation when push comes to shove by not providing large-scale support for defense of overvalued fixed rates. I don't think merely advising emerging economies on choice of regime in Article IV consultations (as recommended by the Meltzer Commission) will get the job done.

On the conceptual level, we also need to understand better why so many emerging economies exhibit a serious "fear of floating," as documented in several recent empirical papers.[29] One explanation is history, that is, a long memory by domestic and foreign creditors of earlier periods of high inflation (and sometimes, also negative or very low real interest rates). This memory can lead private creditors to think that any temporary easing of monetary policy means the authorities are again "off to the races." Brazil's recent post-crisis experience, however, with managed floating cum inflation-targeting and an independent central bank, suggests that history need not be insurmountable. A second and more weighty explanation is that many of these economies have large, unhedged, foreign-currency denominated liability positions on the part of banks and/or corporations; given that mismatch, a large depreciation would make many banks and

firms insolvent, with large adverse effects on the real economy a la the Asian crisis.[30] Here, dollarization is seen as a sensible "second best" policy choice -- given the difficulty of reaching the first best policy, namely, reducing or eliminating the mismatch itself. To me, however, the usual arguments put forward as to why the first-best policy option is not available (e.g., private capital markets will not lend to emerging economies in their own currency) are not convincing. As such, I still regard managed floating -- probably with inflation-targeting as a nominal anchor -- as the preferred choice in most circumstances.

I suspect that the choice between the two corners over the next few years will depend heavily on the real-life experiment now going on in Latin America. If Argentina's currency board eventually disappears because the cost of not having (domestic) monetary policy available to help emerge from anemic economic growth proves too great to bear, then the momentum for currency boards and dollarization will fade in favor of managed floating. On the other hand, if Brazil is unable to sustain its recent progress on inflation and/or the exchange rate runs out of control, then managed floating could well become a relic for most emerging economies. We will see who wins the race; right now, I would bet on the managed-floating horse.

Turning to private-creditor burden-sharing -- or PSI (private sector involvement) -- the aim is to see that private creditors do not escape from paying their "fair share" of the burden of crisis resolution. As outlined earlier, the worry is that if private creditors do not "take a hit" when they make poor lending and investment decisions, there will not be sufficient incentive to undertake more careful risk assessment in the future.

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[29] See, for example, Calvo and Reinhart [2000].
[30] Turkey's banks are also reported to have suffered large losses in the recent (February 2001) depreciation of the lira due to unhedged currency positions.

Judging from a recent Report of G-7 Finance Ministers [2000], recent Congressional testimony by former U.S. Treasury Secretary Summers, and a recent progress report on IFA reform by the IMF [2000}, the official sector (at least in the major industrial countries) felt it has been making real progress on PSI. In this connection, the G-7 Finance Ministers [2000] have noted that "... private sector investors and lenders have been more involved in the financing of recent IMF-led programs." (p. 2). Similarly, in listing recent important achievements on the reform of the IFA (in testimony before the House Banking Committee in March of this year), Secretary Summers stated that "... we have found new ways to involve the private sector in the resolution of crises -- most notably in the cases of Korea and Brazil (pp. 2-3). And an IMF [2000] progress report observed that: "... two recent cases of efforts to secure private sector involvement with members that had lost spontaneous access to capital markets through the restructuring of international bonds had been encouraging" (p. 14); later on, however, that same IMF report also acknowledged that "... only limited progress has been made in lifting institutional constraints to debt restructuring." (p. 17). The references above are to the less than voluntary rollover (albeit with a government guarantee and interest rates 150-200 basis points higher than pre-crisis rates) of interbank credits by G-7 commercial banks in South Korea in early 1998, to the voluntary rollover of interbank and trade lines in Brazil in March 1999, to a tougher initial negotiating stance by the IMF and/or the Paris Club in several recent (1999 and 2000) emerging-market bond restructurings (Ecuador, Nigeria, Pakistan, Romania, and Ukraine), and to rather limited success in encouraging creditor committees and inclusion of "collective-action clauses" (hereafter, CACs) in sovereign bond contracts (at least among the G-7 countries).

