

---

## Halifax II Reforms

There is nothing like a crisis to motivate a rethink of the adequacy of the existing crisis prevention/management architecture. In this sense, the Mexican peso crisis helped to motivate progress on, *inter alia*, an international data standard (the IMF's Special Data Dissemination Standard [SDDS]), an international banking standard (the Core Principles), an Emergency Financing Mechanism in the IMF, and expanding the credit facilities available to the IMF under the New Arrangements to Borrow.<sup>1</sup> In a similar way, the Asian financial crisis is already motivating—and will continue to motivate over the next few years—discussions about how to reform the international financial architecture. As these Halifax II discussions proceed, the following five issues ought to receive priority: (1) reducing moral hazard and making private debt rescheduling more orderly and more flexible; (2) strengthening prudential standards in developing countries and making it more attractive for countries to implement these standards sooner; (3) improving transparency and disclosure in financial markets; (4) giving IMF surveillance more punch; and (5) shoring up risk management in global financial institutions.<sup>2</sup> I turn next to each of these issues.

---

1. See Summers (1996).

2. Some would even go farther and add a review of G-3 exchange rate policy to the agenda. I have given my thoughts on what could realistically be done in this area in Goldstein (1995). Volcker (1997) offers another view on this matter.

## Moral Hazard and Debt Rescheduling

Finding a way to reduce moral hazard and to make the rescheduling of private external debt more orderly should top the agenda. Because these moral hazard and rescheduling issues were not well thought out prior to the current crisis, official rescue packages turned out to be much larger than anyone anticipated, with longer-run moral hazard effects being held hostage to short-term (but admittedly important) financial stability concerns. Although bank debt starts out in the private sector, it often winds up in the official sector, bringing with it all the problems associated with rescheduling sovereign debt. It is not inevitable that such official rescue efforts result in certain private lenders escaping their fair share of the adjustment burden.

One step in a helpful direction would be to seek *international agreement* that in future IMF-led rescue packages that involve restructuring of the financial sector, *governments cannot expect "blanket-guarantee announcements" (issued before the IMF arrives on the scene) to be honored.* As noted above, such blanket guarantee statements were issued by both the Thai and South Korean authorities. Once such statements are made, they place the IMF and creditor countries in a bind. If the guarantees are honored, then the case history of official bailouts gets another entry, and it becomes that much more difficult to convince private creditors that "next time things will be different." On the other hand, if the guarantee statement is rescinded, it reduces the credibility of national authorities when that credibility is important for convincing the market that their future statements will be honored. The answer is to obtain international agreement that the treatment of large, uninsured creditors of private firms (including banks) is part and parcel of the conditionality associated with such programs and that the scope and duration of any guarantees (that extend beyond small depositors of banks) are to be negotiated with the IMF.

A second key step is to encourage emerging economies to *adopt a system of deposit insurance that is incentive compatible and that places large, uninsured creditors of banks in the back of the queue when failed banks are resolved.* In this connection, there is a good deal that can be exported from the features contained in recent US banking legislation, namely, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.<sup>3</sup>

Several features of FDICIA are relevant for how emerging market economies should design their official safety nets. For one, FDICIA retains deposit insurance for small depositors (up to a maximum of \$100,000 per depositor).<sup>4</sup> The rationale for such insurance is that it is small retail

---

3. For a comprehensive discussion of the rationale for FDICIA, as well as for a review of its performance, see Benston and Kaufman (1988, 1997) and Feldman and Rolnick (1998).

4. FDICIA also specifies that the deposit-insurance premiums paid by banks be risk weighted (depending on their capital and bank examination ratings), although debate continues on

depositors who are least likely to be able to ascertain the true financial condition of banks and thus who are most likely to engage in *uninformed* bank runs. It might also be said that because such small depositors are so numerous, they are likely to have enough political clout to get paid off after a crisis anyway, and deposit insurance at least sets out a maximum on that payout. According to a 1996 survey by Garcia and Lindgren (1996), only about 50 of the IMF's 180 member countries had explicit deposit-insurance systems in place (see table 14), and even among those countries that had such systems, departures from best practice were common.<sup>5</sup>

Even more to the issue at hand, FDICIA makes it harder for regulators to bail out large uninsured creditors of banks. Specifically, FDICIA requires that the FDIC evaluate all possible resolution alternatives and pick the one that carries the lowest cost to the deposit-insurance fund (so-called "least cost resolution"). There is a discretionary systemic override provision to fully protect all bank creditors in exceptional circumstances (that is, in banks deemed "too big to fail"), but that override requires the explicit consent of the secretary of the treasury in consultation with the president of the United States, two thirds of the governors of the Federal Reserve System, and two thirds of the directors of the FDIC. While FDICIA has not been in effect long enough to fully test its mettle, the preliminary evidence is encouraging in the sense that the coverage of uninsured depositors at failed banks has been much lower post-FDICIA (1992–96) than it was pre-FDICIA (1986–1991); see figure 1, taken from Feldman and Rolnick (1998).

Other features of FDICIA worth mentioning are that banks become subject to progressively harsher regulatory sanctions as their capital falls below multiple capital-zone trip wires (so-called "prompt corrective action"), well-capitalized banks receive "carrots" in the form of greater banking powers and lighter regulatory oversight, and there is an explicit exit rule for banks that calls for closure of a bank while it still has positive net worth.

