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April 3, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Draft of the Managing Director's Report to the Interim Committee
on Strengthening the Architecture of the International Monetary
System—Prevention, Management, and Resolution of Crises**

Attached for consideration by the Executive Directors is the draft of the Managing Director's report to the Interim Committee on Strengthening the Architecture of the International Monetary System—Prevention, Management, and Resolution of Crises, which is tentatively scheduled for an informal meeting on Monday, April 6, 1998. The formal meeting on this subject is tentatively scheduled for Thursday, April 9, 1998.

Mr. Hicklin (ext. 37137) or Mr. Nord (ext. 37324) is available to answer technical or factual questions relating to this paper prior to the informal meeting.

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Department Heads

INTERNATIONAL MONETARY FUND

**Draft of the Managing Director's Report to the Interim Committee on Strengthening
the Architecture of the International Monetary System—
Prevention, Management, and Resolution of Crises**

April 3, 1998

I. INTRODUCTION

1. The crisis in Asia has given rise to calls for action to strengthen the architecture of the international monetary system. The cornerstones of a strengthened system must be sound and sustainable macroeconomic policies, encouraged through firm surveillance by the international community over the policies and practices of its members; sound domestic financial systems, supported by strong supervisory systems; timely and accurate information regarding both economic data and policies, provided within a framework of internationally-accepted standards; and an open and liberal system of capital movements. In all of these areas the Fund has a key role to play.

2. Numerous proposals or suggestions on strengthening the architecture of the international monetary system have been put forward and are being discussed in various fora including, centrally, the Fund's Executive Board. It is important to have the views and guidance of the Interim Committee on the issues considered by the Board so far, on work currently in progress, and on further areas for examination. Keyed broadly to the subpoints listed under this agenda item, this note briefly outlines conclusions reached in recent Board deliberations, work on issues currently in train, and some points for future consideration.¹ It needs to be emphasized that while there are encouraging signs that the current crisis will be weathered, it is not over, and it is possible for the international community to give only a preliminary assessment of its causes, the performance of various actors in addressing it, or the lessons that should be drawn. In major respects, much of this work is still ahead of us.

**II. ROLE OF THE FUND AND OTHER INTERNATIONAL INSTITUTIONS IN STRENGTHENING
THE STRUCTURES OF INTERNATIONAL AND DOMESTIC FINANCIAL SYSTEMS.**

3. In discussing the origins of the Asian crisis, the Executive Board has re-emphasized the overriding importance of countries durably strengthening financial systems, both globally and in individual economies.

¹ The summings up from relevant Executive Board meetings will be attached to this report when it is transmitted to the Interim Committee.

- ▶ **The Asian crisis has highlighted important weaknesses in the supervision and regulation of financial systems.** In the first instance, national governments have the responsibility for putting their financial system on a sound footing. But we will work actively with members and other organizations to assist in the design of improved banking systems.
- ▶ Sound financial systems will also require work—already in progress in various fora—aimed at **strengthening governance, including in the corporate sector, and accounting standards.** The harmonization of accounting standards, and the development of international standards for disclosure, auditing and valuation of bank assets are key elements.
- ▶ **Efficient national bankruptcy systems are needed,** which allow for orderly reorganization or liquidation of corporations while preserving asset value. Bankruptcy and restructuring can bring with them social problems, and consideration needs to be given to adequate provision of social safety nets.
- ▶ **An open and liberal system of capital movements** should be approached through an orderly process of capital account liberalization in the context of domestic financial sector reform. I will report separately on our work in this area.

III. STRENGTHENING FUND SURVEILLANCE AND RECOMMENDATIONS

4. Fund surveillance has, and should, play a crucial role in crisis prevention. In discussing the role of Fund surveillance in emerging market economies over the past two years, Directors noted that the measures taken in the aftermath of the Mexican crisis in 1994/95 had contributed to strengthening surveillance. The Asian experience pointed to the following five lessons for surveillance:

- ▶ **Markets require timely and comprehensive information provided on a continuous basis.** The Fund will continue to work with members to strengthen their capacity to compile high quality data in a timely fashion and to strengthen the standards for data provision to the public (described below).
- ▶ **The focus of Fund surveillance will need to be broadened further in the area of financial sector and capital account issues.** Following Executive Board discussion, the Fund published a paper entitled *Toward a Framework of Financial Stability*, which provides a first step in strengthening Fund surveillance over members' financial sectors. It draws heavily on the work of the Basle Committee on Banking Supervision, which recently published its *Core Principles for Effective Banking Supervision*. More collaboration with

other institutions, including the World Bank and the BIS, will be vital. More generally, the Fund can play an important role in its surveillance by disseminating internationally agreed standards and encouraging members to adopt them.

