FOR AGENDA

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April 8, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Revised 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 revised 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 discussion tomorrow, 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 Board discussion.

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INTERNATIONAL MONETARY FUND

Revised 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 8, 1998

I. Introduction

1. In the period since the Mexican crisis in 1994/95, much has been done to strengthen the international monetary system, including through more intensive surveillance of financial sectors, closer monitoring of capital market developments, and greater emphasis on transmittal of information to the Fund and to markets. The recent crisis in Asia has reinforced earlier lessons and underscored that further work is required in key areas, including more ambitious actions to tackle financial systems' vulnerabilities, to prevent the emergence of inappropriate structures of external debt, and to bring greater transparency to both public and private sector operations. Dealing with these problems will require not only action by individual member countries, but also a broad-based effort in international cooperation.

2. There is agreement on many aspects of the required strengthening of the architecture of the international monetary system. In particular, 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; transparency in economic policymaking, and timely and accurate information regarding economic data, provided within a framework of internationally-accepted standards; and an open and liberal system of capital movements. Lessons are also being learned and issues defined as regards the design and financing of Fund-supported programs, including the role of private sector creditors. Although some issues are uncontroversial, a consensus has not yet been reached on how to proceed in all areas.

3. Numerous proposals or suggestions 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.

4. In discussing the origins of the Asian crisis—which highlighted important financial sector weaknesses—the Executive Board has re-emphasized the overriding importance of countries durably strengthening financial systems. In the first instance, national governments have the responsibility for putting their financial systems on a sound footing. But the Fund will need to work actively with members and other organizations to assist in the design of improved banking and financial systems.

- **For members themselves**, priority needs to be given to strengthening supervision and the regulatory framework, and establishing the independence of central banks. Sound financial systems will also require work aimed at strengthening governance, including in the corporate sector, and accounting standards in individual countries.

- **The international community has a responsibility** to ensure that work—already in progress in various fora—is further advanced on developing international standards for banking supervision, internationally-accepted standards for accounting, as well as for disclosure, auditing and valuation of bank assets, and guidelines for effective corporate governance. Increased international cooperation will also be required in areas beyond the establishment of standards, including in the sharing of information between regulators, especially those with supervisory authority over institutions operating in major financial centers. Regulators also need to look carefully at flows from offshore centers, where lack of information can blur the portrayal of a country's market exposure and the early identification of a problem.

- These are complex issues and neither the Fund nor the international community as a whole possess the expertise and personnel to provide detailed advice in each of these areas. Nevertheless, the **Fund can play an important role,** especially in its surveillance activities, by disseminating internationally agreed

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[1] The summings up from relevant Executive Board meetings will be circulated separately to the Interim Committee.

standards and encouraging members to adopt them.[2] In this work, as well as in providing technical assistance, collaboration with other institutions, including the World Bank and the BIS, and with the private sector, will be vital.

III. Strengthening Fund Surveillance and Recommendations

5. **Fund surveillance will continue to play a crucial role in crisis prevention.** Directors have noted that the measures taken in the aftermath of the Mexican crisis in 1994/95 had been an important step in adapting Fund surveillance, especially of emerging market economies, to the rapidly changing global environment. At the same time, there were a number of areas where surveillance needed to be further strengthened:

- **The Fund must continue to work with members and with other organizations to help members 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 needs to be broadened further in the area of financial sector issues**. Following Executive Board discussion, the Fund published a paper entitled *Toward a Framework for Financial Stability*, which provides an important 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.*

- **Fund surveillance needs to pay more attention to capital account issues.** The benefits for the world economy of an open and liberal system of capital movements are now widely recognized, and I will report separately on our work on an amendment of the Fund's Articles of Agreement to better equip the Fund in this area. In our surveillance work, we need to monitor carefully the sequencing as well as the pace of capital account liberalization. This is a clear lesson of the Asian experience. In particular, Fund surveillance should focus on the risks posed by the potential reversal of large capital flows, the rapid accumulation of short-term external debt, unhedged exposure to currency fluctuations, and the impact of selective capital account liberalization. We will continue to intensify our efforts to monitor developments and risks in financial markets, including through the WEO and the periodic International Capital Markets reports.

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[2] The attached appendix contains more detail on the case for international standards, and issues for further consideration.

- In our recent work, we have focused on one feature of the rapidly changing structure of international capital markets that has received much publicity in the Asian crisis, namely the rapid growth of **hedge funds**. 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 and other aspects of the rapidly changing world of global capital flows is important, though challenging. One possibility to consider might be the extension of large trade and position reporting systems to cover hedge fund activities.