Some have argued that with consolidation producing more and more large banks, even FDICIA doesn't go far enough in mandating that large uninsured creditors of failed banks take a haircut. Feldman and Rolnick

---

whether the differences across banks in these risk weights are sharp enough (see Benston and Kaufman 1988, 1997). Other countries with risk-adjusted deposit-insurance premiums include Argentina, Portugal, and Sweden (see Garcia 1998).

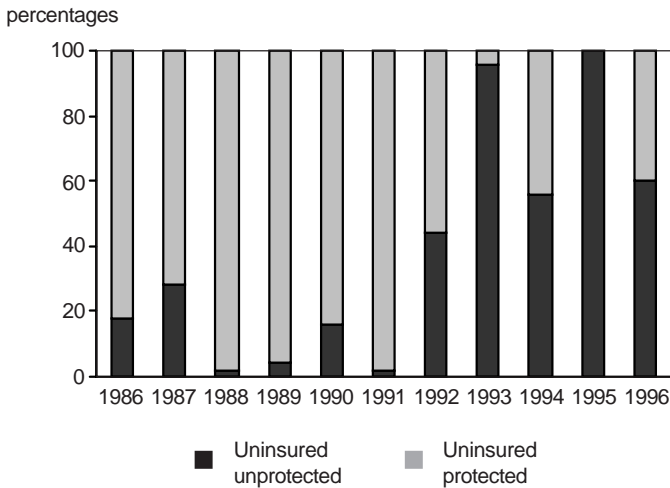
5. Garcia (1998) provides a listing of best practice for deposit insurance systems. In addition to avoiding incentive problems, her list includes, *inter alia*: laying out the system explicitly in law and regulation; providing the banking supervisor with a system of prompt remedial actions; resolving failed depository institutions promptly; keeping insurance coverage reasonably low (e.g., not in excess of one to two times per capita GDP); making membership compulsory (to avoid adverse selection problems); paying out insured deposits quickly; charging risk-adjusted insurance premiums; and ensuring that the deposit insurance agency is independent.

**Table 14 Countries with explicit deposit insurance systems**

<b>Africa (4)</b>	<b>Asia (7)</b>	<b>Europe (23)</b>		<b>Middle East (4)</b>	<b>Western Hemisphere (12)</b>
Kenya	Bangladesh	Austria	Italy	Bahrain	Argentina
Nigeria	India	Belgium	Luxembourg	Kuwait	Brazil
Tanzania	Japan	Bulgaria	Netherlands	Lebanon	Canada
Uganda	Marshall Islands	Czech Republic	Norway	Oman	Chile
	Micronesia	Denmark	Poland		Colombia
	Philippines	Finland	Portugal		Dominican Republic
	Taiwan	France	Spain		El Salvador
		Germany	Sweden		Mexico
		Greece	Switzerland		Peru
		Hungary	Turkey		Trinidad and Tobago
		Iceland	United Kingdom		United States
		Ireland			Venezuela

Source: Garcia (1998).

**Figure 1 Failed commercial banks by uninsured depositor treatment, 1986-96**



Source: Federal Reserve Bank of Minneapolis, 1997 Annual Report; Federal Deposit Insurance Corporation.

(1998), for example, have argued that FDICIA should be amended to guarantee that uninsured depositors cannot be fully protected when “too big to fail” is invoked. This could be implemented by specifying that uninsured depositors experience a threshold loss before they receive any protection (e.g., 20 percent of their uninsured deposits).<sup>6</sup> In addition to “coinsurance” of losses at too-big-to-fail banks, Feldman and Rolnick (1998) propose that deposit-insurance premiums paid by banks incorporate the risk premiums that depositors and other creditors receive in the market on their uninsured funds and that the regulators require the disclosure of additional data (e.g., on loans with late repayments) on banks’ financial condition.

I am not suggesting that emerging economies copy exactly the US model. But they do need some type of (preagreed) mechanism that creates a strong presumption that when serious banking difficulties erupt, large uninsured creditors are going to be placed in the back of the queue, and that when they are protected during truly exceptional circumstances, there will be stringent accountability and transparency conditions on the part of the most senior economic officials. The point is not to ignore legitimate concerns about systemic stability but rather to reach a better compromise between the tools that will be available (to firefighters) for putting out

6. Reflecting wider systemic concerns, Feldman and Rolnick (1998) also argue for a “cap” and a “floor” to these losses for uninsured depositors at too-big-to-fail banks.

the current fire and the incentives needed to make the next set of fires smaller and less likely.

Step number three goes in a similar direction of *limiting the scope and duration of the official safety net*. The rationale for official liquidity support of financial institutions rests on a difference between social and private returns. The social return to rescuing finance companies and merchant banks will normally be weaker than that for rescuing banks. The former, for example, are not usually involved in the operation of the payments system; moreover, they often become a vehicle in emerging markets for engaging heavily in higher-risk activities because of their lighter regulatory burden vis-à-vis banks. Just as uninsured wholesale creditors should normally be expected to take a larger hit than insured retail depositors during a crisis, there should be an *agreement that countries receiving official rescue packages will not extend protection to finance companies and merchant banks*. Extending the same line of argument, the official safety net should not encompass nonfinancial corporations.