- ▶ **Fund surveillance needs to pay greater attention to policy interdependence and the risks of contagion.** To this end, the Fund's multilateral surveillance exercises need to be more fully integrated with its ongoing bilateral dialogue with members. There is also a need to consider whether more frequent and systematic exchange of views between staff and market participants could strengthen the surveillance process.
- ▶ **Fund surveillance should encourage transparency.** As outlined below, the Fund has been working to increase both the transparency of members' data and policies as well as that of its own policy advice. At the same time, the Fund should be careful not to jeopardize the frank dialogue with members.
- ▶ **Effective Fund surveillance depends crucially on the willingness of members to take its advice.** A candid dialogue, and the ability of the Fund to focus on the issues of importance to individual members, are ingredients to the effectiveness of surveillance. There is also an opportunity to harness the opinion of the international community both by asking member governments to pursue bilaterally the conclusions drawn from Board discussions, and by engaging regional fora more actively. The Fund will be working closely with such fora, including those in Asia that have been strengthened in the wake of the events of the past year.

5. The events leading up to the crisis in Asia carry lessons for members' economic policy and the Fund's surveillance. The Executive Board has discussed some of the policy lessons on a number of occasions in recent months. In addition to the World Economic Outlook, the Board discussed two issues of particular concern:

- ▶ **Exit Strategies—Policy Options for Countries Seeking Greater Exchange Rate Flexibility.** The increase in capital mobility has made pegged regimes more difficult to manage, and some countries are likely to seek to move to more flexible arrangements. The best time for such a move is during a period of relative calm in exchange markets; exiting in a crisis can be much more problematic. I can assure you that Fund surveillance will continue to examine closely members' exchange rate regimes and provide candid advice on their sustainability.
- ▶ **Hedge Funds and Financial Market Dynamics.** Hedge funds have grown rapidly in recent years and their role in the Asian crisis has been much debated.

Although they remain small in relation to markets as a whole, hedge funds may encourage herding behavior among investors and may influence asset price movements. Ensuring that regulatory frameworks cover hedge funds is important, though challenging. Extending large trade and position reporting systems to cover hedge fund activities could be a first step in this direction. The Fund's multilateral surveillance will continue to pay attention to developments and risks in financial markets.

IV. TRANSPARENCY, INCLUDING DISCLOSURE OF DATA TO THE FUND AND THE PUBLIC, AND PUBLICITY OF FUND ADVICE

6. The Fund has been actively encouraging the increased transparency of data and of economic policymaking. Information should be based on sound principles and should provide a comprehensive picture of members' policies and market positions. The development of international standards and the transparent dissemination of information on country practices is likely to be increasingly important in a variety of areas, ranging from macroeconomic statistics and prudential banking standards to internationally-accepted accounting standards and principles of corporate disclosure. The Fund's role, in collaboration with other institutions, will be to foster the adoption of sound practices across these areas, including through the surveillance process.

7. In the past few months the Executive Board has discussed **data issues** on several occasions:

- ▶ **Data provision by member countries to the Fund.** There has been progress in the provision of core indicators to the Fund on a continuous and timely basis. Nevertheless, there remains room for further improvement, particularly with regard to timeliness. Moreover, recent experience also shows that the core indicators need to be complemented, on a case-by-case basis, by regular reporting of other data such as reserve-related liabilities, central bank derivative transactions and positions, private sector external debt, and prudential-type banking indicators. We shall continue to provide frank and comprehensive assessments of data issues in Article IV consultation reports. In its review of data provision for surveillance in December 1997, the Board encouraged the staff to develop further its work on the assessment of data quality, with a view to using it to improve the statistical basis for surveillance and program design and monitoring, as well as to identify more effectively requirements for the Fund's technical assistance.
- ▶ **The provision of data to the public.** In establishing the General Data Dissemination System (GDSS) in December 1997, the Executive Board completed the work requested by the Interim Committee on developing