Enough to say that some private analysts do not share this (rosy) assessment. Eichengreen [2000], for example, in a recent comprehensive review of PSI over the past few years, concludes that efforts to significantly enhance the participation of the private sector in crisis management and resolution have so far been a "failure" (p. 1). Moreover, the latest IMF International Capital Markets Report [2000] acknowledges that all the recent successful bond exchanges have involved some form of "substantial sweetener" for existing bond holders.

The Meltzer Report [2000] took a decidedly hands-off approach to the PSI issue, nothwithstanding its concern about lender moral hazard. It concluded that: "... the development of new ways of resolving sovereign borrower and lender conflicts in default situations should be encouraged but left to participants until there is better understanding by debtors, creditors, and outside observers of how, if at all, public-sector intervention can improve negotiations." (p. 50).

In contrast, the CFR Report [1999] took a more activist position on PSI. More specifically, the Report recommended: (i) that all countries -- including the G-7 countries -- commit to including CACs in their sovereign bond contracts and require that such clauses be present in all new sovereign bonds issued and traded in their markets; (ii) that the IMF advise all emerging economies to adopt a 'structured early intervention and resolution' approach to deposit insurance reform in their banking systems and reward countries that do so; (iii) that the IMF make it known that it will provide emergency financial assistance only when there is a good prospect of the recipient country achieving 'balance of payments (BOP) viabililty' in the medium term (including a sustainable debt and debt-servicing profile); that, in extreme cases of unsustainable debt profiles, the IMF

expect as a condition for its support that debtors engage in good faith discussions with their private creditors with the aim of reaching a more sustainable debt profile; and (iv) that the IMF recognize that orderly debt rescheduling may be facilitated by having the debtor declare a temporary payments standstill (with the final decision to impose the standstill resting with the debtor country -- not the IMF).[31] The aim of the CFR approach was to reduce lender moral hazard at the national and international level and to promote timeliness and orderliness in private debt rescheduling -- but without going so far as to promote borrower moral hazard.

The IMF, U.S. Treasury, and G-7 Finance Ministers all seem to have favored a differentiated case-by-case approach to PSI, guided by a few principles. They also favor some institutional changes but are not very specific about what they are willing to do to make these changes come about. A recent G-7 Finance Ministers Report [2000] illustrates the point. They say that the IMF should "encourage" use of CACs to facilitate more orderly crisis resolution but don't indicate what form this encouragement should take. Similarly, they say that use of CACs in international bonds issued by emerging economies in G-7 financial markets should be "facilitated" but don't say how. They recommend different approaches on PSI depending on the borrowing country's medium-term debt and balance-of-payments profile. Where that profile is sustainable, they prescribe catalytic official financing and policy adjustment, or voluntary approaches to overcome creditor coordination problems. Where the debt and BOP profiles are not sustainable, a broader spectrum of actions by private creditors -- including comprehensive debt restructuring -- is regarded as appropriate.

[31] Only one of the 29 members of the CFR Task Force (namely, William Rhodes of Citigroup) dissented from the private-sector burden-sharing and CAC recommendations.

Unlike the Meltzer Report, I do not believe that the PSI problem will solve itself in the marketplace. Also, what the official sector does on PSI inevitably influences the balance of power between official debtors and private creditors in debt negotiations (as the IMF implicitly acknowledged in the late 1980s when it finally endorsed selective use of IMF "lending into arrears" to private creditors).

As argued in the CFR Report, I think the G-7 countries will need to be more activist in facilitating wider use of CACs in sovereign bond contracts, as well as in endorsing selective use of temporary standstills. Eichengreen [2000] estimates that at present slightly more than half of all international bonds and about two-thirds of all emerging-market issues do not contain CACs. In recent empirical work (Eichengreen and Mody [2000] and Eichengreen [2000]), Eichengreen also demonstrates that (counter to the claims made by some private-creditor groups, like the Institute for International Finance) neither CACS nor internationally-sanctioned standstills are likely to raise borrowing costs for emerging economies: CACs seem to lower borrowing costs for more creditworthy emerging economies and raise them for less creditworthy ones, while results for cross-country differences in creditor rights suggests that a well-designed IMF-sanctioned standstill would reduce borrowing costs (that is, the prevention of a creditor grab race has a more powerful effect on borrowing cost than the weakening of creditor rights). The decisions by the United Kingdom and Canada to include CACs in some of their sovereign bond contracts is welcome; other G-7 countries should now follow their lead. Standstills could be given some legal force by following the recent proposal of Canadian Finance Minister Paul Martin (Martin [1999]) to require all cross-border financial contracts to include (ex ante) a provision recognizing the Fund's authority to declare a standstill.