- **Developing vulnerability indicators** and early warning signals of imminent crises will be an intensive focus of staff work, drawing on research within the Fund and elsewhere, as one element in our effort to improve the Fund's effectiveness in crisis prevention.

- **Fund surveillance needs to pay greater attention to policy interdependence and the risks of contagion**. The risks of spill-over effects in a world of integrated capital markets are high and Fund surveillance will need to focus explicitly on such risks, for example through stress testing the impact of changes in competitor country exchange rates, in world interest rates, and in other parameters critical to economic performance.

- **More frequent and systematic exchange of views between staff and market participants** will be required to ensure that Fund surveillance is fully cognizant of market perceptions and that markets themselves better understand Fund views and analysis. At the same time, such contacts must take into account the confidentiality of the Fund's dialogue with members. We will need to examine and experiment with effective modalities for such contacts.

- **The Fund's views need to be effectively communicated to members.** I see merit in a process of incremental steps through which the Fund's concerns are expressed. For example, when addressing our concerns to a member, I could request a response to our views by a certain time in order to be in a position to report to the Board on the member's reaction. While protecting the confidentiality of my correspondence with members, I could share the nature of my concerns with the Board at an early stage, and particularly where members appear to be ignoring our advice. 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.

- **Effective Fund surveillance depends crucially on the willingness of members to take its advice.** A candid dialogue based on the best analysis possible, and the ability of the Fund to focus on the issues of importance to individual members, will help ensure that our views are relevant and convincing—key ingredients to the effectiveness of surveillance.

    - An area of particular importance embraces monetary and exchange rate policies. The choice of exchange rate regime is a complex issue and depends on a number of factors. Whatever regime is chosen, it is critical that macroeconomic and structural policies are consistent with that regime, and that the authorities are transparent about policy objectives and how they intend to achieve them. The increase in capital mobility has made pegged regimes more difficult to manage, and while some members have successfully maintained a fixed exchange rate regime and can continue to do so with the appropriate mix of macroeconomic policies, some countries are likely to seek to move to more flexible arrangements, raising the issue of **exit strategies**. 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. But regardless of the timing, strongly supportive monetary policy measures will be needed at the time of a regime change.

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 policy making. Lessons have been learned from the Mexican experience but more work is needed. 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, including in particular the World Bank and the BIS, will be to foster the adoption of sound practices across these areas, in particular 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. 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. We will intensify the effort to ensure that Article IV consultation reports provide frank and comprehensive assessments of data issues in member countries.

- **The provision of data to the public.** In establishing the General Data Dissemination System (GDDS) 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. We will also need to return to indicators of financial soundness; but in this area we will need to be attuned to the development of standards for disclosure of macro prudential data underway elsewhere, including at the BIS.

- An important issue, to which we will return soon, is the development of **procedures to ensure strict observance** of the SDDS by all countries listed on the Fund's bulletin board. This will be key to maintaining the integrity of the system.

- 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 policy making** 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:

- It is highly desirable to achieve more transparency in Fund-supported programs. The Fund has actively encouraged members to release the **letters of intent** for their programs, which was done in the cases of Thailand, Indonesia, and Korea. This complements our long-standing policy of encouraging members to release **policy framework papers**. There is scope for exploring additional steps in providing further background information and analysis underpinning Fund-supported programs, and I will soon bring proposals to the Executive Board.

- The Fund is in the process of preparing a code of conduct on **fiscal transparency**, which is especially relevant in the light of our experience in Asia recently. We will return to this issue 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. 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. Clear, concise, and analytically sound staff reports, as well as frank and comprehensive assessments by the Board, are key ingredients to an effective PIN process. We will return to these issues in the forthcoming review of our experience with PINs.

- **Whether, when, and through what vehicles to publicly express our concern** in cases where members ignore our advice goes to the heart of the Fund's relations with member countries. While it may make our surveillance more effective in certain cases, we must take seriously the risk that publicity would jeopardize the frank dialogue between the Fund and its members. The Board will continue its deliberations on this issue over the next months.

- The Fund's **views on global developments** are made public in the context of the World Economic Outlook (WEO) and the International Capital Markets Reports. We should explore ways in which our discussions on general policy issues, such as on the HIPC initiative and our debate on capital account convertibility, can reach the public domain.