standards to guide members in the provision of economic and financial data to the public. The Executive Board also completed its first review of the Special Data Dissemination Standard (SDDS), which was established in March 1996. Progress has been made, and more is expected (see Box 1). However, we must now press ahead more forcefully. The Board has agreed to consider an extension of the data category for reserves to include reserve-related liabilities and net central bank commitments in financial derivatives, on the basis of Fund staff's consultations with users and producers of statistics in this area. Before the end of the transition period, which runs through end 1998, the Board will also revisit the coverage of external private debt in the SDDS, and will further consider procedures to ensure observance of the Standard by all countries listed on the DSBB.

- ▶ With the objective of **improving the coverage, periodicity, and timeliness of data on international reserves and external debt**, I have established a task force within the Fund. Based on the work with a pilot group of countries, the staff expects to propose an action plan to address deficiencies in the coverage, collection, and dissemination by member countries of statistics in these areas and to discuss this work with other relevant organizations.

8. **Greater transparency in economic policymaking is highly desirable.** This is true for all member countries and across an array of economic policy areas. The Fund has taken specific steps in recent months:

- ▶ The Fund has actively encouraged members to release the **letters of intent** underpinning Fund-supported programs, which was done in the cases of Thailand, Indonesia, and Korea.
- ▶ The Fund is in the process of preparing a code of conduct on **fiscal transparency**, to which we will return separately in our agenda.

9. **The Fund is also becoming more transparent in its own policy advice:**

- ▶ For the past year, members seeking to disseminate the Fund's views have been able to request a **press information notice (PIN)** following the conclusion of the Article IV consultation. The forthcoming review of the experience with PINs will provide an opportunity to assess progress in this area. In the first ten months since their introduction in May 1997, there have been 116 Article IV consultations, 60 of which have been followed by PINs.
- ▶ Some have argued that there is a need for the Fund to consider a **more proactive approach to transparency**, publicly expressing its concern in cases where members have persisted in ignoring its advice. While this raises difficult

Box 1. Progress on the Data Dissemination Initiatives

The transition period for the **Special Data Dissemination Standard (SDDS)** runs through end 1998, by which time subscribers have committed publicly to be in full observance of the standard.

- The number of subscribers has increased to 43.
- 38 countries now have metadata on their data dissemination practices posted on the Dissemination Standards Bulletin Board (DSBB).
- 13 countries have now established hyperlinks from the DSBB to their national data sites, greatly enhancing the usefulness of the DSBB, and more are coming.
- The SDDS has already led to wider availability and enhanced timeliness of published data and the greater use of advance release calendars, and a pick-up in the pace of improvement is evident.

In December 1997, the Executive Board established the **General Data Dissemination System (GDDS)** for countries that have not subscribed to the SDDS.

- The primary focus is on improving data quality, while providing (i) a framework for evaluating the need for data improvements and prioritizing such improvements and (ii) guidance on data dissemination.
- The GDDS is less prescriptive than the SDDS, with regard to periodicity and timeliness of data dissemination, and it recognizes that improvements may only be achieved over the long run.
- 25 countries have so far responded to the Managing Director's request to nominate a coordinator to work with the staff on GDDS-related issues.
- A series of regional seminars for country officials and selected country visits will commence in mid-1998; the first seminar will be held at the Singapore Training Institute in July.
- Following the distribution of guidance materials, countries will be invited to participate in the GDDS. Formal participation will involve three steps: (1) committing to using the GDDS as a framework for statistical development; (2) designating a country coordinator; and (3) preparing metadata that consist of descriptions of (a) current practices and (b) plans for short- and long-term improvements in these practices. These metadata are intended to be disseminated by the Fund through an electronic bulletin board on the Internet.

issues that go to the heart of the Fund's relations with its member countries, there is scope for more clearly delineating the incremental steps in conveying the Fund's concerns to a member about its policies and to wider audiences, perhaps, including the general public. The Board will continue its deliberations on this issue over the next months.