Much in the same spirit of limiting inappropriate extension of the safety net, in cases where countries do decide to provide guarantees to banks during a crisis (the above arguments notwithstanding), there should be a presumption that *any guarantees will carry a strict time limit, say, no more than one year*. Again, there may be individual-country circumstances where exceptions to this presumption can be justified—but the burden of proof ought to be placed on the borrowing country to convince official lenders of the exceptional nature of its predicament. All guarantees should not be regarded equally: long-running ones should be subject to even greater scrutiny than triage operations.

Yet a fourth helpful step would be to *bring more order and flexibility into the rescheduling of private external debt*. One of the important lessons of the 1980s debt crisis is that long delays in reducing a large debt overhang (that is unlikely to be paid in full anyway) can seriously exacerbate the effects of the crisis on the real economy.<sup>7</sup>

To bring greater order into the debt rescheduling process, governments (as well as large financial firms) should make it their responsibility to have comprehensive and up-to-date figures on the size and composition of external debt, along with the identity and concentration of major creditors. Rescheduling operations cannot proceed efficiently if there is a weak factual basis to evaluate the size of the debt burden and the extent of the cash-flow problem and if there is uncertainty about the practicality of drawing the major creditors together for a discussion. As noted later in this chapter, the incentive to collect and maintain such data can be increased by strengthening the IMF's SDDS.

---

7. See Corden and Dooley (1989). Cline (1995) is more skeptical about the size of any debt overhang effects on the real economy.

Beyond this, the orderliness of private debt rescheduling would be well served by promoting better organization of creditors in advance, and by making adaptations to debt contracts that can help overcome collective action problems. Specifically, there is merit in the proposals put forward by Eichengreen and Portes (1995, 1998) to have *standing steering committees for bond holders and to include sharing clauses and majority voting clauses in these debt instruments*. The idea here is to avoid the costs and delays of organizing creditors on the spot and to make it more difficult for rogue creditors to block rescheduling efforts.

In the G-10 report (1996), the official sector expressed some support for adaptation of debt instruments but would not go so far as setting an example by including majority voting provisions in its own sovereign bond contracts. It preferred instead to wait for the market to lead the way. But as noted earlier (Eichengreen and Portes 1996; Goldstein 1996), this market-led adoption may never come if only bond contracts of less creditworthy borrowers contain such clauses. For in that case, the very presence of the clause may be taken by the market as a signal of a greater intention to renegotiate. In view of the importance of debt rescheduling in the Asian crisis, the G-10 ought to reexamine its earlier position, eliminate the adverse signaling problem, and lead the way by incorporating desirable innovations in its own instruments.

In terms of enhancing the flexibility of debt rescheduling and encouraging private creditors to assume their fair share of the adjustment burden, here too there are helpful changes that can be made at the margin. For the most part, these involve the *official sector in the major creditor countries making it clearer that it will adopt a more benign view of informal debt standstills, of early proposals for debt-for-debt and equity-for-debt exchanges by the debtor, and of IMF "lending into arrears"—so long as these measures are confined to cases where the debtor is truly laboring under a crisis situation cum an unsustainable debt burden and where the debtor has negotiated in good faith with its private creditors.*<sup>8</sup> In the case of IMF lending into arrears, the debtor country

---

8. A policy of having the IMF lend into arrears on private debt does not just affect the balance of power between debtors and creditors in the debt negotiation. It also provides important "debtor in possession" financing for the debtor country; see Calvo and Goldstein (1996). The view of G-7 governments on debt negotiations between debtors from developing countries and financial institutions from G-7 countries can have important effects on the outcome of these negotiations. An outstanding example was the impetus given to debt reduction in the 1980s when the G-7 switched from the Baker Plan to the Brady Plan (see Cline 1995).

As an example of such a flexible approach to rescheduling of private debt, Litan (1998) has proposed a strategy of triage, liquidation, and workouts to handle the private debt overhang in the Asian crisis countries. The first step would be to have each country establish a mechanism for performing triage on all firms and banks facing bankruptcy, using an exchange rate below the precrisis level but above current, excessively depressed market levels. Step two would be to subject all firms and banks that are insolvent under this exchange rate by some threshold margin to a presumption of liquidation or forced merger,

should also of course be meeting its policy commitments under an IMF program. Where decent national bankruptcy laws don't exist, the general stance of the IMF and G-7 governments should be not to oppose ad hoc debt-negotiation proceedings and outcomes that mimic what might be expected to have taken place if such bankruptcy laws were in place.

The intention here is not for the official sector to encourage private debtors to walk away from their contractual obligations at the first hint of trouble. It is rather for the official sector to set itself a higher systemic-risk threshold before it intervenes (with additional liquidity support) as a substitute for beginning debt rescheduling negotiations between private debtors and private creditors. If the official sector in the G-10 countries alternatively sends a signal that such reschedulings and IMF lending into arrears are options that need to be avoided at almost all cost (because, say, of the perceived danger of contagion), then it will be hard to convince private creditors that it is in their interest to push for a prompt resolution. In other words, private debt reschedulings need to be accepted more readily by the official sector as a normal response to truly abnormal circumstances; otherwise, there will be little alternative to placing too much of the adjustment burden on all parties other than private creditors.

This view would not preclude the official sector (both national governments and the international financing institutions [IFIs]) from acting as an "honest broker" if a large share of the banking system or the corporate sector is facing liquidity/solvency problems. In this role, the official sector could assist the negotiating parties in bringing together the necessary factual data, provide an objective assessment of the likely impact on the economy of various debt rescheduling options, and try to keep the discussions from becoming too confrontational.