While it is true (as emphasized by Frankel and Roubini [2000]) that some recent international bond exchanges for small emerging economies have permitted de facto rescheduling without recourse to CACs (or even in their absence), those exchanges were accompanied by substantial sweeteners to creditors; in addition, in those cases where CACS were present, the implicit threat of invoking them may have facilitated the (voluntary) exchange.

I also continue to believe that PSI will not be successful until there is an agreement to limit the size of IMF rescue packages (for non-systemic cases), until the official sector insists (in cases of unsustainable debt profiles) on appropriate debt restructuring with private creditors as a condition for IMF financial support, and until most emerging economies have in place "good" deposit insurance systems. While it's true that small(er) rescue packages may not quell an investor panic, neither is it asssured that large rescue packages (in the politically-feasible range) will do so, and smaller packages at least introduce PSI in a direct way. Although initial IMF efforts in Romania and the Ukraine to condition its support on PSI were unsuccessful, this tells us relatively little about prospects for success in larger emerging-market economies where the stakes for private creditors would be bigger. Finally, most lender moral hazard occurs at the national level -- not at the international level, and this will continue until "good" deposit insurance systems and other elements of an incentive-compatible financial safety net are in place.[32]

(iv) implementation of international financial standards -- It is widely recognized that the elements of IFA reform discussed thus far in this paper are not likely to have much of

[32] By a "good" deposit insurance system, I mean one that puts large uninsured creditors of banks at the back of the queue when failed banks are resolved, that places stringent accountability conditions on senior economic officials when they invoke "too large to fail," and that gives banking supervisors better protection against strong political pressures for regulatory forbearance.

an impact on crisis prevention in emerging economies unless those economies also undertake a broad and determined effort to strengthen their domestic banking and financial systems. After all, over the past 15 years, there have been more than 65 episodes where banking problems in emerging economies got so bad that the entire banking system was rendered insolvent. In the Asian crisis countries, we are now looking at fiscal costs of bank recapitalization that range from 10 to 60 percent of GDP.[33]

One of the key mechanisms being used to guide this upgrading of financial systems in emerging economies is international financial standards. Each of these standards is drawn by an international group of experts and represents agreement on what are minimum requirements for good practice. The Financial Stability Forum (FSF) has now decided that 12 of these standards are crucial for sound financial systems and deserve priority implementation. The 12 key standards (known as the "Compendium of Standards") cover: data dissemination; banking supervision; insurance supervision; securities regulation; insolvency regimes; corporate governance; accounting; auditing; payment and settlement; market integrity; fiscal policy transparency; and monetary and financial policy transparency.

Establishing standards is one thing. Getting countries to implement and enforce these "voluntary" standards is another. In seeking to identify incentives that would speed the implementation of international financial standards, the official sector has relied on two channels.[34]

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[33] See World Bank [2000].

[34] Originally, there was also to be a third incentive channel, namely, linking implementation of international financial standards to preferred risk weights in the revised Basle Capital Accord. I understand, however, that this idea has recently been shelved.

First, there is the expected market pay-off. If market participants can tell who is and who is not implementing the standards and if complying countries are regarded as more creditworthy, then the latter should be the beneficiaries of a lower market cost of borrowing. Early on, there was some hope that the private credit rating agencies might take up the task of evaluating compliance with standards and publish the results. That has not happened. Instead, it is the official sector -- and primarily, the IMF -- that has taken the lead in this process. A few examples illustrate the process. The Fund now posts on the internet the list of countries that have signed on to the data dissemination standard. Similarly, for the banking supervision standard, the Fund prepares Reports on the Observance of Standards and Codes (ROSCs); so far, ROSCs for about 15 countries have been completed and another 20 or so are under preparation. Both the decision to have a ROSC and to have the report published are at the discretion of countries; the majority of completed ROSCs have been published. The Fund and the World Bank jointly produce Financial Sector Assessment Programs (FSAPs) that evaluate financial-sector vulnerabilities as well as assess compliance with those financial-sector standards that affect stability. World Bank staff expect to have about six corporate governance and six accounting reports available soon.[35]