- The Fund recently completed an **internal review** of its surveillance in Asia and other emerging market countries in the period leading up to the recent crisis;

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 44.
- 39 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.

this work is intended for publication. We have also published internal reviews of Fund-supported programs in recent years. Internal reviews have been complemented by **external evaluations** of Fund operations, and the first such evaluation (of the Enhanced Structural Adjustment Facility) has just been made public. The next external evaluation is intended to cover Fund surveillance.

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. Some lessons are already emerging—including on a number of innovative elements incorporated into these programs—and have been reflected as these programs have been adjusted to changing circumstances. We will carefully review these programs and the lessons therefrom 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.

12. The World Bank and the Asian Development Bank have provided critical support for the Fund's effort in Asia. Bilateral support has also been an important element in the strategy. Experience has shown that there is a need to coordinate carefully support from different sources and ensure, in particular, that such contributions are supportive of the conditionality of Fund arrangements. We shall need to reflect on the modalities through which support has been committed in these cases and on the effectiveness of its delivery.

13. 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

14. There is a critical need for the international financial community to strengthen its capacity to respond to balance of payments crises in ways that ensure the appropriate involvement of all groups of private creditors. Such involvement is required to achieve equitable burden sharing *vis-à-vis* the official sector, and to limit moral hazard. Specifically, there is a need to ensure that the means used to resolve one crisis do not encourage imprudent

or unsustainable behavior by creditors or debtors, thereby increasing the potential magnitude and frequency of future crises. We must recognize that this is a very difficult and, in some aspects, an intractable problem.

15. In recent crises, most groups of private creditors have shared in the burden of financing. Investors holding equities and long-term debt instruments have sustained large losses in the secondary market value of their claims, while investors in bankrupt enterprises have received no special treatment. A serious problem has emerged, however, with respect to creditors with short-term claims on financial institutions and the sovereign, who have, by and large, been fully protected. Such claims are very liquid, making it easy for creditors to exit. At the same time, members have tried to avoid defaults on such claims because of the potential impact of such a default on the stability of their financial systems and the sovereign's access to international capital markets.

- **This problem underscores the importance of preventative measures to discourage excessive reliance on short-term financing**. Such measures include appropriate macroeconomic and debt management policies, effective prudential supervision of financial systems, appropriate sequencing of steps to open the capital account, and the provision of timely and comprehensive data to financial markets, including on the debt of the corporate sector. Consideration could also be given to the more widespread use of measures such as those employed by Chile.

- **It also underscores the importance of strengthening countries' capacity to withstand sudden shifts in market sentiment**—in particular by strengthening their financial systems. In addition, consideration could be given to arranging in advance for emergency financing from private sources, possibly in the form of stand-by lines of credit from commercial banks, similar to those arranged by Argentina. It is recognized that such lines may be expensive and that not all countries may be able to negotiate them. But recent experience suggests that a number of emerging market members might pursue this route.

16. Circumstances will arise, however, in which prevention will not be effective, and countries will experience balance of payments crises. In most such cases, the Fund's approach to ensuring the continued involvement of private creditors during a Fund arrangement would be through its catalytic role and the authorities' efforts to rebuild confidence. The Fund would not normally reach out to private creditors for concerted financing.

- The catalytic effect of recent Fund arrangements with Asian members has—in a number of respects—been disappointing. To some extent this may reflect adverse country-specific circumstances.[3] However, it may also suggest that with the increased range of, and diversity of interests among, members of the creditor community, international capital markets are less willing to rely upon the Fund's endorsement of policies, *per se*, in formulating their lending decisions. Instead, creditors may insist on basing their lending decisions on their own assessments of the country's policies and prospects. The steps noted above to provide market participants with factual background on, and the analytical frameworks of, Fund-supported adjustment programs could be helpful in this regard.

- It is recognized that under this approach there may be a temporary reduction in private creditors' exposures during Fund arrangements, associated with partial or full interruption in access to international capital markets pending a restoration of confidence. Official resources will be at risk, to the extent that there will always be uncertainty at the start of an arrangement regarding the timing and pace at which market access can be regained.

17. In extreme circumstances, however, in the face of a rapid loss of reserves and limited prospects for regaining spontaneous access to capital markets, the provision of official resources to allow private creditors to unwind their exposure may place such resources at undue risk, and heighten concern about moral hazard. In such circumstances, in order to avoid a default—and the concomitant dangers regarding a sustained interruption in the member's access to capital markets and the potential effect of contagion on other countries—consideration could be given to approaching private creditors for concerted (or quasi concerted) financing.

- The recent experience with Korea has illustrated a way in which central monetary authorities can intervene in such cases to share information with banks under their supervision, and to apply moral suasion, to encourage banks to maintain their exposure.