To sum up, finding a more orderly and flexible approach to the rescheduling of private external debt is the only way to get back to a situation where official rescue packages are of a reasonable size and where market discipline operates across a broader spectrum of emerging-market financial instruments. Such an approach does entail the risk that, once started, crises may be harder to manage than when large-scale bailouts and guarantees are a large part of the arsenal. But that is the risk that has to be taken to limit incentives that would otherwise increase the likelihood of more and larger crises in the future. The reality is that the Asian crisis will not be resolved until the heavy short-term debt burden of banks and

---

unless creditors quickly accept an equity-for-debt swap. And step three would be to make all insolvent firms and banks not subject to liquidation (or below regulatory capital standards) eligible for Chapter 11-type workouts, with lenders required to exchange some portion of debt for equity. Foreign banks would automatically take haircuts. In lieu of a equity-for-debt exchange, governments would only extend guarantees on loans once they've been partially forgiven. Litan (1998, 8) concludes that such an active liquidation and workout plan "would send a message to all creditors that the days of too big to fail are over and that pain must be widely shared if all are to feel comfortable with the outcome."

corporations in the crisis countries is rescheduled or turned into equity. The sooner creditors accept that reality, the better.

## Prudential/Supervisory Standards

A second key item on the Halifax II agenda should be *strengthening prudential/supervisory standards in emerging economies and improving the incentives for their early adoption*. Because banking crises in emerging economies have been so frequent and so costly over the past 15 years and because banks account for the lion's share of financial assets in these economies, the emphasis should be on moving more countries more quickly toward an international banking standard.<sup>9</sup>

In September 1997, at the Annual Meeting of the IMF and World Bank group in Hong Kong, agreement was reached on the Core Principles (Basle Committee on Banking Supervision 1997). Warts and all, the Core Principles represent a welcome and significant advance on what existed before in international banking supervision. Previous agreements had a narrow scope, that is, they were pretty much restricted to defining regulatory bank capital and to encouraging better cooperation between home- and host-country bank supervisors.<sup>10</sup> The Core Principles are much more comprehensive and address many of the problems that had plagued, and still continue to plague, banking supervision in developing countries. Over the next six months to a year, attention should be directed to two sets of initiatives: making it more attractive for countries to publicly sign on the Core Principles and improving the content of the Core Principles themselves.

While last September's agreement on the Core Principles urged countries to make public their intention to implement this voluntary international banking standard, the agreement unfortunately did not contain a target date for such participation. This was a mistake that should now be rectified. *A target date (for announcing who is and is not complying with the standard) is essential to help to motivate the implementation of the Core Principles*. Ask yourself: how far would the EU countries have come on fiscal consolidation without the spur that entry decisions would be taken by a date certain, namely, early 1998? Similarly, would APEC's 1994 pledge to achieve "free and open trade and investment in the region" have credibility without an explicit 2010 date for industrial countries and a 2020 date for the others?<sup>11</sup> Or, to take an even closer example, why does

---

9. See Goldstein (1997a; 1997b) and Goldstein and Turner (1996).

10. See Goldstein (1997a) for a fuller discussion and critique of previous international banking agreements.

11. See Bergsten (1996).

the IMF's SDDS carry a cut-off date by which countries have to announce their adherence to the standard? The answer is that a target date serves as an action-enforcing mechanism for getting policymakers to take their commitment seriously. In this respect, the Core Principles are no different than other international or regional agreements. Given the magnitude of the task ahead in many developing countries to meet the conditions for the Core Principles, it would in my view be reasonable to set a five-year-hence target date (2003 or so). Some may prefer a slightly shorter or longer target date. But a date certain is a must.

Two other initiatives would reinforce the incentives countries have to sign on to the Core Principles. One would be to *strengthen the mandate that the IMF and the World Bank have in monitoring countries' compliance with the Core Principles*. Because participation is voluntary, the main payoff from participating in the standard is the market payoff (that is, a lower risk premium) attached to having the authorities certify that banking supervision in a country meets minimum international standards. We cannot rely on the national banking supervisor alone to render that judgment because a weak and nonindependent supervisory authority is part of the problem in many developing countries. Having an international agency evaluate compliance with the Core Principles will carry more credibility than evaluation done exclusively by national banking authorities.<sup>12</sup>

Admittedly, the expertise of the IMF and the World Bank on banking supervision is not as deep and broad as it is in their more traditional areas of specialization. Nevertheless, they both have experienced staff in the banking area, and efforts to recruit and train more experts are reportedly moving ahead full steam. Also, an effective monitoring job requires ground troops cum on-site visits, and the Bretton Woods twins are the only IFIs that have enough ground troops to do the job.<sup>13</sup> Over time, it may be that the private rating agencies will see it in their interest to make compliance with international banking standards a regular part of their sovereign risk analysis—but for now, we have to rely on the IMF and the World Bank to get the ball rolling.

As of late, there has been active debate on a proposed amendment to the IMF's Articles of Agreement that would make capital account liberalization a purpose of the IMF and that would extend the IMF's jurisdiction to capital movements.<sup>14</sup> In my view, a better tack—if one wants any major expansion of IMF activities to be anchored in the IMF's articles—would be to make financial stability (rather than capital account

---

12. See Goldstein (1997a, 1997b).

13. The BIS has significant expertise in banking and banking supervision matters but its staff is far too small to take on a monitoring task of this scale.