Two factors have constrained the market pay-off channel. One is the concern that naming publicly the non-complying countries could precipitate runs or crises. Recently, however, that concern appears to be waning. Within the past few months, the FSF published the list of offshore financial centers whose regulatory and supervisory practices are regarded as "lax;" the OECD named jurisdictions that promote harmful tax competition; and the Financial Action Task Force identified 15 jurisdictions that were

[35] See IMF [2000].

judged to be uncooperative in the fight against money laundering. This recent public "naming of names' could be ushering in a more aggressive stance by the official sector. The other constraint is that evaluation of compliance in areas outside the competence of the IMF and the World Bank presupposes a good deal of inter-agency cooperation and coordination. This still remains a bottleneck.

The second incentive channel for implementation of financial standards is the Bretton Woods channel. More specifically, the IMF and the World Bank could give those countries implementing the standards a better insurance deal (larger access or lower interest rates) when they needed financial assistance. This still appears to be on the drawing board. Implementation of financial standards is supposed to be one of the eligibility factors for accessing the CCL, but as mentioned earlier, no country has yet applied for CCL assistance.

The U.S. Treasury and the G-7 Finance Ministers appeared be on the same page on where they wanted to go with the standards. In brief, they were encouraging countries to sign up for assessments of compliance with the standards and to allow the results to be published; in addition, they were encouraging the IMF to identify which standards should have the highest priority for which countries. They were also asking the FSF to see if there are farther supervisory and regulatory incentives that would promote observance of the standards.

The Meltzer Report [2000] took a different tack. It recommended that financial standards should be set by the Bank for International Settlements (BIS) and that implementation of standards, and decisions to adopt them, should be left to domestic

regulators and legislators. Perhaps they were relying on regulatory competition to eventually induce reform.

In contrast, the CFR Report [1999] called on the IMF to monitor countries compliance with standards (at least the ones that fall into its core competence) and to charge lower interest rates to countries that make better crisis-prevention efforts, where implementation of standards would be one of the key elements in “crisis prevention efforts.” Furthermore, the Report urged that this risk-based insurance premium apply to all the Fund’s non-concessional lending -- not just to the CCL. In addition, the CFR Task Force recommended that the Fund publish its evaluations of compliance with standards so that the markets could take note.

Implementation of international financial standards is one of the areas in IFA reform that has shown the most progress over the past few years.

Any recommendation to have domestic regulators act as the sole evaluator of compliance with standards is a bad idea. It is very unlikely that such self evaluations will be objective rather than self serving. In this connection, a survey sent to 129 countries in 1996 by the Basel Committee on Banking Supervision is instructive; on element after element of banking supervision (from government-directed lending, to loan classification procedures, to independence of the supervisory agency... on and on), a very high proportion of respondents ranked themselves as doing a very good job -- and this despite the sorry record of banking crises over the preceding twenty years, to say nothing of the banking crises to come (just a year or so after the survey) in Asia;[36] I understand that a more recent Basle Committee survey again demonstrated the strong bias in self-evaluation. Assessment of compliance with international financial standards should

continue to be done by (more objective) international agencies with the relevant expertise --at least until the private sector is prepared to take up that task in a serious way. The recent decisions by the FSF and other official agencies to publicly "name names" of non-complying economies suggests that they have "crossed the Rubicon" on this issue. This should increase the market payoff to implementing the standards.

The next bottlenecks that need to be tackled are better coordination among the evaluating agencies, and making the private sector -- and particularly the major rating agencies -- more familiar with the official evaluations. It would be very helpful to have assessments on key standards collected and published in one place, say in the IMF's Article IV consultation report. In addition, the IMF, World Bank, and the FSF should increase efforts to publicize their evaluations; until the rating agencies and other market participants become convinced that such (official) evaluations of compliance are useful in evaluating creditworthiness, their impact on market borrowing costs will be minimal.

V. Concluding Remarks

More has been happening on reform of the IFA over the past five years than many people think. But progress has been quite uneven. Progress has been considerable in the setting and implementation of international financial standards. Currency regimes for emerging economies have likewise improved, although that has been forced by the market -- not by the official sector. The redesign of Fund lending facilities is also moving in the right direction. Much less progress has been made, however, on discouraging currency mismatching, on PSI, and on refocusing the mandates of the IMF and the World Bank. That is where the priority needs to be over the next year or two.

