SYMPOSIUM ON "GLOBAL FINANCE AND DEVELOPMENT"
TOKYO, MARCH 1–2, 1999
OPENING SESSION

Crisis Prevention and Crisis Management in a Globalized World

Stanley Fischer
International Monetary Fund

On behalf of the International Monetary Fund, let me say how very grateful we are to have been invited to cosponsor and take part in this important and timely conference.

The international financial crisis through which we have been living for the last 20 months is different from previous crises — because its origins are fundamentally financial, rooted domestically in problems in the financial system and corporate finance, and internationally in the capital account, rather than the current account of the balance of payments. The crisis has exhibited massive volatility in international capital flows to emerging markets and extensive contagion, with pressures on emerging market countries spreading both within and among regions. The crisis has exposed weaknesses in the international financial system and domestic financial systems in industrial and emerging market economies — and it has accordingly led to calls for reforms to the international system, both to reduce the frequency and virulence of crises, and to manage them better once they do occur, as they inevitably will.

Before turning to the architectural issues that are the subject of this conference, let me briefly review recent developments in crisis countries. The Brazilian authorities are in the process of finalizing a revised program that will feature a floating exchange rate, inflation targeting, a stronger fiscal position, and continued structural reforms. Fortunately, the contagion from the Brazilian devaluation to Latin America and the rest of the world appears to be contained, in stark contrast to the period that followed the Russian devaluation and unilateral debt restructuring in August 1998. In Russia, unfortunately, negotiations for a new

IMF agreement have been extremely slow, and the condition of the economy is dire, but negotiations will continue. In Asia, uncertainties regarding the political and security situation have contributed to recent exchange rate volatility and beset prospects for economic recovery in Indonesia, but in the two other key crisis countries — Korea and Thailand — a turnaround is under way: pressures on currency markets have eased or reversed, interest rates have come down significantly, fiscal policies have turned to stimulus, and economic growth is beginning to emerge. The strength of their recoveries will depend importantly on developments in the regional economy.

These positive elements notwithstanding, there is a broad consensus that **both individual countries and the international financial system need to adapt** to the new circumstances of globally integrated financial markets, to reduce the volatility of international capital flows and to increase the resiliency of financial systems and economies to the shifts in market confidence and investor sentiment that will inevitably occur in future.

To that end, work is under way, some of it inside the IMF, to identify the key policy requirements and policy reforms. This work involves three sets of players: governments and the private sector in the emerging market economies; governments and the private sector in the lending countries — that is, the industrialized countries; and international institutions.

In **emerging market countries**, efforts should focus on five areas:

- First, sound **macroeconomic policies**. Here there is a major question about the choice of exchange rate regime. While high inflation countries have benefitted from fixing their exchange rates in the process of stabilizing, it is true that the major crises in the last two years have all affected countries with pegged or quasi-pegged exchange rate systems. Fixed exchange rate systems are crisis-prone. We are thus likely in coming years to see more countries adopting flexible exchange rate systems or, if they choose to fix, to do so in a definitive way, for example by adopting a currency board arrangement.

- Second, steps to **strengthen the financial system, especially the banking system**. With the exception of Brazil, a weak banking system has been at the heart of almost all the recent crises. Thus, preventive efforts to strengthen supervision and prudential regulation, as well as restructuring and recapitalizing banking systems already under stress, are critical.

- Third, provision of better **economic and financial information** on private and public sector activities. This will require efforts toward the adoption of sound accounting and disclosure standards and practices for the corporate and entire private sector, better public sector data and information, as well as steps to collect and then disseminate the information. There is a particular need for better and more timely data on short-term international borrowing.

- Fourth, better **corporate governance and more prudent corporate financing**, accompanied by the establishment and implementation of appropriate bankruptcy legislation and procedures.

- Fifth, **dealing with international capital flows** and finding the appropriate response to capital flow reversals. Excessive short-term capital inflows, followed by rapid and large-scale outflows, have been a major factor in the recent crisis. It is clear that countries need to be cautious in both the pace and sequencing of capital account liberalization, and that it is a mistake to start liberalizing the capital account at the short end. For countries with weak financial systems and that have not yet achieved macroeconomic stability, there can be benefits from imposing market-based controls, Chilean-style, on capital inflows, designed to shift flows to the longer term. But despite the concerns over this issue that have been raised at various stages of the crisis, almost all countries have concluded they have much to gain from participation in the international capital markets — and it is thus also clear that capital account liberalization will continue. In considering how to deal with capital flow reversals, we should think of macroeconomic policies — particularly monetary policy — as the country's first line of defense, with international reserves providing an important cushion against shocks; contingent financing arrangements like those of Argentina and Mexico, some of them supported by the World Bank and Inter-American Development Bank, constitute another useful line of defense. Consideration is also being given to other contingent financing mechanisms, including those in which payments are linked to objective indicators of the country's ability to pay, such as the price of its exports.