14. See Fischer (1997).

liberalization) the focus of an amendment.<sup>15</sup> I say this for two reasons. The first is that there is greater consensus on the need for developing countries to establish a strong supervisory and prudential framework than there is on the wisdom of pushing ahead with capital account liberalization. For example, you don't hear of emerging economies who allegedly fared better during 1997 because they weakened their systems of banking supervision. Second, it is becoming widely accepted that inadequate preparation is the main reason why some many financial crises in developing countries have been preceded by capital account liberalization, and establishing a sound supervisory framework is probably the single most important element of that preparation.<sup>16</sup> In other words, a financial stability element, in addition to its own merits, would contribute to advancing the long-run goal of capital account convertibility while avoiding many of the operational pitfalls associated with a capital account amendment (for example, permitting or even counseling developing countries facing large capital inflows to consider adopting "Chile-type" taxes on short-term capital inflows—at the same time that these countries are being asked to move in the longer term toward dismantling capital restrictions).

In addition to the market payoff, a *second incentive* to sign on to the Core Principles could be linked to *larger access to IMF and World Bank loans*. As suggested in Calvo and Goldstein (1996), the IMF and the World Bank could make the degree of access to their resources more dependent on the crisis-preventive measures taken by countries, including their adherence to international banking and data disclosure standards.<sup>17</sup> Countries that did less to reduce their vulnerability would still be able to draw, but their access lines would be smaller. This would help to reduce moral hazard on the borrower's side from IMF-led rescue packages.

So much for the incentives to upgrade supervisory and prudential standards in emerging economies. Progress would also be furthered by *sharpening and extending the content of the Core Principles in three directions*.

For one thing, the Core Principles should set out a *tougher line on greater transparency for government involvement in the banking system*. It's not adequate simply to say that state-owned banks should be subject to

---

15. It is my understanding that the April 1998 meeting of the IMF's Interim Committee took up this issue.

16. See Kaminsky and Reinhart (1996) on the statistical link between banking crises and financial liberalization in developing countries. See Williamson and Mahar (1998) on the lessons of financial liberalization.

17. Rubin (1998) also suggests that the IFIs should consider conditioning access to loans on countries' willingness to improve their transparency. In addition, he notes that authorities in the major countries could consider making access to their markets by foreign banks conditional on a strong home-country supervisory regime (as demonstrated by adherence to the Core Principles). On the latter point, I suspect that the actual leverage associated with such bilateral actions will be less than it seems; see Goldstein (1997a).

the same supervisory standards as private-sector institutions. Even when the government doesn't own banks, it often exerts a large adverse influence on credit decisions. The reason governments channel assistance to ailing industries via the banking system rather than on the government budget is that the former is less visible to the public.<sup>18</sup> Minimum transparency guidelines would take away much of that incentive.<sup>19</sup> As the Asian financial crisis has demonstrated, if nothing is done to alter the incentives for excessive government ownership and involvement in the banking system, an important source of large credit losses is likely to escape proper supervision.

A second useful revision to the Core Principles would be to alter the capital adequacy guideline for banks. The Core Principles urge countries with volatile operating environments to consider imposing higher capital requirements than the 8 percent risk-weighted minimum. But experience has shown that this advice has seldom been taken. Taken as a group, emerging-market economies have not yet set national capital requirements much above the Basle minimum, nor do their banks typically actually hold capital much above those in countries with much more stable operating environments.<sup>20</sup> The present approach gives the same risk weight to a commercial loan in say, Venezuela as it does to one, say, in the United States (despite the greater risk associated with the former). The *preferred approach should be to treat regulatory capital for credit risk much closer to the way regulatory capital is treated for market risk, that is, closer to a portfolio, "value at risk" approach*; this should produce more sensible capital requirements for countries facing higher risk.<sup>21</sup>

Yet a third helpful amendment to the Core Principles would be to *add the elements of an efficient national bankruptcy law to the list*. Too often, developing economies do not have such laws at all, or, where they do have them, they often make it very difficult and time-consuming for creditors to recover the collateral behind delinquent loans, thereby rendering more disorderly efforts to reschedule private debt and adding to

---

18. A dramatic example of this process at work has been China's use of the state-owned banks to fund loss-making state-owned enterprises. See Lardy (1998) for a discussion.

19. In Goldstein (1997a), I recommend, inter alia, that the government budget include all government costs and quasi-fiscal operations that involve the banking system; that data be published annually on nonperforming loans in state-owned banks (on a basis that permits comparison with privately owned banks); that the nature and extent of government instructions to banks on the allocation of credit be disclosed publicly; and that state-owned banks be subject to an external audit by a private independent external auditor and that the results of that audit be published.

20. See Goldstein (1997a).

21. See Institute of International Finance (1998) for a discussion of many of the issues associated with moving away from the current Basle risk weights toward a portfolio approach to credit risk.

banks' credit losses.<sup>22</sup> Sachs (1995) has made a strong case for why an international bankruptcy code that incorporated certain essential principles and mechanisms found in the domestic context (i.e., an automatic stay to prevent a creditor grab race, provision of working capital to the restructured entity, and preclusion of holdouts and free riding by majority voting and/or cramdown by a bankruptcy court) would be of great benefit. It appears, however, that the practical obstacles to such an international code are too formidable to overcome.<sup>23</sup> But this does not mean that the minimum elements of a good bankruptcy law could not be implemented at the national level.<sup>24</sup> The Core Principles should set out these minimum elements to guide national policymakers in their reform efforts.