- ▶ The Fund has complemented its internal reviews by external evaluations of its operations, and the first **external evaluation (of the Enhanced Structural**

Adjustment Facility) has just been completed and has been made public, as has the earlier internal ESAF evaluation.

V. THE FUND'S ROLE IN THE MANAGEMENT OF THE CRISIS, THE FUND'S FINANCIAL ASSISTANCE, AND THE ROLE OF OTHER OFFICIAL SUPPORT

10. It is unrealistic to expect that every crisis can be anticipated or prevented. When a crisis occurs, the international community must be prepared to respond quickly, with policy advice, well-integrated technical assistance, and, as necessary, programs backed by adequate financial resources. It is too early to assess comprehensively the design, implementation, and results of the programs that the Fund has been supporting in Asia over the past several months. This will be a focus of our attention in the coming months.

11. In the current crisis, the Fund has reacted quickly to provide support to the members most affected under its **Emergency Financing Mechanism**, which has been used in the cases of the Philippines, Thailand, Indonesia, and Korea. In addition, the Executive Board in December created the **Supplemental Reserve Facility**, designed to deal with the circumstances of members experiencing a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves. Loans under this facility have already been made to Korea. At the same time, to safeguard its resources and minimize moral hazard, the Board has stressed the importance of appropriate "burden sharing" among creditors, both official and private. Multilateral Development Banks have provided critical support for the Fund efforts in Asia. Bilateral support has also been an important element in the strategy. Yet, in some cases, uncertainties about the timing and amounts of support may have created confusion, and complicated efforts to restore confidence. Looking ahead, there would seem to be a case for greater transparency regarding the conditions for disbursement of bilateral official support.

12. The Fund cannot continue to do its job—in Asia or elsewhere in the world—unless it has adequate financial resources, and our margin is narrowing rapidly. Thus I urge that you renew your efforts to achieve prompt approval of the NAB and the agreed increase in IMF quotas.

VI. INVOLVEMENT OF THE PRIVATE SECTOR IN CRISIS RESOLUTION

13. The international financial community should strengthen its capacity to respond to crises in ways that do not encourage imprudent or unsustainable behavior by creditors or debtors, and encourage appropriate burden sharing by the private sector. Such efforts are required, even though recent experience suggests that it is primarily short-term bank to bank loans that have been protected in the context of Fund arrangements. Earlier this year the Executive Board discussed a number of issues relating to Fund involvement in the resolution

of sovereign liquidity difficulties. Preliminary consideration was given to extending the policy on lending into arrears to cover arrears on sovereign bonds and other private sector claims, as suggested by G-10 Deputies. Many Directors favored further consideration of such an extension in certain circumstances. At the same time, it was noted that with little modern experience with defaults on international bonds it is difficult to predict how a situation of default would unfold; in the absence of the legal and institutional arrangements, which generally served to ensure that relations with commercial banks during the 1980s debt crisis remained orderly, there is a risk that a sovereign bond default could become disorderly as a result of creditor litigation, complicating the task of economic management and possibly leading to a protracted stalemate in creditor-debtor relations.

14. The Executive Board gave preliminary consideration to three suggestions for possible mechanisms for improving existing mechanisms for resolving sovereign liquidity crises.

- ▶ Regarding the **modification of bond contracts**, there was broad agreement that this could, over time, make an important contribution to facilitating an orderly restructuring, though progress was likely to require some form of official action, possibly in the form of leadership by major industrial country borrowers.
- ▶ Regarding a **sovereign bankruptcy mechanism**, most Directors continued to believe that proposals for establishing a formal international debt adjustment mechanism were impractical and should not be pursued further.
- ▶ Finally, the Board considered the possibility of the Fund **sanctioning a temporary stay** on creditor litigation, thus providing members protection from litigation in the context of Fund lending into arrears. This would require modifying Article VIII, Section 2(b). A number of Directors considered that this approach raised complex issues that merited further discussion, while some Directors were of the view that such a mechanism was not necessary as they considered that the risks and likely consequences of creditor litigation referred to above may not be significant.

15. The Board will return to these issues and will consider similar issues relating to the restructuring of nonsovereign obligations, and will have the opportunity to consider possible ways of involving the private sector in crisis resolution.