- To date, however, there has been no experience with mechanisms to facilitate "bail ins" of other groups of private creditors, including bond holders.

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[3]Including, for example: (i) the announcement effect of the approval of arrangements may have been at least partially offset by the impact of the publication of bad economic news (the size of the forward book in Thailand; and the level of the reserves and the maturity profile of external debt in Korea); (ii) keeping open financial institutions perceived by market players as being insolvent may have delayed the restoration of confidence in financial systems; (iii) to varying degrees and durations, market perception of wavering political support for the adjustment programs may have undermined confidence; and (iv) the Fund being called in only at a very late stage in the development of the crisis (Thailand and Korea).

18. **To buttress efforts described in the paragraphs above, consideration could perhaps be given to exploring closer links with the private sector.**

- A limited approach would consist of an increase in the frequency of informal briefings provided by mission leaders and headquarters. The scope of such briefings could be expanded beyond journalists to encompass selected representatives of the financial community. Limiting briefings to selected market participants would not be even handed, however, and might not be effective in catalyzing private capital.

- A more ambitious approach would be for the Fund to seek to establish closer contacts with the private sector. We might contemplate regular contacts between staff and some form of creditor council. The latter would be a purely voluntary arrangement with no legal standing. But it could provide a forum for representative groups of creditors to receive briefings on developments and prospects, and to convey concerns to the Fund (and the official sector generally). The Fund's relations with such a creditor council could be analogous to the informal semi-annual briefing provided to the Berne Union.

- More ambitiously, a creditor group could also be convened on an *ad hoc* basis and used as a vehicle for explaining Fund arrangements and possibly for assessing the likely availability of external financing. It could perhaps also be used as a forum for creditors and debtors to renegotiate debts, including international bonds.

This raises controversial and difficult issues. But if we are serious about encouraging private-sector burden sharing, this is an alternative we should explore.

19. The recent crises have also highlighted the importance of efficient national bankruptcy systems for the operation of both domestic and international capital markets.

- The enactment and enforcement of comprehensive bankruptcy legislation can provide an important pillar of support for the domestic banking system, by enabling banks to curtail the deterioration in the quality of their claims, including on the corporate sector, whether through a debt restructuring and associated management changes, or through timely liquidation.

- Effective national bankruptcy laws can also help facilitate access to international capital markets. By forcing the shareholders of illiquid companies to recognize the loss of asset value and to reorganize their liabilities, sound bankruptcy procedures should help viable companies to attract equity partners after they emerge from the process. In a similar vein, an efficient liquidation process that focuses on the preservation of asset value and the equitable distribution of the proceeds would enhance companies' ability to attract foreign capital.

- In an increasingly global financial system, bankruptcy proceedings may involve a range of jurisdictions, which underscores the need for clear policies to avoid conflicts between the rules of various jurisdictions.[4]

20. **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 1989 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 a limited extension of this policy in cases in which (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; (ii) negotiations between the member and its private creditors on a restructuring have begun; and (iii) there are firm indications that the sovereign borrower and its private creditors will negotiate in good faith to agree on a debt restructuring plan. It would be important that such a policy not permit legitimate and timely Fund assistance to a member to be held hostage by recalcitrant creditors. Directors noted that all purchases under a program with a member with sovereign arrears to private creditors would need to be subject to financing reviews to allow the Executive Board to monitor closely unexpected developments in creditor-debtor relations.

21. Directors supporting an extension of the policy in lending into arrears considered that the Fund, and the international community more generally, would need to "learn by doing." 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 some 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. Against this background, the Executive Board gave preliminary consideration to 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 a modification of 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 may not be significant.

22. The Executive Board also gave preliminary consideration to two other suggestions for possible mechanisms to facilitate the orderly restructuring of sovereign debt:

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[4] In this context it may be noted that the United Nations Commission on International Trade Law (UNCITRAL) has developed a model law designed to address this issue.

- 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. One approach would be to require that all international bonds admitted to domestic markets after a specified date include such provisions.

- 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.

23. 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.

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24. This paper does not address issues on the social aspects of adjustment that countries have faced in the wake of sharp declines in access to capital markets. Nor does it address the issue of the declining flows of ODA, which remain a primary source of capital for much of the developing world. These issues are taken up to a certain extent in my draft report to the Interim Committee on the ESAF, and will be pursued in the Executive Board's consideration of the operational implications of the recently conducted reviews of the ESAF.