## Transparency and Disclosure in International Financial Markets

*Improving transparency and disclosure in international financial markets* took on higher priority after the Mexican peso crisis (with the establishment of the IMF's SDDS), and it should remain as one of the key agenda items in any Halifax II discussions. Further progress would be particularly welcome on three fronts.

To begin with, all parties would profit from the availability of more comprehensive, more frequent, and more timely data on the *maturity and currency composition of external debt*, including the debt owed by banks and corporations in emerging economies. The BIS (1998) already publishes data on the maturity, sectoral, and nationality distribution of international bank lending to selected emerging economies; one of those series is published semiannually and one quarterly.<sup>25</sup> Indeed, any analyst who was paying attention to that data in the four to five year run-up to the crisis would have found useful hints on the build-up of the liquidity/currency mismatches highlighted in chapter 2.<sup>26</sup> Many market participants were apparently either not aware of these data or did not accord them much weight in their risk analysis. Other useful data on external debt are published by the World Bank and the Organization for Economic Cooperation

---

22. See Eichengreen and Portes (1995) and Goldstein and Turner (1996).

23. See Eichengreen and Portes (1995, 1998) and Calvo and Goldstein (1996).

24. Litan (1998) argues that once a common approach is applied to crisis situations on a national level, important international precedents will have been set. He argues that crisis countries should pass simple bankruptcy legislation (if none exists).

25. The semiannual series on international bank lending is prepared on a globally consolidated basis, whereas the quarterly series is not.

26. See, for example, the data on international bank lending to South Korea discussed in Ito (1998a).

and Development (OECD), and the IMF's SDDS sets out some requirements for the publication of central government debt and for the external position of the banking system.

Given the important role that liquidity and currency mismatches in the banking and corporate sector played in the Asian financial crisis, it would be useful to try to improve the information publicly available on short-term private debt. Specifically, it would be worth investigating whether the *BIS banking data could be published with a shorter time lag* (the lag is presently on the order of four to six months), if the *maturity distribution at the short end (one year or less) could be disaggregated further* (say, to include breakdowns for one month, three months, six months, and one year), if the *globally consolidated series on international bank lending could be made available quarterly*, and if better information on the *currency distribution (for the major currencies) of short-term debt could be made available*.<sup>27</sup> Likewise, the Indonesian crisis highlights the desirability of having more comprehensive information available on the size and composition of the nonfinancial corporate sector's external position. As these data on the maturity and currency composition of external private-sector debt are upgraded, several of the key series should be included in the IMF's SDDS.

Market discipline would similarly be aided if better data were publicly available on *net international reserves*, that is, on gross international reserves less reserve-related liabilities (including commitments in the forward exchange market). At present, the IMF's SDDS "requires" monthly data on gross official reserves but only "encourages" the publication of reserve-related liabilities (as relevant). In view of the difficulties of gauging net reserves in both the Thai and South Korean financial crises, it would be desirable to amend the SDDS so as to make both reserve-related liabilities and forward exchange commitments *required* variables.

Yet a third desirable transparency/disclosure initiative would be to attempt to move closer to an *international harmonized definition of nonperforming bank loans (prepared in accordance with international accounting standards) and to publish such data on at least a semiannual basis as a required element of the SDDS*.<sup>28</sup> As noted in chapter 2 (table 5), official estimates of nonperforming bank loans grossly underestimated the true extent of the problem in many of the Asian-crisis countries, and this experience has

---

27. The World Bank publishes comprehensive data on the currency denomination of long-term foreign debt, but identifying the currency composition of all short-term debt is more problematic.

28. See IMF (1997a), Goldstein (1997a), and the Basle Committee on Banking Supervision (1997) for a discussion of what elements would need to be considered in framing such a harmonized definition. The impact of changes in the definition should not be underestimated. For example, it has been estimated that when Mexico moved to a definition of nonperforming loans based on international accounting standards, that change itself led to a near doubling of nonperforming loans in the banking system; see IMF (1997a).

been repeated over and over in the run-up to previous banking crises.<sup>29</sup> The sooner we can get to a situation where market participants can make a better-informed decision about the health of the banking system, the sooner are we likely to get risk premiums that bear a closer relationship to the true risks at hand.<sup>30</sup>

## IMF Surveillance

After every major financial crisis, there is a call for making *IMF surveillance more effective*. The Asian crisis is no exception. There were apparently two problems. In those cases where the IMF early on saw crisis vulnerability building and recommended corrective actions (external-sector problems in Thailand and banking problems in South Korea), the IMF's advice was not adopted. And in some other cases, the IMF, much like almost all other analysts, did not see the crisis coming (Indonesia, Malaysia, etc.). At its April 1998 meeting, the IMF's Interim Committee (1998c, 2–3) urged the IMF, *inter alia*, "to intensify its surveillance of financial sector issues and capital flows . . . and to develop a 'tiered response,' whereby countries that are believed to be seriously off course in their policies are given increasingly strong warnings."