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[36] See Goldstein [1997] for a discussion of the survey results.

One of the key lessons that we should take away from the emerging-market financial crises of the past seven or eight years is that a 30 percent plus devaluation is a very different animal when banks and corporations have large currency mismatches that when they do not. One only has to compare the widespread insolvencies and deep output losses in the Asian and Mexican crises on the one side (where currency mismatches were large prior to devaluation) with the more moderate effects during the Brazilian crisis on the other side (where mismatches were much smaller) to see what difference it makes to the bottom line. Moreover, wherever large currency mismatches exist, there will be understandably be great reluctance to accept a large devaluation even when the real exchange rate is significantly overvalued, thereby often making the final exchange rate adjustment even larger.

Discouraging currency mismatching is particularly challenging for private-sector borrowing. Whereas an enlightened government debt manager may be able to internalize the externalities associated with unhedged foreign-currency borrowing, private-sector actors often see it differently. If others are availing themselves of lower interest rates on foreign-currency denominated debt, competitive pressures may tempt them to do so as well; in addition, there is always the possibility that losses on foreign-currency borrowing induced by a devaluation may be bailed-out by the authorities (especially if the borrower is a bank).

Most of the antidotes for the currency mismatching problem proposed so far (that is, dollarization, prohibiting foreign-currency denominated loans, and making such obligations unenforceable in domestic courts of developing countries) seem to me to be

either too costly and/or too drastic.[37] I would rather see more emerging economies follow Mexico's recent lead by combining a managed floating rate with active development of hedging mechanisms. In addition, every request for an IMF program should contain data on existing currency mismatching by the banking and corporate sectors, analysis of the sustainability of these mismatches (including scenarios of what the consequences of a devaluation would be), and explicit conditions for reducing the mismatch (if the existing and/or prospective mismatch is judged to be too large). Furthermore, in either its International Capital Markets Report or its World Economic Outlook, the IMF should be drawing attention (on a regular basis) to currency mismatch figures for all countries that have significant involvement with private international capital markets; some of that kind of analysis has appeared in recent issues of the Bank of England's Financial Stability Review and it could be extended by the Fund. The more that private market participants are aware of the magnitude of currency mismatching, the better the chances that market pressures would be brought to bear to reduce it before a crisis takes place.

Turning to PSI, the analysis in Section IV suggests that there could be large dividends to putting in place an incentive-compatible system of deposit insurance for banks in emerging economies, to cutting back on the size of IMF rescue packages for non-systemic crises, and to encouraging greater use of CACs and (in extreme cases) internationally-sanctioned standstills as well.

The former Managing Director of the Fund, Michel Camdessus was fond of saying, "The Fund should do more and do it better." I would argue the Fund should do less so

[37] For analysis of the currency mismatching problem and what to do about it, see Dooley [1999] and Krueger [2000].

that it can do it better. Comparative advantage should apply to the IFIs as well as to their member countries.

A way needs to be found to resist the constant calls on the Fund to become a "general purpose organization." Its core competence in monetary, fiscal, exchange rate, and financial-sector policies should be protected; this will require the cooperation of the membership -- and particularly of the largest shareholders. It will also require firmness from the Fund's new Managing Director. If IMF structural conditionality is to be streamlined, Fund management will have to say "no" more than in the past -- to requests for Fund assistance where the expectation is low that the country will implement Fund policy conditions, to G-7 governments when they propose new tasks for the Fund that go beyond the Fund's core competence, to NGOs that seek to use a country's letter of intent with the Fund to advance agendas that (even if desirable) lie outside the Fund's mandate, and to developing-country finance ministers that want to use micro conditions in Fund programs to impose spending discipline on other government ministries that could not be agreed in their national legislatures. None of this means that the Fund should not take account of social needs in its programs or that the Fund cannot provide good service to its poorer member countries (any more than making price stability the key objective of central banks means that they should ignore the real economy or financial stability). But it does mean that both the Fund and the World Bank have to allow their 19th Street partner to lead in the areas of its comparative advantage, as well as rationalize their lending windows.

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