THE CASE FOR INTERNATIONAL STANDARDS

1. A fundamental lesson of the last year is that, in the world of high capital mobility in which we live, it is difficult to draw a sharp line between domestic and international financial markets. The Fund's traditional role has lay in facilitating balance-of-payments adjustment and providing financial assistance for countries with payments problems. Before members had moved significantly in the direction of capital account convertibility, this meant focusing on the monetary and fiscal policies that had an immediate impact on the current account of the balance of payments.

2. But as capital accounts have been opened, stabilizing the balance of payments has also come to mean stabilizing the capital account. Rising international capital mobility has effectively erased the line between domestic and the international financial systems. Now that domestic and international financial transactions are seamlessly linked, it is impossible to "fix" the capital account without "fixing" the domestic financial system. **In other words, international financial stability requires domestic financial stability.** We know from long experience that domestic financial stability requires sound monetary and fiscal policies and a suitable exchange rate policy. What the recent crisis has taught us is that it also requires a robust institutional framework, notably **sound bank supervision, effective financial market regulation, transparent accounting and auditing practices, effective corporate governance, and efficient corporate insolvency and reorganization procedures.**

3. These are complex issues. It is not clear that we agree among ourselves about best practice in each of these areas. Indeed, given how economic, social and political circumstances differ across countries, there should be a strong presumption that the same arrangements are not suitable for all countries. Nor does the Fund or even the international policy community as a whole possess the expertise and personnel to give each country detailed advice in each of these areas, even were this viewed as desirable.

4. The alternative is to prod the public and private sectors to identify **international standards** for best practice. National practices may differ, but all national arrangements should meet minimal standards if we are to achieve greater financial stability. All countries must have adequate bank supervision and regulation. All must have adequate accounting and auditing standards. All must have transparent and efficient national insolvency codes.

5. This is a prime area for **public-private sector collaboration.** In the case of accounting, for example, there already exists the International Accounting Standards Committee, consisting of representatives of the accounting profession from 91 countries, which promulgates international accounting standards. There exists the International Federation of Accountants, with parallel membership, which has gone some way toward formulating international auditing standards. In the area of financial regulation there is the International Organization of Securities Commissions (IOSCO), which serves as a forum for

securities regulators and has established a series of working groups to coordinate regulatory initiatives. Thus, there already exist private-sector bodies and international committees of regulators positioned to develop standards. In addition, insofar as other international agencies are already engaged in standards-related work in areas such as bank supervision (the BIS), corporate governance (the OECD), bankruptcy codes (the UN), this is also a promising area for **collaboration with other multilaterals.**

6. We could contemplate a sequence of increasingly ambitious steps toward creating a more active role for the Fund in this area. Least ambitious would be to simply observe and encourage the activities of these groups. Somewhat more ambitious would be for the Fund to seek status as an ex officio member of these committees, to certify the standards they identify as measures of international best practice, and to recommend that our member countries commit to meeting them. More ambitious still would be to actively encourage countries to apprise the markets of their compliance. Each self-organizing committee might be encouraged to establish an electronic bulletin board where such information could be centralized. Hyperlinks could be provided to the Fund's own electronic bulletin board. We could consider monitoring countries' compliance with those standards, for example in conjunction with Article IV surveillance. To fend off complaints about Fund "mission creep," it would be desirable to start with standards closely related to the functioning of financial markets.

7. A more active role for the Fund in the promulgation of international standards would be a departure from past practice. But it is the only alternative to inaction if one believes that the Fund does not possess the resources to develop standards in all these areas itself and that it is desirable instead to take advantage of the resources of the private sector. Public-private sector collaboration is certain to be a complicated process, but the alternative—inaction—is not a viable option. Problems in these areas are too pressing for us to do nothing. The response to those who say that financial supervision, auditing and accounting standards, insolvency and reorganization procedures, and corporate governance are mere window dressing is that adequate institutional arrangements in these areas are essential to financial stability in our modern world. If the Asian crisis has taught us one thing, it is that countries cannot restore exchange-rate and balance-of-payments stability without rectifying deficiencies in the organization of their domestic financial systems. And if it is necessary to proceed, there is no alternative to proceeding by way of public-private sector collaboration.

8. Note also that Fund involvement in this area is not unprecedented. What are the Data Dissemination Bulletin Board and the Special Data Dissemination Standard but an international standard for dissemination of macroeconomic and financial information? The recent staff paper, *Toward a Framework for Financial Stability*, can be thought of as contributing to the creation of an international standard for bank supervision. Recent work on a code for **fiscal transparency** can be thought of as an international standard. To those who are skeptical about the feasibility of work in this area, the response is that such work is already underway.