A few years ago, I undertook a wide-ranging analysis of IMF surveillance (Goldstein 1995). From the perspective of the Asian crisis, several points merit emphasis.

While an intensification of surveillance on financial-sector issues and capital flows may help some in identifying crises at an earlier stage, it does not deal with the issue of how to get countries to take the IMF's diagnosis and policy prescriptions more seriously. Recent efforts to make peer pressure more effective—including regional initiatives like the one laid out in the Manila Framework—are worthy of support, but there are likely to be limits to how far such pressure exerted behind closed doors can go in encouraging errant borrowers to take early corrective actions. In the end, the IMF membership needs to accept the reality that for countries that have access to international capital markets, the most potent channel for giving IMF surveillance more punch is by affecting the market's evaluation of a country's policies. In other words, *the IMF needs to affect the information set of those private market participants who move large amounts of funds across national borders*. It is not enough to simply pass information about crisis vulnerabilities within the official sector.

---

29. See Goldstein and Turner (1996).

30. Goldstein and Turner (1996) provide two examples of the types of published information on banking systems that it would be useful to have—for the banking system as a whole and for individual banks.

Since 1994, the IMF has been making public (so long as the country approves) that part of its Article IV country reports that contain the factual information on recent economic developments. Since May 1997, it has also been making available (again, subject to the individual country's approval) summaries of the IMF Executive Board discussion of the Article IV consultation (so-called "Press Information Notices"). But what the IMF does *not* now publish and what would be the most useful to market participants is the IMF staff's evaluation of the country's policies and prospects (that is, the staff appraisal part of the Article IV consultation report). Instead of inching forward every few years by publishing everything but the beef, it's high time for the IMF membership to at least allow those members who are so inclined to publish these Article IV reports. Once a group of the larger economies does this, the process of "competitive transparency" will put strong pressure on the rest to go along.

It is sometimes argued that it is not necessary for the IMF to publish its view of country policies because we have private rating agencies whose *raison d'être* is to evaluate risk. But there is accumulating evidence (Goldstein and Reinhart forthcoming 1998; Larrain, Reisen, and von Maltzan 1997) that these private credit ratings have done a poor job in anticipating currency and banking crises in emerging economies over the past 25 years, and their performance during the Asian financial crisis certainly has done little to alter that pessimistic finding. In other words, it does appear as if there is room for IMF appraisals to "add value" on crisis vulnerability to what warnings already exist in the market from the major private credit-rating firms. Increasing the availability of economic and financial data will pay dividends, but getting better analysis into the marketplace is also worthy of attention.

Objections to having the IMF share its view more widely with private markets are typically voiced on two counts. One objection is that such disclosure will destroy the frankness and confidentiality of Article IV consultations. But assessments of country policies (at least for the major industrial countries and for some larger emerging economies) have been included in the biannual *World Economic Outlook* for over 15 years, and the consultation process is apparently none the worse for it. Also, it is not necessary to provide the markets with a video cassette that includes every piece of information and every conversation that took place during the consultation in order to transmit the IMF's view of vulnerabilities.

The second objection is more serious. It is that by publishing the appraisals in staff reports, the IMF will be accused of precipitating crises and that this would be inconsistent with its purpose of "giving confidence to members." Two cases might be distinguished. The former is one in which the IMF has the correct diagnosis, and release of its appraisal leads to some market reaction. In this situation, it can be argued that once a country's policies go significantly off track, some correction is inevitable

and that it is better to have a smaller market correction early than a full-blown crisis later on. The second case is where the IMF's analysis is faulty, and it leads to a market reaction that (in retrospect) could have been avoided. Given that the ability to recognize crises beforehand is surely going to be subject to some margin of error, this latter situation cannot be ruled out entirely. This is a cost of issuing early warnings that has to be weighed against the benefits to be derived from catching other (presumably more) crises earlier on. Knowing that its diagnosis was going to be public would also, I think, lead over time to an improvement in the quality of these IMF Article IV reports. In addition, I believe the growing empirical literature on early warning indicators of currency and banking crises in emerging economies would help to improve the identification of crisis vulnerabilities.<sup>31</sup> And if the IMF's analysis turned out to be no better, or worse, than that of private-sector groups, then these reports would lose their market impact and the IMF's responsibilities in this area would no doubt be curtailed by its membership.<sup>32</sup>

The truth is that some risk will need to be taken in connection with making IMF surveillance more public if one wants to obtain a significant improvement in its impact. Alternatively, if the official view is that even one false crisis warning is too high a price to pay, then IMF surveillance will continue to be confidential but also of limited effectiveness.

Suppose a decision is made to share more of the IMF's early warnings with the private sector. In addition to the publication of Article IV reports, how should the IMF's message be communicated and to whom? One flawed proposal—which sometimes goes under the heading of “early involvement of the private sector”—would be to communicate that warning confidentially to a group representing large private creditors. The problem here is one of *inside information*. Why should large wholesale investors get this advance warning before small retail investors get it, or why should foreign investors get it before domestic investors? It is one thing to have a standing steering committee of private creditors to facilitate the rescheduling of private debt. In that context, these representative have a legitimate right to be a direct party to these negotiations because it is their claims that are being rescheduled. In addition, the practicalities of negotiating directly with an enormous number of creditors makes a steer-

---

31. See Kaminsky and Reinhart (1996), Goldstein and Reinhart (forthcoming 1998), Frankel and Rose (1996), Eichengreen, Rose, and Wyplosz (1996), and IMF (1998b).