In the **advanced industrialized countries,** a major hurdle was passed late last year with the approval of the IMF quota increase. This confirmed the commitment of all members, including the advanced industrial countries, to the IMF's role as lender to countries experiencing balance of payments crises, to cushion the disruptive effects of crises on economic conditions in these countries. In addition:

- **Prosperity in the world economy requires growth in the industrialized countries** and macroeconomic policies should be aimed at that goal.

- The industrial economies should make every effort to ensure the maintenance of **healthy financial systems** in their own countries. Discussions are now under way in several countries and in the BIS to as to how to monitor and possibly regulate the activities of highly leveraged institutions.

And of course, **the international financial institutions** have to do their part to improve the resiliency of the system. And we — the international financial institutions represented here, as well as our colleagues in Basle and the rest of the world — are accepting their responsibilities. Examples of ongoing initiatives are:

- The design and adoption of **international standards and principles** aimed at strengthening financial and corporate governance. At the IMF, standards have been put in place in the areas of data and of fiscal transparency, and a code is now being developed to guide good practices with regard to the transparency of monetary and financial policies. Meanwhile, a number of other international institutions are working to strengthen existing standards, develop new ones, and encourage their adoption in banking supervision and prudential regulation, securities market regulation, accounting practices and bankruptcy laws.

- Second, international efforts to encourage the improved provision of **better economic and financial data** to the public by emerging market economies. One example is the establishment and increasing adoption by emerging market countries of the IMF's Special Data Dissemination Standard, or SDDS.

- Third, **strengthening the process of surveillance,** to detect emerging problems, as well as to help in the adoption of international standards. Efforts in this area include the better monitoring of international capital flows, especially short-term flows, closer contacts with the private sector, and the publication of IMF reports and assessments.

- Fourth, **potential changes in IFI lending facilities and practices.** At the end of 1997, the IMF introduced the **Supplementary Reserve Facility,** or SRF, which makes it possible to provide large short-term loans to countries undertaking strong adjustment programs. This new facility was used for the first time in the Korean case. We are now considering a new **Contingency Lending Facility**, which could provide precautionary loans to countries with generally good policies facing risks of contagion. Another innovation is the possible use of **guarantees** from multilateral development banks as a way of restoring market access at times of crisis.

- Finally, efforts are being made to deal with what is probably the most difficult issue in modern crisis prevention and management: **how to involve the private sector**. These efforts are intended both to ensure adequate financing for countries facing balance of payments difficulties and to strengthen market discipline and help limit moral hazard in international capital markets. Such steps would be expected to reduce the volume of lending and raise spreads in normal times. Proposals in this area have been debated in numerous fora, including the G-7, G-10, G-22, and IMF. There are no easy solutions: steps that make it easier to involve private creditors once a crisis is under way may cause investors to run sooner and faster in anticipation of a crisis, thus increasing the likelihood of crises; and solutions in one country may spread contagion to other markets.

  A number of options have been tried before or are under consideration, including: (i) the "critical mass" approach that was applied to commercial bank debt in the 1980s; (ii) precautionary guaranteed credit arrangements, as in Argentina and Mexico; (iii) the modification of bond contracts to facilitate debt service rescheduling in times of difficulty; (iv) IMF lending into arrears; and (v) finding a mechanism to allow a country to impose a stay on payments to some or all creditors while an orderly debt workout is negotiated.

The changes in the international system that I have been discussing do not amount to the creation of a radically new international system: rather they represent an adaptation of the existing system, which has until recently served its members well. It is time now to begin putting these ideas and plans into action. The IMF will do its part, and is actively moving ahead. So are the other international institutions. And so are our members countries. In that connection I would like to emphasize the major contribution Japan has been making on several fronts:

- through generous financial assistance to crisis-affected countries;

- through vigorous participation in the systemic debate, where Japan has taken a leading role in providing new ideas;

- and by making progress on the domestic front.

Indeed, determined policy efforts, and their effective and sustained implementation, should assure a strong comeback for the Japanese economy, which we all recognize is vital not only for Japan itself but for the Asian region as a whole.

In view of this significant contribution, Tokyo is indeed a highly appropriate venue for this conference.

Thank you very much.