32. Rubin (1998) adopts a middle-ground view of IMF warnings. On the one side, he seems to support the IMF publicizing its concerns about important gaps in countries' disclosure, as well as more frequent and regular publication of a number of IMF documents and analyses, including analyses of countries' financial regulatory and supervisory systems. On the other side, he opposes giving the IMF the responsibility to publicly predict formal warnings of crises (in part because, in his view, it is not possible to reliably predict combustion into crises).

ing committee a sensible representative mechanism. But there is no analogous constraint on sharing information with all investors (more and more IMF reports are being made available on the internet), and large wholesale foreign investors have no special claim to early information from the IMF.

As regards the vehicles that should be used to carry the IMF's early warnings, I can see benefit in incorporating these warnings in the *World Economic Outlook*, in the annual *International Capital Markets Report*, and in speeches of the IMF management. Because the timing of those reports and speeches (cum the issue of Article IV reports) is spread throughout the year, they ought to provide enough flexibility to capture variations over time in the IMF's concerns about individual countries. The advantage of incorporating warnings in these reports relative to direct bulletins on individual countries is that one can more easily place country prospects within a broader setting and can vary the language across countries and over time to convey a "tiered response" to perceived vulnerabilities. Also, the direct bulletin approach suffers from the disadvantage that absence of a warning may be read by the market as signifying "no problem." As with reports of central banks, the market should over time be able to "read between the lines" to figure out when the IMF is unusually concerned about an individual country's situation.

To sum up, notwithstanding the mantra on the importance of strengthening IMF surveillance in Interim Committee communiqués, the IMF's member countries have for a long time been ambivalent about whether they really want the IMF to engage in "firm surveillance." This reflects the fact that the membership wants the IMF to be *both* a trusted inside advisor to countries and a whistle blower for financial crises. Where the whistle-blowing role conflicts with the inside-advisor role, they usually have opted for the latter. In my view, the Asian financial crisis is but the latest evidence that the membership should change course and begin to "tilt" toward giving pride of place to the IMF's surveillance responsibility.

## **Risk Management in Global Financial Institutions**

Last but not least, *shoring up risk management in global financial institutions* deserves to be part of the Halifax II agenda. As hinted at in chapter 2, a troubling aspect of the Asian financial crisis is that banks in major creditor countries apparently exercised rather poor credit evaluation and risk management in their lending decisions. Coming on top of earlier well publicized failures at Barings, Daiwa, Morgan Grenfell, Sumitomo, and Hokkaido Takusheku, the Asian crisis has driven home the message that improvements in the international financial architecture must encompass the industrial countries as well developing ones, and lenders as well as borrowers.

A comprehensive review of the prudential and supervisory framework in industrial countries would take us beyond the manageable scope of this book. As an illustration of what needs to be done, however, let me draw attention to a recent Group of Thirty (1997) effort aimed at promoting better understanding and management of risk at large internationally active commercial banks (the major participants in large-value payment systems) and at the largest investment banks. Because a growing volume of international financial transactions is heavily concentrated in this group of “core institutions,” it is essential that these institutions get risk management right.<sup>33</sup>

After surveying and studying the risk management practices of these global players, the Group of Thirty’s (1997) study group came up with a set of recommendations for the financial-services industry, global auditors, financial supervisors, and industrial-country legislatures. Among that set, the following deserve particular mention and support in connection with the Halifax II discussions (Group of Thirty 1997, 27–8).

- Acting as a group, *core institutions* should: (1) voluntarily create “a standing committee to promulgate and review global principles for managing risk, covering the full range of management control functions; the full range of risks in a global firm; the efficacy of risk-reduction strategies; and the type, format, and location of information to be maintained by all institutions; (2) subject their worldwide operations to expanded review by a single, independent, external audit firm or firm group, and agree upon more consistent and meaningful disclosure of financial and risk information on a globally consolidated basis; and (3) support efforts to agree upon high quality, uniform accounting standards internationally.”
- *Global auditors* should: “work with global firms, audit standard bodies and supervisors to achieve an agreed upon approach to financial-statement audits and other information for portraying risk.”
- *Financial supervisors* should “agree upon a lead coordinator for all global financial institutions; . . . formulate standards for exchanges, clearing-houses and settlement systems, including risk management and financial stability; protection of customer assets, funds and positions; and netting, contract enforceability and insolvency.”

Until one sees the actual global risk management principles produced by the industry standard committee, it is impossible to know whether

---

33. For example, the Group of Thirty report (1997) notes that just 20 banks clear and settle 70 percent of the dollar leg of the foreign-exchange transactions going through CHIPS. And with the recent wave of mergers and acquisitions in the financial industry—particularly in the United States—concentration in the industry is on the rise.

this Group of Thirty initiative will live up to its promise. But from the standpoint of dealing with potential weak links in the chain of systemic risk, it goes in the right direction.

*The set of Halifax II reforms proposed in this chapter should become part of the action agenda for the next four or five G-8 economic summits (beginning with the Birmingham summit in May 1998) and for the IMF's Interim Committee. The aim should be to forge a broad consensus on the need for such measures, set explicit target dates for their implementation, and request a series of progress reports that monitor how far countries have come in meeting their commitments.*